ISDA® Safe, Efficient Markets

Trading Book Capital – Virtual Event
November 19, 2020

Opening Remarks
Scott O'Malia, CEO, ISDA

Hello everyone, and welcome to this *Trading Book Capital* virtual event. Thank you to all of our speakers and to our event sponsor, Ernst & Young.

We're entering the final stage of a year that has been like no other in living memory. Over the past 10 months, the pandemic has affected almost every aspect of our lives and driven major changes in financial markets. Today, we will explore the impact the crisis has had on trading book capital, and how recent experience should inform the forthcoming implementation of Basel III.

The escalation of COVID-19 to a global pandemic in March resulted in significant market volatility due to the dire economic outlook. As entire firms were forced to switch to remote working, it became imperative to focus critical resources on managing risk and supporting clients. This came at a time when the pipeline of regulation was already full, with the final components of Basel III due for implementation in January 2022.

It became clear that keeping implementation of the revised credit valuation adjustment (CVA) framework and the Fundamental Review of the Trading Book on-track was going to be very difficult as market participants and regulators were giving their full attention to the crisis. To their credit, regulators recognized this early on, and the Basel Committee on Banking Supervision announced a one-year delay in late March. This was critical in freeing up resources so that banks could focus on business continuity and supporting the real economy.

With just over two years to go until the new implementation deadline in January 2023, it is a good time to look back at the recent crisis and make sure we are on the right track. Revised capital requirements for the trading book will be with us for years to come, so it's vital they are implemented in a consistent and risk-appropriate way.

In spite of the challenges that were faced this year, market participants navigated the volatility in fairly good shape. The elements of Basel III already implemented can take much of the credit for this. Since 2011, internationally active banks have doubled their common equity tier-one capital to nearly €3.9 trillion. Enhanced capital requirements have increased the resilience of the banking sector and enabled it to withstand recent shocks. Thanks to the progress made over the past decade, this was not a repeat of 2008.

The increased resilience of the banking sector is certainly positive, but it is only part of the story. Banks must also be available at times of stress to support the real economy, but if capital requirements spike in a crisis, it lessens their ability to do this. That is why standard-setting bodies have sought to reduce procyclicality in the regulatory framework. The new

trading book capital requirements are designed to be less procyclical, and a closer look at the experience of the COVID crisis shows why this is so important.

ISDA, together with the Global Financial Markets Association and the Institute of International Finance, has analyzed data from 20 banks and identified a sharp increase in risk-weighted assets (RWAs) for trading book capital in the first quarter. For CVA, RWAs increased by more than 45%, while counterparty credit risk and market risk RWAs rose by 20% and 22%, respectively. The impact on CVA was the highest because the calculations are heavily dependent on credit spreads, which tend to increase at times of stress.

Procyclical capital requirements threaten to choke off banks' support for the real economy at a time when it is needed most. During the COVID crisis, some regulators stepped in to mitigate these procyclical effects where possible, but the experience underscores the importance of reducing procyclicality in the revised trading book capital standards and raises the importance of risk-appropriate calibration of the capital rules.

We are now entering a critical phase in the rule-making process. We expect to see legislative proposals on the new trading book requirements in the US, European Union and UK next year. The legislative process in Europe will of course be affected by Brexit. Whatever the outcome of the negotiations, it is vital the rules are consistent and harmonized across Europe and the rest of the world.

Consistency in the timing and content of the requirements must remain a priority as we move through the legislative process. When regulators diverge from globally agreed standards, it introduces additional complexity and can lead to distortions in cost and risk management for internationally active firms. ISDA's priority will be to work with regulators to achieve a consistent and risk-appropriate trading book capital framework that takes into account the lessons learned from the pandemic.

As I said earlier, we commend the official sector for its prompt and decisive intervention back in March, and we are delighted to welcome senior officials from the Federal Reserve and the European Commission to our event today. I'm looking forward to hearing their reflections on this extraordinary period and the way forward.

I'd like first to welcome Nathalie Berger, head of unit, banking regulation and supervision at the European Commission, to deliver a keynote address.