ISDA Safe, Efficient Markets

Trading Book Capital
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Opening Remarks
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Hello everyone, and welcome to this Trading Book Capital event. Thank you for joining us today, and special thanks to our event sponsor, KPMG.

This event comes at an opportune moment in the evolution of Basel III. In October, the European Commission (EC) adopted legislative proposals to implement the final parts of the capital framework, including the Fundamental Review of the Trading Book (FRTB) and the revised credit valuation adjustment (CVA) framework. These reforms will be vital in ensuring banks hold sufficient capital to protect against future shocks.

The EU proposal marks the start of the critical process in which jurisdictions transpose the global standards into binding laws, and we expect to see equivalent legislation tabled in other jurisdictions over the coming year.

ISDA has always advocated for capital requirements to be risk-appropriate and consistent. As legislation is drafted and considered, this is more important than ever. When transposing the rules into local law, legislators should be mindful of the need to ensure the framework is appropriately calibrated and does not unfairly impede certain business lines.

Consistency is also critical, both in the way different countries draft the laws and in the way banks implement them. Even minor deviations from globally agreed standards can lead to bigger distortions in cost and risk management, as internationally active banks have to comply with rules that don't quite match up from one country to another.

Greater use of standardized approaches to the calculation of capital requirements under Basel III calls for particular attention to be paid to consistency. Basel III standardized approaches are more complex and risk-sensitive than in previous iterations of the capital framework, allowing them to serve as a credible alternative to internal models.

This greater complexity means that using the standardized approach is no longer about deploying a standard, off-the-shelf model. Banks need to be sure their interpretation and implementation of the standardized approach is consistent with that of their peers. Regulators also need to monitor the use of standardized approaches to ensure accuracy and consistency.

This is why we developed the ISDA Standardized Approach Benchmarking initiative, in which nearly 70 banks and 20 supervisors have participated since 2018. Using advanced quantitative analytics, we work with banks to analyze their capital models and then identify and explain any variations in good time. We started out with a focus on the FRTB, and have since expanded to the standardized approach to counterparty credit risk and the revised CVA framework.

The benchmarking initiative has provided valuable support in the greater use of standardized approaches, but internal models have not been entirely removed from the capital framework. In the case of the FRTB, banks' use of internal models will depend on their passing stringent eligibility tests to secure supervisory approval. This approval process could take up to two years, extending the length of time it will take for banks to fully implement the new framework.

The EC recognized the need for additional time, and has proposed to apply the new rules from the start of 2025, two years later than the Basel Committee deadline of January 2023. This will be critical in ensuring smooth and effective implementation, and we encourage other jurisdictions to align with this timeline as they finalize their rules.

While recognizing the importance of consistent and appropriate capital rules, I'd also like to touch on the need to align the rules with recent market developments, including the growth of environmental, social and governance investing and crypto assets. As new products emerge and gain traction, we must review the framework to ensure it accurately reflects the risk of those products.

Earlier this year, ISDA identified an issue in the FRTB treatment of carbon credits, which have become so important in the transition to a green economy.

Under the FRTB, carbon credits would attract a 60% risk weight, which is twice that of crude oil. ISDA's analysis of volatility during periods of stress has shown that the risk weight should be 37%. Our analysis also indicates the correlation between spot and forward positions should be set higher than applied in the new framework.

ISDA set out these findings in a paper in July and we have had constructive discussions with policy-makers since then. We welcome the EC's decision to create a new risk bucket for carbon trading, which is set at 40%. This less punitive capital treatment will help to ensure banks can continue to participate in the carbon markets, which will be so critical in the drive to reduce emissions.

ISDA will continue to work with policy-makers to advocate for appropriate capital treatment of carbon credits.

We're also closely tracking the development of crypto assets. As institutional participation in this market increases, we can expect banks to become more active and it is therefore important that the regulatory framework capitalizes the risks but does not act as an impediment. The Basel Committee recently consulted on the prudential treatment of crypto-asset exposures. ISDA made a series of proposals in its response to ensure that banks can effectively participate in this rapidly growing market.

I've talked in these remarks about the importance of consistent implementation of the final parts of Basel III, and the need to make sure the treatment of new financial products is appropriate to the underlying risk. The agenda for this conference reflects those objectives, and I'm sure that our speakers and panelists will have valuable insights to share.

Thank you.