

# CRR3 – Fundamental Review of the Trading Book (FRTB)

## February 2022

### Introduction

This paper sets out the industry’s positions related to the design and calibration of market risk framework in Europe as prescribed in the CRR 3 proposal.[1](#_bookmark39) In the EU, the implementation of the Fundamental Review of the Trading Book (FRTB) has followed a two-step approach – with CRR 2[2](#_bookmark40) setting out reporting requirements for both the FRTB Standardized Approach (SA) and the Internal Model Approach (IMA) and certain elements of the trading and banking book boundary. The CRR 3 converts these reporting requirements into pillar 1 capital binding requirements and finalises the trading/ banking book boundary.

As a result, CRR 3 represents a key step in the implementation of FRTB in Europe, and it will be crucial to ensure its calibration and design remains fit and appropriate. It is furthermore important that the standards are implemented simultaneously and harmoniously across jurisdictions to avoid undue technological, operational and business burden for banks. Trading businesses of banks are fundamentally global, and possible fragmentation of trading books because of inconsistent implementation of FRTB would result in reduced market making capacity and fragmentation in the markets.

The two-step approach (CRR2 & CRR3) to implementing the trading and banking book boundary may result in undesired cliff-edge impacts on existing positions that have durations beyond the implementation date of the CRR2 (28 June 2023) and CRR3 (expected January, 2025). While the FRTB rules are designed to provide supervisory control going forward, it was not intended to result in operational burden or to penalise existing positions that have been allocated across the books under the current rules. It is important to have appropriate grandfathering provisions in place, as well as supervisory flexibility for reallocation without undue penalty charges given the bifurcation of the requirements in CRR2 & CRR3 .

In addition, the Industry remains concerned by certain elements in the market risk reforms and the significant impact the package will have on capital requirements for specific product and risk categories. The implementation of the FRTB will materially increase capital requirements for banks with market making activities in Europe, while elsewhere the Commission is trying to promote market-based financing through the Capital Markets Union (CMU) project.

In the latest EBA’s advice[3](#_bookmark41) published in September 2021 using banks’ data as of December 2020, the EBA has estimated that the impact of the FRTB would be 32.5% higher (using a simple average) relative to current RWA levels for the same risks. However, we believe this latest figure is underestimating the impact and is not in line with industry quantitative impact studies, as it reflects a best case scenario where firms can continue using their current modelling permissions which is unlikely to be attained given that some desks are likely to fail the IMA eligibility tests. Furthermore, these estimates from the EBA do not include any market risk impacts from three European G-SIBs. The reason for exclusion of all FRTB data from these institutions was due to their capital treatment of equity investment in funds, which the EBA deemed to be based on overly conservative assumptions.

1 <https://ec.europa.eu/info/publications/211027-banking-package_en>

2 <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32019R0876>

[3https://www.eba.europa.eu/sites/default/documents/files/document\_library/Publications/Reports/2021/1020673/EBA%20Report%20on%20B](https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Reports/2021/1020673/EBA%20Report%20on%20Basel%20III%20Monitoring%20%28data%20as%20of%2031%20December%202020%29.pdf)

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### Globally consistent and aligned implementation of FRTB

Banks’ wholesale and trading operations are profoundly global in nature as investors from different regions are looking for investment opportunities within their mandates and securities issuers want to have access to finance from all corners of the world.

An EU start date of the FRTB framework for the 1 January 2025 as set in the European Commission’s CRR 3 proposal is a positive step forward. The industry is conscious that currently the EU is the only major jurisdiction to propose capital rules through primary legislation and this reflects a reasonable expectation for firms in their preparation planning for implementing FRTB. Given the global nature of these markets, the industry has always stressed that it was crucial the impact of FRTB on banks’ wholesale activities is not further exacerbated by an inconsistent timeline and transposition of the rules in key financial centers.

The mechanisms set in the CRR 3 delegated act under Article 461a, which aims to adjust the timing and calibration based on third country implementation of the FRTB standard is an important step to ensure a globally-consistent and aligned implementation of the market risk capital rules. A number of major jurisdictions (including the US and the UK) have not yet published their rules while others have already set different timing expectations and/or are still consulting on their national rulemaking.

We therefore encourage European policymakers to continue to monitor the progress of the transposition of the FRTB in other major jurisdictions, and amend the implementation timeline in Europe if necessary. The mechanism set in the delegated act under article 461a, offering a potential 2-year delay to the start date of FRTB is useful for providing that flexibility.

As there is not yet full visibility on the rules in other jurisdictions, the other mechanism set in article 461a to adjust downward the calibration of FRTB (by setting a ’0-1’ multiplier to market risk capital) to take into account level playing field issues should be used with caution, and only if there are substantial and material deviations. The industry believes that aligned rules are the optimal outcome and should be the primary objective underpinning the mechanisms behind the delegated act.

**Recommendations**

It is crucial to continue the dialogue with key jurisdictions to ensure coordination and flexibility on the start date for FRTB.

Should the European Commission proceed setting a 0-1 multiplier, it will be important to ensure full transparency and consultation on the methodology used to set the multiplier.

#### Review and incorporate any calibration and other changes stemming from the BCBS process and international development into the EU framework

Beyond the mechanism to adjust the calibration, it will be important to ensure the delegated act can address any inconsistencies and typos in the FRTB rules.

**Recommendations**

As such, the industry would support an extension of the delegated act scope for the Commission to amend the content of the rules based on the latest international developments and possible adaptations in other jurisdictions.

#### Allow concurrent CVA and FRTB implementation timing

There are significant read-across between the FRTB and CVA risk framework which CRR 3 is also addressing. Those interlinks between the two standards stem from the fact that the risk weights in CVA are largely based upon the market risk standard – meaning the market risk revisions will be reflected in the CVA risk framework. As such it will be important to ensure a concurrent implementation of these two frameworks.

**Recommendations**

We would strongly support that the delegated act under article 461a extends its scope to include CVA risk, particularly if the European Commission makes use of the 2-year delay for the start date of FRTB.

#### Allow sufficient time for EBA RTS rulemaking and IMA application process

The implementation period should allow sufficient time between the required date for the EBA to finalise regulatory technical standards (RTSs) and the FRTB go-live date. Firms will need to develop internal models and supervisors require time to validate them. If there is significant uncertainty about the final internal models validation methodology, approval process and the resulting capital levels, then banks may reduce their appetite for market risk in the run-up to implementation – with negative ramifications to the functioning of the EU capital markets.

The EU should make use of the 1-year transitional period defined by the BCBS global standard on market risk between go-live of FRTB and Profit and Loss Attribution Test (PLAT) implementation.

### Implementing FRTB in the European Union

While firms implement FRTB as a reporting requirement and prepare for the start of Pillar 1 capital requirement for the new market risk standards, it can be expected that new issues may emerge during the implementation process. . The FRTB IMA standard has never been tested, and firms have yet to go through the supervisory approval process or through the live calculation of the P&L attribution test using real data. Furthermore, the implementation of pillar 1 capital requirements for FRTB will depend on the EBA developing a number of technical standards in line with its planned roadmap.

The capital impact is significant when considered against the importance of the market-making role of banks in capital markets in Europe. The intermediary role played by banks in capital markets through primary issuance and trading could thus be hampered by measures that increase capital requirements held against certain trading activities, limiting the capacity of banks to offer liquidity and act as market-makers. This was also recognized more recently in the Final Report of the High-Level Forum for the CMU.[4](#_bookmark42)

Finally, it is also important to note that the significance of the recent market turmoil in light of the COVID-19 pandemic has yet to be fully understood and therefore further detailed impact analysis is necessary to help clarify what the long-term impacts will be on the EU economy. In particular, this will help identify any pro- cyclicality aspects that should be avoided in the future market risk framework.

In terms of specific provisions related to FRTB, ISDA and AFME would like to bring to the attention of the co- legislators the following areas:

1. The first relates to the investment in funds, or Collective Investment Undertakings (CIUs) eligible for allocation in the Trading Book. Banks offer derivative products to their clients on performance of specific funds and hedge these products with underlying positions in the reference funds. The FRTB allows for equity investments to be included in the scope of the internal models *if* the bank is able to calculate capital requirements based on the assets underlying the fund (i.e. if the bank can “look through” to the underlying

4 <https://ec.europa.eu/info/news/cmu-high-level-forum-final-report_en>

assets). Otherwise, three different approaches under the Standardized Approach (SA) are used. Two of them lead to conservative capital charges. The third one (the look-through approach under SA), which is the most risk sensitive approach, introduces computational intensity comparable to the IMA. These provisions regarding IMA and SA look-through approaches result in operational complexity in relatively simple and low risk strategies and may result in activity in funds being prohibitively expensive. While CRR 3 has introduced a widened use of the look through approach for SA and IMA including the use of data provided by relevant third-parties, there are still challenges associated with these elements.

1. The Trading book (TB) and banking book (BB) boundary defines which assets fall either within the scope of the capital requirements for market risk (assets held with a trading intent) and credit risk (those in the banking book). The industry remains concerned about the operational requirements, complexity and potential rigidity in instrument designation, as well as downside effects in funding and liquidity activities resulting from the revised trading/ banking book boundary. The two-step approach across CRR 2 and CRR 3 to implement the new boundary can lead to significant disturbance, unless supervisory authorities and banks have the right tools to avoid a cliff-edge.
2. The residual risk add-on (RRAO) is a capital charge intended to only apply to exotic risks. Its design, a flat risk weight on the gross notional of affected products, is risk insensitive and penalizes in some cases well- hedged portfolios, which can result in overly high capital charges for banks, and lead to trading services becoming overly expensive. Moreover, the industry is concerned with the excessive RRAO charge for interest rate (IR) yield curve options and spread options. IR yield curve options are widely used as hedging tools against interest rate curve exposure by clients such as pension funds, life insurance companies, corporates, asset managers and the RRAO charge could increase significantly their cost of hedging.
3. Correlation Trading Portfolios (CTP): The FRTB introduces particularly punitive charges for this business line in terms of default and credit spread risks and by limiting the recognition of hedges. This may incentivize banks to break economic hedges and effectively take on more risk in order to reduce capital, which should not be an aim of a regulatory capital framework. In addition, the rules still lack clarity, which might result in limited own funds requirements comparability between banks.
4. It is essential to ensure the viability of the internal model approaches. While supporting a number of methodology and supervisory measures that will lead a more robust IMA, we are concerned that the extent of these measures may challenge the viability of the IMA altogether. Certain requirements that are unique to the internal model - which due to the strictness of requirements or obvious inconsistencies across model approaches - are potentially undermining this approach as a viable option for banks. Of particular relevance are:
	1. the PLAT, which requires testing on real portfolios to ensure appropriate calibration before becoming a requirement for IMA eligibility[5](#_bookmark43).
	2. the Non-modellable Risk Factors (NMRF) with the prescriptive nature of the requirements potentially leading to a competitive disadvantage; and
	3. an obvious inconsistency in the Default Risk Charge[6](#_bookmark44) (DRC) between IMA and SA in relation to sovereign issuers of low risk. Such as EU Sovereign issuers, covered bonds or other Sovereign issues denominated in local currency of third countries whose supervisory and regulatory requirements are considered equivalent, that give rise to significant differences in the regulatory

5 Extract [BCBS monitoring report](https://www.bis.org/bcbs/publ/d524.pdf) published in September 2021 (p. 78) – “*Overall, 15 banks in eight countries were able to provide sufficient data to perform VaR backtesting versus 20 in the end-2019 data collection. Banks provided enough data for 474 desks for all tests to be performed, a significant improvement in the banks’ capabilities versus the 311 desks in the end-2019 data collection. Of these desks, 43 were able to pass all tests in the green zone and a further 24 desks passed in the amber zone for a total pass rate of 14.2%”*

6 Extract from [BCBS monitoring report](https://www.bis.org/bcbs/publ/d524.pdf) published in September 2021: The default risk capital (DRC) requirement in the Standardised Approach (SA) contributes 29.0% and 34.3% to the total standardised approach capital requirements for Group 1 and Group 2 banks, respectively. The DRC for internal models is expected to contribute 35.1% for Group 1 banks and 37.6% for Group 2 banks.

capital charges associated, as well as their risk perception between these two approaches. In addition, a floor of 3bp leads to a significantly higher charge under IMA (than for SA) for the equivalent risk.

1. Under the BCBS FRTB, carbon certificates have been allocated a risk weight bucket of 60% – among the highest of all commodities (e.g. twice that of crude oil). The Industry welcomes the changes by the Commission in the CRR 3 proposal by introducing a separate bucket for Carbon Trading with a risk weight of 40%, however the framework still penalizes carry positions as the FRTB imposes a correlation of 0.99 between spot and forward positions. While this might be appropriate for commodities to account for physical storage costs, carbon certificates are not typical commodities as there are no physical storage costs. Therefore, a much higher correlation for carbon certificates is appropriate. In fact, data on EU allowance (EUA) spot and forward trades shows a correlation of around 0.996 between returns for spot and future carbon certificates.[7](#_bookmark45)

### Recommendations

* It is crucial that there is dialogue with key jurisdictions to ensure coordination and flexibility on the start date for FRTB and if necessary the scope of the delegated act should be an extended to accommodate the content of the rules based on the latest international developments. It is also imperative that the scope of the delegated be extended to include CVA due to the obvious interlinkages between the capital frameworks.
* For Collective Investment Undertakings (CIUs), it will be important to clarify from the BCBS rules and ensure that
	+ the IMA should not include the mandatory look through requirements, instead it should be acceptable for CIUs to be included in IMA as a single risk factor using the daily liquid price of the CIU as currently permitted the ECB by paragraph 40 of the [ECB guide](https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.guidetointernalmodels_consolidated_201910~97fd49fb08.en.pdf) to internal models;
	+ flexibility should be introduced for the SA so Banks are permitted to use FRTB capital per unit published by the funds where available. This approach is more risk aligned than using specific risk weights. The funds or other arms-length third parties could voluntarily publish the percentage capital per unit for the three components of the FRTB SA, which banks can use as risk weights for their positions in these funds.
	+ Furthermore, the industry believes that the aggregation methodology for the fund-as-single equity approach should be adapted. Risk-weighted exposures should be correlated rather than absolute simple summed as per the ‘other sector’ (bucket 11) specification.
* For the implementation of the TB/BB boundary, it will be important not to unduly burden firms with operational requirements, complexity and potential rigidity in instrument designation. It is also crucially important to avoid any potential issues with the new boundary go-live dates and existing portfolios. Effective supervisory tools and grandfathering arrangements would help avoid any cliff-edge situations that are not intended.
* RRAO should address only risks not capitalized elsewhere in the framework (ex. volatility risk of volatility or variance swaps could well be captured in the SBM Vega risk charge and should not be subject to the 1% RRAO charge), it should be ensured that only real truly exotic underlying risks are subject to the 1% charge and more generally RRAO does not disproportionally charge vanilla rates products.
* CTP exposures should be able to be decomposed to constituents of the product for both SBM and DRC to ensure a capital outcome that is more aligned with the underlying risk for better recognition of hedging.
* Careful implementation of the key IMA requirements using real portfolios and addressing obvious inconsistencies between the IMA and SA approach before go-live of FRTB own funds requirement to ensure the viability of IMA.
* The industry reiterates its proposal to remove the 3 basis-point floor for Sovereigns. In FRTB DRC SA, exposures that receive a 0% risk weight in the credit risk SA (sovereigns, public sector entities and multilateral development banks as well as international organizations that are treated similarly to a sovereign in CRR), shall be assigned a 0% risk weight. However, in IMA, a 3bp probability of default floor applies to exposures that are risk weighted 0%. All counterparties to which a 0% risk weight applies in SA-DRC should not be subject to the PD 3bp floor in IMA-DRC. In addition, a more appropriate calibration for Covered Bond issuers as a separate risk class, reflecting their distinct characteristics and risk should be defined.
* The introduction of a separate bucket with a 40% RW for carbon trading is welcomed, however we recommend setting a tenor correlation parameter (medium correlation scenario) for carbon certificates of 0.995-0.999, reflecting empirical observations[8](#_bookmark46). This is still a conservative approach: as low and high correlation scenarios are calculated based on this parameter, with the largest capital requirement taken from the three scenarios. This will help contribute to the development of a well- functioning forward carbon certificate market that provides certainty about the future costs of emissions, allowing companies to plan ahead.

### Contacts

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| ***ISDA London:***Gregg Jones, GJones@isda.org+44 (0)20 3808 9746 | ***ISDA Brussels:***Sandrine Lapinsonniere, slapinsonniere@isda.org+32 (0) 2 808 8016 |
| ***AFME London:***Jouni Aaltonen, jouni.aaltonen@afme.eu+44 (0)20 3828 2671 | ***AFME Brussels:***Stefano Mazzocchi, stefano.mazzocchi@afme.eu+32 (0)2 788 3972 |

### About ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 850 member institutions from 66 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: [www.isda.org.](http://www.isda.org/)

### About AFME

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society. AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia. AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-

1. Information about AFME and its activities is available on the Association's [website.](http://www.afme.eu/)