ISDA Safe, Efficient Markets

Trading Book Capital: Basel III Implementation, Climate Risk in the Trading Book
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Introduction and Welcoming Remarks
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Good afternoon and welcome to ISDA's Trading Book Capital event. Thanks for joining us today, and thank you to Deloitte for sponsoring and hosting the event.

It's exactly a year to the day since the Prudential Regulation Authority (PRA) published its proposals to implement the final parts of the Basel III framework in the UK. We've come a long way since then, analyzing and testing the impact of the UK proposals and responding to the PRA consultation at the start of this year. We also now have clarity on the expected approach of all of the major jurisdictions, after US prudential regulators published their notice of proposed rulemaking in July.

As expected, some differences have emerged, both in the timing of implementation and the calibration of the standards. As rules are finalized ahead of implementation, we need to work with policymakers to achieve an appropriate, risk-sensitive capital framework that is as globally consistent as possible. Of course, there will always be some level of regional variation, but excess deviation from global standards risks market fragmentation, which creates additional complexity, particularly for internationally active banks.

As it stands, the rules are due to be applied by some banks in Canada, China and Japan early next year, EU rules would take effect from the start of 2025, while the US has targeted implementation from July 1, 2025. We welcome the recent PRA decision to push its implementation date back by six months, bringing it in line with the US. In the EU, proposed legislation would allow changes to align implementation deadlines with other jurisdictions, so we hope there will be further harmonization of timelines.

Turning to the content of the legislative proposals, the PRA stayed fairly close to the Basel standards, while proposing some adjustments with the aim of better capturing risk and supporting the competitiveness of the UK. These included modifications to the Fundamental Review of the Trading Book (FRTB), the standardized approach to counterparty credit risk and the credit valuation adjustment risk charge. We welcome these changes, which will improve the accuracy and risk sensitivity of the framework.

In the US, regulators have proposed more substantial changes to the Basel standards. These include replacing advanced approaches with a new expanded risk-based approach. This means banks won't have the option to use internal models for credit risk, counterparty credit risk or the default risk charge under the FRTB. The US agencies have estimated that the proposals will result in an aggregate 16% increase in common equity tier-one capital requirements, with the largest and most complex banks being hardest hit. The trading book stands to be hit particularly heavily, with US agencies estimating a 75% increase in capital for market risk.

Following an extension, the consultation on the US proposals will end on January 16. US agencies have been collecting data to refine their understanding of the impact, and ISDA has been working with the industry to run its own quantitative impact study. Whatever the outcome, the bottom line remains the same. Disproportionate increases in capital could result in banks stepping back from certain trading and intermediary businesses, which would lead to capacity constraints and raise financing and hedging costs for end users.

As I said earlier, we must strive for an appropriate, risk-sensitive capital framework that is as globally consistent as possible.

At ISDA, our work to ensure consistency in the capital framework extends beyond the rules themselves. Leveraging our quantitative analytics capabilities, we have developed a powerful initiative that enables banks to benchmark their standardized approach capital models and then identify and explain any variations.

As internal models are scaled back under Basel III, standardized approaches have become more risk-sensitive and a more significant driver of bank capital requirements. This means banks need to be sure their interpretation and implementation of standardized approaches is accurate, while regulators need to ensure they are consistently applied.

That's why ISDA's benchmarking initiative has been so popular. It was initially developed in 2018, in collaboration with the PRA. Since then, it has been used across 21 countries by 77 banks and 20 regulators. In addition, 17 technology vendors have licensed the unit tests for use in their own products.

One of the pitfalls of previous attempts at benchmarking capital models has been a failure to properly identify and explain variations in the outputs. This is where our approach is different. We leverage ISDA's Common Risk Interchange Format (CRIF) – a risk data standard that enables users to closely analyze specific data. Our web-based ISDA Analytics platform automates and accelerates the identification of patterns and trends, quickly categorizing any sources of capital divergence.

Before finishing, I'll briefly highlight another area where ISDA is working with market participants to advance on a critical issue – climate risk management.

From extreme weather events to changes in climate policy, it's clear that these shocks can drive sudden changes in the value of assets. Scenario analysis is a valuable tool, but it has typically focused on long-term assets such as loans. When we surveyed a group of banks last year, we found that trading book scenario analysis was viewed as a priority, but there was little consensus on methodology and concern over a lack of reliable data.

During the first half of this year, we worked with Deloitte and more than 30 of our members to develop a conceptual framework for climate scenario analysis in the trading book. We published the framework in July and are now well advanced on the second phase of the work. This involves the development of short-term scenarios that can be used for regulatory stress testing and internal risk management purposes, as well as to inform strategy.

We've collaborated closely with several public-sector entities, including the Network of Central Banks and Supervisors for Greening the Financial System, and have valued this input as we designed the conceptual framework and started to flesh out the scenarios. We look forward to sharing more on this work early next year.

This is a pivotal time in the finalization of the Basel III reforms, and we have a full agenda this afternoon that reflects this. I’d like to thank all of our speakers and delegates, and I hope you find the sessions insightful and constructive.

Thank you.