ISDA Safe, Efficient Markets

Trading Book Capital: Basel III Implementation
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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 EY for sponsoring the event.

This is an opportune time to hold a conference on the topic of trading book capital. It's nearly five months since US prudential regulators published the notice of proposed rulemaking (NPR) to implement the final parts of Basel III, which include trading book capital requirements. And there's just over a month to go until the January 16 deadline for comment on the proposals. So, there's much to discuss – from what's been proposed to what comes next.

US regulators have proposed some substantial changes to the existing capital framework. This comes after banks globally increased their capital by more than $2.8 trillion since 2011. The proposed changes 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 Fundamental Review of the Trading Book.

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 particularly affected, with US agencies estimating a 157% increase in risk-weighted assets associated with trading activity.

Underneath those headline numbers are some very detailed capital requirements, and there is no doubt that the details matter. But we also need to think about the consequences of this package of reforms and the impact that such a big capital hike would have on financial markets and the broader economy. In particular, I'm concerned about liquidity in the US Treasury market – a topic I will touch on at the end of these remarks.

The publication of the NPR means we now have clarity on the expected approach of all the major jurisdictions. As expected, some differences have emerged, both in the timing of implementation and the calibration of the standards. As the proposed rules are finalized, 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 fragmentation creates additional challenges and 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 decision by the UK Prudential Regulation Authority 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.

During the comment period, regulators have been collecting data to refine their understanding of the impact of the proposals, 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. Since its launch in 2018, 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 – 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.

This is a pivotal time in the finalization of the Basel III reforms, but it’s also critical that policymakers take a holistic view of the overall impact of regulatory changes on financial market liquidity. The US Securities and Exchange Commission has proposed rules that would require increased clearing of certain Treasury securities and repo transactions, due to be voted on tomorrow. This will be a seismic change for the US Treasury market, which is the oil that keeps the wheels of financial markets turning. We would urge prudential and market regulators to make every effort to ensure future rule changes are compatible and do not impede the ability of banks to provide vital liquidity to support the global economy.

We have a full agenda this afternoon and I’d like to thank all of our speakers and delegates. I hope you find the sessions insightful and constructive.

Thank you.