IQ In brief

On November 19, ISDA held a Trading Book Capital virtual conference, sponsored by EY. Speakers explored the impact of the COVID-19 pandemic on trading book capital and the forthcoming implementation of the final parts of Basel III

COVID Crisis Underscores Need to Reduce Procyclicality, Says O'Malia

Close analysis of the impact of the COVID-19 crisis in March 2020 demonstrates the importance of reducing procyclicality in the revised trading book capital standards, ISDA's chief executive Scott O'Malia has said.

"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," said O'Malia during his opening remarks at the ISDA Trading Book Capital virtual event, sponsored by EY.

O'Malia cited data from an analysis of 20 banks compiled by ISDA, the Global Financial Markets Association and the Institute of International Finance that showed a sharp increase in trading book risk-weighted assets (RWAs) during the first quarter of 2020, at the height of the coronavirus crisis. For the credit valuation adjustment, RWAs increased by more than 45%, while counterparty credit risk and market risk RWAs rose by 20% and 22%, respectively.

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"Procyclical capital requirements threaten to choke off banks' support for the real economy at a time when it is needed most. The COVID crisis underscores the importance of reducing procyclicality"
Scott O'Malia, ISDA

For market risk, part of the issue was caused by an increase in the number of value-at-risk (VaR) backtesting exemptions, caused by severe market volatility due to the coronavirus pandemic. Under the current Basel 2.5 regime, banks are required to add a multiplier to their capital calculations if actual or hypothetical P&L over the course of a single trading day exceeds VaR estimates more than four times in a year, with the multiplier increasing as the number of exceptions continues to climb. As a result of the crisis, regulators in several jurisdictions moved quickly to smooth the volatility induced procyclical effect of the multiplier – for example, by freezing it for a temporary period.

The new trading book capital requirements, now due to be implemented by January 1, 2023, are designed to be less procyclical. With legislative proposals on the new requirements expected in the US, European Union and UK next year, O'Malia stressed the importance of consistency and risk appropriateness.

"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," said O'Malia.

"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." IQ

Regulators Counting on Banks for COVID Recovery

Banks have played a major role in supporting the economy and continuing to lend throughout the COVID-19 pandemic and regulators expect them to maintain this support during the recovery, according to Nathalie Berger, head of unit, banking regulation and supervision at the European Commission.

"This time, unlike in 2008, banks were not at the root of the crisis – they were part of the solution and we are really counting on them to continue being part of the solution and to play their role in the recovery," said Berger.

Speaking in a keynote address at ISDA's Trading Book Capital virtual conference, Berger reflected on the temporary and targeted capital relief measures enacted by European regulators during the crisis to ensure banks could continue to lend to the economy. While some of those measures focused on credit risk, Berger acknowledged the impact of coronavirus-induced volatility on market risk capital.

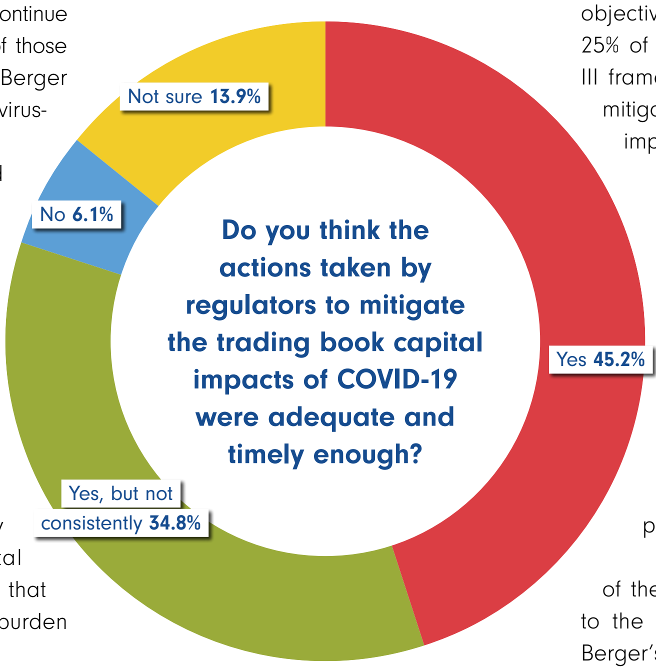
"We were fully aware of the need to allow limited adaptations in the area of market risk as the extreme market volatility at the onset of the crisis in March and April 2020 led to a significant increase in market risk capital requirements due to a number of highly procyclical components embedded in these capital requirements," said Berger.

"Our focus was both on measures that would counteract the procyclicality built into the market risk capital framework, as well as on measures that would alleviate banks' operational burden during the crisis," she added.

One such measure, announced by the European Central Bank on April 16, was a temporary reduction in market risk capital requirements by allowing banks to adjust the supervisory component of the requirements. The qualitative market risk multiplier, which is set by supervisors to compensate for the possible underestimation of capital requirements, was temporarily reduced at that time. Regulators in other jurisdictions took slightly different approaches, but with the same objective of smoothing procyclicality.

"We saw very short-term reactions of different flavours," said Katherine Wolicki, global head of regulatory policy and engagement for group risk at HSBC. "It got us to the same place, which was the recognition that we needed flexibility within the prudential framework, so that was excellent to see and very much welcome."

In a live audience poll, attendees were asked whether the actions taken by regulators to mitigate the trading book capital impacts of COVID-19 were adequate and timely enough. In response, 45% agreed they were, while 35% said they were adequate and timely, but not consistent.



"We had a lot of market risk volatility and a lot of backtesting exceptions that came off the back of unprecedented volatility, which had nothing to do with deficiencies of the internal models," said Wolicki.

Other speakers agreed that the volatility exposed the inherent procyclicality in current market risk capital requirements, which is why regulators had to intervene.

"Broadly speaking, I think that the experience of the COVID crisis showed that if you follow the Basel 2.5 or the preliminary Basel III regulation as it stands, then it is fairly procyclical. If you follow that regime without flexibility, then you're going to have this procyclicality. But what we saw in fact was that regulators were willing and able to step in and use that flexibility to provide relief to banks," said Charuhas Pandit, global head of market risk analytics at Morgan Stanley.

While the Fundamental Review of the Trading Book (FRTB), which is now due for global implementation on January 1, 2023, has been designed to reduce procyclicality in market risk capital requirements, some believe further work may be needed to achieve this objective. In a second audience poll, only 25% of respondents felt that the new Basel III framework would have entirely or mostly mitigated procyclicality if it had been fully implemented this year.

"If we had had FRTB fully in place during March, then the capacity for banks to continue market making would have been damaged much more seriously – in particular, due to the profit and loss attribution test that would probably have forced many desks to fall into standardised approaches, with a massive cliff effect on capital requirements," said Veronique Ormezzano, head of group prudential affairs at BNP Paribas.

Panellists agreed that the experience of the COVID crisis had felt very different to the financial crisis of 2008, welcoming Berger's assertion that they had been part of the solution rather than the problem during this crisis.

"We as banks had been in a period of intense regulatory scrutiny for about a decade – there was a lot of scrutiny, scepticism, and a lack of trust in banks and their agendas," said Wolicki. "This felt decidedly different. Banks were part of the solution – there was a real understanding that we needed to cooperate and face this together." IQ

US Commits to 2023 Start Date for Basel III

The US will implement the final package of Basel III measures, including the Fundamental Review of the Trading Book (FRTB) and the revised credit valuation adjustment (CVA), in January 2023, in line with the schedule set by the Basel Committee on Banking Supervision.

In a keynote address at the ISDA Trading Book Capital virtual event, Norah Barger, senior adviser, director of supervision and regulation at the Federal Reserve Board, said US prudential regulatory agencies would issue a notice of proposed rule-making (NPR) for the remaining Basel III reforms next year. This will be followed by a US-specific hypothetical portfolio exercise and lengthy comment period, with the aim of implementing the rules at the start of 2023.

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>
> **Norah Barger, Federal Reserve Board**

"We are very much sticking to implementing the final Basel III market risk and CVA frameworks for January 2023. We are committed to the Basel deadline for that. The timeline, however, requires a significant amount of work on the part of both the supervisors and for the banks that will be subject to the market risk rule," said Barger.

In March, the Basel Committee announced a one-year delay to the Basel III implementation deadline in response to the coronavirus pandemic to ensure banks could devote their resources to ensuring business continuity, managing severe market volatility and supporting the real economy.

With the virus continuing to spread, Barger acknowledged the 2023 deadline would be challenging and precise timings – including the publication date of the NPR – would be difficult to predict.

"The path of the pandemic can obviously affect any part of this, and it leads to a lot of the uncertainty that we will have around timing. And it is of course not just the pandemic, but also what happens in terms of the general economy because of the pandemic," she said. IQ

Pandemic Adds to Basel III Implementation Challenge

The continued spread of the coronavirus pandemic will create additional challenges for banks in their efforts to implement the final Basel III measures, prompting questions over whether further flexibility from regulators might be necessary.

Noting that banks have a number of implementation initiatives under way simultaneously, Shaun Abueita, partner, financial services and risk consulting, EY, said firms face a complex juggling act.

"Understanding those overlaps and interdependencies and managing implementation and delivery to avoid duplication of effort and inefficiency and regrettable spend is a difficult implementation challenge," he said, speaking at the ISDA Trading Book Capital virtual event.

Global regulators acted quickly to provide regulatory relief in response to the rapid spread of COVID-19 in March and April, including a one-year delay to the final Basel III measures, which include the Fundamental Review of the Trading Book and the revised credit valuation adjustment framework. Speaking on a separate panel, Frédéric Hervo, director for international affairs at France's Autorité de contrôle prudentiel et de résolution, said regulators are striving to meet that new deadline.

"Even with an extra year, this deadline is certainly challenging, taking into account that the banks have to be prepared. But we so far have no indication that this deadline is no longer the target for EU implementation, and everyone is working hard to reach this target," he said.

Echoing earlier remarks in a keynote address by Norah Barger, David Lynch, deputy assistant director at the Federal Reserve Board, said US prudential regulators are targeting a January 2023 implementation for Basel III, but recognised that flexibility may be required if the coronavirus pandemic worsens.

"If the lockdown severity increased around the world, I think we would have to think about the timing once again, but right now, we're still looking at January 2023," he said.

Participants on the panels welcomed the action taken by regulators so far in response to the crisis, but stressed the need for continued coordinated action if further measures are necessary.

"I've heard everyone say that we're committed to 2023, and while we all acknowledge that is an extremely aggressive timeline, I do hope that we're consistent on implementation timing," said Debbie Toennies, managing director, head of regulatory affairs – corporate and investment bank, JP Morgan. "These are global capital markets and so trading securities or pricing securities for global issuance becomes very difficult if you have materially different capital associated with them in different jurisdictions." IQ