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Fundamental Review of the Trading Book

The Fundamental Review of the Trading Book (FRTB) is a Basel Committee on Banking Supervision initiative to overhaul trading book capital rules, with the aim of replacing the current crop of measures under Basel 2.5 with a more coherent and consistent framework (see box, *FRTB at a Glance*).

The FRTB is vast in scope and touches upon a number of complex but pivotal issues – from the design of the basic model used to measure risk, to the process for deciding what sits in the banking and trading books. While Basel 2.5 was implemented in the immediate aftermath of the financial crisis as a stop-gap measure to lift trading book capital requirements, the FRTB is primarily aimed at consolidating existing measures and reducing variability in capital levels across banks. ISDA and its members welcome the switch to a more streamlined, consistent market risk framework, and have been working constructively with regulators to help hone the rules.

A huge amount of progress has been made. But given the scale of the overhaul and the complexity of the issues, it's important all elements are fully tested before the framework is finalised. Without comprehensive assessment, the objectives of a globally consistent and coherent capital framework may be undermined. Certain business lines may end up being hit by inappropriately high capital levels, causing banks to scale back from those activities. That could, in turn, reduce liquidity and increase financing and hedging costs for end users. A lack of consistency also creates the risk that individual jurisdictions will take different approaches when transposing the FRTB framework into domestic rules, similar to how national regulators have applied credit valuation adjustment capital requirements differently.

As such, ISDA believes an additional quantitative impact study (QIS) in the second half of 2015 is required to comprehensively evaluate the impact of the rules and ensure they are consistent and coherent. This would extend the scheduled completion date beyond the end of 2015, but would not alter the scheduled 2018 implementation date.

This paper is intended to summarise the main components of the FRTB, as well as highlight areas where further attention may be required.

OVERVIEW

Timing: ISDA believes a further QIS is necessary to fully test aspects of the rules that were not considered in earlier studies. The first QIS was based on a hypothetical portfolio, and the second and third experienced a number of operational and specification issues that led to significant variation in the results across banks. (ISDA raised more than 130 FAQs on behalf of members to clarify areas of uncertainty in the most recent QIS.) In addition, the third QIS lacked the required granularity to properly assess the impact to individual business segments.

A further, more granular QIS would capture and test every component of the framework, including the impact of potential changes to non-modellable risk factors and back-testing requirements, which otherwise would not be taken into account. A new QIS would extend the time needed to finalise the rules beyond the intended completion date of end-2015, at the expense of part of the calibration period. However, this would not affect the scheduled implementation date of 2018.

Economic Impact: Although the affect on overall capital levels is not clear, and is subject to final calibration, it is likely to lead to punitive capital increases in certain business lines, and will potentially cause some key markets, such as securitisation, to become uneconomic. Certain credit products could see capital requirements increase by up to six times, while a sovereign downgrade could increase capital charges by 73%. This could lead to lower liquidity and increased financing costs for borrowers. It is therefore important that the cumulative impact of the rules is fully understood through a holistic QIS.

Regulatory Inconsistency: Policy-makers are increasingly focused on initiatives to generate and sustain global economic growth. In Europe, for instance, efforts are under way to develop a capital markets union, and well-functioning securitisation markets are considered to be an important element underlying that growth. The FRTB's current treatment of securitisations could threaten this market and negatively affect the economic growth agendas of policy-makers.

FRTB at a Glance

- New rules determining the scope of instruments eligible for inclusion in the trading book, and more stringent requirements governing internal risk transfers between the banking and trading book.
- A revised standardised approach for market risk based on price sensitivities, which is intended to be more risk sensitive compared to the existing standard approach, and therefore reduce the gap between internal models and standard rules.
- The substitution of value at risk and stressed value at risk with an expected shortfall risk measure to capitalise for loss events in the tail of the P&L distribution.
- The introduction of liquidity horizons in the expected shortfall calculation to reflect the period of time required to sell or hedge a given position during a period of stress.
- Replacement of the incremental risk charge with an incremental default risk model, which is designed to capture default risk in the market risk framework.
- Back-testing requirements of internal models at trading desk level. Failure to meet the validation criteria would force a desk to revert to using the standardised approach.
- Enhanced public disclosures on market risk capital charges, including regulatory capital charges calculated using both standardised and internal models approaches.

SUMMARY OF KEY FRTB COMPONENTS

Liquidity Horizons

The FRTB introduces liquidity horizons (LHs) under the internal model approach, which aim to capture the amount of time required to liquidate a specific instrument in the market. But the LH buckets for many instruments are overly conservative and lack granularity, giving rise to cliff effects.

For a large-cap, high-yield corporate name, for example, the LH for credit spread and volatility is 120 days and 250 days, respectively, while the LH for equity price and equity volatility is 10 days and 20 days. The credit market is not as deep as the equity market, but the differences are overstated and are not borne out by experience, even in stressed markets. This could result in increased underwriting and lending costs (or an unwillingness by banks to underwrite new issues), and reduced liquidity in secondary markets.

ISDA believes the liquidity horizons should be re-evaluated to better reflect market experience, and recommends targeted studies to ensure that the capital impact is well understood before implementation.

Non-modellable Risk Factors

The Basel Committee wants to provide incentives for banks to source high-quality data for use within internal models. As a result, it has proposed standards that will determine whether a risk factor can be used within an internal model calculation, or whether it has to be assigned to a non-modellable risk factor bucket and therefore be subject to a capital add-on (no diversification benefit).

The introduction of eligibility criteria to enhance data quality is positive, but the proposed requirements are currently unworkable in practice. If interpreted strictly, references to “continuously” available, “real prices” and a sufficient set of representative “transactions” could be too restrictive for practical use, resulting in serious implementation challenges. ISDA believes end-of-day marks should be allowed, as these are already subject to well-established processes and controls.

Revised Standard Rules

The FRTB revises the standard rules for market risk capital requirements. The intention is to provide regulators with a credible fall-back approach for each trading desk in the event that internal models are deemed inadequate. The new standard approach (the sensitivity based approach, or SBA) is significantly more risk sensitive than the current standard framework, which is welcome, but some areas still require refinement. Key issues include:

- **Asymmetric Correlations:** Under the SBA, two correlation values (asymmetric correlations) are specified for each pair of risk positions in order to capture the lack of stability in correlation parameters: a higher value for the risk pairs with the same sign (eg, two long or short positions); and a lower value for the risk pairs with different signs (eg, a short and long position). However, this approach comes with challenges. Exposures within a portfolio can change frequently, even over the course of a single day, potentially requiring the correlation parameters to be continually revised. This could lead to high capital charges for even well-hedged basis positions, and increased volatility and uncertainty over portfolio capital requirements. A simpler, alternative approach would be to use a coherent, consistent correlation matrix.

- **Securitisations:** Capital requirements for all securitisation exposures must be calculated using the standardised approach (internal models are not allowed), which entails adding together a credit spread risk charge and a default risk charge. However, there is a high degree of overlap between the two measures, resulting in double counting. Combined with extremely high risk weights for securitisation products (ranging from 800 basis points to 5,000bp) and a lack of granularity in risk buckets, this is likely to lead to unjustifiably high capital requirements. The end result is likely to be lower liquidity and a higher liquidity premium demanded by investors, putting upwards pressure on financing costs for borrowers. ISDA believes an alternative approach should be developed based on recalibrated credit spread stresses and the elimination of double counting.

Trading Book/Banking Book Boundary

The FRTB imposes strict limits on internal risk transfers between the banking and trading books. While recognising the regulatory purpose of eliminating capital arbitrage, ISDA believes the current proposals for internal risk transfers are overly restrictive. Under current proposals, banking book positions can only be transferred into the trading book if the risk is neutralised through separate, matched external hedges. Banks should retain the ability to transfer banking book risk to the trading book in a way that allows the risks to be managed on a portfolio basis, subject to trading book regulatory capital requirements, trading book limits and governance standards that meet supervisory approval.

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