December 2024

FRTB Implementation Challenges:
Capitalization of Funds

CONTENTS

INTRODUCTION

In 2022, ISDA published a whitepaper[1] that highlighted the overly conservative capital requirements and operational complexities arising from the treatment of equity investments in funds (EIIFs) under the Basel III framework. The paper provided an overview of the criteria used to allocate EIIFs to the trading book and the waterfall of trading book methodologies under the internal models approach (IMA) and the standardized approach (SA) for capitalizing EIIFs under the Fundamental Review of the Trading Book (FRTB). It highlighted a lack of proportionality in the criteria for determining the scope of trading book eligible funds, as well as an absence of flexibility in capitalizing trading book EIIFs under the FRTB IMA, with the look-through approach (LTA) the sole option available for banking organizations.

The lack of flexibility in the IMA creates a significant disincentive for firms to implement it for EIIFs. The requirement for a 100% look-through is not possible for mutual funds, and the mandate-based approach (MBA) is difficult to apply due to the broad specification of fund mandates. The conservative fallback approach (FBA) is therefore the most viable option and is likely to be adopted by banks for most of their fund exposures.

A survey included in the 2022 paper reinforced these points, revealing that only 27% of 22 responding firms planned to capitalize EIIFs using the LTA under either the IMA or SA, with the choice heavily dependent on the composition of firms' fund exposures. Four percent opted for the index-based approach (IBA) and 61% leaned towards using the FBA. None of the firms planned to implement the MBA.

Since the publication of the 2022 whitepaper, several jurisdictions have implemented the FRTB (ie, Canada and Japan), while others have finalized their FRTB rules (ie, the EU[2] and the UK[3]) or are consulting on the final rules (ie, the US[4,5]). This topic continues to be a globally important issue for the industry, with many unresolved concerns related to the treatment of EIIFs.

Moreover, the significance of these issues may not be fully recognized by supervisors and regulators. There is a clear disconnect between the theoretical expectations for EIIF capitalization and the practical realities observed, as evidenced by modifications to the submitted data from 19 banks as part of the European Banking Authority's (EBA) Basel III monitoring report[6]. This led to a capital reduction of 80% for EIIFs. A similar adjustment is reported in the Bank for International Settlements Basel III monitoring exercise, although the number of banks involved is not disclosed.

Part 1 of this paper summarizes the important role EIIFs play in the economy. Part 2 examines developments in the regional transposition of the FRTB across jurisdictions and assesses whether these developments have addressed the concerns raised in the 2022 whitepaper. Part 3 sets out recommendations to resolve the issues that remain unaddressed by the EIIF rules published so far. These recommendations include resolving areas of divergence to ensure a level playing field across jurisdictions.

[1] ISDA, *Capitalization of Equity Investments in Funds under FRTB* (2022), www.isda.org/2022/01/10/capitalization-of-equity-investments-in-funds-under-the-frtb/

[2] European Union, *Regulation (EU) 2024/1623 of the European Parliament and of the Council of 31 May 2024 amending Regulation (EU) No 575/2013 as regards requirements for credit risk, credit valuation adjustment risk, operational risk, market risk and the output floor* (2024), https://eur-lex.europa.eu/eli/reg/2024/1623/oj

[3] Bank of England, PS17/23 – *Implementation of the Basel 3.1 standards near-final part 1* (2023), www.bankofengland.co.uk/prudential-regulation/publication/2023/december/implementation-of-the-basel-3-1-standards-near-final-policy-statement-part-1

[4] Federal Register, *Regulatory Capital Rule: Large Banking Organizations and Banking Organizations With Significant Trading Activity* (2023),

[5] The September 2023 Notice of Proposed Rulemaking in the US is expected to be superseded by a re-proposal. However, the process is subject to change following the November 2024 US election and the change in administration

[6] European Banking Authority, *Basel III Monitoring Exercise Results Based on Data as of 31 December 2023* (2024), www.eba.europa.eu/sites/default/files/2024-10/eee3e459-52f3-4fe5-a911-18f9adf1d6cb/Basel%20III%20monitoring%20Report.pdf

MAIN FINDINGS AND RECOMMENDATIONS

Since the 2022 whitepaper, the most significant development has been the publication of the US Notice of Proposed Rulemaking (NPR) on Basel III, which includes greater flexibility in the rules versus those set by the Basel Committee and by regulators in other jurisdictions. There has also been greater clarity on the third-/external-party approach (EPA) in the EU and UK. However, the main elements of the capitalization treatment remain largely consistent with the Basel standards for most jurisdictions. While the industry welcomes the EPA, it does not resolve the underlying issue, as these third/external parties face the same data constraints on fund holdings as banks. Furthermore, there has yet to be a viable third-party solution available for banking organizations.

The existing lack of proportionality and flexibility in the criteria for inclusion in the trading book persists, as does the requirement for a full look-through to support this approach. In addition, no significant changes have been made to improve the MBA as a viable alternative. Therefore, the significant concerns raised about EIIF capitalization remain unresolved. Absent any changes, banking organizations are likely to apply the FBA for a significant number of fund exposures, as evidenced by previous surveys and the Basel III monitoring exercises.

ISDA and its members have proposed several recommendations to directly address these issues. They apply to specific approaches for the IMA and SA and are not mutually exclusive. Regulators should therefore consider them all.

General

- **Reflect Proportionality in Trading Book/Banking Book Criteria:** Introducing a materiality threshold would allow EIIFs to remain in the trading book if banking book holdings are immaterial. Existing rules applicable to EU Undertakings for Collective Investment in Transferable Securities (UCITS), which use a materiality threshold (ie, 10% of net asset value (NAV)), could serve as a model. This threshold would not only account for immaterial banking book holdings in EIIFs, but also reduce the possibility of risk-weighted asset (RWA) volatility from moving EIIFs or related hedges between the trading and banking books due to marginal condition changes.

  The current EU and UK rules state that banking organizations must have knowledge about the content of a fund's mandate to qualify for trading book inclusion when the LTA is not employed. This requirement should be removed for the FBA, as it imposes a disproportionate operational burden given the already conservative capital treatment, effectively precluding firms from applying the FBA. This requirement contradicts the spirit of the trading book, where turnover of fund positions may be high.

  Finally, seed capital invested by banking organizations in funds should be excluded from EIIF treatment.

[7] European Parliament and the Council of the European Union, *European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations* (2003)

[8] Investment Company Act 1940, www.govinfo.gov/content/pkg/COMPS-1879/pdf/COMPS-1879.pdf

FRTB-IMA & SA

- **Allow a Partial LTA for Qualifying EIIFs:** The LTA should be redefined to permit banking organizations to treat a **material portion – specifically a majority** – of a market-risk-covered position with multiple underlying exposures (such as index instruments, multi-underlying options, equity positions in an investment fund or correlation trading positions) as if those underlying exposures were held directly by the banking organization. This partial LTA would be applied to well-diversified, unleveraged funds that fall under existing regulatory requirements – eg, the EU UCITS Directive[7], the US 1940 Investment Company Act[8] and equivalent standards in other jurisdictions.

FRTB-SA

- **Enhance the MBA with New EIIF Buckets:** Remove the practical difficulties of using fund mandates to derive risk weights by implementing an enhanced and transparent approach that prescribes a limited number of fund buckets specifically for EIIFs, each with corresponding risk weights. This approach would facilitate simpler and more consistent implementation across banking organizations.

- **Treat Qualifying EIIFs Equivalently to Existing Index Rules:** Recognize the diversity in risk profiles and the transparency of holdings data within the EIIF market by allowing those EIIFs that align with index risk and transparency characteristics to be treated consistently with indices. This could be achieved by introducing new criteria for EIIFs that are equivalent to existing index criteria – for example, Article 325i (2) and (3) of the EU Capital Requirements Regulation (CRR) – adjusted to reflect the specific properties and characteristics of EIIFs.

The industry has also identified new issues following the finalization of the FRTB rules for funds in the EU and UK, which could create an unlevel playing field for firms. It could also result in a lack of clarity in rule formulation, leading to interpretations that do not align with the intention of regulators.

- **Clarify the Treatment of EIIF Vega Risk Bucketing in the CRR:** Align the rules with industry interpretations on the treatment of vega risk indices or multi-underlying instruments where the LTA has been used for delta and curvature risks. This includes single sector bucket mapping or index bucket mapping criteria applicable to EIIFs. This interpretation recognizes the diversification and hedging benefits with other vega risks in the same bucket for such instruments.

- **Align EU CRR Criteria for EIIF Holding Data Frequency with Major Jurisdictions:** Establish a requirement for data frequency on underlying constituents to be quarterly in the EU, consistent with proposals in the UK and US. It would also align with the external reporting timelines of major jurisdictions.

- **Level Playing Field: Remove the Standalone Aggregation of the FBA Own-funds Requirement with the Rest of the Portfolio:** Address changes made by the EU and UK that make the FBA overly conservative by removing the requirement to aggregate FBA capital on a standalone basis with the rest of the banking organization's portfolio. This is inconsistent with the FBA outlined in the Basel standards and the proposals set out in the US NPR.

- **Level Playing Field: Utilizing the Full Potential of the EPA Own-funds Requirement as Prescribed in the EU:** Ensure consistency and reduce the capital burden arising from differences in the EPA in the UK and EU by removing the standalone aggregation requirement in the UK rules and aligning them with the EU.

PART 1: IMPORTANCE OF EIIFs

The investment funds industry comprises a wide variety of fund types, including mutual funds, exchange-traded funds (ETFs), pension funds and hedge funds, each characterized by unique risk profiles, transparency criteria and regulatory obligations. It is important that bank capital regulations recognize this diversity given the crucial role investment funds play in the global economy.

- Capital allocation: Investment funds facilitate the allocation of capital to various sectors of the economy, fostering the growth of businesses and infrastructure. By pooling resources, these funds can invest in startups, established companies and projects that drive innovation and development.

- Risk diversification: Funds enable individual investors to diversify their portfolios by spreading risk across different asset classes, industries and geographies. This diversification helps mitigate the impact of underperformance in any single investment.

- Liquidity: Investment funds enhance market liquidity, making it easier for investors to buy and sell shares. This liquidity is essential for the smooth functioning of financial markets, enabling efficient price discovery.

- Economic growth: By investing in a range of projects and companies, investment funds stimulate economic growth. They provide capital for new projects and businesses, contributing to job creation and economic development.

Banking activity facilitates important features of the fund management industry's product offering, including the provision of hedging solutions on funds. These hedging solutions enable the availability of capital protected products linked to UCITS, mutual funds and ETFs, which help protect retail investors and retirees against losses. For example, a typical business strategy is to sell vanilla call options on a basket of UCITS mutual funds and ETFs or provide gap protection for constant proportion portfolio insurance (CPPI) strategies run by asset managers and insurers, which provide protection to retail investors that buy these products. An overly conservative FRTB treatment of these hedging solutions would result in a large RWA increase for banking organizations, making this business uneconomical and negatively affecting the provision of these hedging solutions.

In summary, investment funds are an essential mechanism for mobilizing savings, fostering economic growth and providing investors with the means to manage risk effectively. Banking organizations are key providers of hedging solutions that facilitate risk management strategies in fund products and services. A capital framework for banking organizations that is overly conservative may negatively affect the provision of key services provided by banking organizations to funds, with a resulting knock-on impact to the real economy.

PART 2: EIIF CAPITALIZATION RULES DEVELOPMENTS FROM REGIONAL IMPLEMENTATION OF BASEL III

Overall, the capitalization treatment of EIIFs across jurisdictions has largely remained aligned to the Basel framework. This consistency is observed in jurisdictions that have implemented the FRTB, including those with final or near-final rules, such as the EU and UK. Some flexibility in the treatment of funds was reflected in the US NPR that was published in September 2023. Specifically, flexibility was provided for the use of alternative modelling approaches other than the LTA following supervisory approval. The use of a hypothetical portfolio approach has been extended with the option to use the most recent quarterly disclosures, in addition to its use in the MBA. While the industry welcomes these proposals, more detail and clarity are required to understand if they address the issues previously raised.

Other developments since 2022 relate to the third-party (EU) and external-party (UK) approaches, where regulators have provided more detailed guidance on the use of third-party-sourced risk wights or risk-weighted exposures and the qualifying criteria necessary to use these options. For both the third-party and external-party approaches, the calculations must be externally audited and verified by the banking organization as appropriate. Importantly, the third/external party must know the exact holdings of the EIIF in accordance with the LTA.

Another significant development is an approach adopted by the Swiss Financial Market Supervisory Authority, which relies on complete LTA compliance. This approach introduces a new 50% risk weight for situations where a banking organization has full knowledge of the fund constituents but opts not to decompose, either due to implementation choices or operational issues. This risk weight is lower than the 70% FBA that would otherwise apply.

Unresolved Concerns

While these developments have been welcomed by the industry as helping to mitigate the reliance on the FBA for a significant portion of EIIFs, both the EPA and the new 50% risk weight option depend on a full look-through into constituent data for the EIIFs.

As a result, neither approach addresses the two primary issues with the LTA in the 2022 whitepaper – the lack of frequently updated, comprehensive constituent data and the significant challenges associated with implementing the necessary infrastructure and computational enhancements to support the scale and complexity of the required risk data. Furthermore, clarity on what constitutes a valid frequency for the availability of constituent data has not been provided across all major jurisdictions, such as the EU.

There have also been no improvements to the MBA as a viable alternative when the LTA is impractical[9]. The calibration remains extremely conservative and fails to consider that funds typically contain thousands of individual holdings diversified across geographies, asset classes, sectors or other attributes. Representing a diversified fund as a concentrated portfolio based on the lowest-quality constituents allowed by the mandate will materially misrepresent the fund's risk profile.

[9] This comment does not include the Swiss Financial Market Supervisory Authority case where the 50% risk weight has been introduced in cases where LTA is possible but not practicable

Having a single conservative approach ignores the diversity of traded EIIFs, particularly as most are mutual funds, which are subject to high levels of diversification and transparency mandated by existing legislation, such as the UCITS regulatory framework in the EU. This legislation is designed to protect individual investors, making these funds generally safer than hedge funds. A pragmatic, risk-sensitive approach for EIIFs should recognize and utilize existing legislation to ensure the capitalization treatment for qualifying mutual funds is not equivalent to the treatment for hedge funds.

Greater clarity is also needed in the regulatory text on whether multi-underlying instrument option vega can be capitalized in the same buckets as index option vega. For options on funds that track an index and meet the tracking error criteria specified in the text, the rules currently allow using the index bucket for capitalizing option vega sensitivity. However, the regulatory text is less clear for other well-diversified funds and multi-underlying instruments. Without clear regulatory guidance, a fragmented approach across firms may be inevitable.

Part 3 outlines several industry recommendations for changes to the capitalization treatment that directly address these points, while still adhering to the principles of risk alignment, conservativeness and consistency in capital requirements across the industry.

PART 3: EIIF CAPITALIZATION RECOMMENDATIONS

General

Reflect Proportionality in Trading Book/Banking Book Boundary Criteria

Introducing a materiality threshold enables EIIFs to remain in the trading book if they have an immaterial amount of banking book holdings. In the EU, for example, the materiality threshold for UCITS[10] limits the investment in a single entity to 10% of NAV. Applying a similar 10% threshold for EIIFs would not only account for immaterial banking book holdings in EIIFs, but would also reduce the RWA volatility that can arise from moving EIIFs or corresponding hedges between the trading and banking books due to exogenous changes in the characteristics of EIIF constituents, such as corporate actions in the case of listed equities.

In the EU, the CRR imposes restrictions that prohibit the use of the LTA or MBA for third-country overseas funds. These restrictions, which should be removed, result in a 1,250% risk-weight due to reclassification to the banking book. These restrictions are not included in comparable jurisdictional frameworks (eg, UK PS 17/23). Maintaining these restrictions would limit the ability of EU banks to invest in third-country funds.

Furthermore, the requirement for banking organizations to have knowledge of the fund's mandate should be removed when applying the FBA. While this obligation is sensible for the IBA and MBA, it is disproportionate for the FBA, which is already conservative. Adding this operational burden for fund positions that may only be held for a short period incurs unnecessary costs without providing prudential benefits. Positions should be allowed to remain in the trading book as long as firms have daily pricing and the ability to trade or hedge those positions, rather than being forced into the banking book due to unnecessary operational demands. Finally, seed capital investment in funds by banking organizations should be excluded from the EIIF treatment.

FRTB-IMA/SA

Allow Partial LTA[11]

It is proposed that the LTA be re-defined so banking organizations can treat a material portion of a market-risk-covered position with multiple underlying exposures (such as index instruments, multi-underlying options, equity positions in investment funds or correlation trading positions) as if those underlying exposures were held directly by the banking organization. The term 'material portion' is inserted to allow banking organizations to opt for the LTA when most of the underlying holdings in the fund are known and can be priced. The remaining portion would be treated under the FBA.

This approach would address the challenges with data availability, particularly in situations where decomposition is possible[12] but limited by data or infrastructure challenges that prevent banking organizations from fully decomposing all underlying holdings.

[10] European Parliament and the Council of the European Union, *Regulation 49 (1) (a) of the European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations* (2003), https://service.betterregulation.com/document/93183

[11] ISDA and SIFMA, *Basel III Endgame Comment Letter on Partial LTA* (2024), www.isda.org/a/r41gE/ISDA-SIFMA-Basel-III-Endgame-Comment-Letter-Partial-LTA.pdf. Further details on this approach can be found in this addendum that was shared with the US gencies

[12] Exchange-traded funds, such as the iShares iBoxx Dollar High Yield Corporate Bond ETF and the iShares iBoxx Dollar Investment Grade Corporate Bond ETF, would fall under this cohort

The measure used to determine materiality would be NAV, as it is publicly available on a frequent basis across all funds. The exact materiality threshold would be determined by the banking organization based on the specific risk characteristics of the fund, such as leverage, concentration of holdings across geography, credit quality or sector.

The proposed methodology is both prudent and risk-sensitive because each underlying holding would receive either an appropriate risk weight based on its reference information or the most conservative FBA risk weight. This also improves the recognition of diversification between a fund and a portfolio of single-name equity or bond positions (or among funds with similar underlying holdings).

The partial LTA would be applied to well-diversified, unleveraged funds that fall under existing regulatory requirements – for example, the EU UCITS Directive[13], the US 1940 Investment Company Act[14] and equivalent standards in other jurisdictions. As a result, mutual funds and ETFs with the relevant regulatory oversight would be covered, and more exotic leveraged/hedge funds and inverse ETFs would be excluded.

Allowing for partial LTA instead of full LTA would also help incentivize the adoption of the FRTB-IMA by banking organizations.

This proposal would entail minimal changes to the existing rule text. It could be achieved by introducing a qualifier to the current text to incorporate the materiality clause and any relevant paragraphs outlining the metrics and measures for materiality. In jurisdictions where the rule text explicitly prohibits the use of more than one approach for a single fund – for example, under the EU CRR – this clause would also have to be amended.

FRTB-SA

Enhance MBA by Adopting New EIIF Buckets[15]

While the idea behind the MBA is fundamentally sound, there are practical difficulties in using fund mandates to derive risk weights. An improved and more transparent version of this approach would involve prescribing a limited number of fund buckets specifically for EIIFs, along with corresponding risk weights. By specifying the risk weights and the criteria for allocating EIIFs to appropriate buckets, the rules would be more practical to implement, while still allowing regulators to maintain control over risk weight calibration. This proposal would serve as a credible alternative to the LTA, offering a more capital intensive but less operationally demanding option. The approach would consider whether the fund qualifies as well diversified, the main investment strategy employed and any relevant information on the fund's actual holdings that would inform the allocation to the appropriate buckets.

The appropriate buckets for each EIIF would differ based on whether it is a credit or equity fund. For credit buckets, classifications would be determined by fund type (ie, sovereign and corporate), credit quality (ie, investment grade and high yield) and weighted duration of fund holdings based on a standardized scale (ie, under one year, between one year and five years, between five years and 10 years and over 10 years). Equity risk weights would be determined based on fund type (ie, large cap and liquid and other). The selection of the appropriate fund bucket could be guided by a fund's prospectus or mandate. For example, if a mutual fund's prospectus indicates it will primarily invest in US large-cap equity securities, then that mutual fund should be assigned to the 'large cap and liquid economy funds' bucket for capitalization purposes.

[13] European Parliament and the Council of the European Union, *European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations* (2003)

[14] Investment Company Act 1940, www.govinfo.gov/content/pkg/COMPS-1879/pdf/COMPS-1879.pdf

[15] ISDA and SIFMA, *Basel III Endgame Addendum Comment Letter* (2024), www.isda.org/a/q8wgE/ISDA-SIFMA-Basel-III-Endgame-Comment-Letter-Addendum.pdf

The risk weights for these fund buckets could be calibrated by calculating capital based on the LTA for a set of representative ETFs[16] where a full LTA is possible and reflective of the relevant asset class buckets. From this, a base effective fund risk weight can be derived at the ETF level, ensuring it infers the same level of capital. A scaling factor would then be applied to this base effective risk weight to generate the full set of risk weights. For equity funds, this approach would likely yield risk weights similar to those currently specified within the existing equity index buckets (ie, 15%-25%).

For fixed income, the risk weights derived using this methodology would generally be much lower than the prescribed 70% FBA risk weight across all jurisdictions. The 70% risk weight is commensurate with the economic risk of speculative and sub-speculative non-sovereign funds with a duration of 20 years, which is rarely encountered in practice, as speculative grade debt typically has much shorter durations (eg, the iShares iBoxx Dollar High Yield Corporate Bond ETF has a duration of 3.55 years). However, the 70% risk weight is proposed for high-yield non-sovereign debt funds with a duration exceeding 10 years for the sake of completeness.

Aggregation within and across buckets for a given asset class would adhere to the principles already defined under the FRTB-SA rules. There would be no recognition of diversification benefits between fixed income and equity fund buckets or across other risk classes. Capital requirements for both fixed income funds and equity funds under this approach would be calculated separately.

Other approaches for calibrating new EIIF buckets and associated risk weights could be explored, as these do not need to be mutually exclusive from the approach outlined above. For example, a simpler implementation could leverage existing single-name equity risk weights, which range from 30% to 50% for large market cap/advanced economies and 45% to 70% for small market cap/developing economies. This would better reflect the diversification across constituents within an EIIF, as opposed to the current approach that assumes zero correlation. Another consideration for determining buckets could involve distinguishing between different types of EIIFs. In the EU, for example, a proposal specific to UCITS funds could use the existing synthetic risk and reward indicators that are mandated as part of the key investor document to determine buckets and the appropriate risk weights.

Treat Qualifying EIIFs Equivalently to Existing Index Rules

The recommendation for an additional set of buckets for EIIFs is universal and comprehensive in its application across fund types and is one of the industry's main recommendations on EIIFs. Another recommendation would apply to a narrow set of EIIFs that exhibit characteristics similar to index-like instruments. While this segment may not constitute a large part of the market, it could be significant for a banking organization based on their specific holdings.

For these EIIFs, it is recommended that criteria are prescribed that would result in own-funds requirements (OFR) calculated in a manner equivalent to index instruments under the FRTB. This would not only align EIIF capital more closely with how banks manage risk and report profit and loss but would also significantly reduce the computational effort and data sourcing required to apply a full LTA. This approach would allow a banking organization to compute a single sensitivity for a position in an EIIF when calculating the OFR for delta and curvature risks. If at least 75% of the EIIF constituents fall within a single bucket, the total EIIF exposure could be treated as a single-name sensitivity. Otherwise, an EIIF bucket could be applied.

[16] A few representative ticker symbols include LQD, HYG, SHY, EMB and MHB

New EIIF criteria would be like those in existing index rules, such as Article 325i (2) and (3) of the EU CRR, but would consider the following properties of the fund:

- The banking organization can look through all constituents of the fund, with their respective weightings known.
- There must be a minimum number of constituents.
- There should be percentage limits on any single constituent of the fund or a minimum number of constituents as a percentage of the whole fund.
- There must be a minimum size for the fund.

All these elements would need to be met for a fund to qualify for this approach.

The industry has also identified new issues that have emerged during the finalization of the FRTB rules for funds in the EU and UK, which regulators should consider when implementing changes.

Clarify Vega Treatment for EIIFs

When the LTA criteria (either full or partial) are satisfied for delta and curvature, it is recommended that firms calculating a single sensitivity for the multi-underlying option vega (including options on funds) should capitalize the option vega within one of the sector-specific buckets if more than 75% of the constituents in the fund or multi-underlying instrument correspond to a single specific sector equity bucket. In other cases, the sensitivity may be mapped to an equity index bucket. This approach will allow diversification with other vega risks in the same bucket, therefore recognizing the hedging benefits of these instruments.

This recommendation could be incorporated into the EU CRR via the following amendment (bold & underlined) to Article 325j (1) (a) of CRR3:

1. An institution shall calculate the own funds requirements (OFR) for market risk of a position in a EIIF using one of the following approaches:

   a) An institution that meets the condition set out in Article 104 (8), point (a), shall calculate the own funds requirements for market risk of that position by looking through the underlying positions of the EIIF as if those positions were directly held by the institution; <u>**for the purpose of the calculation referred to in Article 325e (1) (b) for instruments with optionality on a EIIF, the institution may apply Article 325i (1) (c).**</u>

Consistent EIIF Holdings Data Frequency Across Major Jurisdictions

To promote consistency in data frequency requirements across jurisdictions, it is recommended that quarterly access to the underlying constituents offers the appropriate flexibility. This frequency aligns with the UK PS17/23 and is also reflected in the US NPR. It also corresponds to the external FRTB reporting frequency established by major jurisdictions. Adopting this quarterly frequency in other jurisdictions, including the EU, would help ensure a level playing across all regions.

Remove Additional Conservative Standalone Aggregation for the FBA

Under the FBA, the risk associated with an EIIF is bucketed in the 'other' bucket, which incurs the most conservative risk weight of 70%. Risk factor aggregation is performed by simply summing the absolute weighted sensitivities for each risk factor, with inter-bucket and intra-bucket correlations set to zero for exposures in the 'other' bucket. This approach is extremely conservative, as it fails to recognize any diversification among the constituents of the fund, a scenario that is unlikely for many funds.

In some jurisdictions, published rules add an extra layer of conservativeness when aggregating the risks of the portfolio and FBA EIIFs, either explicitly in the rulebook (ie, Article 325j.1a.b of the EU CRR) or implied by the policy statement (ie, UK PS17/23: 3.22). This additional conservativeness arises from a standalone aggregation treatment that simply adds the FBA capital requirement of each EIIF to the portfolio's OFR, effectively decoupling the EIIFs under the FBA from the rest of the risk-class-specific OFR for delta/vega:

$$\sqrt{\sum_b K_b^2 + \sum_b \sum_{c \neq b} \gamma_{bc} S_b S_c} + \sum_{b=FBA} K_b.$$

This additional layer of conservativeness could lead to an increase of approximately 35% in required capital. It is therefore recommended that the standalone aggregation requirement be removed, as the existing conservative approach of applying a high risk weight and zero correlation for the 'other' bucket should be sufficient to ensure safety and soundness without the need for separate aggregation. Standalone aggregation is not prescribed in the Basel rules, nor was it included in the US NPR proposal.

EPA – Level Playing Field Between UK & EU

The industry welcomes the introduction of the EPA by the EBA and UK Prudential Regulation Authority (PRA), as it provides banks with the flexibility to use third parties for calculating the capital charges of EIIFs using the LTA. However, third/external parties in practice face the same data constraints as banking organizations and there is currently no single third-party solution that banking organizations can effectively utilize. The scope of the EPA also differs between the EU and UK.

In the EU, banks can fully leverage the EPA by using all the look-through information provided by third parties to aggregate it with the rest portfolio, as if they had directly implemented the LTA. In contrast, the PRA requires third parties to provide a single risk weight per EIIF, which banks must use to calculate capital on a standalone basis. As a result, the diversification benefits of the EIIF under the PRA approach are effectively lost, as banks must simply add each EIIF to the overall portfolio.

The same EIIF will therefore incur significantly higher capital charges in the UK compared to the EU. Given the equivalent third-/external-party requirements in both jurisdictions, the industry recommends that the full benefits of the EPA should be permitted by using a full LTA.

CONTACTS

Panayiotis Dionysopoulos
Head of Capital
International Swaps and Derivatives Association, Inc. (ISDA)
25 Copthall Avenue, 3rd floor,
London EC2R 7BP
Tel: +44 (0)20 3808 9700
pdionysopoulos@isda.org

Gregg Jones
Senior Director, Risk and Capital
International Swaps and Derivatives Association, Inc. (ISDA)
25 Copthall Avenue, 3rd floor,
London EC2R 7BP
Tel: +44 (0)20 3808 9700
gjones@isda

ABOUT ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 1,000 member institutions from 76 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.
Follow us on LinkedIn and YouTube.