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Trading Book Capital
Basel III Implementation and Latest Industry Trends
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Welcoming Remarks
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Good afternoon and thank you for joining us for this trading book capital event. Thank you to all our speakers, and special thanks to EY for sponsoring.

It's been just over a year since we last held this event in New York, in December 2023. At that time, like many other organizations, ISDA was in the final stages of developing our response to the Basel III 'endgame' proposal, which we submitted in January 2024. A year on, we've seen Basel III catapulted to prime time – from National Football League games to the State of the Union address – but we don't yet have a final set of rules.

I'll address two key issues in these remarks. First, I'll explain why the Basel III endgame proposals must be redrafted to improve risk sensitivity and avoid disproportionate increases in costs. Second, I'll highlight the impact the proposed rules would have on market functioning and liquidity.

The new administration in the US and a changing of the guard at many of the regulatory agencies presents an ideal opportunity to review the capital framework to ensure it is appropriately calibrated. In doing so, Basel III should not be considered in isolation – it is imperative that policymakers think about the interplay with existing and forthcoming market reforms, including US Treasury clearing. Based on rigorous analysis, we believe the Basel III endgame package is inappropriately calibrated. This will constrain the capacity of banks to offer intermediary services, including client clearing, and negatively impact market liquidity.

The stakes couldn't be higher – for the preservation of deep and liquid markets, we need a risk-appropriate and robust capital framework. Just think about the consequences of disproportionate capital requirements. This would result in capital increases of a magnitude that would drive banks to make difficult choices about their participation in certain critical business lines.

For hundreds of thousands of companies that rely on banks for intermediation and risk management services to raise financing for growth and investment, the consequences would be severe: diminished access to funding; lack of hedging solutions; increased vulnerability to external shocks. Poorly calibrated capital rules are damaging to market liquidity and will compromise economic activity.

As proposed, the Basel III endgame and the capital surcharge for global systemically important banks would place excessive capital requirements on client clearing, at a time when policymakers are seeking to extend mandatory clearing to the US Treasury market. I'll talk later in these remarks about the need to reverse this mistake in the proposed rules. We must also ensure the US Treasury market remains deep and liquid. To achieve this, changes must be made to the supplementary leverage ratio, and the capital framework must be adjusted to recognize the benefits of cross-product netting.

We simply have to get this right; however hard it seems and however long it takes.

Basel III

I'll start with Basel III.

When ISDA responded to US agencies last year, we presented the results of our industry impact study and used that data as the basis to recommend a number of specific calibration changes to improve risk sensitivity and avoid inflicting a negative impact on the liquidity and vibrancy of US capital markets. We stand by all those recommendations, which include greater recognition of diversification in the market risk framework to reflect actual risk exposure and changes to certain aspects of the rules for securities financing transactions.

ISDA also proposed changes to the credit valuation adjustment (CVA) risk framework, including an exemption for the client clearing leg of a cleared derivatives transaction from CVA capital requirements. We think this is a necessary change that would avoid inflicting additional costs on client clearing businesses.

One of the defining features of the new framework is a more stringent testing and approval process for banks that want to use internal models. It was always likely that this would drive a decline in the use of internal models, but it now appears that drop will be sharper than anticipated. Last year, ISDA conducted a study that found only 10 out of 26 global banks plan to use internal models for a significantly reduced scope of trading desks under the FRTB market risk framework. That's a big change that would mean less alignment between risk and capital and less diversity in models and behavior.

While the new standardized approaches will be more sensitive to risk than in the past, the reliance on a one-size-fits-all model will be a major shift that could lead to herd behavior and drive concentrations in particular assets. Given the increasing investment in private markets, the need to retain more risk-sensitive internal models is particularly important.

ISDA has recommended changes to improve the incentives for the use of internal models, which would include recalibration of certain key elements of the new market risk framework, such as the profit-and-loss attribution test, the risk factor eligibility test and non-modellable risk factors. We believe the expected drop in the use of internal models is a serious issue and urge policymakers to consider how this might be avoided.

With a new administration now in place in the US, it's time to take a fresh look at the calibration issues in the Basel III endgame. This must be a priority if we are to maintain deep and liquid markets and preserve the vital lifeline they provide to the real economy.

We must get this right.

Clearing

As I mentioned at the start of these remarks, the Basel III endgame rules would have a significant impact on market functioning and liquidity. This includes the provision and expansion of clearing.

There's one particular number that we at ISDA have cited repeatedly over the past year – 80%. That's the expected increase in capital for client clearing businesses due to the proposed Basel III rules and the capital surcharge for global systemically important banks (G-SIBs). Based on a quantitative impact study, we found the combined effect of the two proposals would increase capital by $7.2 billion for US G-SIB client clearing businesses, which is equivalent to more than 80%. This is completely at odds with the post-financial crisis policy objective to promote central clearing. As such, it could negatively impact market stability.

To fix this issue, policymakers must address both flaws – the inclusion of the client-facing leg of a cleared derivatives transaction in the Basel III CVA framework and the proposed modifications to the complexity and interconnectedness categories of the G-SIB surcharge to include client derivatives cleared under the agency model. We will continue to bang this drum, with the aim of preserving the capacity of banks to offer vital client clearing services.

This brings me to the Securities and Exchange Commission's (SEC) US Treasury market reforms, which will include mandatory clearing of certain cash Treasury securities from the end of this year, with repos following in mid-2026. Leveraging our long-running experience in clearing derivatives, ISDA has been working with market participants and policymakers to lay the groundwork for Treasury clearing. But it's also critical that the US prudential framework is calibrated to support the introduction of Treasury clearing.

Again, the capital framework imposes a tax on a low-risk, low-margin business that will affect the ability of US banks to offer client clearing services and support the systemically important US Treasury market.

As it stands, the proposed US capital framework doesn't recognize cross-product netting for transactions based on US Treasury securities and interest rate futures. Services like these allow firms to obtain initial margin efficiencies from offsetting trades in a portfolio of transactions, but there are no commensurate benefits from a capital perspective under the standardized approach for counterparty credit risk. As more Treasury securities and repos are cleared under the SEC rules, the lack of recognition of cross-product netting will constrain bank balance sheets and limit their ability to offer client clearing.

ISDA has been exploring this issue in partnership with FIA and we will continue to emphasize the need for improved recognition of cross-product netting in the US capital framework. The implementation of Treasury clearing will be a huge change in a systemically important market that keeps the wheels of global finance turning. It is absolutely essential that prudential rules are adjusted where necessary to ensure there is sufficient capacity to support that change.

To maintain deep and liquid markets, we must get this right.

Leverage ratio

Before finishing I'll touch on the supplementary leverage ratio (SLR).

In recent years, policymakers have shone a light on a series of market stress events that have tested the stability of financial markets, starting with the dash for cash at the start of the COVID pandemic in March 2020. That episode highlighted the vulnerability of the US Treasury market to liquidity shocks during periods of stress, which in turn provided impetus for the SEC reforms.

The problem is that the SLR is inconsistent with the objective to improve the efficiency and resilience of the Treasury market. It acts as a non-risk-sensitive binding constraint on banks that can impede their ability to act as intermediaries, including their capacity to offer client clearing. In April 2020, with financial markets in turmoil, the US Federal Reserve took steps to address this issue by temporarily excluding US Treasury securities from the SLR calculation.

Last year, ISDA wrote to US prudential regulators to request that the exemption should be reintroduced on a permanent basis. We believe this would improve banks' capacity to expand their balance sheets and provide liquidity, enhancing the stability and resilience of the US Treasury market. There are also other ways in which the SLR could be adjusted to avoid negative repercussions for the Treasury market, which is why we would welcome an industry consultation to determine the best way forward. Given the expected increase in the size of the market and the important role banks play, we cannot afford to wait until the next shock to address this issue.

To maintain deep and liquid markets, we must get this right.

Conclusion

I've talked in these remarks about a range of policy issues that could easily be considered in isolation. But to do so would be to ignore the interconnectedness between the prudential and market regulatory frameworks.

It's a time of change in the US. We have a new administration and new faces at the top of many of the key agencies. When it comes to Basel III and its intersection with clearing, we need to take stock of where we are and where we need to go. ISDA has set out the key fault lines we believe should be addressed, and we look forward to working with policymakers to achieve positive outcomes in the months ahead.

Thank you.