Trading Book Capital: Policy Challenges for the EU 2024-2029 Mandate
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Welcoming Remarks
Scott O'Malia
ISDA Chief Executive Officer

Good morning and welcome to ISDA's trading book capital event. It's great to be here in Brussels and to have the opportunity to engage with policymakers and market participants on this critical topic.

As I prepared these remarks, I was reminded of a similar event we held here five years ago, in early March 2020. Like today, the topic was the completion of the Basel III framework, and we'd come up with a catchy tagline: 'EU Banking Reforms: Crossing the t's and dotting the i's'. The Basel Committee had finalized the new market risk capital rules a year earlier, and the European Commission (EC) was planning to publish its legislative proposals later in 2020. Finishing touches seemed an appropriate mantra.

Little did we know that a global pandemic was just a few weeks away, or that it would be another 18 months before the EC proposals would be published in late 2021. Five years on, the global picture is one of fragmentation, with implementation proceeding on very different timescales around the world. The UK has delayed the rules until the start of 2027, and the US rules are still to be finalized. Here in the EU, Basel III came into effect at the start of this year, with the exception of the Fundamental Review of the Trading Book (FRTB). Yesterday, the EC launched a consultation on a set of possible amendments to the framework.

It's fair to say that crossing the t's and dotting the i's remains a work in progress.

Despite the delays, some things haven't changed. As in 2020, ISDA continues to make the case for a robust and risk-appropriate capital framework to maintain deep and liquid markets. All over the world, companies rely on banks for intermediation and risk management services to raise financing for growth and investment. If capital requirements are too high, this can have serious consequences – reduced access to funding, a lack of hedging solutions and increased vulnerability to external shocks. It's also important that the rules are as consistent as possible across borders. A lack of alignment creates additional complexity for globally active banks, making it more difficult for them to efficiently manage their risk and service their clients.

So, when it comes to trading book capital, the stakes are high and we have to get it right, however long it takes. I'll talk in these remarks about the impact of the changes being considered in the EU, and why we need deep and liquid derivatives markets.

Basel III

As it stands, the FRTB market risk framework is due to be implemented in the EU at the start of next year under the third Capital Requirements Regulation. But with ongoing uncertainty over implementation in the UK and the US, the EC has the opportunity to revise the framework, with a possible delay and certain targeted revisions.

The EC is seeking industry feedback on three possible options – implementing the FRTB as planned from the start of next year, delaying by one year until the start of 2027, or applying a set of targeted amendments for a three-year period.

The EC is consulting on 10 possible changes that could be made to the internal models approach and the standardized approach. Although they are designed to be temporary, many of these changes address issues that ISDA has long advocated to resolve. These adjustments would improve the risk sensitivity of the framework and result in more appropriate capital requirements. Time does not permit me to address all 10 proposed changes, but I'll pick out a few that we see as particularly positive.

First, the EC has proposed that the profit-and-loss attribution test under the internal models approach could be used as a monitoring tool until the start of 2029. ISDA has previously highlighted the significant challenges posed by this test and the instability of the resulting capital requirements. The proposed reprieve would be a very welcome change, allowing data to be collected initially so the impact can be carefully monitored over time.

Second, the EC has recognized the punitive impact of the additional capital charge for non-modellable risk factors (NMRFs) and proposed the application of a discount factor over a three-year period. Further analysis will be needed to determine if the discount is appropriately calibrated or whether alternative solutions are warranted, but we are pleased that this component of the FRTB is being reviewed. The discount would reduce the capital impact of NMRFs in the first phase of implementation.

Third, ISDA has long advocated for the treatment of highly rated sovereigns under the default risk charge to be revisited. We welcome the proposal to assign a 0% risk weight under both the standardized and internal models approaches, subject to supervisory approval. This would remove the disproportionate treatment of sovereigns when using internal models and reduce one of the impediments for banks to use their own models for market risk capital.

The proposed amendments also include improved recognition of diversification in the standardized approach and a more pragmatic approach to the capitalization of equity investments in funds, an issue ISDA has worked with members to address for some time

ISDA appreciates the EC's willingness to revisit this important rulebook, and we believe these amendments would lead to a more appropriate, risk-sensitive framework. We will work closely with our members to thoroughly analyze the proposals and develop a response to the consultation.

Value of Derivatives

I mentioned earlier that a risk-appropriate capital framework is a necessary ingredient for deep and liquid derivatives markets. Before wrapping up, I'd like to briefly explain why this is so important.

Companies around the world rely on derivatives to transfer risk, enhance returns and manage their liquidity. To mark ISDA's 40th anniversary, we published a report last week that explores how and why derivatives are used and the impact they have on company value and economic growth.

The report reviewed nearly 1,200 companies in seven major stocks indices and found that 87% use over-the-counter derivatives. These include blue-chip multinationals, agricultural companies, asset managers, pension funds, insurance companies and banks. For all those entities, derivatives create value by enhancing stability and certainty, and protecting against losses. This enables companies to plan for the future and make strategic investments, leading to business expansion and economic growth.

By presenting quantitative evidence of the value of derivatives, the report makes for a very interesting read. For example, a study of nearly 7,000 firms in 47 countries found companies using derivatives had lower cashflow volatility, reduced financing costs, higher returns and greater investment capacity.

It's critical that companies can continue to access derivatives markets with as little friction as possible. That's why ISDA is maintaining its laser focus on the development of an appropriate FRTB framework that supports deep, liquid markets.

Thank you.