Dear Chairman Ingves and Chairman Draghi,

RE: Importance of assessing the impact of the design and calibration of the FRTB in advance of finalizing the framework

We, the undersigned organizations, support the intent of global policymakers to develop a regulatory framework that improves the safety and resilience of global financial markets. Toward that end, we and our members have worked constructively with policymakers to help drive real progress in a number of important prudential policy areas.

One of those areas is the Basel Committee’s Fundamental Review of the Trading Book (FRTB). We have worked closely with policymakers throughout this process and committed substantial resources to this effort. We very much value the level of engagement between the industry and the BCBS’s Trading Book Group (TBG) that has significantly improved the current proposed framework.

Nevertheless, we are extremely concerned that several key areas of the proposed FRTB framework – which have not been adequately assessed – will result in severe and disproportionate impacts on the capital levels for certain products and markets. One consequence of that is a heightened risk of jurisdictions transposing the FRTB differently to compensate for the significant adverse impacts on local markets. Such an outcome would undermine the specific objectives of the Basel Committee to ensure a globally consistent and coherent capital framework.

It is important to underscore that the adequacy of market risk capital levels (i.e. multi-fold increases) has been addressed by Basel 2.5, further supplemented by higher minimum capital ratios and better quality capital in Basel III. While we acknowledge that the FRTB is intended to address structural shortcomings in Basel 2.5, including the development of a risk-sensitive standardised approach and factoring in market liquidity – objectives our organizations and members support – we believe several key aspects of the FRTB proposed rules will have significant negative consequences:

1 The capital charge on traded market risk tripled as at the end of 2011 based on a sample of 11 large international European banks, according to analysis from Standard and Poors Rating Services. http://www.standardandpoors.com/ratings/articles/en/us/?articleType=HTML&assetID=1245334380388
2 Basel III monitoring exercise as at 31 December 2011 estimated the impact of Basel 2.5 on the 101 largest banks in their study (Group 1 banks defined as banks with Tier 1 capital in excess of €3 billion and which are internationally active) to be an increase of 4.9% in total risk weighted assets (RWA). This compares to an overall increase in RWA of the various Basel regulatory changes (Basel 2.5 and III) of 18.1%.
As proposed, the FRTB’s final rules may undermine the fundamental policy goal of an appropriate capital framework and have disproportionate impact on certain products and markets. While the overall capital impact of the FRTB is not yet clear, our analysis suggests that the FRTB framework will result in punitive capital increases for certain business lines. Some of the most affected products are those with the greatest significance for the wider economy, such as bond markets, SME credit, securitisations, small cap equities, and commodities and foreign exchange hedges. Impacts from the FRTB on these products will have an adverse impact particularly on emerging markets. Additionally, such costs will also impact the end users of capital markets in jurisdictions where the local banking sector is not the main source of capital markets services.

Higher trading book capital requirements in these markets will further increase issuance costs and will negatively impact secondary market liquidity that is already subdued due to the impact of other regulatory initiatives. Given such an environment, investor participation in certain markets is likely to fall further thereby negatively impacting on their depth and efficiency. Such loss of efficiency and increased costs might also be expected to discourage some market participants from hedging their risks raising the prospect of increased market volatility and significant financial instability. Moreover, a reduction in liquidity means that issuers will face higher financing costs, as investors demand higher liquidity premiums. In particular, costs faced by corporates and sovereigns are likely to increase significantly as a result of higher capital requirements faced by banks given the current calibration of liquidity horizons.

The FRTB framework may conflict with other public policy initiatives, including those that support economic growth. In addition to reforms that strengthen the resiliency and safety of financial markets, policymakers are also focused on initiatives to generate and sustain global economic growth. High-quality and well-functioning securitisation markets, as well as the development of deeper capital markets for European SMEs, are considered to be an important element underlying that growth; this is evidenced in such proposals as the European Capital Markets Union, and the development of bond markets in Asia, which both aim to develop and diversify the supply of funding, particularly for companies that rely solely on credit extension by banks.

As a result of these issues, we believe it is crucial that key components of the FRTB framework are fully assessed. We therefore respectfully urge the BCBS to reconsider the timeline for finalizing the framework in order to reassess its key components through further impact analysis including at least one holistic granular QIS exercise. This would not necessarily extend the overall timeline and, on the contrary, it may even reduce the time spent implementing the rules locally. While Basel 2.5 satisfied the immediate crisis reform objective of increasing market risk capital levels, the objectives of the FRTB is to further improve the framework and to provide supervisors with a toolkit to better manage banks’ trading activities. If these objectives are to be met without significant distortions to the functioning of capital markets it is crucial that adequate time is taken to design robust and coherent rules.
These and related issues are explained in more detail in the attached presentation, and we request a meeting with you at your earliest convenience to discuss them in more detail.

Sincerely,

Scott O’Malia
CEO
ISDA

Kenneth E. Bentsen, Jr
CEO
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Timothy D. Adams
President & CEO
IIF

CC: Members of the Group of Governors and Heads of Supervision
Members of the Basel Committee on Banking Supervision
Mr. William Coen, Secretary General, Basel Committee on Banking Supervision