30 October 2015

Mr. Mario Draghi, President of the European Central Bank
Chairman, Group of Governors and Heads of Supervision (GHOS)

Mr. Stefan Ingves, Governor of Sveriges Riksbank
Chairman, Basel Committee on Banking Supervision (BCBS)

Bank for International Settlements,
Centralbahnplatz 2, CH-4002, Basel, Switzerland

RE: Finalizing the Fundamental Review of the Trading Book Framework

Dear Chairman Ingves and Chairman Draghi:

On behalf of the Global Financial Markets Association (GFMA), The International Swaps and Derivatives Association (ISDA), and the Institute of International Finance (IIF), we are writing to highlight key areas of the Fundamental Review of the Trading Book (FRTB) framework that require further consideration in order to ensure a balanced and more robust market risk capital framework and prevent negative impacts on the market broader economy. We urge the Basel Committee on Banking Supervision (BCBS) to continue to devote resources to the calibration of the framework, even after the planned finalisation at year end, through the use of a monitoring period. We respectfully request that this letter is distributed to GHOS and BCBS members.

The industry greatly appreciates the work undertaken by the BCBS Trading Book Group's (TBG) this year to advance the proposed FRTB framework. We also commend the efforts to find solutions for issues that have been identified in the previous Quantitative Impact Study (QIS), and we remain committed to assisting policymakers in the resolution of these outstanding items.

Given the compressed timeframe to finalise the proposed framework before year-end we are concerned that if the most impactful remaining issues are not adequately addressed, particularly those that either are risk insensitive or significantly overstate risk, the FRTB will have profound negative impacts on the market and broader economy. Moreover, the quantum of capital suggested by the FRTB is well beyond the recently implemented and heightened levels mandated by Basel III and other measures aimed at ensuring capital adequacy. We therefore believe that the proposals require further work and analysis.

Key findings of the industry run QIS

In order to help the TBG in its deliberations, the industry produced an analysis run by the Global Association of Risk Professionals (GARP). The analysis is based on firm's actual QIS submissions to the Basel Committee and covers the QIS returns for 28 global and regional banks (based on June 2015 data). The submissions were aggregated to generate comparative metrics for a single "aggregate bank". We have shared the results with the TBG and the wider regulatory community. Based on feedback received, we understand that the numbers the industry presented are substantially different in certain areas to those calculated by the TBG. The difference between the results is likely to be due to the TBG analysis' focus on impacts to the "median bank", while the industry QIS analysis assesses the impact on an "aggregate bank". We believe that a "median bank" in a sample of over 40 banks is not representative of a global market making bank, and thus does not adequately represent the industry-wide impacts of the FRTB proposal.

Non risk sensitive measures will drive the capital outcomes
Based on the industry QIS results, it is concerning that the capital outcomes for both the Internal Models Approach (IMA) and the Standardised Approach (SA) are largely driven by non-risk sensitive measures, namely the IMA's Non Modellable Risk Factors (NMRFs) and the SA's Residual Risk Add-on (RRA). The RRA accounts for 47% of total market risk capital under the SA, and NMRFs account for 29% of the IMA capital charge for market risk. The scope and methodology for calculating these add-on charges discourages the critical function of prudent market risk hedging.

The SA will not be a credible fall-back to the IMA, unless the calibration is improved
The industry QIS analysis also shows that without significant adjustment to the calibration of the framework, the SA will not serve as a credible fall-back to the IMA by ensuring that there is an alternative to non performing internal models. While the TBG's stated regulatory objective is to have a sufficiently risk-sensitive standardised approach that can be "turned on" when internal models fail, this objective may not be achieved due to the significant gap (2.1 – 4.6 times, depending on risk factor class) between the SA and IMA results.

In addition, given that there is another Basel work stream to create a capital floor based on standardised approaches to risk-weighted asset calculations, the gap may lead to a substantial increase in overall capital requirements. This would fundamentally alter the market making capacity of regulated entities, resulting in significant changes in market structures and secondary market liquidity.

Capital charges on sovereign bonds and equities are inconsistent with the underlying risk
As shown in the industry QIS analysis, key drivers of the higher capital requirements under the IMA and SA are the treatment of sovereign bonds and equities:

- SA: The capital requirements for investment grade sovereign bonds are unduly high. For example, a 30-year US Treasury bond, a Japanese Government Bond, and a German Bund incur 64%, 70% and 98% capital charges respectively (see Annex 1 for a broader list of sovereigns). Furthermore, the capital requirement goes up materially if a sovereign is downgraded. Such outcomes will unnecessarily increase capital requirements against sovereigns and exacerbate pro-cyclical trading and selling off of downgraded sovereign bonds during economic downturns. In this context, we understand that the recent downgrade of Brazil is not captured in the Basel QIS results.
- IMA: The conservative calibration of the default risk charge, resulting in 2.3x the current equivalent (IRC), has a significant impact on the capital required for sovereign debt trading.
- Equities: The SA does not fully recognise hedging and leads to capital charges 4.6 times higher than results under the IMA. This outcome results in a substantial disconnect between economic risk and regulatory capital, and can create perverse risk management incentives as common market risk hedges such as options, futures and forwards are not recognised.

Securitized products are treated punitively under the framework
The industry analysis shows a significant impact on securitisation, a 2.2x increase in capital due mainly to the double count between the credit spread and default risk charges, as well as to the severe credit spread shocks. In many cases, the amount of capital exceeds the maximum potential loss, even for relatively senior tranches. We propose that capital levels should be more accurately calibrated in order to (i) appropriately represent the risk of the exposure, and (ii) make capital markets intermediation in these instruments economic. Failure to do this would run counter to the well understood policy objectives to revive this key financing product.

Impact on emerging market assets needs further review
The industry analysis also finds that the FRTB's impacts on emerging markets need further consideration as many banks that are active in these markets have not participated in the Basel QIS studies. The initial analysis indicates that emerging market sovereign debt issues will be broadly impacted across different maturities. Furthermore, many emerging market regulators have not fully participated in this effort as their regulated firms do not have significant trading book exposures. However, international banks impacted by the FRTB provide market making support for these emerging market economies. Activity and market liquidity in emerging market securities may be substantially hampered if potential negative impacts are not fully understood.

Calibration of the profit and loss (P&L) attribution test needs more time
Based on a survey conducted across the participating banks in the industry QIS analysis, only a limited number of banks have been able to contribute data to the Basel Committee for the P&L attribution test. Therefore the impacts of the test to internal model validation are unknown at this stage and further analysis is required to ensure proper calibration of the framework.

Conclusion
Although significant progress has been made in addressing many issues with the proposed FRTB framework, there are still major components of the framework that could create perverse incentives in instances where the risk of positions and their hedges are not adequately recognised. The material loss of risk sensitivity and resulting substantial increase in capital requirements could result in significant changes in market intermediation, and in particular banks' ability to provide primary and secondary market liquidity – specifically in sovereign, equity, securitised products and emerging markets.

Moreover, the FRTB as currently framed could have a harmful impact on the European Capital Markets Union, EU securitisations project, Asian capital markets development initiatives and banks' role as intermediaries more generally. Indeed, a number of banks are already withdrawing from certain business lines – even before the FRTB proposals have been finalised.

On all these issues raised, we have been in dialogue with the TBG and have proposed technical solutions or alternatives that we believe preserve the prudential goals that the proposed rules aim to achieve. We appreciate the need to complete the FRTB rulemaking process, but believe it is crucial that the aforementioned outstanding issues are addressed prior to finalization where possible. Similar to the implementation of other Basel standards, we strongly believe that it is essential that the Basel Committee continue to devote resources to the calibration of the framework, even after the planned finalization at year end, through a formal monitoring period that monitors the key areas referred to above, or issues that may arise through further study.

Sincerely,

Kenneth E. Bentsen, Jr.	Scott O'Malia	Timothy D. Adams
CEO	CEO	CEO
Global Financial Markets Association	International Swaps and Derivatives Association, Inc.	Institute of International Finance

Annex 1: SBA capital requirements/notional value for major sovereign debt securities across different maturities

Capital	2Y	3Y	5Y	10Y	15Y	20Y	30Y
USA	6%	10%	15%	28%	50%	60%	64%
UK	6%	9%	15%	29%	49%	58%	74%
Indonesia	18%	24%	49%	76%	91%	98%	106%
India	5%	8%	14%	24%	30%		41%
Japan	7%	10%	16%	31%	51%	54%	70%
Mexico	6%	11%	18%	29%	36%	42%	48%
Singapore	7%		16%	30%	44%	53%	67%
Korea	8%	9%	16%	31%		59%	81%
China	6%	10%	16%	30%			
Hong Kong	7%	11%	17%	33%	45%		
France	7%	10%	16%	31%	46%	72%	90%
Germany	6%	10%	16%	32%	61%	74%	98%
Brazil			44%	47%	51%		
Canada	7%	9%	15%	30%		70%	82%
Sweden	6%		19%	33%		51%	
Turkey	6%	9%	13%	20%			
South Africa	6%	9%	14%	25%	24%	24%	32%