ISDA® Safe, Efficient Markets

afme/ Finance for Europe

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To:
[redacted], DG FISMA, European Commission
[redacted], European Central Bank
[redacted] European Banking Authority,
[redacted] Prudential Regulation Authority

Cc:
[redacted] DG FISMA, European Commission

Dear [redacted]

Re Trading Book Capital Covid-19 Issues

Given the rapid escalation of the COVID-19 pandemic and the severe market volatility it has caused, the International Swaps and Derivatives Association (ISDA), the Association for Financial Markets in Europe (AFME) and our members would like to highlight some specific issues that require timely action to ensure banks can focus on immediate critical priorities, such as business continuity, managing risk and supporting the real economy.

We greatly appreciate the swift and decisive action taken by regulatory authorities so far in response to the pandemic. However, we believe additional, specific measures are needed relating to value-at-risk (VaR) backtesting exemptions and supervisory reporting under the Fundamental Review of the Trading Book (FRTB) to ensure banks have the capacity to respond to the crisis.

We believe action on these points will help to further free up scarce resources at a time when many banks have implemented remote working and contingency plans. It will also help to maintain financial stability and ensure banks can continue to serve their customers.

In this letter, we have identified a number of key issues and set out recommendations. Some of these issues have already been addressed by other jurisdictions, so we would urge you to take swift action to ensure European financial institutions are best positioned to continue serving their clients.

Current Trading Book Capital Framework

<u>VaR, Stressed VaR and the Backtesting Multiplier</u>

The rapid spread of the coronavirus outbreak has resulted in extreme market volatility across asset classes. In this context, historically calibrated VaR models have come under severe stress, and are likely to generate a number of backtesting exceptions.

Even a daily recalibrated VaR window (i.e. daily incorporating new events in its tails as they unfold in the market) might not be responding quickly enough in an environment in which market dislocations are continuously generating even larger extreme events and thus exceptions might occur even though VaR continues to increase.

The impact of this would result in a material increase in the 'add-on' to the multiplier (i.e. +1) – and this would stay at this level for a year – at a time when VaR will have reached extremely high levels. If the multiplier were to move from 3 to 4, this would represent an increase of 30% in Market Risk RWAs, exacerbating a metric which will have already increased due to the significant market volatility.

The Stressed VaR window – most commonly referencing the 2008 period – may also move to the current window. This means that VaR and Stressed VaR will both capitalize the same market events, resulting in banks effectively double counting capital held against current market events in both VaR and Stressed VaR and likely using the highest possible multiplier. Stressed VaR will hence become a pro-cyclical rather than anti-cyclical capital buffer.

In addition, VaR levels will increase significantly, incorporating current market conditions in their re-calibration. The increase in VaR would gradually be seen in market risk RWAs (through the average over the quarter).

While each exception will be closely analyzed to assess if it might unveil any deficiency in the current modelling framework for its subsequent improvement (e.g. missing risk factors), the mechanical increase of the multiplier seems inappropriate under these extraordinary conditions.

Recommendation

We propose to suspend the automatic effects of increasing the multiplier due to backtesting breaches until the extreme events of the COVID-19 crisis are over. We understand that some jurisdictions have already provided guidance[1,2], but we ask you to collaborate with other regulators on an approach to avoid inconsistent treatment across jurisdictions.

Additionally, we would urge regulators not to trigger mandatory model reviews in cases where the maximum number of exceptions is reached, as these are driven by the extreme circumstances rather than by deficiencies in the IMA. Both of these actions will assist banks in managing their scarce resources during this crisis period.

Implementation of FRTB in Europe

Supervisory Reporting for the FRTB Standardised Approach

The EU CRR II framework introduced a reporting requirement for market risk leaving the capitalization to be defined in the CRR III banking package.

The reporting for the standardized approach to market risk in accordance with the FRTB framework will start once the revised elements of the FRTB framework, finalised by the BCBS in 2019, are incorporated in European Union law (by means of a delegated act for the elements of the standardised approach (SA-MR)).

In addition, the EBA was mandated to produce the Implementing Technical Standard outlining the reporting requirements in more detail. The EBA is expected to deliver their mandate by June 2020. Any new reporting requirements set out in such implementing technical standards shall not be applicable earlier than six months from the date of their entry into force.

[1] https://www.osfi-bsif.gc.ca/Eng/fi-if/in-ai/Pages/DTI20200327_let.aspx
[2] https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/publication/2020/var-back-testing-exceptions-temporary-approach.pdf?la=en&hash=2C747DA5257758AE3AF33B47DE2D29F7DBB2D86F

In practice this could mean that banks could be obliged to start reporting as early as Q1 for SA, which in turn means that they would have to finalise their adjustments to IT systems even before. Under normal circumstances, meeting these timelines would be feasible. However, with Covid-19, key staff needed to deliver changes to the internal systems are working from home slowing down the factual outputs.

ECB implementation timeframe

In similar vein, operational impacts are also noticeable with regard to the preparatory work on implementation of changes to internal models. Even though the ECB deadline of application of July 2021 appears to be a long time away, every day is still needed to become ready for formal submission.

At this stage it is expected to see delays, due to:

- Reduced focus on project activities as resources have to prioritise their time on ensuring banks remain operationally resilient
- Reduced project resourcing as capacity is impacted by illness & childcare arrangements during individual country lockdowns
- Reduced delivery velocity as productivity is impacted by remote working (public network connectivity issues and effect on collaborative working)

Recommendation

The FRTB SA reporting requirement is currently expected to go-live as of Q1 2021 and banks are using valuable resources to ensure operational readiness.

To EC: We would encourage the EC to announce a delay to FRTB SA Reporting as soon as possible so banks can divert resources. As the EC legislative proposal for the final calibration for the market risk, expected by 30 June 2020 [CRR2 Article 519b Own funds requirements for market risk], has been delayed *sine die* at this stage, all acts due for the FRTB reporting purposes including the SA Delegated Act and Regulatory Technical Standards, should be further delayed for a reasonable period of time to allow for the new EC proposal.

This could be achieved by 1) further delaying the submission of the delegated act into the Official Journal or by 2) setting the entry into force date in the DA at a later date. Both would provide banks the much-needed capacity to manage day-to-day operations during this crisis period. Such a delay should be consistent with the announced postponements of the overall Basel III package as mentioned below.

To ECB: The announcement from the BCBS on the 30th March 2020 has stated that the implementation timeline for Basel III has shifted by one year to 1st Jan 2023. We ask that the European Central Bank update its implementation roadmap so banks can consider the medium to longer term effects on their change management programs.

To PRA: We also encourage the Prudential Regulation Authority to inform banks on its approach to FRTB reporting and as necessary consider the resource implications for firms which would be in scope for any potential go-live date for FRTB SA reporting and ask that this is delayed consistently with the European Commission.

EBA Regulatory Technical Standards

We applaud the very decisive action already taken by the EBA, recognizing that firms need to devote all available resources to ensuring business continuity, risk managing severe market volatility and supporting the real economy.

We note that the EBA has published its final draft standards on March 27 on key areas for the EU implementation of the FRTB covering liquidity horizons, criteria for assessing the modellability of risk factors and backtesting and profit and loss attribution requirements. Once these regulatory technical standards are approved by the European Commission and entered into the Official Journal, this will trigger the three-year timeline for banks to prepare for internal model approach reporting. This is acknowledged by the EBA as being beneficial for market participants by providing early information for the successful EU implementation of the FRTB framework.

The industry remains concerned on various elements of the framework and in particular, the stressed expected shortfall calculation and welcomes the two-month delay until May 2020 of the consultation period for this significant part of the FRTB framework, during which the market situation will be re-evaluated.

We continue to engage with our working groups and monitor the situation as new information emerges and we remain at your disposal to support any further discussion on the issues highlighted above.

Yours sincerely