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ISDA Safe, Efficient Markets

Why the FRTB matters for EU capital markets

FRTB

The Fundamental Review of the Trading Book (FRTB) is part of the European Commission's CRD5/CRR2 proposals and introduces a new approach for calculating how much capital banks must hold against their market intermediation activities.

Banks' capital requirements for market risk were already increased under Basel 2.5[1]. Unless certain design and calibration issues of the FRTB are addressed, its introduction may well lead to another significant increase in the capital requirements for this risk category.

This note briefly illustrates how this would go against the CMU objective of developing the EU's capital markets and would ultimately be detrimental for all EU economies, **regardless of the current structure of their local financial system or whether they are home to banks which are major capital market players.**

All EU Member States should carefully consider the impacts of the FRTB

1 Implemented in the EU through the CRD3 in 2010.

Banks' role in capital markets

Banks that conduct wholesale or market intermediation activities provide clients, such as governments, corporates (including SMEs) and other banks, with access to investors across the globe by enabling market-based finance and foreign exchange transactions.

- They help individuals and institutional investors (such as insurance companies, pension funds and other asset managers) access investment opportunities on a global basis.
- In addition to helping end-users raise funds, they play a key role in ensuring that securities can be bought and sold at the best price and in the most cost-effective manner, which facilitates market liquidity.
- Finally, they also provide risk management solutions to a wide range of corporates and financial institutions.

The main providers of market intermediation services tend to be global players

The provision of market intermediation services is often carried out by internationally active banks as they can access global investor bases and are able to invest in the infrastructure, technology, products, trading expertise and risk management skills necessary to conduct such activities.

Impacts of the FRTB on these players will affect domestic end-users of capital markets

Unless some important flaws in its design and calibration are addressed[2], the FRTB is likely to lead to a significant increase in the capital such banks are required to hold for these activities, with the latest studies estimating increases of between 1.6 to 2.5 times the levels under existing requirements[3].

Therefore, regardless of where they are located, all European users of the market intermediation services provided by these international players[4] are likely to find their access to markets reduced, or the costs of financial market products and services increased, once the FRTB comes into force. This would clearly be against the CMU objectives of developing deep European capital markets to unlock alternative sources of capital or complement bank financing.

Regardless of whether their domestic banking institutions engage directly in market intermediation or not, **all EU Member States should therefore carefully consider the impacts of the FRTB**.

2 A number of these issues relate to various aspects of calibration of the FRTB standard and are explained in detail in the **AFME/ISDA position paper on the CRR FRTB proposals**, as well as in our **non-technical paper on the impacts of the FRTB**.

3 Source: ISDA/GFMA/IIF FRTB QIS7 Refresh, June 2017.

4 Whether directly, or indirectly via a domestic commercial bank interacting with the international wholesale bank.

Some examples of how internationally active banks support local end-users of capital markets, and other impacts of the FRTB

Governments - Any Member State wanting to borrow will typically rely on internationally active banks to guarantee the success of the issuance and find investors willing to buy the issued bonds, ensuring that the government's cost of funding is kept as low as possible. These banks will also commit to providing prices for either selling or purchasing the securities after they have been issued, thereby promoting the liquidity of secondary markets for this debt. Figure 1 illustrates the important role that banks headquartered outside the country in question have in the issuance of EU government bonds.

Domestic corporates - EU corporates wanting to issue debt and equity will also typically turn to wholesale banks (or access their services through a local intermediary) to raise capital. Figure 2 shows the role non-domestic players play in underwriting corporate bond issuances across EU countries and Figure 3 illustrates the part they play in equity issuances (both initial public offerings (IPOs) and secondary offerings). It is also worthwhile noting that the less liquid a security is, the more likely it will be particularly penalised by FRTB requirements[5].

Domestic banks - Domestic retail and corporate banks also rely on wholesale banks to access capital market funding and hedging solutions to manage their risks. Additionally, while local banks tend not to engage directly, or to the same extent in market activities as international players do, they may still be subject to one of the approaches for calculating capital under the FRTB for the market activities they do undertake. In this case, they are likely to be subject to the simpler, or standardised, FRTB approach which is calibrated in a very punitive manner, particularly for risk classes such as foreign exchange or equities[6]. This disproportionate calibration risks stifling the development of local players and regional capital markets.

Smaller and less developed EU capital markets may find that liquidity becomes progressively more restricted

5 Due to the very strict criteria set out in the FRTB for risk factors to qualify as being "modellable". According to an industry estimate based on 24 million data points taken from DTCC, Trace, Euroclear, Trax (Xtraketr) and ICE covering more than 10 000 firms, **more than 50% of these "names"** would not meet the criteria set out in the FRTB.

6 June 2017 industry QIS estimates are that the capital for FX risk and equity risk are respectively 5.3x and 3.8x higher under the FRTB standardised approach than the advanced approach.

International players have a key role in local markets

Figure 1: Domestic vs non-domestic lead underwriters for government bonds issuances in 2016

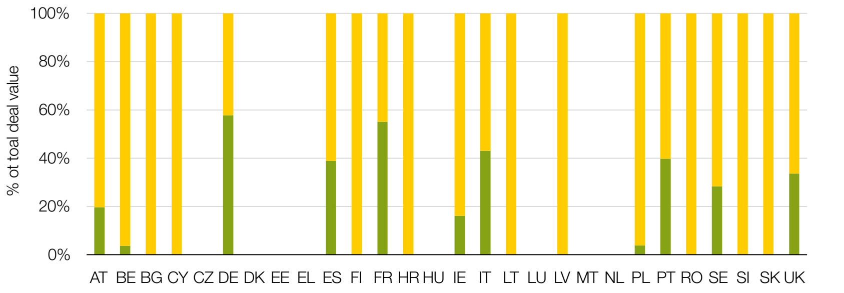


Figure 2: Domestic vs non-domestic lead underwriters for corporate bonds issuances in 2016

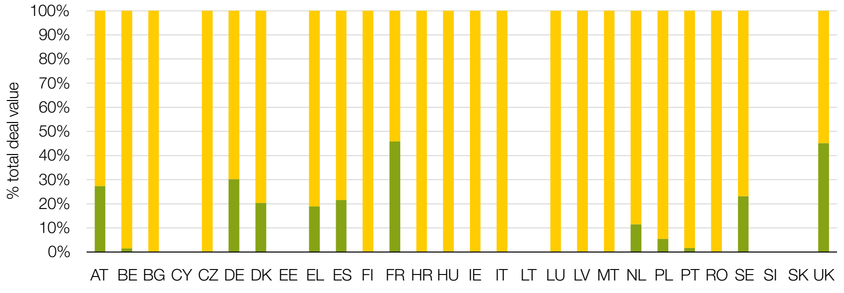
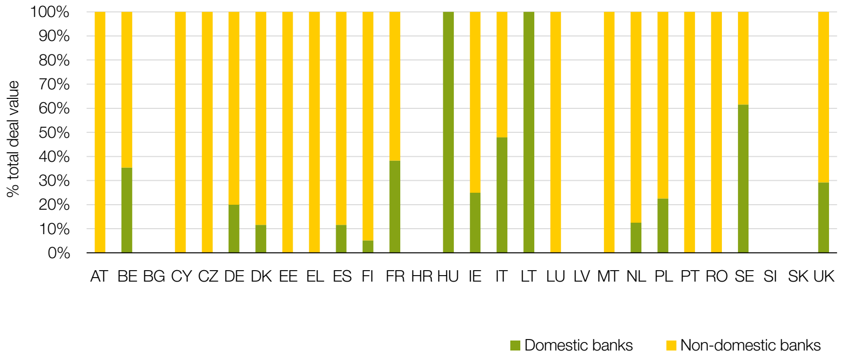


Figure 3: Domestic vs non-domestic lead underwriters for domestic IPO & follow-on equity offerings in 2016



(Source: Dealogic)

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Note on the data used

Syndicated deals in the respective category extracted from Dealogic for 2016, with bookrunners classified as domestic or non-domestic according to location of their parent company's headquarters versus the nationality of the deal (for corporates this is the country where the majority of the issuer's business takes place).