



TOPICS:

Market risk

SOURCE

International Swaps and Derivatives Association

ISDA: The Impact of the FRTB on Correlation Trading

- The ISDA report examines **the regulatory implications of the Fundamental Review of the Trading Book (FRTB) on Correlation Trading Portfolios (CTPs)**, highlighting significant concerns regarding the misalignment between current capital requirements and actual risk management practices. The FRTB's Sensitivities-Based Method (SBM), Default Risk Charge (DRC), and Residual Risk Add-On (RRAO) impose excessive capital burdens due to inconsistent application of the Look-Through Approach (LTA), particularly in the EU and UK.
- **CTPs**, which involve synthetic securitizations of corporate credit exposures, **play a critical role in enhancing market liquidity**, supporting efficient credit risk transfer, and facilitating macroeconomic growth. These instruments allow precise risk segmentation and enable tailored investor exposures, but the current regulatory framework threatens their utility and the broader market functions they support.
- The report advocates for **explicit allowance of LTA in SBM and DRC calculations** to align capital requirements with economic risk and hedge recognition.

Under SBM, prohibiting decomposition of indices (e.g., CDX series) leads to capital charges that do not reflect actual risk, undermining effective hedging. Similarly, DRC requirements lack clarity on netting and scaling, potentially overstating or misrepresenting default risks if decomposition is not consistently applied. ISDA proposes using non-securitization LGDs and risk weights post-netting to ensure coherence and accuracy.

- For **the RRAO**, the report contends that economically equivalent full capital structure trades should be exempt from additional charges, as they replicate untranching exposures and do not introduce residual risk.
- ISDA recommends that **Basel standards and regional implementations (EU, UK, US) converge to explicitly recognize LTA for multi-underlying instruments**, ensuring globally consistent treatment. Without these adjustments, the CTP market may face reduced liquidity, increased capital inefficiency, and diminished capacity for credit risk intermediation, ultimately affecting funding conditions for the real economy.

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