

US BASEL III ENDGAME: TRADING AND CAPITAL MARKETS IMPACT

What is the Basel III 'Endgame' and What are the Risks to US Capital Markets?

In July 2023, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation proposed capital rules known as the US Basel III 'endgame' based on the global minimum regulatory capital standards developed by the Basel Committee on Banking Supervision (BCBS). If finalized as currently drafted, the US Basel III proposal will have a significant negative impact on trading activity and the liquidity and vibrancy of the US capital markets, with adverse effects on derivatives end users, investors, businesses and consumers.

In response to the proposal, ISDA and SIFMA conducted a quantitative impact study (QIS) that showed that the market risk portion of the proposal, known as the Fundamental Review of the Trading Book (FRTB), will result in a substantial increase in market risk capital of between **73% and 101%**, depending on the extent to which banks use internal models. This matters because trading and capital markets activities play a crucial role in the ability of US businesses to raise funds and perform risk management functions, with debt capital markets in the US representing 75% of total financing. By requiring banks to hold additional capital that is misaligned with levels of risk, the proposal would significantly reduce capital market access for US end users and businesses, restrict the ability of businesses to hedge exposures to changes in commodity prices, and increase the cost of everyday consumer goods, including food and gasoline.

Based in Basel, Switzerland, the BCBS develops global minimum regulatory capital and liquidity standards through a multi-year process involving regulators from participating countries around the world. Given the BCBS has no enforcing powers, each jurisdiction transposes those standards into local law or regulation, as applicable. Although jurisdictions participating in the Basel process generally follow these standards, they may deviate to reflect philosophical differences and national priorities on local markets and economies. However, the US Basel III proposal would impose more stringent requirements than those embodied in the global framework in several areas.

This note summarizes key findings based on the results of the ISDA/SIFMA QIS. Several issues highlighted in the ISDA's comment letter to the US agencies were not quantified but are equally important and are summarized in the Appendix.

Why is this an Issue for Banks and their Customers?

Overall Capital Impact

The US Basel III proposal would significantly increase the risk-weighted assets (RWAs)¹ of banking organizations, which would result in a large rise in the amount of capital banks must maintain to satisfy both minimum capital and buffer requirements. This comes on top of already large increases in capital since the 2008 financial crisis. For the eight US global systemically important banks (G-SIBs), common equity tier 1 capital has increased from approximately \$214 billion before the crisis to approximately \$880 billion in 2022².

In a major deviation from other BCBS jurisdictions, the US agencies introduced a new expanded risk-based approach (ERBA) that replaces the advanced approaches. Under the ERBA, banks will no longer have the ability to use internal models for credit risk and counterparty risk. The only part of the ERBA that allows internal models is the FRTB.

Continued →

¹ Risk-weighted assets (RWAs) represent a bank's assets or off-balance-sheet exposures, weighted according to their inherent risks

² See PWC, Basel III Endgame: The next generation of capital requirements, April 2023, <https://explore.pwc.com/baselliendgame/basel-iii-end-game-report>

Under the proposal, banks will need to calculate RWA amounts under the US standardized approach (SA) and the ERBA and use the higher of the two amounts. While the SA generally currently serves as the binding constraint for US-G-SIBs, this will likely become the ERBA, which includes credit valuation adjustment (CVA)³ and operational risk. Combined with the inclusion of a new capital surcharge for G-SIBs, it is estimated this will increase overall capital by approximately 30%⁴.

Trading and Capital Markets Impact

These new capital requirements, coupled with the Federal Reserve's supervisory stress test and stress capital buffers, would have a very material impact on trading and capital markets activities.

The ISDA/SIFMA QIS found that the FRTB will result in a substantial capital increase in market risk capital of between **73% and 101%**, depending on the degree to which banks opt for internal models. However, there's a concerning trend of banks in all jurisdictions reducing their use of internal models. A recent ISDA survey⁵ indicates that only 52% of banks globally currently using internal models for market risk intend to continue doing so under the FRTB, with the scope of trading desks utilizing internal models falling from 86% to 31%. As a result, the FRTB capital impact is expected to be at the higher end of the estimate.

In addition, CVA capital will be fully additive to the binding constraint due to the introduction of the ERBA, which will increase RWAs by approximately **\$217 billion**. The capital for securities financing transactions (SFTs) is also affected and will rise by **18%** for US G-SIBs. The Basel III proposal and the G-SIB surcharge⁶ will cumulatively result in an **80%** increase in capital requirements for clearing businesses.

Why do Capital Requirements for Trading and Capital Markets Activities Matter?

US capital markets are the largest in the world and continue to be among the deepest, most liquid and most efficient. The increased capital that banks would be required to hold would make it more expensive to hedge risk, which could result in activity moving outside the banking system and increased costs for end users. It would also force banks to reduce the amount of inventory they are able to maintain, affecting liquidity.

Put simply, the higher the capital required for a given activity, the more expensive it is to run that business. If capital levels aren't aligned with risks and returns aren't enough to offset capital costs, then banks will be forced to either scale back from that business or raise costs. Neither is good news for end users – particularly as the business lines that will be most affected are those that are critical to financing and hedging.

Importantly, the US G-SIBs have weathered a series of market shocks, from the pandemic to Russia's invasion of Ukraine. The main challenge banks faced during these events was not the continued viability of their institutions, but the sharp reductions in market liquidity and capacity – a problem likely exacerbated by inappropriately large increases in capital for bank trading activities. None of these shocks revealed any shortfall in capital requirements at US G-SIBs that would warrant the substantial increases in capital that would result from the US proposals.

Recommendations

ISDA recommends:

- The US agencies perform a comprehensive review of the capital framework, including how the US proposal would interact and overlap with other prudential requirements, including the G-SIB surcharge, the supervisory stress testing framework and the stress capital buffer requirements.
- The US agencies provide banks with sufficient implementation lead time by prescribing an effective date for banks applying for model approval at least 18 months from finalization of the US rules.
- The US agencies act to ensure the framework is appropriately calibrated to reflect the underlying risks.

Continued →

³ Credit valuation adjustment (CVA) is a part of the regulatory capital framework that captures the possibility of a counterparty's default. The adjustment therefore represents the market value of counterparty credit risk

⁴ Letter from the Financial Services Forum to the US agencies, January 16, 2024, <https://fsforum.com/a/media/fsf---b3e-comment-letter.pdf>

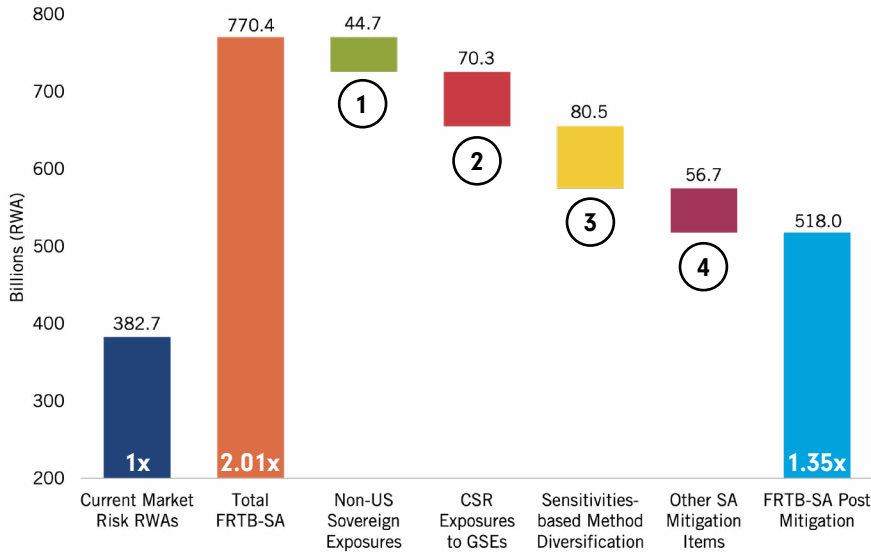
⁵ ISDA response to the PRA CP 16/22, Implementation of the Basel 3.1 standards, page 140, www.isda.org/a/hvJgE/ISDA-Responds-to-PRA-Consultation-on-Basel-3.1-Implementation.pdf

⁶ Federal Reserve, Regulatory Capital Rule: Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies; Systemic Risk Report (FR Y-15), 88 Fed. Reg. 60,385, September 1, 2023

Impact on Capital

FRTB-SA Impact

If banks were to apply the FRTB-SA across all portfolios, the increase in market risk capital would be approximately **101%**.

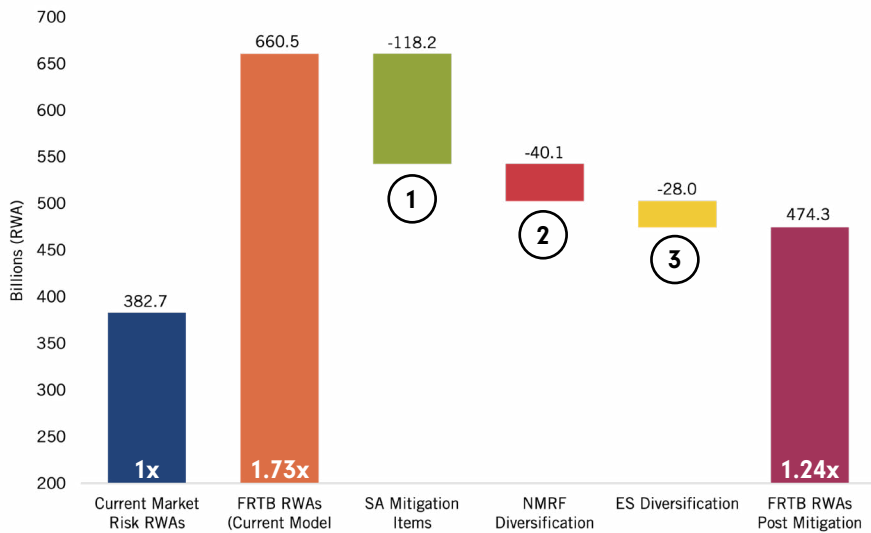


Industry Recommendations:

- 1. Treatment of non-US sovereign exposures:** The treatment within the market risk rules should match those for credit risk for certain highly rated sovereigns that receive a 0% risk weight.
- 2. Treatment of credit spread risk (CSR) exposures to government sponsored entities (GSEs):** The rules should be changed to fully recognize hedges of the underlying Fannie Mae and Freddie Mac security pools.
- 3. Better recognition of diversification in SA:** The rules should allow for better offsetting across asset classes and risk categories.
- 4. Other SA mitigation items⁷.**

FRTB-IMA Impact

If banks apply the internal models approach (IMA) for the FRTB, the increase in market risk capital would be approximately **73%**.



Industry Recommendations:

- 1. SA mitigation items:** Not all trading desks will qualify for the IMA, so the FRTB-SA industry recommendations should apply for those desks that apply the SA.
- 2. Better recognition of diversification for non-modellable risk factors (NRMF):** The recommendation is to reduce the NRMF rho parameter to better recognize diversification across NRMFs.
- 3. Better recognition of diversification for expected shortfall (ES):** The ES is calculated as a simple average of diversified and non-diversified capital charges for modelled desks. The recommendation is to place greater weight on the diversified capital charge.

Continued →

⁷ Includes a few items: (a) \$27.8 billion in RWAs - incorporating correlation trading portfolio decomposition and non-securitization risk weights; (b) \$11.1 billion in RWAs - excluding ineligible CVA hedges from market risk covered positions; (c) \$7.4 billion in RWAs - reverting the securitization supervisory 'p' factor to 0.5; (d) \$5.4 billion in RWAs - lowering the risk weight for carbon trading from 60% to 40%; (e) \$5.0 billion in RWAs - reducing risk weights and loss-given default for tax-exempt municipal bonds

CVA Impact

CVA is **fully additive** by moving from the current SA to the ERBA as the binding constraint (**\$217 billion in RWAs**).

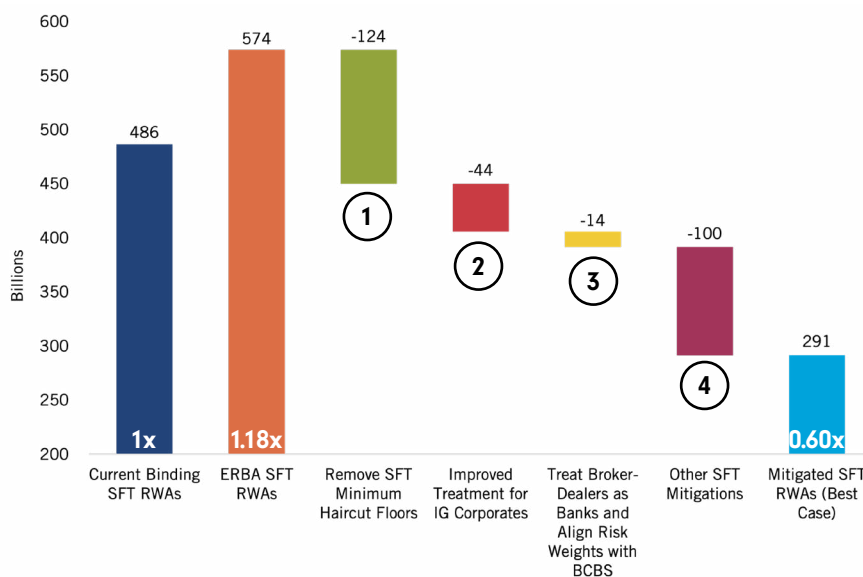


Industry Recommendations:

- 1. More granularity in CVA:** Distinguish between regulated and unregulated financial institutions.
- 2. Remove CVA for client cleared transactions:** This would align with practices in the EU and the UK.
- 3. Improve hedge recognition:** The proposal does not properly recognize the risk-reducing effects of credit default swap index hedges. The recommendation is to increase the correlation between index hedges and other CVA credit spread exposures.

SFT Impact

The US Basel III proposal would increase RWAs for SFTs by **18%**.



Industry Recommendations:

- 1. Remove the minimum haircut floor for SFTs:** Other jurisdictions have not implemented the minimum haircut floor, including Canada, the EU⁸, Japan and the UK.
- 2. Better treatment for investment-grade (IG) corporates:** Apply a 65% risk weight for investment-grade corporates, even if there are no publicly traded securities.
- 3. Revert to BCBS risk weights for bank exposures⁹.**
- 4. Other SFT mitigations¹⁰.**

Continued →

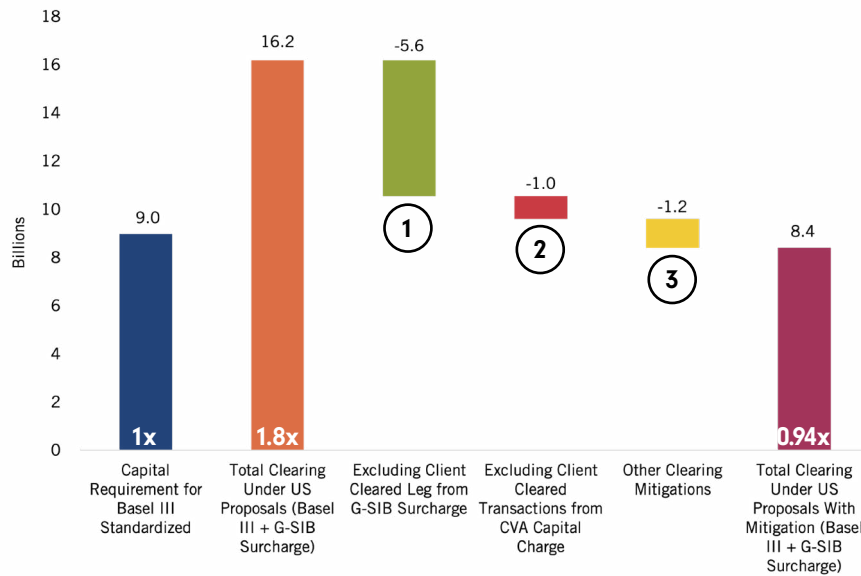
⁸ European Banking Authority, Policy Advice on the Basel III Reforms on Securities Financing Transactions (SFTs), August 2, 2019, www.eba.europa.eu/sites/default/documents/files/documents/10180/2886865/870bbd5e-ae8f-4933-9f36-784c7183c7f4/Policy%20Advice%20on%20Basel%20III%20reforms%20-%20SFTs.pdf

⁹ Treat broker-dealers as banks and align risk weights for short-term bank exposures with the Basel Committee standards

¹⁰ \$100 billion in RWAs: Other items include allowing netting set exposure calculations with diversification benefit for single transactions/margin loans, removing the public listing requirement for the recognition of investment-grade corporate debt, and removing the collateral requirement from market risk election

Clearing

Capital requirements for clearing will increase by **80%**.



Industry Recommendations:

1. G-SIB surcharge: Exclude client transactions cleared under the agency model from the complexity and interconnectedness indicators in the G-SIB capital surcharge.

2. Exclude client cleared transactions from CVA: This would align with rules in the UK and the EU.

3. Other clearing mitigations¹¹.

About ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 1,000 member institutions from 77 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org. Follow us on [X](#), [LinkedIn](#) and [YouTube](#).

Continued →

¹¹ Permit netting of settled-to-market and collateralized-to-market transactions, allow index decomposition of non-linear derivatives under the standardized approach for counterparty credit risk, and remove the public listing requirement for investment-grade collateral

Appendix

It is critical to consider the exhaustive list of issues set out in ISDA's US Basel III comment letter to avoid unintended consequences to key US markets, including but not limited to the following:

Area	Topic	Key Ask
FRTB-SA	Treatment of term repos in the market risk framework	Retain the ability to recognize the risk-mitigating effects of non-investment-grade corporate debt securities of term repo-style transactions by not requiring the underlying security collateral in the market risk measure. Industry analysis shows the haircut applicable to non-investment-grade collateral is sufficiently conservative, meaning this treatment is appropriate.
FRTB-SA	Equity investments in funds	Revise available approaches for equity investments in funds under the FRTB-SA so that they are implementable and appropriately aligned with inherent risk. The 'fallback method' is too conservative and insufficiently risk sensitive.
FRTB-SA	Securitization framework	Improve the calibration of the proposed securitization standardized approach, including through the inclusion of a simple, transparent and comparable securitization framework similar to that set out in the Basel Committee's final rule, appropriately adjusted for the operation of the US market.
FRTB-SA	Covered bonds	The credit spread risk weight for covered bonds should be reduced from 2.5% to 1.5%. This approach would be consistent with the underlying risk of these positions given that most covered bonds are highly rated.
FRTB-SA	Equity hedge recognition	Enhance the risk sensitivity of equity hedge recognition in the DRC for derivatives. Given the removal of internal models for calculating DRC, we propose to extend the maturity scaling allowed for physical equities to derivatives, as well as 'option early termination' clauses in equity derivatives contracts.
Trading book/ banking book Boundary	Market risk covered positions	Clarify market risk covered position eligibility of structured notes and stipulate that bank-owned life insurance and company-owned life insurance exposures are out-of-scope from market risk covered positions.
FRTB IMA	Profit and loss attribution (PLA) test	Convert the PLA test for modelled desks to an entirely qualitative requirement used for supervisory monitoring as this test would otherwise introduce artificial volatility in capital levels that would disincentivize banking organizations from using the FRTB-IMA.
FRTB IMA	NMRFs	Certain NMRFs should be subject to capital requirements based on the expected shortfall methodology, with revisions to reflect the relatively lower level of liquidity of those NMRFs.
FRTB IMA	FRTB-SA cap	Cap the total FRTB-IMA capital at the FRTB-SA to provide appropriate incentives for banking organizations to adopt the FRTB-IMA and to recognize the conservatism of FRTB-SA.
CVA	Appropriate recognition of hedges	Improve the recognition of single name and index hedges under both the basic CVA approach (BA-CVA) and standardized CVA approach (SA-CVA) frameworks.
SFTs	Volatility haircuts for GSE debt / exchange traded funds (ETFs)	<ul style="list-style-type: none"> Haircut for GSE debt should be lowered from the proposed level applicable to corporate debt. A bank should be permitted to assign haircuts to ETFs based on a look-through approach similar to mutual funds.
SFTs	Definition of investment grade	The current definition of investment grade only applies to certain exposures - ie, a loan or security or the reference entity of a credit derivative. The definition should be expanded to apply to all exposures, including derivatives and repo-style transactions.
SFTs	Netting set formula for eligible margin loans	Clarify that the netting set formula applies to eligible margin loan transactions booked as a single unit of account for US Generally Accepted Accounting Principles and permit it for single repo-style transactions with multiple securities as collateral.