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# Appropriate Capital Rules Are Critical for Financial Markets

SETTING CAPITAL REQUIREMENTS FOR globally active banks is a fine balancing act. As regulators learned during the Global Financial Crisis (GFC), insufficient capital creates vulnerabilities in the banking sector that can have damaging consequences in times of stress. However, if banks are required to hold disproportionately high levels of capital, this will constrain their ability to act as intermediaries, negatively affecting liquidity in financial markets. To avoid both scenarios, policymakers have a critical responsibility to get the balance right.

As the final parts of the Basel III capital framework are implemented around the world, striking this balance is more important than ever. As it stands, the draft Basel III Endgame package that US regulators presented for consultation in 2023 would tip the balance too far. Based on the International Swaps and Derivatives Association's (ISDA's) analysis of the impact on banks' trading books, there is no doubt that the rules would constrain the capacity of US banks to offer vital intermediary services and have a negative impact on market liquidity.

Deep and liquid financial markets are an essential prerequisite for a healthy, vibrant economy, providing critical financing sources that enable businesses to invest and grow. However, this can only be achieved with an appropriate risk-sensitive regulatory framework. To achieve this, the calibration of the Endgame package must be reviewed to reduce its impact on capital requirements. For the preservation of deep and liquid markets, this must be a priority.

## Basel III Endgame

The completion of the Basel III reforms, which were originally developed in response to the Global Financial Crisis, has been a long time coming. The Basel Committee on Banking Supervision (BCBS) finalized the standardized approach for counterparty credit risk (CCR) in 2014, the revised credit risk framework and output floor in 2017, the new market risk framework in 2019 and the credit valuation adjustment (CVA) risk rules in 2020. Since then, policymakers around the world have focused on the long process of transposing the standards into regional and national laws.

Certain jurisdictions—including the European Union (EU), Canada, China and Japan—have already implemented some of these standards, while others have finalized the rules but not yet implemented them. In the United Kingdom, for example, the deadline was recently moved to the start of 2027. The reason for this delay is the lack of clarity over when and how the rules will be implemented in the United States. While the original US proposal, published in July 2023, envisaged implementation would begin on a phased basis from the middle of this year, the rules have not yet been finalized, making that deadline impossible.

In January 2024, ISDA and the Securities Industry and Financial Markets Association (SIFMA) responded to a consultation by US prudential regulators on the proposed rules. We presented the results of our industry impact study and used that data as the basis for recommending specific calibration changes to improve risk sensitivity and avoid any negative impacts on the liquidity and vibrancy of US capital markets. We stand by those recommendations, which include greater recognition of diversification in the market risk framework to reflect actual risk exposures, changes to certain aspects of the rules for securities-financing transactions and improvements to the CVA risk framework.

One of the defining features of Basel III is its more stringent testing and approval process for banks that want to use their own internal models to calculate capital requirements.

It was always likely that this would drive a decline in the use of internal models, but it now appears that the drop will be sharper than anticipated. Last year, an ISDA study found that only 10 out of 26 global banks plan to use internal models for far fewer trading desks under the new market risk framework. That's a big change that would mean less alignment between risk and capital and less diversity in models and behaviors.

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Basel III introduces new standardized approaches to capital calculations that will be more sensitive to risk than previous iterations, but the reliance on a one-size-fits-all model will be a major shift that could lead to herd behavior and drive concentrations in particular assets. Given increasing investments in private markets, the need to retain more risk-sensitive internal models is particularly important. That's why ISDA has recommended improving incentives for using internal models, and we urge policymakers to consider those adjustments.

With a new presidential administration now in place in the US, it's time to take a fresh look at the calibration of the Basel III Endgame to enable banks to continue offering the full range of intermediation services. This must be a priority if we are to maintain deep and liquid markets and preserve the vital lifelines they provide to the real economy.

## Clearing

As US policymakers revisit Basel III, they must consider the impacts of the rules on market functioning and liquidity. This includes the provision and expansion of central clearing, an activity that is widely recognized as risk-reducing but could be hit with exceptionally high capital requirements if certain elements of the rules aren't adjusted.

ISDA's analysis has shown that the combined effect of the Basel III rules and the capital surcharge for global systemically important banks (G-SIBs) would increase capital for six US G-SIB client-clearing businesses by $7.2 billion, equivalent to more than 80 percent. This is a huge increase that is completely at odds with the post-financial crisis policy objective to promote and incentivize central clearing. As such, it could negatively impact market stability.

ISDA has recommended specific changes that can be made to both the Basel III Endgame and the G-SIB surcharge to fix this issue. This work must be prioritized so banks can continue to offer client-clearing services that reduce risk and improve market stability.

This effort comes at a time when clearing is set to expand significantly with the introduction of the US Securities and Exchange Commission's (SEC's) reforms to the US Treasury market. These reforms will include mandatory clearing of certain cash Treasury securities from the end of this year, with repurchase agreements following in mid-2026. Leveraging our long-running experience in derivatives clearing, ISDA has been working with market participants and policymakers to lay the groundwork for Treasury clearing. We're also advocating for improved recognition of cross-product netting in the US capital framework, which will enable firms to obtain valuable capital efficiencies from offsetting trades in a portfolio of transactions.

These reforms are being implemented in response to a series of market stress events that have tested the stability of financial markets in recent years, starting with the dash for cash at the start of the COVID pandemic in March 2020. That episode highlighted the vulnerability of the US Treasury market to liquidity shocks during periods of stress. Unfortunately, the US supplementary leverage ratio (SLR) is inconsistent with the objective of improving the efficiency and resilience of the Treasury market. The SLR acts as a non-risk-sensitive binding constraint on banks that can impede their ability to act as intermediaries, including their capacity to offer client clearing.

In April 2020, with financial markets in turmoil, the US Federal Reserve (the Fed) took steps to address this issue by temporarily excluding US Treasury securities from the SLR calculation. Last year, ISDA wrote to US prudential regulators to request that the exemption be reintroduced on a permanent basis. This would improve banks' capacity to expand their balance sheets and provide liquidity, enhancing the US Treasury market's stability and resilience. There are other ways in which the SLR could be adjusted to avoid negative repercussions for the Treasury market, so an industry consultation would be the best way to determine the path forward. Given the expected increase in the size of the market and the important role banks play, we cannot afford to wait until the next shock to address this issue.

## Getting it right

From Basel III to central clearing and the SLR reform, these are highly complex policy issues that might easily be addressed in isolation, without attention to the bigger picture. But to finalize capital rules without regard to their effect on market functioning and liquidity would be to ignore the need for vibrant, well-functioning markets.

For the hundreds of thousands of companies that rely on banks for growth and investment, a disproportionate capital framework would have severe consequences, such as diminished access to funding, lack of hedging solutions and increased vulnerability to external shocks. The stakes couldn't be higher. For the preservation of deep and liquid markets, we need a robust, risk-appropriate capital framework. We simply must get it right. «