US Rates Strategy

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Basel III: Market implications

While Basel III is expected to reduce overall bank tier 1 capital requirements, its effects on trading activity and market risk are more nuanced. The new rules will increase capital required for some types of trades and securities.[1] But, capital will become less pro-cyclical.

- **Requirements for large banks are expected to fall 5%**. However, most of the reduction at the largest banks (Category I and II) comes from changes to stress testing assumptions and updates to the GSIB systemic risk scoring framework.[2] **Outside these changes, trading asset risk weightings for Cat. I and II banks *increase* sharply under the new rules.**

- **Within trading risk, the increase reflects two general changes to the treatment of banks' market risk.** Basel III limits risk diversification benefits and applies stricter assumptions about non-modellable risks.

- **We expect these changes will increase capital requirements for less liquid securities, those with more complex payouts, and those whose returns are difficult to model**. But this may have more of an effect on *how* banks trade these securities than their volume.

- We look for more activity to shift to clearing with some reduction in warehoused positions. Banks may expand their efforts to model risk.

- **The changes to the liquidity horizon in stress testing and the reduced reliance on VaR modeling will likely reduce pro-cyclicality in bank capital levels**. In turn, this should make bank intermediation steadier during periods of financial market stress.

Basel III

Last week the Federal Reserve and other bank regulators released a final Basel III bank capital framework. Comments are due June 18. As the full document covers more than 1200 pages of regulatory language we have focused on the portions we think are the most relevant to markets and trading.

The new framework follows earlier attempts to finalize bank capital rules that would have resulted in significantly higher requirements. But these failed to be approved by all three of the principal regulators:

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[1] In this report, our focus is the Basel III proposal rather than the separate proposal (also released last week) to revise the structure of the GSIB systemic risk framework.

[2] Large banks are split into 5 categories based on their size. The largest (Cat. I) are the eight (largest) GSIBs, followed by Cat. II banks that have more than $700bn in assets or more than $75bn in cross-jurisdictional activity. Cat. III banks have more than $250bn in assets or more than $75bn in either nonbank assets, (weighted) short-term wholesale funding, or off balance sheet exposures. Cat. IV banks have assets of between $100bn and $250bn. "Other firms" are those with assets between $50bn and $100bn.

the Federal Reserve, FDIC, and the OCC. Regulators returned to the drawing board, and spent the last three years re-working the capital rules. The new framework is meant to be simpler and intended to more closely tie risk with required capital. **Regulators estimate that capital requirements at the largest banks – Cat. I-IV – will fall by about 5%**.[3] But the effects are considerably more nuanced.

First, the reduction is concentrated in two aspects of banks' capital calculation. For Category I and II banks most of the capital reduction comes from changes to the GSIB surcharge and their stress testing requirements. **Changes to trading activity risk will instead increase their capital requirements**. The GSIB surcharge is the extra capital large banks hold to internalize the systemic cost that their failure might create given their size and complexity. Among other changes, regulators are updating the weights in the scoring framework to reflect the growth in the economy since 2015. Similarly, large banks are subject to regular stress tests to ensure that they have enough capital to continue lending through a severe economic or financial market crisis. The proposed Basel III rules reduce the liquidity horizon (or time to liquidate positions) during the global market shock used in the "severely adverse scenario" of these tests.

Second, the 5% reduction in capital requirements is measured across all banks. But banks have different business models so the potential amount of freed up capital at the bank level will vary. As the effects are activity-dependent, the reduction in required tier 1 capital will depend on the relative distribution of an individual bank's activities – and particularly on the volume and nature of their trading activities. Across all banks, interest income on loans accounts for nearly 70% of the total (Figure 1). But interest earned from securities holdings is about 15%. (The balance is made up of income on leases and miscellaneous balances due from other banks).

For traditional bank lending, the Basel III changes will lower the risk weights applied to residential mortgages and mortgage servicing revenue. It will also apply more favorable risk weights for investment grade corporate borrowing. But some of this is offset by technical changes to the treatment of exposures shorter than 1y. Basel III effects on credit card lending are mixed and depend on the type of borrowing and their repayment history.

Trading activity risk

Banks' trading risk is made up of several components reflecting market, operational, and counterparty risk. Operational risk reflects potential losses tied to failed internal processes, systems or people. Market risk is easier to model than either credit or operational risk, particularly for commonly traded instruments like Treasuries.

Bank regulators are making two general changes to the market risk component. **They are limiting the risk diversification assumptions applied to large bank portfolios. And they will apply stricter standards for non-modellable risks**. Non-modellable risk refers to assets whose returns are difficult to model because they are either non-normally distributed, or there is little available data to gauge the severity of shocks.

Regulators estimate that these two general changes will *increase* risk weighted assets at Cat. I and II banks by 20%. **Adding the proposal's changes to the CVA (credit valuation adjustment) and operational risk treatment of trading activity would push their risk-weighted assets up 30%**.[4]

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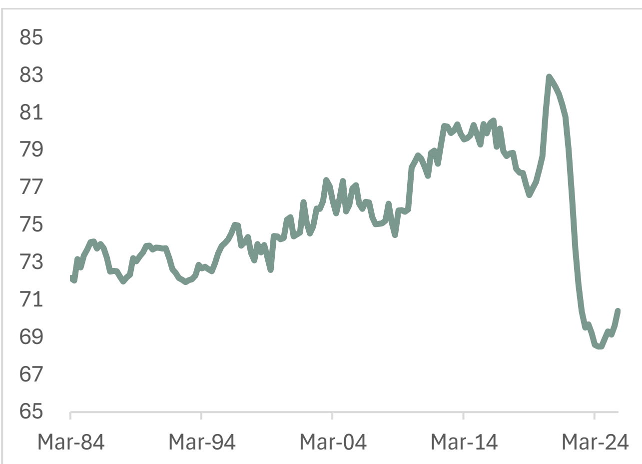
[3] See, "Board of Governors Staff Memo, Basel III proposal, GSIB surcharge proposal, and standardized approach proposal", March 19, 2026.

[4] CVA and operational risk are included in the advanced approaches calculation but not the standardized one. Under Basel III's "expanded risk-based framework" both are included. CVA risk adjustment measures the potential

Despite the sharp increase in their risk-weighted assets, changes to the GSIB score and modifications to global stress testing described above reduce the effect on their required tier 1 capital. That said, Cat. I and II banks will need to hold *more capital against their trading activity*; regulators estimate the combined effect will be a "moderate 9.2%".[5]

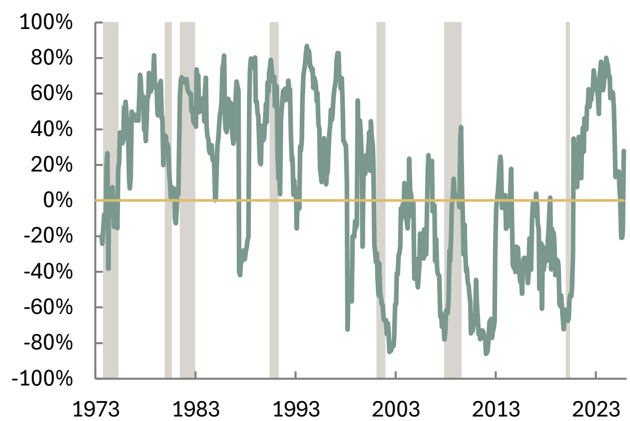
These changes will have a smaller effect on the trading activities of the non-Cat. I and II banks. Regulators estimate these banks' risk-weighted assets would *decline* 39% because of increased recognition of credit and equity hedges under the new framework. But, as some of these banks have large volumes of over-the-counter (OTC) derivatives trading, this will add to their CVA risk calculation and largely offset the decline in risk-weighted assets. Cumulatively across all these banks the risk-weighted assets might increase by 0.9%. At the individual bank level, this is sensitive to the volume of OTC derivatives trading.

Figure 1: Loan interest (% interest income)



Source: FDIC, SMBC Nikko

Figure 2: Equity-Treasury bond correlation (%)



Note: 12m trailing correlation between the S&P500 and the Treasury Total return index, unhedged. Source: Bloomberg, SMBC Nikko

The Basel III proposal makes other changes to trading activity capital calculations. It replaces VaR with "expected shortfalls" when calculating potential losses to better reflect tail events – particularly for securities that do not have normally distributed returns. The proposal would also replace the uniform 10d liquidity period with tailored holding periods – of up to 120d – consistent with the possibility that it might take some time to dispose of an asset or position. In addition, Basel takes a more conservative approach to the recognition of trading portfolio diversification – for example, noting that the correlation between stock and bond returns has shifted over time (Figure 2).

Implications

Overall, these changes increase capital requirements on trading activity for banks with more than $100bn in assets. But we think the effect on trading will be uneven. Some activities are likely to require more capital while trading in liquid instruments such as Treasuries, listed equities, and corporate bonds

loss to a derivatives position from a counterparty default.

[5] See page 616.

will be unchanged. Large banks may need more capital to trade and hold positions in less liquid instruments or those that have complex payouts. Securities with little transaction or historical data or whose returns are difficult to model will also require more capital.

Banks can respond by reducing their intermediation activity in these securities, and, for example, pushing more of it toward smaller banks or non-bank intermediaries. Regulators note the potential for such a shift but are unable to provide any estimates of its size or scope. Alternatively, the banks may charge their counterparties more to trade and make markets in these issues. And banks may do nothing – large banks often subsidize their less capital efficient businesses (like repo) to support other higher return activity.

That said, we wonder if the larger effect is a change in *how* banks execute and hedge risks on these securities. We expect more activity will shift to central clearing as risk netting through a CCP gets more favorable capital treatment under Basel III. Similarly, banks may reduce the number of positions they hold in inventory and instead rely more heavily on matching buyers with sellers rather than warehousing securities. Finally, banks may gather more transaction data with which to model risk to reduce their holdings of non-modellable risk assets.

The Basel III changes are likely to reduce the pro-cyclicality of bank capital. Reducing the reliance on VaR modeling in calculating exposures means that capital is less likely to rise sharply during periods of financial stress. The shortening of liquidity horizons in the global market shock under the stress testing framework also reduces pro-cyclicality as banks are assumed to be able to reduce their positions more quickly. **Our sense is that stickier bank capital will increase the willingness of banks to make markets and intermediate in periods of financial stress**.

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