

Fund Finance Friday



U.S. Regulatory Capital Proposals: Key Points for Fund Finance

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The path forward for bank risk-based capital and the GSIB surcharge has been clarified with the release of three rule drafts yesterday: **The Basel III proposal** (covering large banks), the **Standardized approach proposal** (all non-Category I and II banks), and the **GSIB surcharge proposal**.

Together, the revised rules soften edges from the 2023 proposals, as is reflected in anticipated reductions in Tier 1 Capital requirements across size groupings. Look for upcoming publications from our Financial Services partners for comprehensive coverage of the newly proposed framework. Here are the points that stand out for fund finance:

- Category I (the GSIBs) and Category II banking organizations will benefit from an overall simplification by eliminating the dual-stack reporting they have been required to maintain (e.g., calculating their capital requirements under both the advanced approach and the standardized approach).
- Category I and II banking organizations will have broader access to a 65% risk weight for non-subordinated corporate exposures when they determine that the exposure is to an investment-grade counterparty using an internal credit risk rating system that is used in actual business and risk-management decisions and is subject to validation requirements. The 2023 proposal provided a narrower 65% carve-out for investment-grade corporates that have, or are controlled by a company that has, a publicly traded security outstanding.
- Broadening that carve-out is a meaningful positive for Category I and II firms and relevant to fund finance lending. A company is broadly defined to mean a “corporation, partnership, limited liability company, depository institution, business trust, special purpose entity, association, or similar organization,” and corporate exposure as an exposure to a company other than specified excluded categories such as sovereigns, banks, GSEs, residential mortgages, securitizations, equity exposures, and certain other listed items.
- For banks on the standardized approach, the proposal would reduce the general corporate risk weight to 95%, from the current 100%. The Standardized Approach NPR does not create a broader lower-risk corporate bucket analogous to the 65% treatment in the Expanded Risk-Based Approach NPR. This creates a substantial advantage for the largest banks. *But note*, smaller banks can voluntarily opt into the expanded approach (but then they would also take on significant additional burdens like operational risk capital).
- For unused commitments that are not unconditionally cancelable, the Expanded Risk-Based Approach NPR would replace the current 20% credit conversion factor (CCF) for commitments of one year or less and 50% for commitments over one year with a flat 40% credit conversion factor regardless of maturity. This removes an incentive to originate 364-day facilities. (The basic mechanics are: $RWA = \text{undrawn amount} \times CCF \times \text{risk weight}$.)

- Unconditionally cancelable commitments will move from the current 0% CCF to 10% under the Expanded Risk Based Approach. That means a Category I or II bank that extends uncommitted facilities will see an increased capital cost for the undrawn portion.
- Under the Standardized Approach, commitments that are not unconditionally cancelable likewise move to a flat 40% CCF regardless of maturity, replacing the current 20%/50% percent split, but unconditionally cancelable commitments remain at 0% for risk-based capital purposes, with a 10% floor only for supplementary leverage ratio purposes. The bottom line: Regional banks also lose a motivation to lend at 364-day tenor.
- The GSIB surcharge will be updated to include private equity exposure when assessing intra-financial system assets and intra-financial system liabilities indicators. Private equity was added in the 2023 proposal, but the term is still not clearly defined and the proposal seeks comment on how to improve clarity. For GSIBs with meaningful exposures to private equity funds and related entities, the proposal could increase interconnectedness indicators and, at the margin, GSIB surcharge calculations.