Basel III regulations: a practical overview

> » Higher and better quality of capital
> » Tighter standards for liquidity risk measurement and monitoring
> » New rules to addresses forward-looking provisioning for credit losses
> » Additional measures to reduce systemic risk

Basel III is the Basel Committee on Banking Supervision's (BCBS) comprehensive response to the 2008 financial crisis – culminating in two years of regulatory reform including Basel 2.5. It introduces a new regulatory regime for capital, liquidity and banking supervision.

The BCBS identified several factors that contributed to the global financial crisis and therefore need addressing in the new regulations. Banks were too highly leveraged, held insufficient capital (specifically insufficient high-quality capital) and had inadequate liquidity buffers. The crisis was compounded by pro-cyclicality and the interconnectedness of systemically important 'too big to fail' financial institutions. Furthermore, individual banks had inadequate risk management and corporate governance processes and regulatory supervision was not strong enough. It is important to note that Basel II doesn't go away. Basel III introduces enhancements to the Basel II framework.

Key enhancements

New capital enhancements seek to improve both quality and availability of capital

» At the individual firm level, Basel III seeks to improve the quality of capital that banks hold and make definitions of types of capital more transparent.

» The amount of required regulatory capital has been increased, particularly in the trading book where increased capital allocations will be enforced for securitised and OTC derivatives products. Furthermore, counterparty risk must be taken into consideration.

» On top of this a fixed conservation buffer has been introduced. Additional Core Tier 1 capital must be accrued in boom times in order to absorb losses of the core capital if the bank is under financial or economic pressure.

New liquidity ratios aim to address funding needs under stressed conditions

» It is now widely acknowledged that increased levels of capital alone is not enough to prevent another crisis. Another objective of Basel III is therefore to ensure that banks have sufficient liquidity to withstand stressed liquidity scenarios. Two ratios have been introduced to tackle this: these ratios address both short-term liquidity coverage (30 days) and longer-term structural funding.

» Meeting these new liquidity requirements will require a convergence of risk and finance systems which will be a key challenge for banks.

Strengthen the banking industry

» Two new ratios (the leverage ratio and countercyclical ratio) have been introduced to better monitor systemic risk. In addition, measures aimed at Systemically Important Financial Institutions (SIFIs) are being devised.

» **Leverage ratio**: The Committee is introducing a leverage ratio which simply measures the ratio of capital to total assets. The leverage ratio addresses the build-up of excessive leverage in the financial system. Through pro-active management, the BCBS hopes to avoid the destabilising effect of deleveraging during times of stress. This ratio includes both on- and off-balance sheet items and securitisations. It also serves as a "safety net", to guard against any inaccuracies or unforeseen problems with risk weightings.

» **Countercyclical ratio:** The countercyclical ratio addresses the problem of pro-cyclicality or 'credit bubbles'. With this measure, the BCBS aims to protect banking systems against the risks involved with excess credit growth, which has proven to be lethal in many jurisdictions. It is the first time the regulatory community is availing itself of a "macro tool" that complements its traditional approach of measuring risk at individual institutions. Unlike the conservation buffer which is fixed, the countercyclical ratio is to evolve within a defined range. It is derived from the deviation from the long term trend credit /GDP and its calibration is left to national discretion.
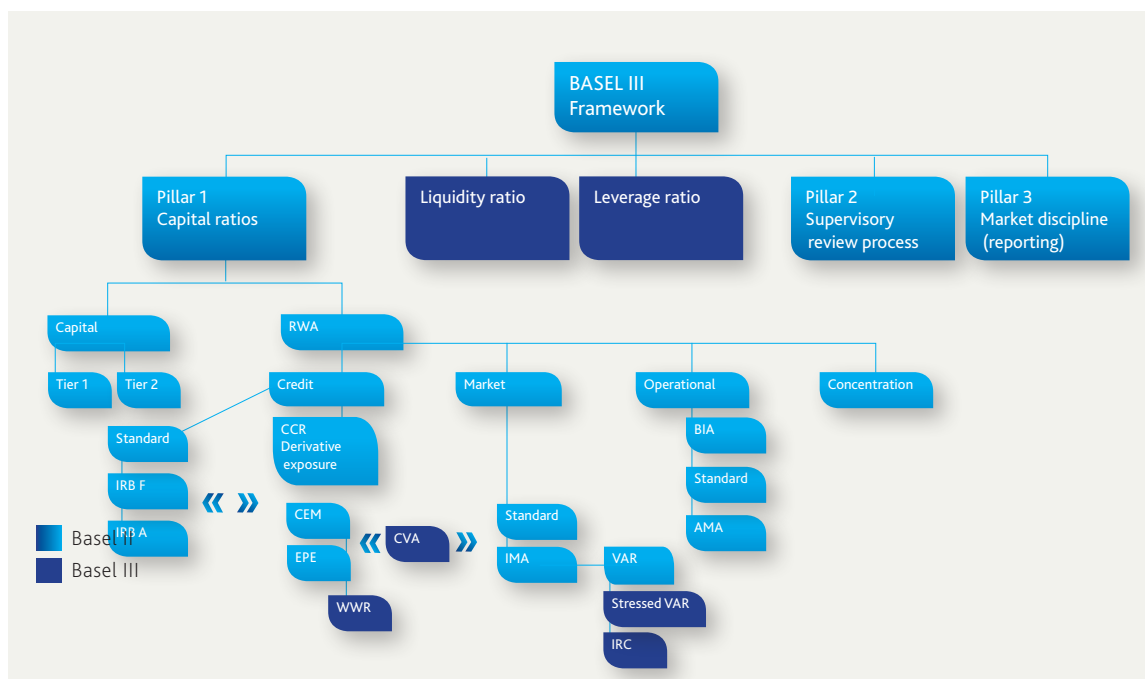
Timelines

Basel III has been ratified by G20 members. However, it is not clear if all of the G20 states will implement Basel III in its entirety. It is also unlikely that all members will implement it at the same time. Other BCBS countries are supposed to implement the Basel II framework as per the BCBS timelines. The US has pledged to implement this framework although it has not fully adopted Basel II. We expect leading emerging markets to also adopt Basel III, as already announced by some Asian states including China. It is notable that some countries, such as the UK and Australia, started to address these issues with local regulation in 2009 and 2010 (specifically liquidity and stress testing).

Basel III: Quantitative requirements and timelines

	2011	2012	2013	2014	2015	2016	2017	2018	2019
Leverage Ratio	Supervisory monitoring		Parallel run 1 Jan 2013 –1 Jan 2017 Disclosure starts 1 Jan 2015					Migration to Pillar 1	
Minimum common equity capital			3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital conservation buffer						0.625%	1.25%	1.875%	2.5%
Minimum common equity plus capital conservation buffer			3.5%	4.0%	4.5%	5.125%	5.570%	6.375%	7.0%
Phase-in deducting from core equity Tier 1				20.0%	40.0%	60.0%	80.0%	100.0%	
Minimum Tier 1 capital			4.5%	5.5%	6.0%	8.0%	6.0%	6.0%	
Minimum Total captial			8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	
Minimum total capital plus conservation buffer			8.0%	8.0%	8.0%	8.625%	9.250%	9.875%	10.50%
No longer qualifying non-core Tier 1 and 2 capital instruments			Phased out over 10-year horizon beginning 2013						
Liquidity coverage ratio	Observation period ends				Introduce minimum standard				
Net stable funding ratio		Observation period starts						Introduce minimum standard	

Basel II to Basel III: What is new?

Basel III capital enhancements: a practical overview

> » Upgrade regulatory capital calculation and reporting systems
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> » Improve capital management strategies

Basel III introduces significant changes to the amount of capital banks need to hold and the quality of capital. These changes affect the risk-weighting rules for credit and market risk, the definition of the capital, and the minimum level of capital adequacy ratio itself (see blue highlights in the ratio definition below):

$$CAR \ \leq \ \frac{\text{Capital (Tier 1+Tier 2+\cancel{\text{Tier 3}}) - Adjustments}}{RWA_{\text{Credit Risk}} \ + \ RWA_{\text{Market Risk}} \ + \ RWA_{\text{Operational Risk}} \ + \ RWA_{\text{Concentration Risk}}}$$

The regulation increases capital requirements for counterparty credit with the objective of expanding the coverage of the capital base.

Significant changes are proposed to the composition of capital: Tier 1 capital is composed of common equity. Tier 1 ratio increases from 4% to 6%. Within the Tier 1 ratio, the minimum Core Tier 1 ratio increases from 2% to 4.5% to reflect the higher quality requirement. Tier 2 capital is harmonised and simplified, and Tier 3 capital is being abolished altogether.

Including the additional conservation buffer and countercyclical buffers, regulatory capital requirements for banks rise from a minimum of 8-10.5% depending on the size of countercyclical buffer (including the countercyclical buffer it could go up to 13%).

The leverage ratio is an alternative measure to the risk-weighting process and aims to guard against the build-up of excessive leverage in the banking system.

Timeline

According to the Basel Committee on Banking Supervision's (BCBS) guidance, the requirements are to be phased in by 2019 with the first phase of compliance required by 2013 and an observation phase starting January 2011. However, in common with previous regulations, the final implementation schedule is determined by national supervisors.

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Regulation issued	◊									
Observation period		█	█							
Phased in Capital Requirements				█	█	█	█	█	█	█
Phased in Leverage ratio				█	█	█	█	█	█	█
Phased in conservation buffer							█	█	█	█