Basel III: An Overview

Seminar for Senior Bank Supervisors from Emerging Economies
Washington, DC
18 October 2011

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The Basel Capital Accord (Basel I)

- This multi-year project was finalised in 1988 with the issuance of the paper *International Convergence of Capital Measurement and Capital Standards* (Basel I)
- A common definition of capital and risk-weight categories was agreed
- It represented the first time that a capital standard would be applied across numerous countries
- Intended for the G10 countries but ultimately adopted by virtually all major jurisdictions
- It was also the first time that the Committee had issued a standard that had a “bite”
From Basel I to Basel II

- In the late 1990s, the Basel Committee, in recognition of weaknesses in Basel I, began to develop a more risk-sensitive approach to capital adequacy calculations.
- This included specific recognition of the need to hold capital against operational risk (market risk had been added to Basel I in 1996).
- It also included two new pillars:
  - the supervisory review process (Pillar 2)
  - market discipline (Pillar 3)
Basel II structure

Three Basic Pillars

Minimum capital requirements
Supervisory review process
Market discipline

Risk weighted assets

Credit risk
Standardised Approach
Internal Ratings-based Approach
Basic Indicator Approach

Operational risk
Standardised Approach
Advanced Measurement Approaches

Market risks
Core Capital
Supplementary Capital

Definition of capital

Core Capital

Supplementary Capital

Minimum capital requirements
Supervisory review process
Market discipline

Risk weighted assets

Credit risk
Standardised Approach
Internal Ratings-based Approach
Basic Indicator Approach

Operational risk
Standardised Approach
Advanced Measurement Approaches

Market risks
Core Capital
Supplementary Capital

Definition of capital

Core Capital

Supplementary Capital
Pre-crisis problems

- Too little capital and much of it of questionable quality
- Excess market liquidity and the search for yield
- Weak governance and risk management
- Perverse incentives (salaries and bonuses)
- Poor underwriting and excessive risk taking
- System-wide risk and interconnections
- Deficiencies in regulation and supervision
- Perimeter of regulation insufficient
- Procyclicality of the banking system
## Business models

<table>
<thead>
<tr>
<th>Originate-to-hold</th>
<th>Originate-to-distribute</th>
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</thead>
<tbody>
<tr>
<td>Raise retail deposits and grant loans which are held on B/S till they mature</td>
<td>Originate/outsource loans and distribute through securitisation. Not retained on B/S</td>
</tr>
<tr>
<td>High customer focus</td>
<td>- Incentives for credit risk assessment?</td>
</tr>
<tr>
<td>Assets – loans</td>
<td>Assets - securities</td>
</tr>
<tr>
<td>Revenue – interest income</td>
<td>Revenue - fee income</td>
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<tr>
<td>Liabilities – retail deposits</td>
<td>Liabilities - wholesale funding</td>
</tr>
<tr>
<td>Credit origination, servicing and monitoring performed by the same bank</td>
<td>Main functions split into several distinct activities performed by several separate entities</td>
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</tbody>
</table>
The age-old problem

- The recent financial crisis reminded us that:
  - the upside of bank risks belongs to shareholders and bank management
  - but a significant portion of the downside risk is borne by society in general, most especially taxpayers
  - “capitalize profits and nationalize losses”
  - this is especially true for “too big to fail” institutions
- The size of a bank’s capital and liquidity cushions determines how much of the risk belongs to the bank and how much belongs to all of us
Strengthening Basel II

- Not only more capital but higher quality capital
- Better risk coverage
  - Failure to capture key risks amplified stress
  - Enhanced treatments for:
    - Trading book
    - Off-balance sheet exposures
    - Securitisations and external ratings
    - Counterparty credit risk
- Address any excess cyclicalality and promote countercyclical buffers
- Non risk-based measure to contain leverage
Strengthening Basel II

- In 2009 the Committee issued two important documents, among others, in response to the financial crisis:
  - *Enhancements to the Basel II framework*, July 2009 (includes supplemental Pillar 2 guidance)
  - *Strengthening the resilience of the banking sector - consultative document* issued in December 2009
- In December 2010 the Committee issued *Basel III: A global regulatory framework for more resilient banks and banking systems* (reissued in 2011 with minor amendments related to CCR)
Basel III
Basel III – what is it?

- Basel III is a comprehensive set of measures to strengthen the regulation, supervision and risk management of the banking sector.

- These measures aim to:
  - improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source.
  - improve risk management and governance.
  - strengthen banks' transparency and disclosures.

- The reforms target:
  - bank-level, or microprudential, supervision.
  - system-wide, or macroprudential, risks.
What about Basel II?

- Basel II is NOT dead – nor is Basel I
  - they continue to be viable capital standards
- Basel III does NOT replace Basel I or Basel II – rather it supplements these two standards
- Basel III is about more than just capital ratios
Basel Committee’s reform package – broad objectives

- Strengthen micro- and macroprudential frameworks
- Increase financial system’s ‘shock absorbers’
- Reduce channels of procyclicality
- Address externalities of systemically important firms
- Review perimeter and scope of regulation
- Strengthen governance, risk management, transparency
Regulatory Response to the Financial Crisis – Basel III

- Raising the Level/Quality of Capital
- Introducing a Global Liquidity Standard
- Supplementing Risk-based Capital with Leverage Ratio
- Reducing Procyclicality
- Addressing Systemic Risk
Committee’s reform package – key elements

- Stronger capital framework
  - increase significantly the **quality** of bank capital
  - increase the **coverage** of bank capital
  - increase the required **level** of bank capital
- Larger capital ‘buffers’ / reduced procyclicality
- Leverage ratio as a “back-stop”
- Robust global liquidity standards
- Greater emphasis on macroprudential supervision
- Enhanced governance and risk management guidance
- Better cross-border bank resolution frameworks
Reminder: the components of a capital ratio

- 3 key components:

Capital

Credit risk + Market risk + Operational risk

- Each of these 3 components has been adjusted in Basel III
The components of a capital ratio

Capital

Credit risk + Market risk + Operational risk

>8%
Definition of capital – at present

- At least six sub-tiers in many jurisdictions:
  - Common equity Tier 1
  - Non-innovative tier 1
  - Innovative Tier 1
  - Upper Tier 2
  - Lower Tier 2
  - Tier 3

- Complicated system of maximums and minimums for each element or group of elements
Erosion of the quality of capital

- Over the past decade or so, the quality of bank capital has eroded
- Tier 1, which was intended to be the purest forms of capital, was particularly weakened
- The financial crisis highlighted the fact that many Tier 2 capital instruments were actually debt
- Going concern vs gone concern issues
Problems with existing definition of capital

- Common equity can be just 2% of RWAs
- Deductions not applied to common equity
  - tangible common equity can be zero or even negative
- No harmonised list of deductions
- Weak transparency
- Global banking system entered the crisis with an insufficient level and quality of capital:
  - Banks had to raise capital and de-leverage
  - Result was a need for massive government support
The new definition of capital

- Objective:
  - Raise quality, consistency and transparency of Tier 1
  - Tighten definition of common equity (focus on common shares and retained earnings)
  - Limit what qualifies as Tier 1 capital (regulatory adjustments such as deductions)

- Main driver of new definition: loss absorption capacity
- Inclusion based on clear principles
- Harmonised internationally and simplified
- New disclosure requirements on Tier 1 composition (Pillar 3)
The new definition of capital

- Just three elements (much stricter definition)
  - Common equity Tier 1 (predominant form of Tier 1)
  - Tier 1 additional going concern capital
  - Tier 2 (gone concern) capital
- No sub-categories of Tier 2
- Elimination of the Tier 3 category (no real impact)
- Minimum requirements established for common equity Tier 1 (CET1), Tier 1 and total capital
The components of a capital ratio

Capital

Credit risk + Market risk + Operational risk

>8%
Denominator – better risk coverage

- The financial crisis highlighted the fact that capital requirements for certain transactions were much too low
  - trading book exposures
  - complex securitisation exposures, off-balance sheet exposures (eg SIVs)
  - counterparty credit risk
- The Committee increased the capital requirements for many transactions in its July 2009 document
- New rules for counterparty credit risk are being finalised
The components of a capital ratio

Capital

Credit risk + Market risk + Operational risk

>8%
Increase the required level of bank capital

- The capital adequacy ratio is being raised
  - Minimum common equity requirement will be 4.5% (as compared to the current 2%)
  - A capital conservation buffer of 2.5% will be added to the 4.5% to make a total requirement of 7% common equity to total risk-weighted assets
Capital conservation buffer

- Lesson from the crisis: banks were distributing earnings even during stress periods
- Demonstrated the importance of building capital buffers during good times in order to create a cushion
- These buffers should be capable of being drawn down
- Buffer range above the minimum capital requirement established (2.5%)
- If bank’s capital levels fall within this buffer range, constraints on the distribution of dividends, on bonuses and share buybacks (but not on the way the bank conducts its business)
Countercyclical buffer

- The Committee has endorsed the creation of a countercyclical buffer that will increase the capital conservation buffer by up to an additional 2.5 percentage points during periods of excess credit growth.
- Make the banking sector a shock absorber rather than a shock amplifier.
- This buffer will be imposed when a credit bubble has given rise to the build-up of system-wide risk.
- The buffer would be released when, in the judgement of supervisors, it would help absorb losses in the banking system that pose a risk to financial stability.
The functioning of the capital buffers

- Proposed **capital conservation buffer** will establish a fixed range above the Tier 1 minimum capital requirement. When a bank’s Tier 1 ratio falls into this range it becomes subject to restrictions on distributions.

- Proposed **countercyclical capital buffer** works by extending size of capital conservation buffer during periods of excess credit growth.
Raise the level of regulatory capital

<table>
<thead>
<tr>
<th>Calibration of the Capital Framework</th>
<th>Capital requirements and buffers (all numbers in percent)</th>
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<tbody>
<tr>
<td></td>
<td>Common Equity (after deductions)</td>
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<tr>
<td>Minimum</td>
<td>4.5</td>
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<tr>
<td>Conservation buffer</td>
<td>2.5</td>
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<tr>
<td>Minimum plus buffer</td>
<td>7.0</td>
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<tr>
<td>Countercyclical buffer range</td>
<td>0 – 2.5</td>
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</tbody>
</table>

…but remember: 8.0% under Basel I/II is not 8% under Basel III
Raise the level of regulatory capital

2010 BoE, Financial Stability Report (a) Common equity or other fully loss-absorbing capital; (b) There is no explicit requirement, it was generally understood that CET1 should form the predominant part of Tier 1; (c) Definition of Capital will be strengthened through new deductions from CET1
Leverage ratio

- Another lesson of the crisis: there are circumstances in which risk-weighted capital ratios provide a misleading picture of banks’ overall health (the risk-weighting rules understate the actual risks, models are flawed, etc)
Leverage ratio: objectives

- Objectives:
  - Supplement the risk-based framework with a simple measure based on total assets plus off-balance sheet exposures (no risk-weighting involved)
  - Introduce additional safeguards against model risk and risk measurement error
  - Contain build-up of leverage in the banking system during boom periods
  - Serve as an additional safeguard against attempts to “game” the risk-based requirements
Leverage ratio: implementation

- The leverage ratio will be calculated as an average over the quarter
- Agreement to have a long transition and an observation phase:
  - Supervisory monitoring from 1 January 2011
  - Parallel run period from 1 January 2013 to 1 January 2017
  - Public disclosure at bank level from 1 January 2015
  - Migration to Pillar 1 in 2018 (after appropriate review and calibration)
- Calibration: minimum Tier 1 leverage ratio of 3% during the parallel run period
Global liquidity standards
The new global liquidity standard

- Currently no international liquidity standard
- Two global liquidity standards to be introduced
  - Liquidity Coverage Ratio (LCR) – short-term
  - Net Stable Funding Ratio (NSFR) - longer-term structural ratio
- Supplement the 2008 “Principles for sound liquidity risk management and supervision”
The new global liquidity standard

- Aim of the framework is to require banks to be able to withstand more severe shocks than they have been able to in the past
- The objective is to change behaviour: more effective to increase the term of funding than to hoard liquid assets
- The Basel Committee will use an observation period to ensure that the framework is calibrated to achieve its intended objectives
Liquidity coverage ratio (LCR)

- Promote short-term resilience by requiring sufficient high-quality liquid assets to survive acute stress lasting for one month
- Stock of high quality liquid assets in relation to net cash outflows over 30-day stress period should be at least 100%
Net stable funding ratio (NSFR)

- Lessons from the crisis: over-reliance on short-term wholesale funding
- Promote resilience over longer term through incentives for banks to fund activities with more stable sources of funding
- A structural ratio
Global liquidity standards

- Liquidity Coverage Ratio (short-term)

\[
\frac{\text{Stock of high quality liquid assets}}{\text{Net cash outflows over a 30-day time period}} \geq 100\%
\]

- Net Stable Funding Ratio (longer-term, structural)

\[
\frac{\text{Available amount of stable funding (ie sources)}}{\text{Required amount of stable funding (ie uses)}} > 100\%
\]
Introduction of the new liquidity standard

- New set of standards requires careful approach
- LCR
  - Observation period from 2011
  - Introduction as a minimum standard in 2015
- NSFR
  - Observation period from 2012
  - Introduction as a minimum standard in 2018
Implementation
Allow sufficient time for a smooth transition

- The timetable for implementing the new standards is very generous
- This recognises the need for banks to raise capital and retain earnings in order to meet the new requirements
- It also highlights the Basel Committee’s commitment to avoid stifling economic recovery
Transition to the new regime

- Basel III: a substantial strengthening of existing requirements
- Transition arrangements to enable banks to meet the new standards while supporting the economic recovery
- Transition arrangements:
  - From 2013 to 2018
  - Gradual phase-in of some provisions
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<tr>
<td><strong>Leverage Ratio</strong></td>
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<td>Supervisory monitoring</td>
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<td><strong>Parallel run</strong></td>
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<td>1 Jan 2013 – 1 Jan 2017</td>
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<td><strong>Disclosure starts</strong></td>
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<td>1 Jan 2015</td>
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<td><strong>Migration to Pillar 1</strong></td>
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<tr>
<td><strong>Minimum Common Equity Capital Ratio</strong></td>
<td>3.5%</td>
<td>4.0%</td>
<td>4.5%</td>
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<td>4.5%</td>
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<td><strong>Capital Conservation Buffer</strong></td>
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<td></td>
<td>0.625% 1.25% 1.875% 2.50%</td>
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<tr>
<td><strong>Minimum common equity plus capital conservation buffer</strong></td>
<td>3.5%</td>
<td>4.0%</td>
<td>4.5%</td>
<td>5.125%</td>
<td>5.75%</td>
<td>6.375%</td>
<td>7.0%</td>
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<tr>
<td><strong>Phase-in of deductions from CET1</strong></td>
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<td>20% 40% 60% 80% 100% 100%</td>
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<td>(including amounts exceeding the limit for DTAs, MSRs and financials)</td>
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<td><strong>Minimum Tier 1 Capital</strong></td>
<td>4.5%</td>
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<td>6.0%</td>
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<tr>
<td><strong>Minimum Total Capital</strong></td>
<td>8.0%</td>
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<tr>
<td><strong>Minimum Total Capital plus conservation buffer</strong></td>
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<td>8.0%</td>
<td>8.0%</td>
<td>8.625%</td>
<td>9.125%</td>
<td>9.875%</td>
<td>10.5%</td>
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<tr>
<td><strong>Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital</strong></td>
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<td>Phased out over 10 year horizon beginning 2013</td>
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<tr>
<td><strong>Liquidity coverage ratio</strong></td>
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<td>Observation period begins</td>
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<td><strong>Introduce minimum standard</strong></td>
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<tr>
<td><strong>Net stable funding ratio</strong></td>
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Going forward

- Timely and consistent implementation of Basel III
  - BCBS member countries to translate Basel III rules into national legislation and regulations by beginning of 2013
  - Basel III requirements will take effect from beginning of 2013 and will be progressively phased in until 2018
  - Beginning of 2019 – Basel III framework should be in place
- During the phase-in process, BCBS to monitor implementation to detect & correct possible unintended consequences
- In general, FSB and BCBS to actively oversee effective implementation of the regulatory reform
  - FSB: Peer National and Thematic Reviews
  - BCBS: Standards Implementation Group (SIG) Reviews
Going forward

- BCBS to continue standard setting work
  - Fundamental review of the trading book
  - Reducing reliance on external ratings in the regulatory capital framework
  - Framework for systemically important banks (together with FSB)
  - Updating cross-border bank resolution recommendations
  - Revision of the Core Principles for Effective Banking Supervision
Basel III conclusions

- Basel III: a comprehensive reform
  - Capital requirements (minimum and buffers), leverage, liquidity…
  - Micro and macro-prudential components
- Main decisions taken – final text issued in December 2010
- Significant strengthening of the regulation
  - Banking system should be more resilient in the future
- Long transition period to avoid negative impact on the economy in the short-term
More details on Basel III on the BIS website: http://www.bis.org/bcbs/basel3.htm
Questions

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