

## The forest of Basel III has too many trees

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The new Basel III Accord confirms the radical shift in bank capital requirements. The focus is on more and better quality capital, primarily for the large banks. Now, the larger and the more 'universal' a bank is, the more capital it will need, which is the opposite of what had been the case before the crisis. But the new framework is becoming very complex, and policy-makers had better cut some of the dead wood out of the earlier versions of the Basel accords for the sake of clarity. The multitude of required ratios and divergent implementation deadlines will not ease the task of assessing a bank's soundness. When will a bank effectively be Basel III-compliant?

The new Basel framework, published on 15 December 2010, is an important building block in the new post-crisis regulatory paradigm. It maintains the current risk-weighted capital ratios framework (tier 1 and 2), and adds, on top of a stricter definition of capital: 1) a minimum ratio of common equity, 2) a capital buffer and 3) a countercyclical provision. It complements these risk-weighted ratios with 4) a simple leverage ratio, and two minimum liquidity requirements: 5) a liquidity coverage ratio and 6) the net stable funding ratio. These new rules will be introduced from 2013 onwards over an extended transition period, and will all be fully applicable from 2019 onwards. Two important elements still need to be filled in: the re-calibration of the risk-weight of assets and a surcharge for large, systemically important financial institutions (SIFIs).

The new framework is considerably more complicated than that of the current Basel II, which required banks to hold a minimum of 8% of regulatory capital based on risk-weighted assets. Basel II (2005) had amplified the possibilities to calculate the soundness of the asset base of the bank, and added Pillar 2 (supervisory review) and Pillar 3 (market discipline) without changing the minimum capital ratio or definition of capital set out in the original 1989 Basel Accord. Basel III narrows the definition of capital and adds other ratios. But it retains the base for calculating the risk weightings of assets, i.e. on the basis of the ratings assigned by credit rating agencies (ERBA) or by internal risk models (IRBA).

The new framework is composed of several building blocks, each of them with different implementation deadlines (see the table below). The upgraded 8% minimum Tier 1 + Tier 2 is applicable from 2013, but the restricted definition of capital will be phased in gradually and will only fully apply from 2018 onwards. The table below sums up the different ratios, the minimum levels and their implementation deadlines.

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### Basel III ratios and deadlines

Ratios	Basel II	Basel III	Deadline
Minimum Tier 1 leverage	n.a.	3%	2018
Risk-weighted ratios:			
1. Minimum Common Equity Capital	n.a.	4.5%	2015
2. Capital Conservation Buffer	n.a.	2.5%	2019
1+2=	n.a.	7%	2019
3. Minimum Tier 1	4%	6%	2015
4. Minimum Tier 1+2	8%	8%	2013
Countercyclical capital buffer	n.a.	0 - 2.5%	2019
Liquidity coverage	n.a.		2015
Net stable funding ratio	n.a.		2018
<i>Deductions from common equity</i>	n.a.		2018

The new Accord discusses at length the definition of capital, which raises the question why it never managed to harmonise this in the first place. Common equity, consisting of equity capital and retained earnings, must be at least 4.5% of risk-weighted assets at all times, effective from 2015 onwards. The inclusion of minority interests in equity capital is restricted to the elements that fully meet the criteria of equity capital. Other elements will be phased out over a 5-year period. Based on an analysis of the large banks, the IMF has estimated that between 20 and 30% will have to be deducted from the current Tier 1 ratio to arrive at the new common equity capital ratio, with Europe being on the higher end. The proposed deductions would lower these banks current Tier 1 capital ratio from 8.6% to 6.7%, or to 5.8% including the market risk provisions.<sup>1</sup> Banks should accumulate retained earnings in response, and thus pay less to shareholders in dividends or employees in bonuses.

In addition to the new core capital ratio, except during periods of stress, banks should hold buffers of capital above this regulatory minimum of 2.5% of risk-weighted assets. Banks not meeting the capital buffers will be subject to capital distribution constraints. The capital conservation buffer will be phased in from 2016 onwards, and be fully effective from 2019.

The creation of a countercyclical capital buffer will be decided by national jurisdictions, under Basel Guidelines, when excess aggregate credit growth is judged to be associated with a build-up of system-wide risk. It will vary between zero and 2.5% of risk-weighted assets. The charge can be applied regionally or on a national basis for internationally active banks. The timing is the same as for the capital buffer.

Two other ratios set minimum prudential standards for liquidity risk management. The liquidity coverage ratio requires banks to hold a minimum of high-quality liquid assets to meet its liquidity needs for 30 days in a stress situation, designed not only to deal with a bank run, but also with stresses in wholesale markets. The net stable funding ratio focuses upon guaranteeing stable sources of funding on the liabilities side. Under normal circumstances, if a minimum capital standard is well regulated, there would be no need for liquidity regulation. However, in times of stress, debt markets can become illiquid, drastically reducing the substitutability of debt for in cash, as was also clear during the sovereign crisis in some euro countries.

Compared with Basel II, the update substantially extends the requirements and introduces significant changes for banks, supervisors, investors and users. Rather than using only one ratio, for example, banks will now be assessed on the basis of up to seven different ratios! The crisis had clearly demonstrated that the old Basel II Tier 1 (and 2) ratio had become of limited relevance. Its definition

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<sup>1</sup> Inci Ötker-Robe and Ceyla Pazarbasioglu, *Impact of Regulatory Reforms on Large and Complex Financial Institutions*, IMF Staff Position Note, IMF, Washington, D.C., 3 November 2010.

of capital was too broad, and not sufficiently harmonized. It was biased towards, e.g. sovereigns and real estate exposures, and incomplete with regard to exposures to off-balance sheet instruments or trading positions. As a result, markets started to increasingly use the leverage ratio, a very crude, but probably the most transparent measure.

The combined effect of a minimum leverage ratio, a risk-weighted minimum common equity ratio and capital buffer, and minimum liquidity requirements should result in a better capitalised and thus more resilient banking system. But important deficiencies of Basel II remain to be addressed, or have been kept in place. For example, the risk-weightings have not been reviewed nor has the use of external credit rating agents been critically examined in the ratings-based approach to determine the risk weights. The criteria for ratings have been strengthened, and rating agents are requested to comply with the IOSCO Code of Conduct. Also the use of the internal ratings is maintained, although forms of self-regulation have been widely discarded as a result of the crisis.

The big question that emerges from this complex structure is how does one determine when a bank is effectively Basel III-compliant, as some will soon start to claim. Is it when it meets all ratios at the same time? Or will it be when it complies with the leverage ratio and the minimum levels of common equity and capital buffer? Will banks then also refer to their ratios under all different elements, as they have done with Tier 1 and Tier 2 of Basel II so far? This becomes very confusing for investors and depositors alike. Moreover, outsiders will only be able to personally check one of the ratios, the leverage ratio, as s/he will not have access to information on the subdivision of assets according to risk weightings. Market discipline thus remains a weak part of the Accord.

These questions should be taken into account as the EU embarks on the transposition of Basel III into legislation. The EU could strive to improve the accessibility of Basel III by introducing some limited simplification of its provisions, for example by abolishing the old Tier 1 and Tier 2 capital ratios. It could indicate what the benchmark ratio will be. It could also synchronise and shorten the implementation deadlines, although it could be expected that the EU banking industry will rapidly complain about competitive distortions. However, the EU has already acted unilaterally, with the 2009 and 2010 amendments to the Capital Requirements Directive (CRD), which imposed higher charges for the trading book re-securitisation and new rules on bonus payments. Rating agents are now licensed and separately supervised in the EU, subject to strict governance and conduct of business criteria.

But the most sensitive issue in the EU implementation will be the risk-weighting of sovereigns, which are 0%, irrespective of the rating. Under Basel II, they are 0% until AA-, 20% until A- and 50% from BBB+, the level at which Greek debt is now rated. Another hot issue is the weighting of real estate, where Basel II applied a 35% risk weighting for residential property and 50% for commercial real estate. The latter is one of the many instances of national discretion or implementation options, which currently total some 141 in the CRD (see the website of the European Banking Authority <http://www.eba.europa.eu/>). With the increased use of regulations in financial services and the objective to arrive at a single rulebook for the new supervisory authorities, a huge task lies ahead for the EU to come forward with a streamlined Basel III and to withstand pressures for national discretion.