“Basel III”:

the reform of the existing regulatory framework of the Basel Committee on Banking Supervision for strengthening the stability of the international banking system

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PART A

The sources of the new regulatory framework and the rationale for reform

A. The sources of the new regulatory framework and the rationale for reform

On 16 December 2010, the Basel Committee on Banking Supervision (hereinafter the "Basel Committee") adopted and published two important reports entitled:

- *"Basel III: A global regulatory framework for more resilient banks and banking systems"*, and
- *"Basel III: International framework for liquidity risk measurement, standards and monitoring"*

These reports are the result of extensive consultations that have taken place since 2008, namely in the middle of the recent (2007-2009) international financial crisis. Both are *quasi* final, since, in the upcoming months, there may be amendments and/or additions to their provisions, according to the Basel Committee's current agenda. Indeed, on January 13, 2011, the Committee already issued a Press release entitled: *"Basel Committee issues final elements of the reforms to raise the quality of regulatory capital"*

A. The sources of the new regulatory framework and the rationale for reform

These two reports are collectively known as the "Basel III" regulatory framework (hereinafter "Basel III"), and constitute the Basel Committee's probably most important reaction to the recent crisis. Their provisions lay down a new international regulatory framework for international banks, by reforming the existing one, in order to strengthen the stability of the banking system through:

- enhanced bank-level, or microprudential, regulations, which will help raise the resilience of individual banking institutions during periods of stress, and
- macroprudential regulations, addressing system-wide risks that can build up across the banking (and in general financial) sector, as well as the "procyclical" amplification of these risks over time

A. The sources of the new regulatory framework and the rationale for reform

The term "financial macro-prudential policies" (of which macroprudential regulations are a part) refers to the set of policies (mainly of a prudential nature) adopted and implemented to limit the financial system's exposure to the "systemic risk", ensuing from factors that do not concern individual financial service providers or individual markets and structures of the financial system, but are more general in character. A "systemic risk" is the risk of a malfunction in the supply of financial services (and/or failure to supply), due to the weakening of a sector or of the entire financial system, potentially leading to serious negative consequences in the real sector of the economy

A. The sources of the new regulatory framework and the rationale for reform

Macroprudential policies seek to address the two dimensions of systemic risk:

a) *The first is the "time-dimension", namely the systemic risk's evolution through time. In this context, macroprudential policies seek to strengthen the resilience of the financial system at times of economic recession by limiting procyclicality, which can increase the systemic risk because of the interactions developed either within the financial system, or between the financial system and the real sector of the economy*

b) *The second dimension is the "cross-sectional dimension", namely the distribution of risk in the financial system at any given point in time. In this case, macroprudential policies aim at limiting systemic risk concentration, which could result either because of the concurrent exposure of multiple financial institutions to risks from similar exposures, or because of the interconnectedness of such institutions (and the contagion of problems amongst them), especially if they are systemically important*

A. The sources of the new regulatory framework and the rationale for reform

Accordingly, “Basel III” seeks to significantly strengthen the content of the existing regulatory framework’s provisions, and introduce additional means of microprudential regulation. Yet, the main *novum* of “Basel III” is the adoption of rules on macroprudential regulation. In this sense, Hannoun's remark that “Basel III” is an *“enhanced Basel II plus a macro-prudential overlay”* is very accurate

In the European Union, “Basel III” will be implemented by way of an extensive amendment of the European Parliament and the Council Directives 2006/48/EC and 2006/49/EC. The work is already underway and is expected to be completed in 2012

PART B

The provisions of “Basel III”: an overview

I. Overall examination

1. Systematic classification

From a systematic point of view, the provisions of "Basel III" can be classified into two categories:

(a) The first category includes the provisions amending provisions of the existing regulatory framework governing the capital adequacy of international banks (namely "Basel II"), as well as additions thereto

(b) The second category includes the provisions introducing "innovative" elements, which are further distinguished into:

- those introducing additional rules on microprudential regulation, and
- those introducing rules on macroprudential regulation

All the provisions of the new regulatory framework are expected to be phased-in, starting January 1st, 2013 and until January 1st, 2019 (deadline for full implementation)

I. Overall examination

2. Amendments and additions to the existing regulatory framework governing the capital adequacy of banks

a) Provisions on banks' minimum regulatory capital

The most important amendment to the existing regulatory framework of the Basel Committee on bank capital adequacy refers to the definition of regulatory capital.

b) Provisions on banks’ cover against exposure to credit risk

During the recent international financial crisis, some banks suffered significant losses from exposures which were not covered by capital requirements. Hence, the new regulatory framework seeks to strengthen banks’ coverage against credit risk exposure from positions in their portfolio (on- and off-balance sheet), such as OTC derivatives, repurchase agreements, and loans for the purchase of securities and positions in financial and other derivative instruments

I. Overall examination

2. Amendments and additions to the existing regulatory framework governing the capital adequacy of banks

b) Provisions on banks' cover against exposure to credit risk (cont.)

Furthermore, provisions were also introduced regarding the following:

(a) In calculating their capital requirements to cover against credit risk according to the standardised approach, banks must assess themselves the credit risk of their exposures, irrespective of whether there is a rating by a credit rating agency, and determine whether the risk weights applied to such exposures are appropriate or not.

(b) In order to recognise a credit rating agency as "eligible", national supervisory authorities must verify whether such an agency meets the appropriate criteria, using as reference the 2008 revised IOSCO code ("Code of Conduct Fundamentals for Credit Rating Agencies, Report of the Technical Committee")

I. Overall examination

3. "Innovative" elements (I): additional rules on microprudential regulation

a) Leverage ratio

"Basel III" introduces a simple, non-risk based leverage ratio (namely, assets and off-balance sheet items of banks are not risk-weighted as in the case of capital adequacy requirements). The leverage ratio, which is calibrated to act as a credible supplementary measure to the risk based capital requirements (as a "backstop measure"), is amounting to 3%, and has been designed to have:

- as numerator, banks' Tier 1 capital (according to the new definition), and
- as denominator, their on- and off-balance sheet exposures, based on their book value, without risk-weighting and (initially) without right to net assets and liabilities (as is the case of capital adequacy requirements).

I. Overall examination

3. "Innovative" elements (I): additional rules on microprudential regulation (cont.)

b) Liquidity ratios

(1) Liquidity coverage ratio

This standard aims to ensure that a bank maintains an adequate level of high-quality liquid assets that can be converted into cash to meet its liquidity needs. This standard, which must be equal to or in excess of 100%, is defined as the ratio of:

- the stock of high-quality liquid assets,
- to the total net cash outflows over the next 30 calendar days

I. Overall examination

3. “Innovative” elements (I): additional rules on microprudential regulation (cont.)

b) Liquidity ratios

(2) Net stable funding ratio

The net stable funding ratio was introduced in order to address the problem caused by liquidity mismatches of assets and liabilities in a bank's balance sheet, and create incentives for banks to use stable sources to fund their assets (including loans) with a term in excess of one year. This standard, which must be in excess of 100%, is defined as the ratio of:

- the available amount of stable funding,
- to the required amount of stable funding

I. Overall examination

4. “Innovative” elements (II): rules on macroprudential regulation

a) Introductory remarks

“Basel III” introduces, for the first time as well at international level, rules on macroprudential regulation. In this respect, the following remarks deserve attention:

1) The rules adopted are addressing exclusively the time dimension of systemic risk. In this context, banks are called to:
   - create a “capital conservation buffer” in times of economic growth,
   - create a “countercyclical buffer” in times of excessive credit expansion,
   - build strong “forward-looking provisions”, and
   - cover against excessive cyclicality of their minimum capital requirements.
2) On the contrary, no specific provisions have been introduced with regard to the cross-sectional dimension of systemic risk. The Basel Committee considers, however, that some of the rules adopted for banks’ coverage against exposure to credit risk, will address this dimension as well

I. Overall examination

4. "Innovative" elements (II): rules on macroprudential regulation (cont.)

b) Capital conservation buffer

According to the new regulatory framework, in addition to their minimum capital requirements, banks shall also have to hold a capital conservation buffer. This buffer shall be created during times of economic growth and credit expansion, with a view to securing the capacity to use it in order to absorb losses that may ensue in times of stress in the economic cycle

This buffer, of 2.5% of banks' total risk weighted assets (according to the provisions on the capital adequacy ratio), shall exclusively include common equity Tier 1 capital (according to the new definition), and be used to avoid resort to minimum capital. When buffers have been drawn down, banks should rebuild them promptly by reducing dividend payments, share buy-backs and staff bonus payments

I. Overall examination

4. "Innovative" elements (II): rules on macroprudential regulation (cont.)

c) Countercyclical buffer

As already mentioned, losses incurred in the banking sector can be extremely large when an economic downturn is preceded by a period of excess credit growth. To address this problem, "Basel III" imposes on banks to create one additional buffer, the countercyclical capital buffer, to ensure that the capital requirements take into account the macro-financial environment in which they operate

National authorities will activate this obligation and determine the size of the buffer, when excess aggregate credit growth is judged to be associated with a build-up of systemic risk. In this context, authorities are called to monitor credit growth and other indicators that may signal a build up of systemic risk, and assess whether (and to what extent) credit growth is excessive and is leading to the build up of systemic risk. Based on this assessment they will put in place a countercyclical buffer requirement when circumstances warrant

I. Overall examination

4. "Innovative" elements (II): rules on macroprudential regulation (cont.)

c) Countercyclical buffer (cont.)

The size of the countercyclical buffer will vary, depending on the competent authorities' judgement, between zero and 2.5% of risk weighted assets (according to the provisions of capital adequacy requirements). The buffer shall be implemented through an extension of the capital conservation buffer discussed above, and include exclusively, at least initially, common equity Tier 1 capital

Internationally active banks (with subsidiary banking undertakings in a number of states), in particular, shall calculate this buffer on the basis of a weighted average of the buffers that are being applied in the jurisdictions to which they have exposures (given that the economic cycle in them may not be (and usually is not) synchronised)

II. Specifically: provisions on banks' minimum regulatory capital

1. Introductory remarks

As already mentioned, the most important amendment to the existing regulatory framework of the Basel Committee on bank capital adequacy refers to the definition of regulatory capital. This amendment seeks to strengthen the quality of regulatory capital, given that during the recent financial crisis the ability of banks to absorb losses proved reduced. In this context, it is necessary to make the following remarks:

(1) The regulatory capital of banks, called now "minimum capital" (in light of the introduction of the abovementioned two new capital buffers), will continue to be the sum of:

- "Tier 1 capital", which is classified in two categories (an important novelty in terms of the relevant quantitative limits set), and
- "Tier 2 capital"

On the contrary, the alternative definition of capital ("Tier 3 capital"), that banks, according to the existing regulatory framework, can use to fulfil their capital requirements for coverage against market risks, is eliminated

(2) The amendments introduced pertain to the composition of each category of capital, as well as the eligibility criteria of capital elements to be included in each category

II. Specifically: provisions on banks' minimum regulatory capital

2. The provisions on Tier 1 capital

According to "Basel III", Tier 1 capital of banks shall be made up of two classes of elements: common equity Tier 1 capital, and additional Tier 1 capital

a) Common equity Tier 1 capital

Common equity Tier 1 capital consists of the following elements (subject to specific conditions):

- the value of paid-in share capital in terms of common shares (with or without voting right), all classes of preferred shares being excluded,
- retained earnings, including interim profits or losses,
- disclosed reserves,
- common shares issued by consolidated subsidiaries of the bank, and held by third parties ("minority interest"), and
- share premium from the issue of the above common shares

II. Specifically: provisions on banks' minimum regulatory capital

2. The provisions on Tier 1 capital (cont.)

b) Additional Tier 1 capital

Additional Tier 1 capital consists of the following elements (subject to specific conditions):

- preferred shares and bonds with no maturity date ("perpetuals"), issued and paid-in, subordinated to depositors and general creditors, containing no step-up or redeem clause, and recallable at the initiative of the issuer only after a minimum of five years,
- instruments with the above characteristics issued by consolidated subsidiaries of the bank, held by third parties, and not included in common equity Tier 1 capital, and
- the share premium from the issue of preferred shares included in this category

Consequently, perpetual, non-cumulative preferred shares are still included in banks' Tier 1 capital, though under quantitative limitations. On the contrary, innovative instruments which, according to the existing regulatory framework, are included in Tier 1 capital of banks up to 15%, shall no longer be eligible

II. Specifically: provisions on banks' minimum regulatory capital

3. The provisions on Tier 2 capital

Tier 2 capital includes the following elements (subject to specific conditions):

- fixed-term preferred shares and bonds complying with the abovementioned terms on additional Tier 1 capital, and a minimum original maturity of five years,
- instruments with the above characteristics issued by consolidated subsidiaries of the bank, held by third parties, and not included in Tier 1 capital,
- the share premium from the issue of preferred shares included in this category, and
- certain general provisions and general loan-loss reserves

Consequently, undisclosed and revaluation reserves, which, according to the existing regulatory framework, are included in Tier 2 capital, shall no longer be eligible

II. Specifically: provisions on banks' minimum regulatory capital

4. Specific provisions

Detailed provisions have been introduced regarding the deduction of instruments from individual elements of banks' regulatory capital, which are definitively stricter than the existing ones. "Basel III" also significantly strengthens the regime governing the obligation of banks to disclose information regarding the composition of their regulatory capital

II. Specifically: provisions on banks' minimum regulatory capital

5. Quantitative limits

"Basel III" has set the following new quantitative limits regarding the minimum capital requirements of banks, that must be observed on a continuous basis:

- common equity Tier 1 capital must be at least 4.5% of risk-weighted assets and off-balance sheet items;
- Tier 1 capital must be at least 6.0% of risk-weighted assets and off-balance sheet items (currently 4.0%);
- total capital (Tier 1 plus Tier 2) must be at least 8.0% of risk-weighted assets and off-balance sheet items; by induction, the amount of Tier 2 capital must not exceed 2.0%

PART C

Assessment

I. Cost and benefits from the phasing-in of the new rules

According to the overview made above of the "Basel III" provisions, these will be phased-in from 2013 and with a six-year horizon, while some provisions will most certainly be amended, during the supervisory monitoring transitional periods that were introduced. This leads to two conclusions; a positive one and a negative one

(1) The decision to introduce an adjustment period has been taken correctly on the consideration, among others, that if the new rules were to be fully and cumulatively implemented within a short period of time, the negative repercussions on the operation of banks, due to the resulting cost, would be significant. Capital requirements will increase substantially (especially in times of economic growth and mainly for systemically important banks), while implementation of the provisions on liquidity ratios will, in some cases, lead to a redefinition of banks' business models

(2) On the contrary, the fact that some of the provisions of "Basel III" will almost certainly be amended, creates a climate of ambiguity, which may lead to delays in their implementation, all the more so since this will be at the discretion of national authorities

II. Risks from the implementation of the new rules

There is no doubt that the new regulatory framework will reduce banks' profitability margins, as well as their return on equity (no matter the extent to which they will be able to pass the cost over to their clients, or the potential for cost-cutting). This, of course, is the price of safeguarding the stability of the banking system on a worldwide basis, against the risk of another major financial crisis like the recent one. Even if the claim (which the author supports) that in the new environment banking will be "overregulated" is correct, the experiences from the recent crisis make the adoption of stricter measures a politically justifiable choice (albeit not always adequately justified). However, this entails three (at least) risks, whose importance should not be underestimated:

(1) First of all, implementation of the new rules can, at least in certain cases, lead to a reduction in the supply of borrowed funds by banks, with negative consequences on the real sector of the economy and on growth. Consequently, it is critical that there be accurate and reliable assessments of the impact that the new rules will have on banks' lending activity (especially of smaller and specialised ones – mortgage, savings and cooperative banks), both during economic growth and during recessions

II. Risks from the implementation of the new rules (cont.)

(2) Moreover, given that the banking system as a whole will be called to raise considerable amounts of equity capital from the markets (albeit within a six-year horizon), primarily by issuing common shares, the expected reduction in banks' return on equity (ROE) will bring them in a competitive disadvantage to enterprises in other sectors of the economy, whose ROE will remain stable or even increase

It is noteworthy that systemically important financial institutions (and in particular banks) may even be subject to an additional capital requirement, amounting to 2% of their risk weighted assets and off-balance sheet items which, again, will have to be covered by common equity Tier 1 capital. As a result, the equity capital of large international banks may, in extremis, need to increase eightfold in the upcoming years!

Consequently, in order to comply with the requirements of the new regulatory framework, banks that fail to raise the necessary capital from markets, will be forced to deleverage (and in such case curtail their lending capacity), and/or resort to restructurings that will increase the degree of concentration in the banking sector, without any obvious positive synergies therefrom

III. The problem of competitive equality

In general, the rules adopted by the Basel Committee (as well as by other international *fora* which are shaping public international financial law) are not legally binding and enforceable (constituting "soft law"). Consequently, implementation of the provisions of "Basel III", in full or in part, remains (mainly) at the discretion of national regulators (and in the case of the EU, the European regulator, i.e., the European Parliament and the Council)

Accordingly, one of the most important issues arising is the extent to which "Basel III" will be implemented, and in particular by which states, in order to achieve a level playing field for banks with international activities, given that the regulatory cost imposed on them is a substantial factor of their competitiveness (especially in foreign markets). The precedent from the refusal of certain Basel Committee member states to implement "Basel II", is recent and striking

Total Capital Requirements to be imposed on banks according to the regulatory framework of Basel Committee after the transitional periods (*)

(percentages in relation to the total risk-weighted assets and the off-balance sheet)

	Common Equity	**Tier 1 Capital**	Total Capital Requirements
1. Minimum Capital Requirements (from 1.I.2015)	4,5% (from 2%)	6,0% (from 4%)	8,0% (unchanged)
2. Capital Conservation Buffer (from 1.I.2019)	2,5% (new)		
3. Sum 1 and 2 (from 1.I.2019	7,0%	8,5%	10,5%
4. Countercyclical Capital Buffer (from 1.I.2019)	0-2,5% (new)		

(*) An additional capital requirement of 2% may be introduced for systemically important banks