# THE FRAMEWORK RESULTING FROM THE BASEL III REGULATIONS

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***Abstract:*** *The banking sector is under prudential regulations set internationally by the Basel Committee, in order to ensure its strength, stability and mitigate competitive inequities. Its founding principle is based on a minimum solvency ratio introduced in 1988 in the form of the Cooke ratio, resulting in a harmonization of the rules of banking supervision governing the level of own funds.*
*Basel II was introduced after the various financial crises of the 1990s (the Mexican crisis of 1994, the Asian crisis, and the Brazilian and Argentinean crisis). Despite a series of reforms, Basel II has quickly shown its limitations with the 2007 crisis that has strongly impacted the financial markets and the world economy generally. In this context, the Basel Committee has developed within Basel III a number of requirements which aim at strengthening the resilience of the banking institutions and financial system. These adjustments will be applied to the three pillars already in place and relate to capital, liquidity and systemic risks.*
*The new Basel provisions relating to the calculation of the numerator of the solvency ratio are declined according to the triptych: strengthening the quality of prudential eligible own funds instruments, increase of the statutory deductions provided by Basel II, and higher minimum thresholds of solvency ratios. Furthermore, a limitation of the lever, calculated from the balance sheet and elements of off-balance sheet based on non-weighted by the risks, will be introduced.*
*The Basel III criteria entering into force between 2013 and 2018 constitute one of the major challenges to which the banking sector will face. The real impact of the Basel III reform will depend on the attitude of the banks that will have to change in their strategy, their cost structure and policy of remuneration of the shareholders. A reform which will have therefore an impact on the world economy ensuring as estimated by Governors and supervisors, stability and long term economic performance. This paper will present the main adjustments proposed by the Basel Committee.*

***Keywords:*** *capital requirements; liquidity coverage ratio; leverage ratio.*

***JEL classification:*** *G21; G32.*

## Introduction

The new architecture of European financial regulation confirms the need to stem the systemic spread of financial risks by increasing the prudential ratios. The immediate cost of these requirements is offset by the lower occurrence of major crises. The additional costs induced by a strengthening of the liabilities of the banks' capital requirements is not necessarily a strong negative impact on the cost of intermediation.

The recommendations of the Basel Committee, echoed by the G20 countries, modify capital requirements from the Basel II regulations in a logical macro-prudential. The new standards aim on the one hand, to mitigate the procyclicality of previous framework by introducing more flexibility in prudential targets. This is to avoid the liquidation of assets and the sudden restriction credit crisis. They fold, on the other hand, on a narrower equity, less open to hybrid products.

## 1. Equity Capital Strengthening

There are two ways to avoid a liquidation precipitated asset: either raise own funds in the event of blow, or allow a temporary decline in the prudential ratio. As appropriate to maintain a certain level of own funds at any time, they must be more abundant outside periods of crisis. However the regulatory prudential ratios of own funds were not a real constraint when the crisis because many banks had much higher ratios. The Basel Committee has decided to raise the level of capital called hard (common equity Tier One) strengthening the same time, the quality of capital that constitute and adding a cushion (conservation buffer) additional 2.5% in which banks can draw in case of difficulties. In other words, the target capital is set at 7%, but banks may deviate temporarily in a margin of 2.5%. However some voices, especially in financial circles to consider that these new restrictions will affect the cost of credit and ultimately dampen growth. Others, in contrast, emphasize the incomplete nature of the reforms.

### 1.1. Pillar 1 and Capital Requirements

The crisis has shown that the risk-weighted capital ratios sometimes give a false idea of the General solidity of banks and it happens the rules of weighting to underestimate the actual risks. Finally, in order to remedy to this problem and to support the requirement of own funds against the risk, Basel III has developed a leverage ratio which should help contain the build-up of systemic risk in the event of rapid development of leverage.

#### *1.1.1. Improvement of Equity Capital Quality and Level*

- *Improvement of equity quality and coherence*

Basel III is intended to improve the quality of equity capital of banking institutions to strengthen their ability to absorb losses (BCBS, 2011). Equity capital is divided into next *3 categories* as shows Figure 1. *Tier 1* is decomposed itself into two categories, the Core Tier One (solid core) and Tier One. Core Tier 1 (commonly referred to as Common equity or solid equity) corresponds to the narrower base of equity capital (including capital and reserves). Tier 1 (or basic equity capital) includes capital, reserves and certain hybrid securities (subordinated debts). The new regulation is more restrictive and many hybrid securities should be removed (and integrated in Tier 2) from Tier 1. *Tier 2* (which includes the entire complementary equity capital) was harmonized and incorporates hybrid titles which are not included in Tier 1. *Tier 3,* according equity capital belonging to Tier 3 will be removed from regulatory capital. It is currently used to cover market risks (BCBS, 2011).

- *Equity capital amount increase*

The financial crisis has underlined the need for the banking sector to have a larger volume of equity capital, mainly with reference to Level 1. Basel regulations currently require a minimum Core Tier 1 of 2%, which will be increased to 4.5% by Basel III. Minimum Tier 1 equity ratio has increased from 4% to 6% by Basel III.

| Equity capital – Basel III | |
|---|---|
| Tier 1 | **Core Tier 1 (Common Equity)** |
| | Capital, retained earnings<br>Gains and losses directly recognized in equity<br>Minority interests when the branch is a bank and according to a cap<br>Treasury shares, intangible assets, goodwill<br>Shareholdings in financial and insurance companies<br>Insufficient provisions in relation to the expected loss<br>Gains or losses from cash flow<br>Miscellaneous |
| | **Lower Tier 1** |
| | Equity instruments able to absorb losses, satisfying certain conditions<br>Instruments of the same nature held in other financial institutions (banks, insurance) |
| Tier 2 | Subordinated loans which have a period of at least five years and which meet certain conditions<br>Instruments of the same nature held in other financial institutions (banks, insurance) |

**Figure 1:** Composition of regulatory capital under Basel III
Source: Author based on Moss Adams LLP (2012)

Two additional buffers were introduced to absorb losses during periods of crisis. *Capital conservation buffer*: 2.5%, consisting of Core Tier 1 items. This buffer is designed to ensure that banks can maintain a minimum capital level during an economic recession. *Countercyclical buffer*: 0 – 2.5%. This buffer is introduced at the request of the national regulatory authority to deal with sectorial risks during a period of strong growth of credit. This variable ratio is a function of macroeconomic variables and must consist of Tier 1 capital.
Application of the additional buffer will be communicated to banks with 12 months before entering in force, and its reduction will be applied immediately in order not to penalize credit granting.
A buffer for systemic risk is considered for banks identified as systemic. The level remains to be defined.

**Table 1:** Changes in capital ratios under Basel III

| Capital requirement in 2019 | | | |
|---|---|---|---|
| | Core Tier 1 after deduction | Total Tier 1 | Total equity capital |
| Minimum | 4.50% | 6.00% | 8.00% |
| Conservation buffer (Cb) | 2.50% | | |
| Minimum (incl. Cb) | 7.00% | | |
| Countercyclical buffer | 0 – 2.50% | 8.50% | 10,50% |
| Systemic risk buffer | To be defined | | |