Stefan Ingves: Basel III is simpler and stronger

Op-ed by Mr Stefan Ingves, Governor of the Sveriges Riksbank and Chairman of the Basel Committee on Banking Supervision, published in the Wall Street Journal, 15 October 2012.

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The economic cost of the global financial crisis during the past five years has been frighteningly large. One clear lesson from the crisis is that regulatory capital requirements for the banking system were too low. Or in other words, leverage was too high.

Under the pre-crisis rules, banks were allowed to increase their leverage to unprecedented levels. This increased risk in the financial system and when the crisis hit, the implicit guarantees resulted in massive public bailouts around the globe.

The Basel Committee's capital reforms, known as Basel III, substantially raise capital requirements from pre-crisis levels to reduce the probability of bank failures and the associated risks to taxpayers and to financial stability.

Recently, much has been made of the perceived shortcomings of Basel III. Some argue that Basel III, which comes into effect next year, is not enough. Others argue that Basel III is too complex and should be replaced by a simple leverage ratio, calculated as tangible equity to non-risk weighted assets.

In my view, the Basel III agreement fundamentally enhances national and global financial stability by both raising the level of capital required by banks, and by simplifying the regulatory framework.

It is no small task to reach a global consensus on these often quite technical matters. Part of the consensus is that Basel III should be seen as a set of minimum requirements. Hence, countries are free to impose more stringent rules if they wish.

But we should not underestimate how Basel III strengthens bank-capital adequacy rules. A fundamental feature of the new framework is the significant increase in required minimum capital levels. All banks must hold common-equity capital of at least 7% of their risk-based assets, compared with only 2% previously.

In the event of a credit boom, banks under Basel III would potentially need to hold a further 2.5% in common equity, bringing the total to 9.5%. Finally, the most systemically important banks must hold up to 2.5% in additional common equity. That is a total of 12%, a sixfold increase from pre-crisis levels for these institutions.

The Basel Committee supports a regulatory framework that is both prudent and as simple as possible. Hence the Basel III agreement introduces several simplifying changes to the regulatory framework. For instance, the definition of capital now focuses on tangible common equity, the truest form of loss-absorbing capital. Moreover, all components of the capital base and associated deductions such as goodwill or deferred tax assets must be disclosed in a fully comparable manner.

By standardising and simplifying the measure of capital, Basel III makes the regulatory framework easier to understand, and will enable market discipline to work better.

Another important step has been the introduction of a non-risk based leverage ratio as a supplement to the risk-based requirement. This is a "belt and suspenders" approach to capital regulation. The leverage ratio will help contain the buildup of excessive leverage in the system, serving as a backstop to the risk-based regime and safeguarding against banks' attempts to "game" the risk-based requirements.

Equally critically, the risk-based framework helps ensure that banks do not game the leverage ratio. Let's not forget that simple measures like a leverage ratio have been in place in the past and did not alone prevent banking failures.

Risk-weighting is difficult but vitally important. Therefore the Basel Committee is in the process of reviewing the risk-weighting regime of the capital framework to ensure that it is as simple and comparable as can be while still capturing the risk profile of banks' varied asset portfolios.

Complexity is a byproduct of the desire, among regulators and banks, for risk sensitivity. Risk measurement will never be perfect. Simplicity, however, can sometimes come at a cost. Ignoring risk does not make it disappear. Without measuring risk properly, we may allow it to build up undetected.

Operating only with a non-risk-based leverage ratio creates incentives to shed safe assets and to increase the riskiness of asset portfolios; to forgo risk-reducing hedging strategies because they could result in higher capital requirements; and to engage in off-balance sheet activities and other sophisticated structures that expose a bank to contingent risks. This is likely to increase the aggregate risk in the economy and thereby create global financial stability concerns.

The lesson, therefore, is not to rely on either risk-based or non-risk-based measures alone, but to have each reinforcing the other. A combined approach, as Basel III introduces, is better than any single approach.

I believe Basel III strikes a reasonable balance by strengthening overall bank-capital requirements while continuing to recognise that there are a wide range of risks within a bank's business. Going forward, the Committee will look to further simplify the framework while ensuring that it appropriately measures and responds to the risks it is supposed to mitigate.