

Discussion of “Simplifying Basel III: On the Interactions Between Capital and Liquidity Requirements”

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This discussion represents the presenter's personal opinions and do not necessarily reflect the views of the Deutsche Bundesbank or the Eurosystem.

Paper summary

Question: Can Basel III be simplified by identifying which capital and liquidity rules do distinct work?

Data

- 87 large EU banks, end-2024
- Assets $\geq$ EUR 25bn ($> 92\%$ of EU banking-system assets)

Method

- Express all four requirements in one balance-sheet inequality
- Plot each bank by risky-asset share (ϕ) and debt-funding share (β)
- Compare distances to the four constraints

Headline

- All four requirements share one algebraic form — weighted funding $\geq / \leq$ weighted assets

Implications

- At most one capital and one liquidity rule binds at a time
- In the sample, risk-based capital ratio and LCR are the most often binding constraints
- Composite capital-liquidity stress tests change the capital-side assessment

A useful map for the simplification debate – without starting from Basel III's legal architecture.

Contribution and strengths

- **Holistic view:** capital and liquidity requirements analysed jointly, not as separate silos.
- **Simple geometry:** four rules become restrictions on the same two balance-sheet choices.
- **Empirical discipline:** the framework is applied to bank-level EU data, not only to a stylised example.
- **Policy and supervisory relevance:** gives structure to the simplification debate and to joint capital-liquidity stress testing.

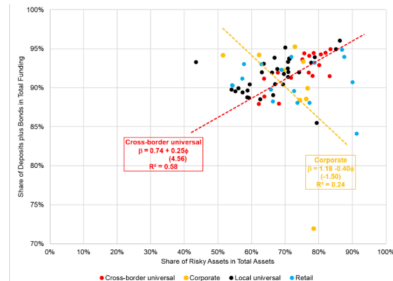
The paper takes the necessary first step: an integrated view of all four Basel III ratios as a precondition for credible simplification.

Comment A: Substitutes – in algebra, in incidence, in behaviour

Paper's result: tightening risk-based capital or the LCR are equivalent moves in the diagram — both reduce risky assets and increase debt funding.

But different in the economy:

- Incidence differs across business models and lines (credit supply, HQLA demand, repo)
- Behavioural response: removing the NSFR re-shapes funding and maturity choices
- Endogeneity: among cross-border universals, more risk pairs with more debt ($R^2 = 0.58$); on a risk-weight axis they line up along the RWA constraint (Section IV.A)



Source: Casellina et al. (2026), Figure 4 Panel B

Suggestion / question: Legal, managerial and market binding differ – so can policy treat the two as interchangeable, or does incidence break the symmetry?

I Comment B: Redundant does not necessarily mean useless

Paper's result: for the sample, the NSFR is rarely the closest liquidity constraint. Moderate LCR tightening would make it redundant for every bank in the sample.

Why the result is important

- Identifies potential overlap in liquidity regulation
- Focuses the debate on actual binding constraints
- Simplification may be feasible without lowering resilience

Reasons for caution

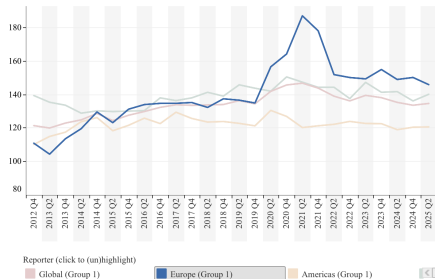
- 30-day liquidity risk is not the same as structural funding risk
- A non-binding rule can still discipline behaviour and serve as insurance against model error
- Banks adapt once a rule disappears
- MREL is outside the empirical model but acts as a de-facto structural-funding constraint (34.7% TREA in eligible resources held at end-2024; EBA MREL Report 2026)

Suggestion / question: Should redundancy be judged by current slack – or by stress-time slack and post-reform behaviour?

Comment B (cont.): The snapshot is a regime, not a constant

Which constraint binds depends on the macro regime in which the data are observed.

- End-2024 LCR buffers are high but already receding from their 2021 peak — and ample buffers are precisely why the NSFR looks slack
- Risk weights are procyclical: in a downturn, higher PDs/LGDs tighten the RWA constraint
- The level of rates moves HQLA valuations, the deposit franchise, and run-off behaviour (March 2023)
- Quantitative tightening shrinks reserves — and with them the liquidity buffers driving the result



Source: BCBS Liquidity Coverage Ratio Dashboard

The redundancy result is conditional on today's liquidity regime. Re-run it across rate and liquidity cycles before deleting a rule.

| Comment C: The missing axis – acknowledged, but the right tool?

The authors raise this themselves (paper, Section V): prudential regulation should target solvency, run, and fire-sale risk — but the four ratios only address the first two.

Solvency risk

Bank-level. Fits a single-bank diagram.

Run risk

Bank-level. Funding side of the same diagram.

Fire-sale risk

Lives *between* banks: endogenous to other banks' actions and to market liquidity.

March 2023 also surfaced IRRBB, deposit concentration, and confidence dynamics — none on the two axes. Off-balance-sheet commitments matter for all three.

Fire-sale risk may need a different layer altogether – macroprudential, network, LOLR/MMLR – not a third dashed line.

■ If the NSFR is redundant and fire-sale risk is missing – what is left?

Risk	Currently addressed by	Paper's implication
Solvency	Leverage and risk-based capital ratios (Pillar 2 for IRRBB)	Risk-based ratio does the work; leverage binds for niche banks
Run	LCR, NSFR	LCR sufficient; NSFR redundant under modest run-off recalibration
Fire-sale	LOLR, MMLR, macroprudential (outside Basel)	Not addressed by the framework

Streamlining to risk-based capital + LCR is internally consistent – but only if structural funding and fire-sale risk are explicitly assigned to other tools (MREL, LOLR/MMLR, macroprudential). The paper diagnoses the redundancy; it does not yet do the re-assignment.

| Comment D: Joint stress tests – the algebra is the easy part

The contribution is real: the composite test changes capital-side resilience meaningfully and forces supervisors to think about correlated stresses.

Where the framework stops

- Joint scenario design – the correlation of losses and deposit outflows – is not algebraic
- Behavioural responses (management actions, asset sales, dividend cancellation) are outside the model
- Binding constraints outside Basel – MREL, Pillar 2, market thresholds – may move first
- HQLA haircuts, fire-sale dynamics, and central-bank facilities are not in the two-axis plane

The framework gives the right algebra for joint stress testing. The supervisory work – correlated scenarios, behavioural plausibility, off-balance-sheet – begins where the framework ends.

Concluding thoughts

Strengths

- Elegant unification of four requirements
- Clear visual and algebraic framework
- Empirical discipline using large EU banks
- Direct relevance for the simplification debate
- Strong case for joint capital-liquidity stress testing

Key questions remain

- Redundancy: current slack or post-reform behaviour?
- Substitutability: same resilience or different incidence?
- External validity: would the framework have flagged March 2023?
- Architecture: with MREL, LOLR, and macroprudential outside the diagram, is the four-becomes-two a re-allocation – or a net reduction?

Basel III indeed does have many rules.

Before removing the spare part, we should know whether it is ballast, a belt, or an airbag.