Basel III: towards a safer financial system

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Introduction

Today I would like to review the agreement recently reached in Basel to strengthen financial regulation. As you know, a long series of international meetings was just held at the BIS. On 12 September, the Group of Governors and Heads of Supervision, the Basel Committee's governing body, announced higher global minimum capital standards for commercial banks. This followed the agreement reached in July regarding the overall design of the capital and liquidity reform package. Together, these reforms are referred to as "Basel III".

Basel III represents a fundamental strengthening – in some cases, a radical overhaul – of global capital standards. Together with the introduction of global liquidity standards, the new capital standards deliver on the core of the global financial reform agenda, and will be presented to the Seoul G20 Leaders Summit in November.

As significant as this past weekend's agreement was, it was neither the beginning nor the culmination of the Basel Committee's reform programme. Significant progress had already been achieved since the start of the financial crisis in 2007, and there is still more work to do. So Basel III is a key part, but not the only part, of the much wider agenda coordinated by the Financial Stability Board to build a safer financial system and ensure its resilience to periods of stress.

I should caution, however, that better regulation is critical but not enough. It is just one piece of the puzzle. The promotion of financial stability requires a broad policy framework, of which prudential policy is only one element. The BIS has been a consistent and long-standing advocate of the essential role played by macroeconomic policies, both monetary and fiscal, as an important element in fostering financial stability. A third key ingredient is market discipline: the crisis has reaffirmed the importance of effective bank supervision to ensure full implementation of prudential policies, to avoid moral hazard posed by too-big-to-fail institutions, and to promote strong risk management practices and appropriate disclosure. And, of course, the financial industry – and here I am referring to banks, shareholders, investors and other market participants – is an integral piece of the puzzle too. The crisis revealed a number of shortcomings related to governance, risk management, due diligence, etc that the private sector itself needs to address.

Needless to say, international cooperation is the foundation on which all of these elements stand. Indeed, a key feature of the G20 process is the premium put on the universal adherence to the goals of financial stability and sustainable economic growth. It is important to note that the Basel III regulatory standards have been developed by the Basel Committee's *global* community of 27 member jurisdictions represented by 44 central banks and supervisory authorities.

Now let me turn to the key features of the new capital standards under Basel III. At the risk of oversimplifying what are rather complex issues, I would like to stress today that the implementation of Basel III will:

(1) considerably increase the quality of banks' capital;

(2) significantly increase the required level of their capital;

(3) reduce systemic risk; and

(4) allow sufficient time for a smooth transition to the new regime.

1. Better capital quality

First, Basel III will considerably increase the quality of bank capital. This crucial feature tends to be forgotten because observers are mainly focusing on the *level* of regulatory capital required by Basel III. Certainly, the agreement reached on 12 September on calibration of the new standards has attracted a great deal of attention, and rightly so. But it was the July agreement on the *design* of the framework that paved the way for its calibration. The new definition of capital is every bit as significant as the increased level of capital, and was an essential step in the process: it was imperative to define capital adequately before setting its level. Higher capital quality means more loss-absorbing capacity, which in turn means that banks will be stronger, allowing them to better withstand periods of stress.

What are the new capital requirements? A key element is the greater focus on what is called common equity, ie the highest-quality component of a bank's capital. Under current standards, as you know, banks have to hold at least half of their regulatory capital as Tier 1 capital. The remainder is made up of other items of lower loss-absorbing capacity. In addition, half of Tier 1 capital must be common equity. Other Tier 1 capital is also high-quality relative to other elements of the capital structure, but not of the same calibre as common shares and retained earnings. The sharper focus on common equity means that the Basel III framework puts greater emphasis on the minimum requirement for higher-quality capital.

Moreover, the definition of common equity – also called "core capital" – is now stricter. Under the present system, certain types of assets of questionable quality are already deducted from the capital base (ie Tier 1 and Tier 2 capital). Under Basel III, these deductions will be more stringent since they will be applied directly to common equity. This represents a substantial strengthening of the definition of the highest-quality part of banks' capital. And, going one step further, the definition of Tier 1 capital has also been strengthened to include common equity and other qualifying financial instruments based on strict criteria.

By strengthening the quality of capital, Basel III will lead to a substantial improvement in the loss-absorbing capacity of banks. Under Basel II, the ratios for the minimum requirements for common equity and Tier 1 capital were 2% and 4%, respectively. According to the new definition of capital, these ratios are now equivalent to around 1% and 2%, respectively, for an average internationally active bank. The new rules mean that, everything being equal, banks will need to increase their common equity capital to meet minimum requirements.

2. More capital

But *better* capital is not enough. As the financial crisis painfully revealed, we need *more* capital in the banking sector. This is the aim of the higher capital requirements recently agreed by the Basel Committee's governing body.

A key element of Basel III is an increase of the minimum common equity requirement to 4.5%. This is much higher than the minimum ratio of 2% under Basel II, which, as I said, is more like 1% for an average representative bank when one measures common capital under the new, stronger definition.

Similarly, the Tier 1 minimum capital requirement will be increased to 6%. This ratio has to be compared to a minimum ratio of 4% under the present standards.

Banks will also be required to hold a capital conservation buffer of 2.5% of common equity to withstand future periods of stress. The consequences of not meeting this requirement are direct: the closer a bank's capital level gets to the minimum requirement, the more constrained its earnings distribution (eg dividend payments, share buybacks and bonuses) will be until capital is replenished. This will help ensure that capital remains available to support the bank's ongoing business operations during times of stress. Thus, during normal periods the total common equity requirements for banks will be effectively brought to at least 7%. Such an increase will also be complemented by additional countercyclical buffers, to which I will come back in a moment.

So far I have discussed only the level of capital, ie the numerator of the capital ratios. But it is important not to lose sight of the asset base against which capital is compared. Significant progress has been achieved on this front. In 2009, the Basel Committee increased the capital required for trading book and complex structured products; the higher requirements will be introduced by no later than end-2011.

Lastly, these risk-based capital requirement measures will be supplemented by a non-risk-based leverage ratio, which will help contain the build-up of excessive leverage in the system, serve as a backstop to the risk-based requirements and address model risk. It has been agreed to test a minimum Tier 1 leverage ratio of 3% – that is, the ratio of Tier 1 capital (calculated using the new, stronger Basel III definition) to the bank's total non-weighted assets plus off-balance sheet exposures – during a preliminary period that will begin in January 2013. This test will allow the Basel Committee to monitor how banks' actual leverage ratios evolve during the economic cycle, the impact this can have on their business models, and how risk-based requirements and an overall leverage ratio interact.

In short, the new global capital standard for banks will increase substantially in the coming years. Let me emphasise that these standards set a floor for the actual level of banks' capital. As before, it is important to ensure that banks hold sufficient capital above the minimum levels, depending on their risk profile, business models, prevailing economic conditions, etc. The possibility for national supervisors to require a more stringent capital base under Pillar II – as well as a more rapid implantation of the standards – will therefore continue to be a key element in the new Basel III rules.

3. A macroprudential overlay to tackle system-wide risks

The third essential element of the new regulatory capital framework is that it provides what might be called a "macroprudential overlay" to deal with systemic risk, that is, the risk of financial system disruptions that can destabilise the macroeconomy. To be sure, better capitalised individual banks will lead to a stronger banking system, but this firm-specific approach by itself may not be sufficient. This is because the risk posed to the system is greater than the sum of the risks faced by individual institutions, as has been particularly evident during the financial crisis that started in 2007. At the BIS, we believe that two key tasks must be pursued to effectively limit systemic risk. The first is to reduce procyclicality, that is, the financial system's tendency to amplify the ups and downs of the real economy. The second task is to take account of the interlinkages and common exposures among financial institutions, especially for those deemed systemically important.

Basel III thus represents a fundamental turning point in the design of financial regulation. The conscious need to supplement the micro level of financial supervision with the macroprudential dimension is something that, I think, has for the first time found expression in financial regulation.

On the procyclicality aspect, Basel III will promote the build-up of buffers in good times that can be drawn down in periods of stress. First, as I already noted, the new common equity requirement is 7%. This new higher level includes the capital conservation buffer of 2.5%, and will ensure that banks maintain a buffer of capital that can be used to absorb losses during periods of stress without going below the minimum capital requirements. This will reduce the possibility of a self-reinforcing adverse cycle of losses and credit cutbacks as compared with previous arrangements.

Second, a key element of the Basel III rules to limit procyclicality will be the countercyclical capital buffer, which has been calibrated in a range of 0–2.5%. This countercyclical buffer would build up during periods of rapid aggregate credit growth if, in the judgment of national authorities, this growth is aggravating system-wide risk. Conversely, the capital held in this buffer could be released in the downturn of the cycle. This would, for instance, reduce the risk that available credit could be constrained by regulatory capital requirements. The intention is thus to mitigate procyclicality and attenuate the impact of the ups and downs of the financial cycle.

Apart from addressing procyclicality, Basel III will also allow for a better handling of the systemic risk due to the interlinkages and common exposures across individual institutions. The key principle in this context is to ensure that the standards are calibrated with respect to the contribution that each institution makes to the system as a whole, not just with respect to its riskiness on a standalone basis. The FSB and the Basel Committee are exploring several measures to deal with these systemically important financial institutions (SIFIs). Under the Basel III framework, it has been agreed that these institutions should have loss-absorbing capacity beyond the common standards. Work is still under way to delineate the modalities for addressing systemic risk, but one possibility would be to allow national authorities to establish a systemic capital surcharge for SIFIs.

The new Basel III package encompasses specific macroprudential tools that national supervisory authorities can use to establish targeted capital requirements in order to deal with systemic risk both over time and across institutions. From this perspective, Basel III provides an anchor for the development of a fully fledged and strong macroprudential framework that takes account of these two dimensions of systemic risk.

4. Transition arrangements

These tightened definitions of capital, significantly higher minimum ratios and the introduction of a macroprudential overlay represent what has been described by some as a historic remake of banking regulations. At the same time, the Basel Committee, its governing body and the G20 Leaders have consistently stated that the reforms will be introduced in a way that does not impede the recovery of the real economy. In addition, time is needed to translate the new internationally agreed standards into national legislation. In this spirit, the Governors and Heads of Supervision also announced on 12 September a set of transitional arrangements for the new standards. As I have already noted, national authorities can, and in fact should, impose higher standards if deemed appropriate in the local circumstances and prevailing economic conditions; similarly, they can impose shorter transition periods where appropriate.

The new, strengthened definition of capital will be phased in over five years: the requirements will be introduced in 2013 and fully implemented by the end of 2017. In addition, existing public sector capital injections will be grandfathered until the end of 2017. Capital instruments that no longer qualify as non-common equity Tier 1 capital or Tier 2 capital will be phased out over 10 years beginning 1 January 2013.

Turning to the minimum capital requirements, the higher minimums for **common equity and Tier 1 capital** will be phased in beginning in 2013, and will become effective at the beginning of 2015. The schedule will be as follows:[1]

- The minimum common equity and Tier 1 requirements will increase from the current 2% and 4% levels to 3.5% and 4.5%, respectively, at the beginning of 2013.
- The minimum common equity and Tier 1 requirements will be 4% and 5.5%, respectively, starting in 2014.
- The final requirements for common equity and Tier 1 capital will be 4.5% and 6%, respectively, beginning in 2015.

The 2.5% capital conservation buffer, which will be comprised of common equity and is in addition to the 4.5% minimum requirement, will be phased in progressively starting on 1 January 2016, and will become fully effective by 1 January 2019.

Finally, the leverage ratio will also be phased in. The test (the so-called "parallel run period") will begin in 2013 and run until 2017, with a view to migrating to a Pillar 1 treatment on 1 January 2018 based on review and appropriate calibration.

Conclusion

I am sure you will agree with me that the new Basel III package is a very important milestone. The international community is very grateful to Nout Wellink, Chairman of the Basel Committee, Jean-Claude Trichet, Chairman of the Group of Governors and Heads of Supervision, and Mario Draghi, Chairman of the Financial Stability Board: they have all been instrumental in ensuring the success of this endeavour and of the broader financial regulatory agenda.

Much has already been achieved to strengthen the financial system, and of course a great deal of work remains to be done to implement internationally agreed standards in all jurisdictions. Central banks and financial supervisory authorities are dedicated to this goal, and will benefit from the full support of the BIS and the international groupings it hosts in Basel.

Today I have focused my comments on the new capital standards. Another important aspect of Basel III is the introduction of new global minimum liquidity standards, which is particularly significant because no such international standards currently exist:

- The Committee's liquidity coverage ratio, which will be introduced on 1 January 2015, will promote banks' short-term resilience to potential liquidity disruptions. It will require banks to hold a buffer of high-quality liquid assets sufficient to deal with the cash outflows encountered in an acute short-term stress scenario as specified by supervisors.
- The other minimum liquidity standard introduced by Basel III is the net stable funding ratio. This requirement, which will be introduced as a minimum standard by 1 January 2018, will address funding mismatches and provide incentives for banks to use stable sources to fund their activities.

There is currently great diversity in global liquidity risk management and national liquidity supervision regimes. The Committee will therefore adopt rigorous reporting processes to

[1] The total capital requirement remains at the existing level of 8% and thus does not need to be phased in.

monitor the ratios during the transition period to ensure the standards behave and interact as intended.

Basel III thus provides a combination of capital and liquidity standards that will help increase the resilience of the financial sector in the face of stress. But before ending, I would like to emphasise these four key points:

- First, the new Basel III package affords the financial industry **more clarity** on the regulatory front. In today's still challenging economic and financial conditions, uncertainty is the enemy. Removing regulatory uncertainty can contribute importantly to the ongoing recovery.
- Second, the new Basel III package combines enhancements at both the micro- and the macroprudential level. The new standards improve on the Basel II framework at the micro level of individual financial institutions, especially by strengthening the level and quality of capital. But Basel III also has **a macroprudential overlay** to promote the greater stability of the financial system as a whole. The aim is to establish appropriate capital schemes to address the procyclicality of the financial system and to deal with systemic risk. The countercyclical capital buffer will be activated by national authorities within the general guidance provided by an international agreement, depending on circumstances in specific jurisdictions. Tools will be available to limit systemic risk, and this will surely put a premium on effective supervision within jurisdictions, as well as on international peer reviews of local arrangements to ensure their international consistency. Last but certainly not least, the foundation of a sound macroprudential framework has now been laid.
- Third, there will be an appropriately **long transition period**. The new definition of capital, higher risk weights and increased minimum requirements will entail a significant amount of additional capital. The agreed transitional arrangements will help ensure that the banking sector can meet the higher capital standards through reasonable earnings retention and capital-raising, while still supporting the flow of new lending to the economy.
- Fourth, we must **avoid complacency**. True, the financial industry will have time to adapt so as to both maintain an adequate supply of credit for the economy and repair balance sheets. Banks and supervisors alike will have to redouble their efforts to foster behavioural changes to ensure a sustained global recovery from the deep financial crisis. From this perspective, it goes without saying that those banks that already meet the minimum standards but do not meet the conservation buffer should apply the conservation principle. In other words, they should do their best to satisfy the conservation buffer requirement as soon as reasonably possible. Supervisors, for their part, must remain vigilant and actively promote a transition to the new standards as bank-specific and broader economic conditions warrant. I should point out that market discipline also plays an important role in guarding against complacency.

Thank you very much for your attention.

Strengthened capital framework: from Basel II to Basel III

In percentage of risk-weighted assets	Capital requirements							Additional macroprudential overlay	
	Common equity			Tier 1 capital		Total capital		Counter-cyclical buffer	Additional loss-absorbing capacity for SIFIs*
	Minimum	Conservation buffer	Required	Minimum	Required	Minimum	Required	Range	
Basel II	**2**			4		**8**			
Memo:	*Equivalent to around 1% for an average international bank under the new definition*			*Equivalent to around 2% for an average international bank under the new definition*					
Basel III New definition and calibration	**4.5**	2.5	**7.0**	6	8.5	**8**	**10.5**	0–2.5	Capital surcharge for SIFIs?

* Modalities to be defined.