

Basel III: capital quality, buffers and the leverage ratio

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The core of the post-crisis reforms was published in December 2010 under the title "Basel III: A global regulatory framework for more resilient banks and banking systems", with a revised version in June 2011. The G20 leaders had endorsed the main elements at their summit in Seoul in November 2010. The chairman of the Committee during these negotiations was Nout Wellink, President of De Nederlandsche Bank, who was succeeded in July 2011 by Stefan Ingves, Governor of Sveriges Riksbank.¹

The first theme of Basel III was the quality of capital. The crisis had shown that only common equity and retained earnings could absorb losses while a bank continued to operate. Basel III therefore created a new category, Common Equity Tier 1 or CET1, and required banks to hold CET1 capital of at least 4.5 per cent of risk-weighted assets. Total Tier 1 capital had to reach at least 6 per cent, with total capital remaining at a minimum of 8 per cent. Deductions for goodwill, deferred tax assets, investments in other financial institutions and similar items were to be made from CET1, whereas many of them had previously been made from total capital or not at all.²

Hybrid instruments and subordinated debt could count as Additional Tier 1 or Tier 2 only if they met strict criteria. Additional Tier 1 instruments had to be perpetual, with fully discretionary coupons, and had to absorb losses through conversion into equity or write-down at a trigger point. In January 2011, the Committee added the requirement that all such instruments contain a clause ensuring their write-off or conversion at the point of non-viability, which would be determined by the authorities.³ The write-down of the Additional Tier 1 instruments of Credit Suisse in March 2023, discussed in Part E of this book, tested these mechanisms in practice and revealed political consequences that their designers had hardly anticipated.

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The second theme was the build-up of buffers in good times that could be drawn down in bad times. A capital conservation buffer of 2.5 per cent of risk-weighted assets, to be met with CET1, was placed above the minimum. A bank whose capital fell into the buffer zone was to face restrictions on distributions such as dividends, share buybacks and discretionary bonuses. Including the buffer, the effective CET1 requirement thus rose to 7 per cent. A countercyclical capital buffer of up to 2.5 per cent, to be set by national authorities when credit growth was excessive, was added in order to address the procyclicality that had been criticised under Basel II.⁴ Switzerland was among the first countries to activate a countercyclical buffer, which it applied to residential mortgage loans from 2013, as discussed in Part E.

The third theme was a leverage ratio, a simple measure of Tier 1 capital in relation to total exposure that did not depend on risk weights. It was intended as a backstop to the risk-based requirements, because risk weights could be manipulated or simply be wrong. The Committee calibrated the ratio at 3 per cent, tested it during an observation period and made it a binding Pillar 1 requirement from 1 January 2018. In the final package of 2017, a leverage ratio buffer for global systemically important banks was added, set at half of the bank's risk-based surcharge.⁵

The new requirements were to be phased in gradually between 2013 and 2019, which allowed banks to build capital mainly through retained earnings. Monitoring reports published by the Committee showed that the large internationally active banks had raised their CET1 capital considerably over that period. According to the Committee's monitoring, the capital shortfall of the large banks relative to the fully phased-in requirements had been largely closed well before the end of the transition.⁶

1 Notes

1. Basel Committee, *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems* (December 2010, revised June 2011); G20 Seoul Summit Leaders' Declaration (November 2010). To be verified. ↩
2. Basel Committee (2010/2011), paragraphs 49–96 (definition of capital) and paragraph 50 (minimum ratios of 4.5, 6 and 8 per cent). Paragraph references to be verified. ↩
3. Basel Committee, press release *Minimum Requirements to Ensure Loss Absorbency at the Point of Non-Viability* (13 January 2011). To be verified. ↩

4. Basel Committee (2010/2011), paragraphs 122–150 (capital conservation buffer and countercyclical buffer); Basel Committee, Guidance for National Authorities Operating the Countercyclical Capital Buffer (December 2010). To be verified. ↩
5. Basel Committee, Basel III Leverage Ratio Framework and Disclosure Requirements (January 2014) and Basel III: Finalising Post-Crisis Reforms (December 2017), leverage ratio section. To be verified. ↩
6. Basel Committee, Basel III Monitoring Report (published semi-annually since 2012). Figures to be verified. ↩

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