Basle III Accord on Capital Requirements

The cornerstone of financial reforms?

Factsheet

The Seoul G20 summit will agree on a new framework on capital requirements for banks, the so-called Basle III agreement.

Capital requirements are a fundamental element in the regulation of banks. Therefore national regulations have been existing for many years. In the course of globalisation more harmonisation of the different became imperative. This is why in 1988 the *Basle Committee on Banking Supervision* adopted an accord (Basle I), which provided for common standards. The core of the first Basle accord were minimum capital requirements of 8% for all banks.

The *Basle Committee* is attached to the *Bank for International Settlement (BIS)*, located in the Swiss town of Basle. Its members are the representatives of central banks and supervisory authorities of the OECD countries.

In 2006 a new agreement (Basle II) was adopted. Basle agreements are recommendations and legally not binding, but there is a strong de facto pressure to integrate them into national legislation. Common standards increase mutual confidence and thus reduce capital costs. With the agreement of the revised Basle accord by the G20 its status is even improved.

Basle II – inspired by neoliberal thinking

Basle II was very much inspired by the neo-liberal thinking. It was lowering capital requirements and giving more flexibility to the Banks. It introduced a complex system of risk measurement, which was left to the banks. Furthermore, Basle II was only dealing with risks at micro-economic level. The accords only cover banks, whereas Hedge Funds, Private Equity Funds and other non-bank actors are not concerned. In 2006 the EU had taken over *Basle II* in two directives. The US, however, had not yet adopted Basle II.

Basle II has not met the expectations, as the failure of Europeans banks proves. At the contrary, it contributed to undue risk taking and was weakening the resilience of the system. This is why there are negotiations for a Basle III agreement.

Basle III will not replace Basle II. Most elements of the former agreement will continue to be in place, whereas the core figures for capital requirements will be increased.

The main elements of the new agreement are as follows:

the core capital will be increased from 2% to 4.5% of total capital;

- a *capital conservation buffer* of 2,5% will be introduced, bringing the requirements all in all to 7%. Banks are allowed to draw on this buffer to absorb losses during periods of financial and economic stress. While using this buffer, there are restrictions to pay dividends;

- as a third component countercyclical buffer ranging from 0 - 2,5% according to the conjuncture should be implemented. This buffer will only be in effect when there is excess credit growth that is resulting in a wide system of built up risk. The obligation to accumulate the countercyclical buffer will absorb capital in a boom phase and work as a break to build up bubbles;
- For systemically important banks additional requirements beyond these standards have been announced and should be discussed in the G20;
- A leverage ratio of 3% has also been agreed upon. This means that leverage is limited to 33 times the banks core capital;
- Also a liquidity ratio is envisaged, which should allow a bank to meet its short term obligations. A figure has not been set;
- Finally, an essential issue is the definition of capital. According to the new agreement only own and liquid assets of the bank, i.e. equity capital and disclosed reserves, will be accepted as core capital, or *common equity*, as it is called in the insider jargon. This improves the quality of the core capital.

Leverage ratio and stricter regulations for systemically important financial institutions (SIFIs) would add a macro-prudential dimension to the new agreement – under the condition that they are really implemented. In particular the issue of SIFIs is highly controversial.

The implementation of Basle III shall start on the 1st January 2013. This would give banks the time to accumulate the additional capital. However, implementation will only be step by step and the transition period to full implementation will last until 2018.

A step in the right direction, but still falling short of what is necessary

The agreement is reversing the trend to lower standards as it was the case with Basle II, and stability will increase to a certain extent with higher standards.

The question is, however, whether the new requirements are sufficient. Initially the secretariat had proposed higher levels (above 10%), but this position could not prevail in the negotiations. Also the long transition period seems to be very complaisant vis à vis the financial industry. Given the very unsecure economic conjuncture with global imbalances, debt crisis and the risks of a currency war the next crisis might come before the new agreement is fully implemented.

Furthermore, as Basle III is not replacing Basle II, the basic philosophy of Basle II prevails: risk measurement and management remains in the hands of the banks, although the ideology of self-regulation of the markets went bankrupt in the crisis.

Finally Hedge Funds, Private Equity Funds and other highly leveraged institutions are not captured by Basle III, which is a major loophole.

All in all, Basle III can be at maximum a first step towards a future system of really efficient regulation of finance. If it were the cornerstone of new financial architecture, this building would be very unsafe. Basle III makes the casino safer, but what is needed is the closing down of the casino.

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