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**“BASEL III”:  
THE REFORM OF THE EXISTING  
REGULATORY FRAMEWORK OF THE BASEL  
COMMITTEE ON BANKING SUPERVISION FOR  
STRENGTHENING THE STABILITY OF THE  
INTERNATIONAL BANKING SYSTEM**

**by Professor Christos Vl. Gortsos**

**November 2011**



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**“Basel III”:  
The reform of the existing regulatory framework of the Basel Committee on  
Banking Supervision for strengthening the stability of the  
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**Abstract**

“Basel III” regulatory framework is comprised by two reports. These reports are the result of extensive consultations that have taken place since 2008, namely in the middle of the recent (2007-2009) international financial crisis. Their provisions lay down a new international regulatory framework for international banks, by reforming the existing one, in order to strengthen the stability of the banking system.

The present paper, structured in three sections, explores the regulatory framework introduced by these reports. Section A analyses the sources of the new regulatory framework and the rationale for reform. Section B provides an overview of the provisions of Basel III, and Section C contains some concluding remarks.

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*\* This article is updated until March 31, 2011*

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## A. The sources of the new regulatory framework and the rationale for reform

### 1. The Basel Committee reports constituting the sources of “Basel III”

On 16 December 2010, the Basel Committee on Banking Supervision (hereinafter the “Basel Committee”)<sup>1</sup> adopted and published two important reports entitled:

- “*Basel III: A global regulatory framework for more resilient banks and banking systems*”,<sup>2</sup> and
- “*Basel III: International framework for liquidity risk measurement, standards and monitoring*”.<sup>3</sup>

These reports are the result of extensive consultations that have taken place since 2008, namely in the middle of the recent (2007-2009) international financial crisis.<sup>4</sup> Both are *quasi* final, since, in the upcoming months, there may be amendments and/or additions to their provisions, according to the Basel Committee's current agenda. Indeed, on January 13, 2011, the Committee already issued a Press release entitled: “*Basel Committee issues final elements of the reforms to raise the quality of regulatory capital*”.<sup>5</sup>

These two reports are collectively known as the “Basel III” regulatory framework (hereinafter “Basel III”), and constitute the Basel Committee’s probably most important reaction to the recent crisis.<sup>6</sup> Their provisions lay down a new international regulatory framework for international banks, by reforming the existing one, in order to strengthen the stability of the banking system through:<sup>7</sup>

- enhanced bank-level, or microprudential, regulations, which will help raise the resilience of individual banking institutions during periods of stress, and
- macroprudential regulations, addressing system-wide risks that can build up across the banking (and in general financial) sector, as well as the “procyclical” amplification of these risks over time.

*The term “financial macro-prudential policies” (of which macroprudential regulations are a part) refers to the set of policies (mainly of a prudential nature) adopted and implemented to limit the financial system's exposure to the “systemic risk”, ensuing from factors that do not concern individual financial service providers or individual markets and structures of the financial system, but are more general in character.*<sup>8</sup> A “systemic risk” is the risk of a malfunction in the supply of financial

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<sup>1</sup> On the composition and the work of the Basel Committee, see **Walker (2011)**, p. 17-62, and **Giovanoli (2010)**, p. 25-26.

<sup>2</sup> **Basel Committee (2010a)**, at: [www.bis.org/publ/bcbs189.htm](http://www.bis.org/publ/bcbs189.htm).

<sup>3</sup> **Basel Committee (2010b)**, at: [www.bis.org/publ/bcbs188.htm](http://www.bis.org/publ/bcbs188.htm).

<sup>4</sup> The author uses the term “recent” crisis (and not “current”), since in his view the crisis lasted from 2007 until 2009. This does not negate the fact that in some states there is still crisis in the banking sector, nor the fact that in some cases (the most striking being Greece) the current malfunctions of the banking system are the result of “fiscal crises” that emerged mainly out of the international financial crisis.

<sup>5</sup> **Basel Committee (2011)**, at: [www.bis.org/press/p110113.htm](http://www.bis.org/press/p110113.htm).

<sup>6</sup> For an overview of the Committee's overall work as a reaction to the crisis, see at: [www.bis.org/bcbs/fincriscomp.htm](http://www.bis.org/bcbs/fincriscomp.htm).

<sup>7</sup> Basel Committee (2010a), para. 6.

<sup>8</sup> On the issue of “macroprudential policies”, see **Committee on the Global Financial System, Macroprudential instruments and frameworks: a stocktaking of issues and experiences**, CGFS

services (and/or failure to supply), due to the weakening of a sector or of the entire financial system, potentially leading to serious negative consequences in the real sector of the economy.<sup>9</sup>

*Macroprudential policies seek to address the two dimensions of systemic risk:*

*(a) The first is the “time-dimension”, namely the systemic risk's evolution through time. In this context, macroprudential policies seek to strengthen the resilience of the financial system at times of economic recession by limiting procyclicality, which can increase the systemic risk because of the interactions developed either within the financial system, or between the financial system and the real sector of the economy.<sup>10</sup>*

*(b) The second dimension is the “cross-sectional dimension”, namely the distribution of risk in the financial system at any given point in time. In this case, macroprudential policies aim at limiting systemic risk concentration, which could result either because of the concurrent exposure of multiple financial institutions to risks from similar exposures, or because of the interconnectedness of such institutions (and the contagion of problems amongst them), especially if they are systemically important.<sup>11</sup>*

Accordingly, “Basel III” seeks to significantly strengthen the content of the existing regulatory framework’s provisions, and introduce additional means of microprudential regulation. Yet, the main *novum* of “Basel III” is the adoption of rules on macroprudential regulation. In this sense, Hannoun's remark that “Basel III” is an “*enhanced Basel II plus a macro-prudential overlay*” is very accurate.<sup>12</sup>

*In the European Union, “Basel III” will be implemented by way of an extensive amendment of the European Parliament and the Council Directives 2006/48/EC and 2006/49/EC.<sup>13</sup> The work is already underway and is expected to be completed in 2012.*

## **2. The rationale for reform**

### **2.1 The sources of the existing regulatory framework: “Basel I” and “Basel II”**

“Basel III” is (as its name suggests) the second major amendment of an already existing regulatory framework that the Basel Committee has developed. Indeed, in the context of its work on microprudential banking regulation, dating back to the mid-1980’s, the Basel Committee undertook initiatives for an international convergence of rules concerning the calculation and fulfilment of bank capital requirements to cover against their exposure to various financial risks and then also to operational risk. The

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Papers, No. 38, May 2010, and **Financial Stability Board, IMF and BIS**, *Macroprudential policy tools and frameworks*, February 2011, at: [www.financialstabilityboard.org/publications/r\\_1103.pdf](http://www.financialstabilityboard.org/publications/r_1103.pdf).

<sup>9</sup> **Committee on the Global Financial System (Fn. 9)**, section 2.1.

<sup>10</sup> For a detailed overview of the problem contagion channels between the financial system and the real sector of the economy, see **Basel Committee**, *The transmission channels between the financial and real sectors: a critical survey of the literature*, Working Paper No. 18, February 2011, and **Galati and Moessner (2011)** section 5.2.

<sup>11</sup> On the definition of systemically important financial institutions (“SIFIs”), see indicatively **Huertas and Lastra (2011)**, p. 255-258.

<sup>12</sup> **Hannoun (2010)**, p. 9.

<sup>13</sup> OJ L 177, 30.6.2006, p. 1-200 and 201-255, respectively.



result was in 1988 “Basel I”<sup>14</sup> and in 2004 “Basel II”,<sup>15</sup> which, as in force, constitutes the relevant existing regulatory framework.<sup>16</sup>

## 2.2 The causes of the recent international financial crisis

There are many causes that led to the recent international financial crisis, which are attributed to failures in several fields, such as:

- financial prudential regulation (including, among other, the lack of adequate rules of macroprudential nature),
- banking accounting standards,
- the exercise of micro-prudential supervision of financial firms, and
- the fiscal and monetary policies implemented in several states.<sup>17</sup>

When the crisis broke out in 2007, in most states whose banking system was affected by the crisis, banks were adequately capitalised,<sup>18</sup> which was undoubtedly also attributable to the fact that most of them had implemented the provisions of “Basel II” into their national law. This, however, proved insufficient to prevent either the breaking out of the crisis or the occurrence of the problems that resulted from it, due to the occurrence of several factors. In particular:

(a) One of the most important causes of the crisis was the excessive leverage in the banking system in many states, which occurred both on and off the balance sheet of a significant number of banks. Although these banks initially had very robust capital adequacy ratios, leverage led to their gradual deterioration. This leverage was, at least in part, the result of the existing regulatory framework on capital adequacy, since banks, aiming at reducing the cost from application of its rules, resorted to regulatory capital arbitrage, mainly through excessive securitisations.<sup>19</sup>

(b) At the same time, it proved that many banks did not even have adequate liquidity buffers. According to the Basel Committee, during the initial liquidity phase of the recent financial crisis, many banks, whilst they had adequate capital adequacy, encountered problems due to the non-prudent management of their liquidity. This fact

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<sup>14</sup> **Basel Committee (1988)**: “*International convergence of capital measurement and capital standards*”, July, at: [www.bis.org/publ/bcbsc111.htm](http://www.bis.org/publ/bcbsc111.htm).

<sup>15</sup> **Basel Committee (2004)**: “*Basel II: International Convergence of Capital Measurement and Capital Standards, A Revised Framework*”, June, at: [www.bis.org/publ/bcbs107.htm](http://www.bis.org/publ/bcbs107.htm).

<sup>16</sup> The provisions of “Basel I” and “Basel II” as in force in 2006, were codified into one single text entitled: “*International Convergence of Capital Measurement and Capital Standards, A Revised Framework*”, **Basel Committee (2006)**, June, at: [www.bis.org/publ/bcbs128.htm](http://www.bis.org/publ/bcbs128.htm). For a presentation of the provisions of “Basel II” see **Gleeson (2010)** and **Macht (2010)**, p. 67-100.

<sup>17</sup> For an overview of the causes of the crisis, see indicatively **Lastra and Wood (2010)**, p. 537-545, and **Tirole (2010)**, p. 11-47. For a comparison of the causes of the recent crisis to those of the 1931 international crisis and the respective policy responses, see **Moessner and Allen (2010)**.

<sup>18</sup> This remark does not apply for the so-called “investment banks” in the US, which are non-depository institutions, constituted part of the so-called “shadow banking system”, and found themselves at the core of the recent crisis and which. On this, see **Tirole (2010)**, p. 24-26.

<sup>19</sup> On this, see **Tirole (2010)**, p. 19-21 and 28-32, and **Goodhart (2010)**, p. 7-8. In balance, on the positive aspects of securitisation, see **Albertazzi et. al. (2011)**.

demonstrated the importance of adequate liquidity buffers for the smooth operation of financial markets and the banking system.<sup>20</sup>

(c) Although there is no doubt that during the recent crisis exposure to systemic risk was very strong, it was also clear that the existing regulatory framework did not contain any rules for the prevention of systemic risk, neither in terms of its time dimension nor in terms of its cross-sectional dimension. On the contrary, the existing regulatory framework on capital adequacy, especially when capital requirements are calculated according to the “internal ratings-based approach”,<sup>21</sup> was considered to be one of the factors intensifying procyclicality.<sup>22</sup> In fact, it was considered that it created incentives for banks:

- on the one hand, to stimulate further credit expansion in times of economic growth (as the capital requirements imposed on them for the provision of loans are laxer), and
- on the other hand, to reduce the provision of borrowed funds in times of recession (as the relevant capital requirements become stricter).<sup>23</sup>

### 2.3 The consequences of the crisis and the Basel Committee’s reaction

As a result of the abovementioned factors, many banks internationally (small and large, some even systemically important) were not in a position to absorb the losses that resulted from the crisis. At its peak in 2008, financial markets exerted pressure on banks to reduce their leverage which resulted in increased losses, reduced equity capital, and diminished capacity to provide loans to businesses and households.<sup>24</sup> At the same time, there were major liquidity problems for an extended period of time.

*Among others, apart from the negative effects on the real sector of the economy, in many cases this resulted in forcing governments (especially in the USA and several European countries) to intervene in order to support and/or rescue banks<sup>25</sup> (and in some cases, the entire banking system<sup>26</sup>). This intervention placed a burden on their budgets, and, in some cases, created serious fiscal imbalances, some of which evolved to become fiscal crises.<sup>27</sup>*

Consequently, the Basel Committee proceeded to adopt the new international regulatory framework, “Basel III”, in order to address the abovementioned failures. The Committee deemed (according to the above) that “Basel II” was not adequate, while its shortcomings and some of its provisions contributed (to a certain extent) to the breaking out of the crisis and the subsequent negative consequences on the real sector of the economy.<sup>28</sup>

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<sup>20</sup> **Basel Committee (2010b)**, para. 2.

<sup>21</sup> On this so-called “IRB approach”, see **Gleeson (2010)**, p. 125-158.

<sup>22</sup> The same applies for banking accounting standards (**Lastra and Wood (2010)**, p. 539).

<sup>23</sup> On this see **Tirole (2010)**, p. 32-33, and **Goodhart (2010)**, p. 8.

<sup>24</sup> **Basel Committee (2010a)**, para. 151.

<sup>25</sup> For an overall examination and evaluation of these measures, see **Panetta et. al. (2009)**, and **Gortsos (2009)**, p. 9-46

<sup>26</sup> The most striking example was that of Iceland.

<sup>27</sup> The most striking and recent example in this case is Ireland.

<sup>28</sup> On the work of other international fora that have undertaken initiatives to address the causes of the crisis, see the report of the **Financial Stability Board**, “*Progress in the Implementation*

## B. The provisions of “Basel III”: an overview

### 1. Overall examination

#### 1.1 Systematic classification

From a systematic point of view, the provisions of "Basel III" can be classified into two categories:

(a) The first category includes the provisions amending provisions of the existing regulatory framework governing the capital adequacy of international banks (namely “Basel II”), as well as additions thereto (see under 2, below).

(b) The second category includes the provisions introducing “innovative” elements, which are further distinguished into:

- those introducing additional rules on microprudential regulation (under 3), and
- those introducing rules on macroprudential regulation (under 4).

All the provisions of the new regulatory framework are expected to be phased-in, starting January 1st, 2013 and until January 1<sup>st</sup>, 2019 (final deadline for full implementation). For a brief examination of the transitional provisions introduced, see the table in Annex 4 of the first of the reports constituting “Basel III”.<sup>29</sup>

#### 1.2 Amendments and additions to the existing regulatory framework governing the capital adequacy of banks

##### a) Provisions on banks' minimum regulatory capital

The most important amendment to the existing regulatory framework of the Basel Committee on bank capital adequacy refers to the definition of regulatory capital. This aspect will be discussed in more detail below, under B II.

##### b) Provisions on banks' cover against exposure to credit risk<sup>30</sup>

During the recent international financial crisis, some banks suffered significant losses from exposures which were not covered by capital requirements. Hence, the new regulatory framework seeks to strengthen banks' coverage against credit risk exposure from positions in their portfolio (on- and off-balance sheet), such as OTC derivatives, repurchase agreements, and loans for the purchase of securities and positions in financial and other derivative instruments.

Furthermore, provisions were also introduced regarding the following:

(a) In calculating their capital requirements to cover against credit risk according to the standardised approach,<sup>31</sup> banks must assess themselves the credit risk of their exposures, irrespective of whether there is a rating by a credit rating agency, and determine whether the risk weights applied to such exposures are appropriate or not.

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of the G20 Recommendations for Strengthening Financial Stability”, February 2011, at: [www.financialstabilityboard.org/publications/r\\_110219.pdf](http://www.financialstabilityboard.org/publications/r_110219.pdf).

<sup>29</sup> **Basel Committee (2010a)**, Annex 4: Phase-in arrangements.

<sup>30</sup> *Ibid*, para. 97-121.

<sup>31</sup> On this approach, see **Gleeson (2010)**, p. 81-103.

(b) In order to recognise a credit rating agency as “eligible”, national supervisory authorities must verify whether such an agency meets the appropriate criteria, using as reference the 2008 revised IOSCO code (*“Code of Conduct Fundamentals for Credit Rating Agencies, Report of the Technical Committee”*).<sup>32</sup>

### 1.3 “Innovative” elements (I): additional rules on microprudential regulation

#### a) Leverage ratio<sup>33</sup>

As already mentioned (see above, under A II 2 (a)), one of the underlying features of the recent international financial crisis was the build-up of excessive leverage in the banking system. Therefore, and with a view to prevent the build-up of leverage in the future (due to the major negative consequences that deleveraging processes of banks have on the real sector of the economy in periods of stress), “Basel III” introduces a simple, non-risk based leverage ratio (namely, assets and off-balance sheet items of banks are not risk-weighted as in the case of capital adequacy requirements).

The leverage ratio, which is calibrated to act as a credible supplementary measure to the risk based capital requirements (as a “backstop measure”), is amounting to 3%, and has been designed to have:

- as numerator, banks’ Tier 1 capital (according to the new definition), and
- as denominator, their on- and off-balance sheet exposures, based on their book value, without risk-weighting and (initially) without right to net assets and liabilities (as is the case of capital adequacy requirements).

*Accordingly, the scope of regulatory capital arbitrage by substituting low risk weighted assets for high risk ones will be reduced.*

#### b) Liquidity ratios<sup>34</sup>

The new regulatory framework introduces, for the first time at international level, two liquidity ratios for banks: a short-term, the “liquidity coverage ratio”, (“LCR”, see under (1) below), and a long-term, the “net stable funding ratio” (“NSFR”, under (2)).

##### (1) Liquidity coverage ratio

This standard aims to ensure that a bank maintains an adequate level of high-quality liquid assets that can be converted into cash to meet its liquidity needs. This standard, which must be equal to or in excess of 100%, is defined as the ratio of:

- the stock of high-quality liquid assets,
- to the total net cash outflows over the next 30 calendar days.

##### (2) Net stable funding ratio

The net stable funding ratio was introduced in order to address the problem caused by liquidity mismatches of assets and liabilities in a bank's balance sheet, and create incentives for banks to use stable sources to fund their assets (including loans) with a

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<sup>32</sup> Available at: [www.iosco.org/library/pubdocs/pdf/IOSCOPD271.pdf](http://www.iosco.org/library/pubdocs/pdf/IOSCOPD271.pdf).

<sup>33</sup> **Basel Committee (2010a)**, para. 151-164.

<sup>34</sup> **Basel Committee (2010b)**, para. 16-186. For a definition of the liquidity risk and the various measures for its assessment, management and supervision, see **Basel Committee (2008)**: *“Principles for Sound Liquidity Risk Management and Supervision”*, September, at: [www.bis.org/publ/bcbs144.htm](http://www.bis.org/publ/bcbs144.htm).

term in excess of one year. This standard, which must be in excess of 100%, is defined as the ratio of:

- the available amount of stable funding,
- to the required amount of stable funding.

## 1.4 “Innovative” elements (II): rules on macroprudential regulation

### a) Introductory remarks

As already mentioned (see above, under A II 2 (c)), “Basel III” introduces, for the first time as well at international level, rules on macroprudential regulation. In this respect, the following remarks deserve attention:

(1) The rules adopted are addressing exclusively the time dimension of systemic risk (see above, under A I). In this context, banks are called to:

- create a “capital conservation buffer” in times of economic growth (see under b) below),
- create a “countercyclical buffer” in times of excessive credit expansion (under c) below),
- build strong “forward-looking provisions”,<sup>35</sup> and
- cover against excessive cyclicity of their minimum capital requirements.

(2) On the contrary, no specific provisions have been introduced with regard to the cross-sectional dimension of systemic risk. The Basel Committee considers, however, that some of the rules adopted for banks’ coverage against exposure to credit risk (as discussed above, under 2 b)), will address this dimension as well.<sup>36</sup>

### b) Capital conservation buffer<sup>37</sup>

According to the new regulatory framework, in addition to their minimum capital requirements, banks shall also have to hold a capital conservation buffer. This buffer shall be created during times of economic growth and credit expansion, with a view to securing the capacity to use it in order to absorb losses that may ensue in times of stress in the economic cycle.

This buffer, of 2.5% of banks’ total risk weighted assets (according to the provisions on the capital adequacy ratio), shall exclusively include common equity Tier 1 capital (according to the new definition), and be used to avoid resort to minimum capital. When buffers have been drawn down, banks should rebuild them promptly by reducing dividend payments, share buy-backs and staff bonus payments.

### c) Countercyclical buffer<sup>38</sup>

As already mentioned, losses incurred in the banking sector can be extremely large when an economic downturn is preceded by a period of excess credit growth. To address this problem, “Basel III” imposes on banks to create one additional buffer, the countercyclical capital buffer, to ensure that the capital requirements take into account the macro-financial environment in which they operate.

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<sup>35</sup> **Basel Committee (2010a)**, para. 23-25.

<sup>36</sup> *Ibid.*, para. 33.

<sup>37</sup> *Ibid.*, para. 123-132.

<sup>38</sup> *Ibid.*, para. 136-149.

National authorities will activate this obligation and determine the size of the buffer, when excess aggregate credit growth is judged to be associated with a build-up of systemic risk. In this context, authorities are called to monitor credit growth and other indicators that may signal a build up of systemic risk, and assess whether (and to what extent) credit growth is excessive and is leading to the build up of systemic risk. Based on this assessment they will put in place a countercyclical buffer requirement when circumstances warrant.

The size of the countercyclical buffer will vary, depending on the competent authorities' judgement, between zero and 2.5% of risk weighted assets (according to the provisions of capital adequacy requirements). The buffer shall be implemented through an extension of the capital conservation buffer discussed above, and include exclusively, at least initially, common equity Tier 1 capital.

Internationally active banks (with subsidiary banking undertakings in a number of states), in particular, shall calculate this buffer on the basis of a weighted average of the buffers that are being applied in the jurisdictions to which they have exposures (given that the economic cycle in them may not be (and usually is not) synchronised).

*On this, note that in December 2010, the Basel Committee published a guidelines document addressed to the national authorities operating the countercyclical capital buffer, laying down the general principles they need to adhere to in terms of imposing and calculating it.<sup>39</sup>*

## 2. Specifically: provisions on banks' minimum regulatory capital<sup>40</sup>

### 2.1 Introductory remarks

As already mentioned, the most important amendment to the existing regulatory framework of the Basel Committee on bank capital adequacy refers to the definition of regulatory capital. This amendment seeks to strengthen the quality of regulatory capital, given that during the recent financial crisis the ability of banks to absorb losses proved reduced. In this context, it is necessary to make the following remarks:

(1) The regulatory capital of banks, called now "minimum capital" (in light of the introduction of the abovementioned two new capital buffers), will continue to be the sum of:

- "Tier 1 capital", which is classified in two categories (an important novelty in terms of the relevant quantitative limits set), and
- "Tier 2 capital".

On the contrary, the alternative definition of capital ("Tier 3 capital"), that banks, according to the existing regulatory framework, can use to fulfil their capital requirements for coverage against market risks,<sup>41</sup> is eliminated.

(2) The amendments introduced pertain to the composition of each category of capital, as well as the eligibility criteria of capital elements to be included in each category.

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<sup>39</sup> **Basel Committee (2010c)**: *Guidance for national authorities operating the countercyclical capital buffer*, December, at: [www.bis.org/publ/bcbs187.htm](http://www.bis.org/publ/bcbs187.htm).

<sup>40</sup> **Basel Committee (2010a)**, para. 48-93.

<sup>41</sup> This category includes subordinated short-term loans (**Basel Committee (2006)**, para. 49 (xiii)-(xiv)).

## 2.2 The provisions on Tier 1 capital

According to “Basel III”, Tier 1 capital of banks shall be made up of two classes of elements: common equity Tier 1 capital, and additional Tier 1 capital.

### a) Common equity Tier 1 capital

Common equity Tier 1 capital consists of the following elements (subject to specific conditions):

- the value of paid-in share capital in terms of common shares (with or without voting right), all classes of preferred shares being excluded,<sup>42</sup>
- retained earnings, including interim profits or losses,
- disclosed reserves,
- common shares issued by consolidated subsidiaries of the bank, and held by third parties (“minority interest”), and
- share premium from the issue of the above common shares.

### b) Additional Tier 1 capital

Additional Tier 1 capital consists of the following elements (subject to specific conditions):

- preferred shares and bonds with no maturity date (“perpetuals”), issued and paid-in, subordinated to depositors and general creditors, containing no step-up or redeem clause, and callable at the initiative of the issuer only after a minimum of five years,<sup>43</sup>
- instruments with the above characteristics issued by consolidated subsidiaries of the bank, held by third parties, and not included in common equity Tier 1 capital, and
- the share premium from the issue of preferred shares included in this category.

*Consequently, perpetual, non-cumulative preferred shares are still included in banks' Tier 1 capital, though under quantitative limitations. On the contrary, innovative instruments which, according to the existing regulatory framework, are included in Tier 1 capital of banks up to 15%,<sup>44</sup> shall no longer be eligible.*

## 2.3 The provisions on Tier 2 capital

Tier 2 capital includes the following elements (subject to specific conditions):

- fixed-term preferred shares and bonds complying with the abovementioned terms on additional Tier 1 capital, and a minimum original maturity of five years,
- instruments with the above characteristics issued by consolidated subsidiaries of the bank, held by third parties, and not included in Tier 1 capital,

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<sup>42</sup> Special rules apply for banks that do not have the legal form of a joint-stock company (e.g., cooperative banks), and hence no share capital.

<sup>43</sup> According to the Annex attached to the abovementioned **Basel Committee** Press release (2011), preferred shares and bonds included in Tier 1 or in Tier 2 capital, should moreover comply with the terms indicated therein, thus ensuring the best possible “loss absorbency”.

<sup>44</sup> **Basel Committee (2006)**, Annex 1.

- the share premium from the issue of preferred shares included in this category, and
- certain general provisions and general loan-loss reserves.

*Consequently, undisclosed and revaluation reserves, which, according to the existing regulatory framework, are included in Tier 2 capital,<sup>45</sup> shall no longer be eligible.*

## **2.4 Specific provisions**

Detailed provisions have been introduced regarding the deduction of instruments from individual elements of banks' regulatory capital, which are definitively stricter than the existing ones. "Basel III" also significantly strengthens the regime governing the obligation of banks to disclose information regarding the composition of their regulatory capital.

## **2.5. Quantitative limits**

"Basel III" has set the following new quantitative limits regarding the minimum capital requirements of banks, that must be observed on a continuous basis:

- common equity Tier 1 capital must be at least 4.5% of risk-weighted assets and off-balance sheet items;
- Tier 1 capital must be at least 6.0% of risk-weighted assets and off-balance sheet items (currently 4.0%);
- total capital (Tier 1 plus Tier 2) must be at least 8.0% of risk-weighted assets and off-balance sheet items; by induction, the amount of Tier 2 capital must not exceed 2.0%.

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<sup>45</sup> *Ibid.*, para. 49 (iv)-(vi).



## C. Assessment

### 1. Cost and benefits from the phasing-in of the new rules

According to the overview made above (under B) of the “Basel III” provisions, these will be phased-in from 2013 and with a six-year horizon, while some provisions will most certainly be amended, during the supervisory monitoring transitional periods that were introduced. This leads to two conclusions; a positive one and a negative one.

(1) The decision to introduce an adjustment period has been taken correctly on the consideration, among others, that if the new rules were to be fully and cumulatively implemented within a short period of time, the negative repercussions on the operation of banks, due to the resulting cost, would be significant. Capital requirements will increase substantially (especially in times of economic growth and mainly for systemically important banks), while implementation of the provisions on liquidity ratios will, in some cases, lead to a redefinition of banks’ business models.

(2) On the contrary, the fact that some of the provisions of “Basel III” will almost certainly be amended, creates a climate of ambiguity, which may lead to delays in their implementation, all the more so since this will be at the discretion of national authorities (on this issue, see further below, under III).

### 2. Risks from the implementation of the new rules

There is no doubt that the new regulatory framework will reduce banks’ profitability margins, as well as their return on equity (no matter the extent to which they will be able to pass the cost over to their clients, or the potential for cost-cutting).<sup>46</sup> This, of course, is the price of safeguarding the stability of the banking system on a worldwide basis, against the risk of another major financial crisis like the recent one. Even if the claim (which the author supports) that in the new environment banking will be “overregulated” is correct, the experiences from the recent crisis make the adoption of stricter measures a politically justifiable choice (albeit not always adequately justified). However, this entails three (at least) risks, whose importance should not be underestimated:

(1) First of all, implementation of the new rules can, at least in certain cases, lead to a reduction in the supply of borrowed funds by banks, with negative consequences on the real sector of the economy and on growth. Consequently, it is critical that there be accurate and reliable assessments of the impact that the new rules will have on banks’ lending activity (especially of smaller and specialised ones – mortgage, savings and cooperative banks), both during economic growth and during recessions.<sup>47</sup>

(2) Moreover, given that the banking system as a whole will be called to raise considerable amounts of equity capital from the markets (albeit within a six-year horizon), primarily by issuing common shares, the expected reduction in banks’ return on equity (ROE) will bring them in a competitive disadvantage to enterprises in other sectors of the economy, whose ROE will remain stable or even increase.

*It is noteworthy that systemically important financial institutions (and in particular banks) may even be subject to an additional capital requirement, amounting to 2% of*

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<sup>46</sup> In this context, it is interesting to note a remark made by a member of the banking supervisory community, Mr. Jochen Sanio, president of BaFin (i.e., the single supervisory authority of the German financial system), that there is a clear risk of the banking sector being converted into a “low return industry” (Sanio (2011), 2011, p. 39).

<sup>47</sup> On this see **Basel Committee**, *Results of the comprehensive quantitative impact study*, December 2010, at: [www.bis.org/publ/bcbs186.htm](http://www.bis.org/publ/bcbs186.htm).

*their risk weighted assets and off-balance sheet items which, again, will have to be covered by common equity Tier 1 capital. As a result, the equity capital of large international banks may, in extremis, need to increase eightfold in the upcoming years!*<sup>48</sup>

Consequently, in order to comply with the requirements of the new regulatory framework, banks that fail to raise the necessary capital from markets, will be forced to deleverage (and in such case curtail their lending capacity), and/or resort to restructurings that will increase the degree of concentration in the banking sector, without any obvious positive synergies therefrom.

(3) Finally, the need for banks to resort to cost-cutting as a result of the implementation of the new regulatory framework, may lead to:

- a new cycle of regulatory arbitrage, mainly by shifting activities to parts of the financial system which will continue not to be subject to regulatory intervention and supervision, as well as to states with a laxer regulatory and supervisory framework, and
- financial innovations, *per se* positive, that may, however, expose banks to risks that today are non-identifiable.

This makes the need to upgrade the role (and independence) of supervisors (who, in any case, will shoulder a heavier burden with the introduction of the new regulatory framework) even more imperative, in order to enable them to constantly monitor developments, and timely submit proposals for adjustments. In the words of a supervisor: *“Als ‘Vorwegnehmer’ müssen Regulatoren ein Gespür für die Entstehung neuer Risiken entwickeln. Und sie müssen präventiv Regeln entwickeln, mit denen sich die neuen Risiken unter Kontrolle halten lassen, auf dass sie sich nie zu einer systemischen Krise aufwachsen können”*.<sup>49</sup>

### 3. The problem of competitive equality

In general, the rules adopted by the Basel Committee (as well as by other international *fora* which are shaping public international financial law) are not legally binding and enforceable (constituting “soft law”).<sup>50</sup> Consequently, implementation of the provisions of “Basel III”, in full or in part, remains (mainly) at the discretion of national regulators (and in the case of the EU, the European regulator, i.e., the European Parliament and the Council).

Accordingly, one of the most important issues arising is the extent to which “Basel III” will be implemented, and in particular by which states, in order to achieve a level playing field for banks with international activities, given that the regulatory cost imposed on them is a substantial factor of their competitiveness (especially in foreign markets). The precedent from the refusal of certain Basel Committee member states to implement “Basel II”, is recent and striking.<sup>51</sup>

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<sup>48</sup> On this see **Sanio (2011)**, p. 39.

<sup>49</sup> **Sanio (2011)**, p. 37.

<sup>50</sup> On this see **Giovanoli (2010a)**, p. 33-44, **Boyle and Chinkin (2007)**, p. 211-229, and **Stein – von Buttlar (2009)**, p. 150.

<sup>51</sup> The case of the USA is indicative. Although their supervisory and monetary authorities which are participating in the Basel Committee strongly supported the adoption of “Basel II”, they have not yet implemented its rules into their national law.

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