It's Official: *Habemus* Basel III

By Alfredo B. Roisenzvit

The Bank for International Settlements(BIS) has officially begunapplying the designation"Basel III"to its latest series of reforms to the Capital Adequacy Framework, formerly referred to as Basel II. The BIS websitenow lists Basel III as its first "quick link," under the Basel Committee heading.

Some questions arise. Is this really a profound change? What motivates this (somewhat sudden) version change? Was this always the plan? And finally, what has actually changed from Basel II?

I will try to address these questions from my own experience as a regulator and from my humble participation as a close observer of the Basel II process.

Marketing First

The Basel IIIdesignation, though not its content, might very well be a marketing move—one that is welcome, wellthoughtout, and beneficial for the industry, but a marketing move nonetheless. We should welcome this action from the Basel Committee because it shows awareness that how a concept is presented is important, probably more important than the concept itself. It could be argued that lack of smart marketing cost Basel II a favorable reputation, especially in efforts toward strengthening financial systems—that and the poor timing of the crisis relative to Basel II implementationThe reforms that constitute the core of Basel III were presented, for the most part, in early 2009. At that time, there was no evidence, discussions, or indications that these reforms would imply a "version change." On the contrary, the idea was that they were important but normal reforms in the natural progression toward improving Basel II.

I will cite Jaime Caruana, who, in ahigh-level meeting with the Financial Stability Institute, expressed the idea that Basel II could be thought of as evolving software, improved through experience and presented as Basel 2.1, 2.2, etc. The actual reforms now known as Basel III could certainly be called Basel 2.1. But suddenly that idea has changed.

Certainly, establishing Basel III is a welcome and positive development. It willcurb negative pressures coming from less informed stakeholders, such as the general public, many legislative bodies, and nonfinancial government agencies. These groups tended to associate Basel II with the financial crisis and with the negative image projected onto banks and regulatorsthereafter.

The truth is,these latest changes—although important and positive—are not essential, much less fundamental. The magic was (and still is) in Basel II; the marketing was not. The name Basel III should bring the marketing to the magic already present and add toit hope for the new and wisdom from lessons learned.

What is the "magic"? It is risk management. Basel II changes the regulation and administrationparadigm through risk management, not through the use of advanced models for capital. Those were present some years before in many banks.

Basel II mandates that supervisors must be satisfied (and hence convinced) that banks have a comprehensive framework for managing *all* material risks and allocating capital in accordance with those risks (Pillar II). Since this gives banks more power on the

asymmetry of information to the detriment of depositors, the regulation mandates how capital is calculated for the three most relevant risks—credit, market, and operational (Pillar I). Italso mandates that banks make this calculation available to the market and, most importantly, demonstrate their qualitativeunderstanding of risks (Pillar III).

Unfortunately, many valuable years were wasted arguing and writing papers and spending long high-level meetingsdiscussingPillar I, which, because it outlines the calculation rules for capital, is the least important of the three pillars. The important change that Basel II brought to Basel I is risk management! Unfortunately,risk management was not adequately addressed and communicated, nor was it discussedinternally with sufficient depth.

The crisis was a vivid example of poor risk management. If it had been focused and presented correctly, Basel II would have been validated after the crisis. If the "real" Basel II with its risk management guidance had been applied, some majoraspects of the crisis would have been less damaging.

What's under the Hood?

Basel III contains four main reforms. All were originally reforms to the Basel II framework and were discussed and released separately.

First, there is a new sense of importance given toliquidity, which was highly underestimated, and a liquidity coverage ratio has been added.

Second, there is a requirement for more and better-quality base capital (see the figure). With the tier divisions, banks could allocate capital in different forms, especially if they are different from cash. Better capital means a higher requirement for investing the bank's own money, in order to better respond to crises and to better align risk appetite incentiveswith depositors.

Third, the total level of regulatory capital has been augmented, to a minimum of 10.5%. Depending on the bank's profile and systemic stance, this figure could be increased or decreased. Additionally, a general limit has been given to leverage, which is the inverse calculation (same implication) of the higher capital requirement. But in this case, it is not risk- focused but a general effective limit.

These three measures are a clear indication of the reach of the Basel Committee member parliaments. They indicate aretreat from more modern risk management schemes to more practical and broad regulations regarding limits. However, this move is not necessarily a step backward; it is a calibration emerging from the context that will eventually change as the context changes.

The fourth important reform is a novel scheme for avoiding procyclicality. This newmeasure involves countercyclical capital buffers, which are triggered after specific variables indicate accelerated growth. They must be built in during times of growth and used in times of stress. Taking into account that banking regulation is an intrinsically procyclical activity, these instruments are quite well thought , and could work well in some environments.

Basel III provides for a long period of calibration and adjustments, whichextends up to 2019. So chances are good for a Basel IV or more changes before then.

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.

Source:"Basel III: Towards a Safer Financial System," speech by Jaime Caruana, general manager of the Bank for International Settlements, at the Third Santander International Banking Conference, Madrid, Spain, September 15, 2010.

It'sStill about Risk Management

In my opinion, what will make Basel III work and succeed is Basel II. This view is based on the understanding that Basel II is risk management. Basel III, then, is Basel II but with more real capital and less leverage, a liquidity ratio, countercyclical capital buffers, and other details. Yet Basel III will require banks to have comprehensive processes for managing all material risks and calculating capital based on those comprehensive evaluations.

The official presentation of Basel III came in a speech by Jaime Caruanaatthe Bank of Spain. To my surprise, he barely mentioned risk management.

I am in no position to offer Mr. Caruana any advice. It would be quite beneficial, however, if the Basel Committee were to adopt the"risk management stance" when presenting Basel III, and take advantage of the well-thought-out design of Basel II. After all,Basel III, as well as Basel II (or 2.1)isa soundrisk management framework.

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