basel III capital Accord

took effect between January 2013 and January 2019

Because of the 2008 credit crisis

builds further upon the Basel II Accord

tries to further strengthen global capital standards.

Its key attention points

greater focus on tangible equity capital (greatest loss absorbing capacity)

reduced the reliance on models developed internally by the bank and ratings obtained from external rating agencies

greater focus on stress testing for systemically important banks

stresses the need to have a loss-absorbing capacity beyond common standards

greater focus on tier 1 capital (shares and retained earnings) by abolishing the tier 3 capital (Basel II) as it was deemed of insufficient quality to absorb losses

introduced a risk-insensitive leverage ratio as a backstop to address model risk

includes some facilities to deal with procyclicality (due to a cyclical nature, economic downturns amplify losses)

introduced a liquidity coverage and net stable funding ratio to satisfy liquidity requirements.

Compared to the Basel II guidelines the Basel III Accord has no major impact on the credit risk models themselves.

It does however introduce additional capital buffers as we discuss in what follows.

tier 1

4% rwa in the Basel II

6% rwa in Basel 3 (by 2015)

common tier 1 capital ratio (common equity: common stock and retained earnings but no preferred stock)

2% rwa in Basel II

4.5% rwa in Basel 3 (by 2015)

capital conservation buffer

2.5 % rwa to be covered by common equity (by 2019)

counter-cyclical capital buffer

0 to 2.5 % rwa (by 2019)

non risk based leverage ratio was introduced

3 % of assets and covered by tier 1 capital

assets and not risk weighted assets as with the previous ratios.

The assets also include off-balance sheet exposures and derivatives.

The idea here is to add this ratio as a supplementary safety on top of the risk-based ratios in Basel II.

The total capital ratio is the sum of the tier 1, tier 2, and tier 3 capital ratio.

In Basel III, the capital ratio = the tier 1 capital ratios + the capital conservation buffer + the counter-cyclical capital buffer and if relevant an additional capital ratio for systemically important banks