

Basel III

- Introduced as a result of the 2008-09 financial crisis
- Addresses shortcomings of Basel II

What remains the same

- 3 pillars
- 3 risks & methodologies (albeit with a few tweaks)

What changed

- Consideration of liquidity risk via 2 ratios i.e. LCR & NSFR
- Introduction of capital conservation buffer
- " " countercyclical buffer
- " " leverage ratio
- changes in minimum capital requirements

1) Liquidity ratios

a) Liquidity Coverage Ratio

- Looks at ability to survive over a 30-day period of liquidity disruption

$$LCR = \frac{HQLA}{\text{Net cash outflow over next 30 days}}$$

HQLA : High Quality Liquid Assets

- Highly liquid & easily convertible to cash
- Unencumbered



→ Consider a model expected cash outflows under a stress scenario

- Run-down of deposits
- Loss of funding availability
- Derivative cashflows
- Collateral requirements
- Disbursements of undrawn amounts
- Outflows on guarantees & letters of credit given

b) Net Stable Funding Ratio

→ Focus on resilience & stable funding profile for banks

→ Focuses on the long-term

$$NSFR = \frac{\text{Available stable funding}}{\text{Required stable funding}}$$

ASF: Associated with liabilities & funding profile

RSF: Associated with asset side of balance sheet

The more stable the source of funding,
the higher the ASF factor

The more volatile the asset, the higher
the RSF factor

$$NSFR = \frac{\sum ASF \text{ factor}_i \times Item_i}{\sum RSF \text{ factor}_i \times Item_i} \geq 100\%$$

2) Capital conservation buffer

- Provide in good times for bad times
- CCB = 2.5% of RWA
- Only composed of common equity tier 1 capital
- When losses are incurred, you can draw down on this capital buffer
- Whenever CCB < 2.5%, there are restrictions on capital distribution i.e. no dividends

3) Countercyclical buffer

- Aligns banking sector with macro environmental conditions
- Countercyclical in nature i.e. higher in periods of growth & lower in periods of de-growth
- Determined as a % of exposure to each jurisdiction
- Can vary between 0% to 2.5% of RWA
- As with CCB, CCyB also needs to be held in the form of common equity tier 1 capital only

4) Leverage ratio

$$\text{Leverage ratio} = \frac{\text{Capital measure}}{\text{Exposure measure}} \geq 3\%$$

Capital measure : Tier 1 capital after all deductions

Exposure measure : On balance sheet, off-balance sheet, repos, reverse-repo exposures

Eg:	A	B
Capital	100	80
Exposure	2,000	1,000
RWA	800	800
LR	$\frac{100}{2000} = 5\%$	$\frac{80}{1000} = 8\%$

→ Penalises large banks which may have sound risk mgmt policies

5) Changes in minimum capital requirements

→ Total capital ratio $\geq 8\%$.

Tier 1 capital $\geq 6\%$.

Common equity tier 1 $\geq 4.5\%$.

→ No tier 3 capital