



# The Status of the Basel III Capital Adequacy Accord

**Walter W. Eubanks**  
Specialist in Financial Economics

October 28, 2010

**Congressional Research Service**

7-5700

[www.crs.gov](http://www.crs.gov)

R41467

## Summary

The new Basel Capital Adequacy Accord (Basel III) is of concern to Congress mainly because it could put U.S. financial institutions at a competitive disadvantage in world financial markets. The Basel capital accord is an agreement among countries' central banks and bank supervisory authorities on the amount of capital banks must hold as a cushion against losses and insolvency. Higher capital requirements constrain bank lending and profitability. The accords are not treaties. Member countries may modify the agreement to suite their financial regulatory structures. The concern is that Basel III might be in conflict with the new capital requirements U.S. regulators are implementing under the Dodd-Frank Act (P.L. 111-203). Basel III was the central focus of the discussion at the September 22, 2010, House Committee on Financial Services hearing on international regulatory issues relevant to the implementation of the Dodd-Frank Act. A day after member central bank governors approved the quantitative capital requirements of Basel III, Senate Banking Committee Chairman Christopher Dodd issued a statement warning of the potential for international regulatory arbitrage in implementing Basel III.

The first Basel accord was adopted in 1988 and is credited with providing stability to the international banking system. Banking regulators in the United States and other countries developed Basel II in 2004 because Basel I was not sufficiently sensitive in measuring risk exposures. By 2006, the European Union implemented Basel II. U.S. banking regulators issued the final rules for the implementation of the Basel II on December 7, 2007, and published the final regulations for implementing Basel II on April 1, 2008. At the time, the United States was in the most severe economic recession in more than 70 years. Federal regulatory agencies turned their attention to stabilizing the financial system, and Basel II was never fully implemented.

Basel III would make significant changes in bank regulatory capital requirements. It would increase the amount of common tangible equity held as minimum regulatory capital because common equity improves loss absorbency. Tangible common equity consists of bank shares and retained earnings. This increase is a significant change in regulatory capital requirements because many assets that are being used as regulatory capital would have to be converted to common tangible equity. By 2015, more than half of the total regulatory capital would be composed of common tangible equity capital. Common tangible equity will also be used in a new conservation capital buffer. This capital conservation buffer is to ensure that banks build up capital outside periods of financial stress that can be drawn down when losses are incurred. The minimum total capital plus conservation buffer would be 10.5% of risk-weighted asset in January 1, 2019, which is 2.5% higher than the current minimum requirement. If another element, the countercyclical capital buffer, is fully added, the minimum total capital requirement would be 13% of risk-weighted assets. This would be a remarkable increase in capital requirement from current levels. Very few U.S. banks were able to maintain 13% of risk-weighted assets at the highest level of U.S. bank profitability. At that time, the average total equity capital ratio was 10.52%.

This report follows the basic elements of the Basel III documents on the types of capital requirements and their phase-in schedule, which were approved by the Basel member central bank governors on September 12, 2010. The elements are the *new definition of Tier 1 capital*, the *minimum common equity capital*, the *capital conservation buffer*, *countercyclical capital buffer*, *liquidity coverage ratio*, *global leverage ratio*, and *wind-down government capital injections*. The report concludes with *some implications* drawn from its content. This report will be updated as developments warrant.

## **Contents**

Background .....	1
The Basel III Capital Adequacy Accord.....	3
A New Definition of Capital.....	4
A Capital Conservation Buffer .....	5
A Countercyclical Capital Buffer.....	5
A New Liquidity Requirement.....	6
Introduction of a Global Leverage Ratio.....	7
Withdrawal of Government Capital Injections .....	8
Basel III’s Major Issues Remaining .....	8
Short Deadline for Implementation.....	8
What’s Next .....	9
Criticisms of Basel III and Some Responses .....	9
United States Adoption and Implementation of Basel III.....	11
The Small Bank/Large Bank Issue.....	11
Specific Dodd-Frank Act Issues .....	11
Some Implications of Basel III .....	12

## **Tables**

Table 1. Basel III Minimum Capital Requirements and Phase-in Arrangements .....	9
---	---

## **Contacts**

Author Contact Information .....	13
----------------------------------	----

## Background

The Basel III capital adequacy accord is the most recent international effort to establish a new capital standard for banks. Specifically, Basel III is an agreement on capital requirements among countries' central banks and bank supervisory authorities. The accords are not treaties. Member countries may modify the agreement to suite their financial regulatory structures. Basel capital accords are produced by the Bank for International Settlements Basel Committee on Banking Supervision.<sup>1</sup> These agreements provide a framework for determining the minimum capital financial institutions must hold as a cushion against losses and insolvency. The less capital a bank holds the more capital it has to lend, which generally increases the bank's profitability, but makes it more vulnerable to losses and failure, which could lead to the need for government financial assistance. Without financial institutions holding this minimum amount of capital, banking regulators would not permit banking organizations to conduct normal banking business.

The first Basel accord was adopted in 1988 and is credited with providing stability to the international banking system, both through defining consistent safety and soundness standards and by promoting better coordination among regulators and financial supervisors in participating countries. However, Basel I had flaws. Banking regulators in the United States and other countries developed Basel II in 2004 because it had become clear to regulators that the methods use to calculate the requirements in Basel I were not sufficiently sensitive in measuring risk exposures. It was also clear that the regulatory capital needed in the increasingly complex and dynamic banking system could not be determined accurately and consistently under the Basel I framework. Banking institutions were able to game the system to minimize capital-consuming assets and by moving assets off their balance sheets, often leading to capital levels not adequate for the associated risk exposure.

The Basel II capital accord upon which Basel III was built is a three-pillared framework. The first pillar draws the most attention. It provides the methodology for calculating the minimum capital requirements for various categories of banks and banking instruments, such as mortgages, payment cards, and private and government securities. In the Basel II framework the capital requirement for each bank asset was subject to measurement. Consequently, it was found to account for more of the risk exposures in the assets in a bank's balance sheet than Basel I. Basel I determined the risk exposures for large categories of assets, making it less sensitive to individual asset risk exposure. The second pillar specifies the supervisory review process. For example, pillar two requires banks to maintain management mechanisms to conduct ongoing internal self-evaluation of risk exposures and compliance with the minimum regulatory capital requirement for each level of risk exposure. It also requires regulators to validate these mechanisms. The third pillar facilitates market discipline in the banking system to create the proper incentives to adopt the best safety and soundness practices. A bank's financial disclosure, for example, could determine the willingness of depositors and investors to do business with that bank.<sup>2</sup>

By 2006, the European Union implemented Basel II in most of its member countries, while the United States operated under Basel I. The U.S. federal regulators published the final regulations

---

<sup>1</sup> See the background section for a brief history of the Basel Committee in CRS Report RL31984, *The New Basel Capital Accord: A Return to Bank Supervisory Judgments*, by Walter W. Eubanks. (This report is out of print but can be obtained from the author.)

<sup>2</sup> *Ibid.*, pp. 3-4.

for implementing Basel II in April 1, 2008, six months into the most severe economic recession in more than 70 years. Federal regulatory agencies turned their attention to stabilizing the economy with the Emergency Economic Stabilization Act (EESA) of 2008, and the implementation of its programs, the Troubled Asset Relief Program (TARP) and the Federal Deposit Insurance Corporation's (FDIC's) Temporary Liquidity Guarantee Program (TLGP) among other government assistance programs to the financial system, including the placing of Fannie Mae and Freddie Mac under the U.S. Treasury's conservatorship. Basel II was not fully implemented in the United States.

Basel III is of concern to Congress. It could put U.S. financial institutions at a competitive disadvantage in world financial markets. The day after 27-member central bank governors approved the Basel III's capital and liquidity requirements, Senator Christopher Dodd, chairman of the Senate Banking Committee, made a statement warning against regulatory arbitrage with financial institutions shopping for the weakest regulator.<sup>3</sup> In other words, when the United States raises its regulatory standards, banking institutions could move their business to other countries where they face less regulatory burden, thus, putting U.S. banks at a disadvantage. Foreign banks would have more capital to lend because they would not be holding it as capital requirement. Ten days later, on September 22, 2010, the House Financial Services Committee held a hearing that focused on the Basel III agreement in which Treasury Secretary Timothy F. Geithner testified.<sup>4</sup> One of the major concerns at the hearing was whether the U.S. trading partners will raise their regulatory standards as high as the United States'.

The purpose of Basel III is to remedy the regulatory capital and liquidity failures that resulted in the 2007-2009 global financial crisis. However, similar remedies were being pursued at the national level by the United States and other countries:

- In the United States, capital requirements were increased in the Dodd-Frank Act;
- In Germany, the Act for Strengthening of Financial Markets and Insurance Supervision increased capital;
- In the United Kingdom, the White Paper on Financial Regulatory Reform presented plans to increase capital on banks; and
- In Spain, the Fund for Ordered Bank Restructuring was created to increase capital to prevent bank insolvency and taxpayers' bailouts in future financial crises.

Basel III may conflict with these national efforts. For example, Switzerland and the United Kingdom have pushed for tougher rules and are moving ahead with additional regulatory restrictions on their financial institutions. In short, Congress is concerned that Basel III may not be able to keep the international banking playing field level given all these individual countries' efforts to use increased capital requirements among other regulations to help prevent another financial crisis. So far, the obligation to harmonize these efforts is less of a priority than getting these regulations implemented nationally.

---

<sup>3</sup> See [http://banking.senate.gov/public/index.cfm?FuseAction=Newsroom.PressReleases&ContentRecord\\_id=0ccaa7b1-090a-0d78-0057-cfd203d95150&Region\\_id=&Issue\\_id=](http://banking.senate.gov/public/index.cfm?FuseAction=Newsroom.PressReleases&ContentRecord_id=0ccaa7b1-090a-0d78-0057-cfd203d95150&Region_id=&Issue_id=)

<sup>4</sup> See <http://financialservices.house.gov/Hearings/hearingDetails.aspx?NewsID=1358>.

The European Parliament is also concerned with Basel III for similar reasons. On October 7, 2010, the European Parliament passed a resolution pressing the European Commission to determine whether Basel III would give U.S. banks competitive advantages over European-based banks. The resolution refers to the Dodd-Frank Act's ban on external credit rating agencies:

Recently passed laws in the United States could lead to serious inequalities in the implementation of the current standards and those agreed by the Basel committee in September, especially given the recognition of external rating agencies is restricted and that the standards apply only to certain types of banks.<sup>5</sup>

In addition, European countries are considering a tax on too-big-to-fail institutions, and Switzerland proposed the first capital surcharge on such institutions. These are national regulatory policies that could undermine the efforts to level the international banking playing field and promote global economic recovery.

This report is generally laid out in the same way as the basic elements presented in the Basel III documents. After a description of each element, the quantitative capital requirement and phase-in schedule of that element are presented. The quantitative requirements and phase-in schedules were approved by the 27-member jurisdictions and 44 central banks and supervisory authorities on September 12, 2010.<sup>6</sup> The first element is an attempt to improve the quality of capital with a *new definition of Tier 1*<sup>7</sup> capital. The phase-in arrangement approved by the governors is that banks must raise their *minimum common equity capital* from the current 2.0% to 4.5% by January 1, 2015. The next element is the introduction of a *capital conservation buffer* that banks must change according to the level of stress the bank is experiencing. In 2016, Tier 1 capital increases to 6.0% and the minimum total capital plus conservative buffer increase to 10.5%. The report then explains a *new countercyclical capital buffer*. This is followed by the *new liquidity coverage ratio* element, and the *global leverage ratio*. At the September 12 meeting, the central bank governors also approved a schedule to *wind down government capital injections* that were necessary during the financial crisis.<sup>8</sup> The report concludes with *some implications* drawn from its content.

## The Basel III Capital Adequacy Accord

Basel III is a work in progress that is far from completion. What is being called Basel III is a consultative document entitled, *Strengthening the Resilience of the Banking Sector* that was first promulgated on December 17, 2009, by the Basel Committee on Banking Supervision at the Bank for International Settlements (BIS) in Basel, Switzerland.<sup>9</sup> This document was an expanded and

---

<sup>5</sup> European Parliament, *New Basel Bank Capital Standards Need fine-tuning Say MEPs*, October 7, 2010, <http://www.europarl.europa.eu/en/pressroom/content/20101006IPR85262>.

<sup>6</sup> Bank for International Settlements, *Basel Committee on Banking Supervision*, Group of Governors and Heads of Supervision announces higher global minimum capital standards, Basel, Switzerland, September 12, 2010, <http://www.bis.org/press/p100912.htm>.

<sup>7</sup> Tier 1 is core capital and is made up of mainly common shareholders' equity (issued and fully paid), disclosed reserves, most retained earnings and perpetual non-cumulative preferred stocks.

<sup>8</sup> For a more details about the financial crisis in the EU and the U.S., see CRS Report R41367, *The European Union's Response to the 2007-2009 Financial Crisis*, by Walter W. Eubanks.

<sup>9</sup> Bank for International Settlements, *Basel Committee on Banking Supervision, Consultative Document*, Strengthening the resilience of the banking sector, Basel, Switzerland, December 17, 2009, <http://www.bis.org/publ/bcbs164.htm>.

updated version of an earlier document entitled, *Enhancement of the Basel II Framework* that was published in July 2009.<sup>10</sup> There is yet to be a BIS document entitled Basel III. The purpose of these two documents was to specify how to improve the banking sector's ability to absorb financial and economic shocks arising from stresses, whatever the source. This in turn would reduce the risk of spillovers from the financial sector to the real economy. Specifically, the central part of the Basel III regulatory reform package is to establish the minimum regulatory capital and liquidity requirements that banks must hold to absorb unexpected losses.

## **A New Definition of Capital**

Basel III redefines regulatory capital. To raise the quality, consistency and transparency of regulatory capital, the committee determined that Tier 1 capital must consist predominantly of common equity and retained earnings. Under current standards, there are two types of capital counted in meeting the capital adequacy rules under Basel I—core capital and supplementary capital. Tier 1 is core capital and is made up of mainly common shareholders' equity (issued and fully paid), disclosed reserves, most retained earnings, and perpetual non-cumulative preferred stocks. Supplementary or Tier 2 capital consists of subordinated debt, limited-life preferred stocks and loan loss reserves, and goodwill. Banks can hold as little as 2% of common equity to risk-weighted assets. Consequently, banks can display strong Tier 1 capital containing a limited amount of tangible common equity. The financial crisis demonstrated that the resources to cushion against credit losses and write-downs came out of retained earnings, which is a part of a bank's tangible equity base. Under the Basel III framework Tier 1 capital is adjusted to narrow it as close as possible to bank tangible common shares. Goodwill and preferred stocks, as well as other assets, would not be included in the new Tier 1 capital.

Until the September 12 meeting, the committee had not set the percentage of risk-weighted assets that banks must hold in the form of the new Tier 1 capital. At the meeting, the central bank governors approved a capital requirement policy that would increase the minimum common equity that banks must hold as capital from the current 2% to 4.5% by 2015. However, instead of just tangible common equity, the central bank governors added mortgage servicing rights (MSRs), deferred tax assets (DTAs), and holdings in other financial institutions (HIOFIs) to be part of Tier 1. The banks argued that MSRs, which are contractual agreements in which the rights to service existing mortgages can be easily sold to offset unexpected losses, should be considered Tier 1 capital. DTAs, assets that are used to reduce the amount of taxes that a company will pay in a later tax period, were also added to Tier 1 capital. Bankers argued that DTAs are very liquid assets that can be used to offset unexpected losses. Finally, HIOFIs were considered by bankers as equivalent to the bank's own common equities and could be easily sold to offset losses. These three added assets, however, should not exceed in aggregate more than 15% of a bank's Tier 1 capital, which limits dilution of the amount of common tangible equity in Tier 1 capital. The total minimum total capital plus capital conservation buffer (discussed below) would be 8.0% on January 1, 2015. Between January 1, 2016, and January 1, 2019, there would be a 2.5% increase in the minimum total capital and conservation buffer at a rate of 0.625% per year, as shown in row 3 of **Table 1**, which would total 10.5% on January 1, 2019. Almost 60% of the minimum total capital plus conservation buffer would be Tier 1 capital. As mentioned above, Tier 1 capital would

---

<sup>10</sup> Bank for International Settlements, *Basel Committee on Banking Supervision, Enhancement of the Basel II Framework*, July 13, 2009, <http://www.bis.org/publ/bcbs157.htm>.

consist of common equity capital after adjustments and would be increased to 6.0% beginning January 1, 2015 (row 6, **Table 1**).

## **A Capital Conservation Buffer**

To ensure that banks build up capital buffers outside periods of financial stress that can be drawn down when losses are incurred, the committee established a capital conservation buffer that banks must maintain. The minimum amount of the conservation buffer is 2.5% of the banks' risk-weighted assets. The capital held in this buffer must be Tier 1 capital. When the buffer is drawn down, banks must find ways to rebuild it. Building the buffer to meet the requirement includes reducing discretionary distribution of earnings, dividend payments, and salary bonus payments. According to Basel III, regulators should forbid banks from distributing capital to signal their financial strength when banks have depleted their capital buffers.

On September 12, 2010, the central bank governors agreed to set the capital conservation buffer at 2.5% of risk-weighted assets to cushion against future periods of stress. The Basel Committee has not changed the total minimum risk-weighted capital requirement under Basel II, which is 8%. The 2.5% capital conservation buffer must consist mostly of common tangible equity. The conservation buffer would increase in increments of 0.625% annually. As shown in **Table 1**, on January 1, 2016, the conservation buffer would be 0.625%; on January 1, 2017, it would be 1.25%; on January 1, 2018, it would be 1.875%; and 2.5% on January 1, 2019.

## **A Countercyclical Capital Buffer**

Procyclicality means that banks are able to disproportionately expand lending when economic activity is expanding and disproportionately contract lending when economic activity is contracting. During economic expansions, lending is less risky and the Basel framework would recommend less need for capital. In economic contractions when lending tends to be more risky, the framework would recommend higher levels of capital, slowing or possibly preventing banks from lending. The Basel accords' procyclicality also works against monetary policy. Monetary policy tries to ease credit and expand lending to reverse a contraction, or to tighten credit and slow lending when the economy is over heated and likely to become inflationary. Procyclicality, in other words, has a destabilizing tendency on the economy.

In addition to the capital conservation buffer in Basel III, the committee introduced a series of measures to address procyclicality. The measures are to

- dampen any excess cyclicity of the minimum capital requirement. One way to do this is to adjust the capital requirement over the business cycle. The capital requirement would be calibrated so that more capital is required in economic expansions than in economic contractions.
- promote more forward looking provisions. This could be done by changing the accounting standards towards an expected loss approach. The committee supports the International Accounting Standard Board plans to issue a set of high level guiding principles that would promote an expected loss approach that captures actual losses more transparently and is also less procyclical than the current incurred loss approach. In short, the committee would prefer moving away from mark-to-market approach.

On September 12, 2010, the central bank governors approved a policy on countercyclical buffers that essentially left it up to the national regulatory authorities to determine when excess credit growth poses a risk to the stability of the financial system. The governors agreed that the countercyclical buffer should be between 0 and 2.5 % of total risk-weighted assets consisting of common equity or other fully loss absorbing capital. The governors set no deadline for meeting this requirement, which would allow national governments to implement the countercyclical buffer according to national economic circumstances. In an economic expansion the buffer would grow and in an economic contraction it would decrease. National governments may also introduce asset-specific countercyclical requirements under financial oversight policy against rapid growth in financial assets during economic expansions. For example, if corporate bonds become increasingly risky, the government could set a higher capital requirement on corporate bonds, which would discourage banks' acquisition of corporate bonds in an economic expansion. According the Basel III schedule, if national governments require their banks to start adding capital for the countercyclical buffer at the rate of 0.625% of their risk-weighted assets per year between January 1, 2016, and December 31, 2018, a countercyclical capital buffer of 2.5% would be on January 1, 2019.

In the mean time, banks may use their current Tier 1 and Tier 2 or higher capital under Basel II to meet the total minimum capital requirement of 8%. In short, by January 1, 2015, banks must hold 8% minimum total capital, 6% of which must be Tier 1 capital. Beginning in January 1, 2016, and by 2019, the total minimum total capital requirement will increase from 8.0% to 10.5% at the rate of .0625% per year. As a result, the minimum total capital plus conservation buffer would be 10.5%. If the countercyclical capital buffer is added in full, the minimum total capital requirement would be 13.0% of risk-weighted assets. Very few U.S. banks were able to maintain a regulatory capital requirement of 13% at the record breaking peak of U.S. bank profitability in 2006. At that time, U.S banks net income was \$145.7 billion, and the total average equity capital ratio was 10.52%.<sup>11</sup> Recent U.S. bank profits are considerably lower and sometimes negative, and future bank profits are expected to be not nearly as high as in 2006.

## **A New Liquidity Requirement**

Banks experienced liquidity difficulties during the financial crisis, despite meeting their regulatory risk-weighted assets capital requirements. Basel III introduced a new global liquidity standard to be internationally harmonized. The committee's standard establishes a minimum liquidity requirement along the lines of the minimum capital requirement of the Basel capital accords. The rapid reversal of the liquidity market in 2008 placed the banking system under severe stress, which required central bank actions to support both the functioning of money markets and individual institutions. The committee developed two minimum standards for funding liquidity. First, there is a 30-day liquidity coverage ratio, consisting mostly of government securities and cash, which would promote short-term resilience to potential liquidity disruptions. The second is a long-term structural ratio to address liquidity mismatches and provide incentives for banks to use stable sources to fund their operations.

On September 12, 2010, the central bank governors approved the introduction of the liquidity coverage ratio requirement effective in 2015 after an observation period beginning in 2011 and

---

<sup>11</sup> See FDIC Quarterly Banking Profile, Table III-A, Full Year 2006, All FDIC-Insured Institutions, December 2006, <http://www2.fdic.gov/qbp/2006dec/all3a1.html>.

ending in December 2014. In the observation period, the committee plans to put in place rigorous reporting processes to monitor the ratio and continue to review the implications of the liquidity coverage ratio for financial markets, credit extensions and economic growth.

## **Introduction of a Global Leverage Ratio**

One lesson learned from the financial crisis is that there was a build up of excessive on-and off-balance sheet leverage (undercapitalized lending) in the banking system, even though banks were able to meet their regulatory risk-weighted assets capital requirements. However, it was only when the banks were forced by market conditions to reduce their leverage that the system increased the downward pressure in asset prices. This exacerbated the decline in bank capital and the contraction in available credit. To prevent the excessive deleveraging from happening again, the Basel Committee has introduced a leverage ratio for the first time that is intended to achieve the following objectives:

- constrain the build up of leverage in the banking sector, helping to avoid the destabilizing and deleveraging processes which can damage the broader financial system and the economy; and
- reinforce the risk-based requirements with a simple non-risk-based backstop measure based on gross exposure.<sup>12</sup>

Even though the United States has always maintained a minimum leverage ratio for its banks, the Basel Committee has resisted establishing one for its accords. Among some non-U.S. regulators, the leverage ratio is thought of as a separate unsophisticated regulatory tool. It is gross capital divided by the average total consolidated on-balance sheet assets. Promoters of this ratio argue that it is a more objective measure than a risk-weighted ratio because it takes away discretionary supervision from banking regulators. Risk-weighted capital requirements depend on the regulators determining the weights. In the United States, banks and their supervisors must take prompt corrective action (PCA) when a bank's minimum leverage ratio falls below 4%.<sup>13</sup>

On July 26, 2010, the phased-in arrangement was announced by the Basel Committee's group of governors and heads of Supervision. However, the governors did not approve a specific leverage ratio, leaving it up to each member country for its determination. The supervisory monitoring period will begin January 1, 2011, and the parallel run, in which both old and new requirements are operating at the same time to determine the differences, would begin January 1, 2013, until January 1, 2015. Based on the results of the parallel-run period, adjustment will be made in the first half of 2017 and the minimum leverage ratio will be determined and applied in January 1, 2018.

---

<sup>12</sup> Bank for International Settlements, *Basel Committee on Banking Supervision, Consultative Document, Strengthening the resilience of the banking sector*, Basel, Switzerland, December 17, 2009, <http://www.bis.org/publ/bcb164.htm>.

<sup>13</sup> See CRS Report RL31984, *The New Basel Capital Accord: A Return to Bank Supervisory Judgments*, by Walter W. Eubanks (out of print; copies available from the author). Prompt corrective action requires that a bank whose capital falls below the mandatory leverage ratio must work with its primary regulator to rebuild its capital to the mandatory level. If the capital level is not restored to the mandatory level, the regulator could take punitive action against the bank. PCA could include putting the bank in conservatorship.

## Withdrawal of Government Capital Injections

As a result of the 2007-2009 financial crisis, many European and American banks are operating with their governments' capital injections. Without this financial assistance, some banks would have failed during the crisis. Even with government capital injections, the troubled-bank list in the United States has now exceeded 800. The governments injected capital into the banks by buying common and preferred stocks of undercapitalized banks. At the Basel III meeting, the central banks' governors agreed to grandfather existing government capital injections into the banking sector by January 1, 2018. Government capital instruments that no longer qualify as non-common equity Tier 1 capital or Tier 2 capital will be phased-out over a 10-year period beginning on January 1, 2013. Beginning in 2013, the recognition of these instruments as qualifying capital will be capped at 90% of the nominal amount of such instruments outstanding, with the cap declining by 10% in each subsequent year.<sup>14</sup> This agreement could mean, for some countries, that taxpayers could suffer losses as a result of their government's capital injections in these banks because the amount or the value of the government capital injections would be reduced over time.

## Basel III's Major Issues Remaining

### Short Deadline for Implementation

Compared with the Basel II negotiations of six years, the initial implementation date for Basel III of two years was extremely short considering that Basel II was never fully implemented in the United States in those six years. Even though the committee stated from the start that it intended to put in place appropriate phase-in measures and grandfather arrangements to allow sufficient time to ensure a smooth transition to Basel III, the criticisms from the international banking community and some governments led to the extension of the implementation deadline to January 1, 2019. **Table 1** summarizes the schedule for the implementation of Basel III that was approved at the September 12, 2010 meeting of the central bank governors, higher capital requirements for trading, derivative and securitizations activities will be introduced at the end of 2011. For banks, the minimum common equity and Tier 1 requirement will be phased in between January 1, 2013, and January 1, 2015. On January 1, 2013, the minimum common equity requirement will be raised from the current 2% to 3.5%. The Tier 1 capital requirement will increase from 4.0% to 4.5%. On January 1, 2015, banks must have 4.5% common equity and 6.0% total Tier 1 requirement. The capital conservation buffer of 2.5% will be phased in between January 1, 2016, and the end of 2018. As shown in **Table 1**, if all the elements are implemented the total minimum capital requirement could be as high as 13%. With Tier 1 capital at 6.0%, Tier 1 capital would 46% of the total capital requirement.

---

<sup>14</sup> Daniel Pruzin, "Central Bank Governors Approve Hike in Minimum Capital Requirements for Banks," *BNA Banking Daily—Breaking News*, September 12, 2010, p. 1.

**Table I. Basel III Minimum Capital Requirements and Phase-in Arrangements**

(all dates of January 1; in percentages)

Types of Capital	Years								
	2011 <sup>a,b</sup>	2012 <sup>b</sup>	2013 <sup>c</sup>	2014 <sup>c</sup>	2015 <sup>c,d</sup>	2016 <sup>c</sup>	2017	2018	2019
Minimum Common Equity Capital Ratio (row 1)			3.5	4.0%	4.5	4.5	4.5	4.5	4.5
Minimum Conservation Buffer (row 2)						.0625	1.25	1.875	2.5
Minimum Total Capital Plus Conservation Buffer (row 3)			8.0	8.0	8.0	8.625	9.25	9.875	10.5
Minimum Countercyclical Buffer (row 4)						.0625	1.25	1.875	2.5
Minimum Total Capital Plus Conservation & Countercyclical Buffer (row 5)									13.0
Minimum Tier I Capital (row 6)			4.5	5.5	6.0	6.0	6.0	6.0	6.0

**Source:** Basel Committee on Banking Supervision,, Group of Governors and Heads of supervision announces higher global minimum Standard, September 12, 2010, p. 7.

**Notes:** Ref. No: 35/2010

- a. Liquidity Coverage Ratio: operation period begins.
- b. Leverage Ratio: supervisory monitoring.
- c. Leverage Ratio: parallel run from January 1, 2013 – January 1, 2017.
- d. Liquidity Coverage Ratio: introduction of minimum standard.

## What's Next

In obtaining the approval of the Basel III framework at this stage of its development, the Basel Committee said it will continue to work on some of the outstanding issues, such as the capital requirement of larger banks. On October 12, 2010, the Basel Committee announced that it will meet in the South Korean capital of Seoul on October 19, 2010, with the goal of finalizing its proposal to be presented to the Group of 20. The Basel III proposal will be discussed by the Group of 20 major economic powers at their meeting in South Korea on November 11-12, 2010. Next, it will be up to the adopting countries' governments and financial regulatory authorities to interpret and formulate regulations that would implement Basel III.

## Criticisms of Basel III and Some Responses

Initially Basel III received harsh criticisms from the banking industry and some regulators. The criticisms were directed at every proposed requirement that the Basel Committee tried to strengthen in response to the 2007-2009 financial crisis. The European banks were most critical of the proposal, arguing that Basel III favors U.S. banks because U.S. banks historically maintained a higher level of capital and would more easily meet the quantitative increase in capital. Moreover, it is much harder to raise capital from the private sector in Europe than in America. The Institute of International Finance, which represents the world's largest commercial

banks, warned in June 2010 that the December 2009 Basel III proposal would require that these larger banks raise \$700 billion in common equity and issue \$5.4 trillion in long term debt over the next five years to meet the standards. The absorption of capital would cause a 3% decline in the United States' GDP compared with what it would be otherwise in five years.<sup>15</sup> JP Morgan Chase and Morgan Stanley<sup>16</sup> argued that the Basel III proposal would significantly reduce the availability of credit to the U.S. economy. The American Securities Forum said that Basel III's liquidity coverage ratio "could have a catastrophic effect on the short-term global capital markets."<sup>17</sup> The main reason is that the liquidity ratio would require banks at all times to hold a stock of highly liquid assets that equal or exceed their net cash flow calculated over a 30-day period. This liquidity would significantly reduce short-term funds needed to issue short-term debt securities, such as money market instruments and corporate and municipal bonds. The Deutsche Bank's comment was that the timetable was too short to increase common equity because the prospects for future profits, the main source of common equity, are not good in the short run.<sup>18</sup> The French Bankers Association assessment was that the adjustment to Basel III was unworkable because it would result in a Tier 1 capital shortage of between \$2.7 trillion and \$4.7 trillion for the Euro-zone countries alone.<sup>19</sup>

The Basel Committee on Banking Supervision made its own assessment of the Basel III proposal's impact on the global economies. It reported its findings in a document entitled, *An Assessment of the Long-term Impact of Stronger Capital and Liquidity Requirements*, on August 18, 2010.<sup>20</sup> The finding of the Basel Committee's assessment was that higher capital and liquidity requirements can significantly reduce the probability of a banking crisis. Taking a different approach to assessing the benefits of Basel III, the committee found that the incremental benefits decline at the margin. Consequently, the benefits are relatively large when capital ratios are increased from low levels and progressively decline as standards tighten. For example, the committee found that the decrease in the likelihood of a crisis is three times larger when capital is increased from 7% to 8% than when capital is raised from 10% to 11%. The assessment concluded that better capitalization reduces both the likelihood of crises and the severity of crises when they occur.

---

<sup>15</sup> Daniel Pruzin, "Basel Committee Bends to Bank Pressure, Issues Details of Modifications to Basel III," *BNA Banking Daily*, July 27, 2010, pp. 1-4.

<sup>16</sup> See these two banks' comments at <http://www.bis.org/publ/bcbs165/jpmorganchase.pdf> and <http://www.bis.org/publ/bcbs165/morganstanley.pdf>.

<sup>17</sup> See the American Securitization Forum, Consultative Documents—International Framework for Liquidity Risk Measurement, Standards and Monitoring; and—Strengthening the Resilience of the Banking Sector, p. 4. at <http://www.bis.org/publ/bcbs165/americansecurit.pdf>.

<sup>18</sup> See <http://www.bis.org/publ/bcbs165/deutschebankcap.pdf>.

<sup>19</sup> Association Francaise Des Societes Financieres, *ASF's Position on Possible Further Changes to the Capital Requirement Directive (CRD IV)*, Paris, France, April 22, 2010, <http://www.asf-france.com>.

<sup>20</sup> Bank for International Settlements, *Basel Committee on Banking Supervision*, Assessment of the long-term economic impact of stronger capital and liquidity requirements, Basel, Switzerland, August 18, 2010.

# United States Adoption and Implementation of Basel III

## The Small Bank/Large Bank Issue

The unfinished business of implementing Basel II complicates the United States' implementation of Basel III. Although U.S. regulators agreed to rules to implement Basel II with modifications to address the Basel II disadvantages to smaller banks, those modifications were never implemented due to the onset of the 2007-2009 financial crisis.<sup>21</sup> Large banks were scheduled to complete their implementation by the first quarter of 2011, but there was never a schedule for smaller banks to comply with Basel II. The inequity between smaller and larger banks remains unresolved. At the heart of that issue is that Basel II would have given larger banks an unfair advantage because they were able to afford to invest in sophisticated management systems that allowed regulators to permit these large banks to determine the amount of risk-weighted capital they must hold. Based on the Basel Committee study of these large banks self-assessments of their risk-weight capital requirement, they would have to reduce their capital requirement by as much as 29%. Smaller banks complained at Basel II congressional hearings held in 2005.<sup>22</sup> Basel II was adopted in April 2008 during the financial crisis.

## Specific Dodd-Frank Act Issues

In addressing the 2007-2009 financial crisis, the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203) has a number of provisions that conflict with Basel III. The most recognized conflict is the Dodd-Frank Act's ban on the use of rating agencies. Section 939A of the Dodd-Frank Act is the result of rating agencies, such as Moody's and S&P, giving mortgage-related securities investment-grade ratings they did not deserve. The inflated ratings helped create the U.S. housing bubble, which was a critical determinant of the financial crisis. Basel III would rely on these rating agencies for determining the riskiness of these securities and therefore the amount of capital banks must hold against them. The U.S. regulatory agencies are in the process of developing alternatives to rating agencies. There are other conflicts such as the Basel III clause that bans hybrid bonds as capital. Basel III has a different time frame than Dodd-Frank. Dodd-Frank gives larger banks less time to phase out the bonds and smaller banks more time. Basel III does not make the distinction.

The Basel III trading-book rules may be in conflict with the Volcker rule that prohibits a bank or institution that owns a bank from (1) engaging in proprietary trading (buying and selling securities and equities) that is not at the behest of its customers, (2) owning or investing in a hedge fund or a private equity fund, and (3) limiting the liabilities that the largest banks could hold. Because other member countries of the Basel Committee have not embraced the Volcker rule, its implementation in the United States may lower U.S. bank profits domestically. If bank

---

<sup>21</sup> CRS Report RL33278, *The Basel Accords: The Implementation of II and the Modification of I*, by Walter W. Eubanks.

<sup>22</sup> Christian Bruce, "Agencies Spar Over Capital Requirements As Discord Persists on Basel II Agreement," *BNA Banking Report*, May 16, 2005, p.1, Ethan Zindler, "At Senate Hearing, Bruce, "Hawke Voices More Doubts on Basel II, Says Flexibility Needed for Target Dates," *BNA Banking Report*, December 22, 2003, p. 1.

profits drop at home because of the Volcker rule, U.S. banks may move their proprietary trading activities to their foreign operations. This transfer could have a negative impact on U.S. trade in financial services.

## **Some Implications of Basel III**

As approved by the central bank governors, Basel III has not addressed a major cause of the financial crisis—which is whether large firms that are heavily intertwined with the global financial system should be required to set aside more capital because of the broader risks they pose to the global financial system. The work the committee has done so far on Basel III has not specifically recognized the role of international counterparty risks, which is a critical part of the business model international banks continue to use. Consequently, some analysts believe that the Basel Committee missed a historic opportunity to help level the international banking playing field. Supporting the status quo, the committee has left the counterparty risk capital requirement problem to each country's regulatory authorities. If that is the case, national bank regulators could undermine the economic recovery.

Central bankers told [bank] executives at weekend meetings to expect more financial rules, especially for the largest firms, after the international regulators set minimum standards in Basel last month. If countries surpass that accord, they will deny banks a level playing field and impede growth, chief executive officers including Deutsche Bank AG's Josef Ackermann and Standard Chartered Plc's Peter Sands warned at the annual meeting of the Institute of International Finance. "There are growing signs that global coordination is fizzling and unilateral actions are pending," said Ackermann, chairman of the IIF, which represents more than 400 financial institutions. "Global banks will have to comply with the higher rules in every jurisdiction, regardless of their home base. That will steal from credit to companies and hurt job creation."<sup>23</sup>

Basel III would significantly raise the capital requirement on banks. At the end of the implementation period, Basel III could require a minimum total requirement of 13% of a bank's risk-weighted assets. This is a level very few large U.S. banks were able to achieve at the height of their record level of profits in 2006.

The complexity of Basel III increases the probability that it would be unenforceable. As the Basel III framework was presented, it appeared to be as complex as Basel II that took six years to negotiate and was never fully implemented before the greatest financial crisis in 70 years began. The Basel Committee in Basel III tries to simplify the definition of capital to improve transparency and enforceability. The industry through its regulators, however, forced the committee to include other types of assets. By including these assets with common tangible equity, the committee adds complexity to the process of enforcement because the roles of mortgage servicing rights and tax deferred assets, for examples, vary widely among countries. This complexity could undermine the ability to keep the international banking playing field level. Some analysts attribute the severity of the most recent financial crisis to the lack of regulatory enforcement. Basel III is complicated not only by the regulations themselves but also by the implementation schedule.

---

<sup>23</sup> Yalman Onaran, "Bankers Voice Resistance As National Regulators Say Basel Is Just a Start," *Bloomberg News*, October 11, 2010, p. 1.

Basel III adopts a separate global leverage ratio as a part of its regulatory framework. The major advantage of this regulatory tool is its simplicity. It is an effective constraint of the amount of leverage banks are able to create with a given amount of capital. A leverage ratio of 10% limits the amount of leverage to no more than 10 times the bank's capital. However, if the ratio is not effectively enforced, it will not prevent banks from over-leveraging. For example, although U.S. regulators had a leverage ratio in place before the financial crisis, it was not able to prevent the financial crisis. In the United States, the leverage ratio was not enforced as widely as it should have been and overleveraging was a major cause of the crisis.

Although extending the deadline for implementing Basel III gives the industry more time to raise additional capital, it also delays putting in place the countermeasures for preventing the next financial crisis. Analysts have argued that many industrial countries' economies are not yet strong enough to withstand another financial crisis in the near future. The delayed-implementation schedule undermines the stated purpose of Basel III to prevent the next financial crisis. According to the new schedule, it will be nine years before Basel III is fully in place. Some analysts say it is very likely that there will be another crisis before then. On the other hand, some policymakers are concerned that a shorter transition period may impede the economic recovery. Because Basel III is implemented by national authorities, they are free to impose shorter transition periods if deemed necessary.

## **Author Contact Information**

Walter W. Eubanks  
Specialist in Financial Economics  
weubanks@crs.loc.gov, 7-7840