

Basel III, Qualitative Challenges: New Standard Ratios , Higher Capital and Higher risk weights



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age ratio

Second : Recommendations

1. Compliance with the new requirements in terms of capital increase
2. Taking into account the new risk weights
3. Introducing minority interests as part of the capital, according to the established conditions
4. Pay attention to the new liquidity indicators and try to adhere to them.
5. Paying attention to financial leverage and trying to implement developments in it

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2. Net facilities (less provisions and outstanding interest).
3. It is not allowed to use thinners.

off balance sheet assets:

1. Any obligations outside the budget that can be canceled are weighed by 10%.
2. Other obligations that cannot be canceled are weighed by 100%. (MURPHY, 2021)

Conclusions and Recommendations

First : Conclusions

1. The agreement gave a new concept to organizational capital, and new deductions were made from the organizational capital.
2. Increasing weights for all kinds of risks
3. Making a number of regulatory amendments to the first and second tiers of capital
4. Minority interests are not recognized as part of the regulatory capital until all regulatory capital conditions CET1, AT1, T2 are met.
5. The agreement brought new liquidity standards, LCR and NSFR
6. The agreement brought about drastic changes in the lever-



- High competition for deposits and stable long-term financing.
- Low rate of return on capital accounts
- Increasing the weighting from 20% - 30% for interbank borrowing
- The new liquidity ratio, which requires banks to keep reserves against credit lines such as credits and guarantees. (RBZ, 2022)

Leverage ratio

- One of the main reasons for the financial crisis is the high leverage of some banks.
- 3% of the assets inside and outside the balance sheet divided by the basic capital (CET1 and AT1):

Basic capital:

According to the instructions of Basel III, Any investments that have been deducted from the basic organizational capital are deducted from the assets inside or outside the budget.

Assets within the budget:

1. accounting value of assets.



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banks due within a period of less than a year. (BIS, 2014)

- **65% weight:**
 - **Home loans that qualify for a 35% risk weight**
 - **Other loans (excluding financial institutions) qualify for a risk weight of 35% or less**

- **85% weight:**
 - **Loans for individuals or small companies with a maturity period of less than a year**

- **100% weight:**

Any other assets. (IFSB, 2015)

- **Off balance sheet items:**
 1. **The ceilings of facilities or unused liquidity (cancellable or irrevocable) are weighed at 5%.**
 2. **Any other items dependent on the supervisory authority.**

The expected impact of the new liquidity ratio on banks:

- **It will most likely lead to a shortage of funding**
- **High cost of financing**
- **Low availability of financing**



unrestricted in disposal and that have an original maturity period of less than one year or a remaining maturity period of less than one year.

3. Financial Instruments vs. Inverse Repurchase Agreement

4. Financial instruments with a maturity period of less than a year

5. Unrestricted loans to financial institutions that have a maturity period of less than one year and are not subject to renewal.

- **5% weight:**

Unrestricted financial instruments with a maturity period of less than one year, issued by parties with a risk weight of 0%.

- **20% weight:**

Financial instruments that are not restricted to the second level assets.

- **50% weight:**

1. Unrestricted equity instruments or non-financial corporate bonds rated A+ to A- with a maturity of less than one year

2. Gold

3. Loans to non-financial companies, governments or central



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- **100% weight:**

- 1. Total regulatory capital (first and second tranches)**
- 2. Preferred shares included in the second tranche, which have a maturity period of more than one year.**
- 3. Other liabilities with a maturity of more than one year**

- **90% weight:**

Stable deposits on demand or for a term with a maturity of less than a year (individuals or small business customers).

- **80% weight:**

Less stable demand or term deposits with a maturity of less than a year (individuals or small business customers).

- **50% weight:**

Demand or term deposits with a maturity of less than a year (major non-financial companies, governments or central banks).

- **0% weight:**

Any other liabilities. (BIS, 2019)

Required amount of stable funding

- **0% weight:**

- 1. Cash available for disposal**
- 2. Short-term financial instruments that are not covered and**



Net Stable Funding Ratio

- Represents the percentage of assets that must be supported by stable financing.

$$\leq = 100 \% \text{ NSFR}$$

Available amount of stable financing

Amount of stable financing required

- Stable financing: It represents part of shareholders' rights and liabilities that are expected to be a good source of financing for a period of more than one year under specific circumstances. (fdic, 2022)

Available amount of stable funding

1. Capital
2. Preferred shares with a maturity period of more than one year
3. Liabilities with a maturity of more than one year
4. Part of demand or time deposits that mature within a year and are expected to remain for more than one year
5. Financing that matures for a period of less than a year and is expected to remain for a period of more than a year. (IMF, 2014)



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- Deposits of banks that have a relationship with the bank 25%
- Major non-financial companies, governments or central banks 75%
- Others (banks, financial companies, insurance companies...) 100%. (cbo, 2021)

Cash outflows from collateral-covered financing

- Financing covered by guarantees of first-class assets 0%
- Financing covered by guarantees of second-class assets 15%
- Financing covered by guarantees for governments or central banks with a weight of 20% or less than 25%
- Financing covered by guarantees for third parties 100%

Incoming cash flows

- Inverse repurchase agreement for:
 1. First class assets
 2. Second class assets
 3. Other assets
- Operational deposits with financial institutions
- Receivables on individuals
- Flows from non-financial institutions
- Flows from financial institutions
- Other cash income. (cbn, 2020)



2. Deposits of less stable individuals 10%

- Term deposits for a maturity period of more than 30 days that have the right to withdraw with a fine or no right to withdraw during this period 0%.

(MAJASKI, 2021)

Cash flows from third parties are not covered

- Cash flows issued from other parties represent obligations resulting from legal entities (companies, institutions...)
- All deposits include claims that can be claimed within a 30-day period, including:
 - Small business clients
 - Major companies
 - Banks
 - Governments. (pwc, 2020)
- Small business stable customer deposit 5%
- Deposits of less stable small business customers 10%
- Deposits of large companies that have an operational relationship with the bank (financial or non-financial companies) 25%
- Deposits of large companies, governments, public institutions or central banks that have an operational relationship with the bank - the part covered by a deposit guarantee of 5%



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- **Unstable deposits:**
 - **The supervisory authorities must specify additional segments for unstable deposits, with a minimum of 10%.**
 - **These deposits are not covered by the Deposit Insurance Corporation or are for individuals with high deposits, or there is a high probability of their withdrawal, or in foreign currency.**
- (HAYES, 2020)**
- **If the bank is unable to determine whether the deposit is classified as stable or unstable, it is classified as unstable**
 - **Not all deposits within the Deposit Insurance Corporation are considered stable.**
 - **Individual time deposits that have a maturity date or the remainder of the maturity date more than 30 days will not be taken into account unless:**
 - **There is no legal right for the depositor to withdraw within 30 days**
 - **There is a high fine for early withdrawal (in excess of interest).**
 - **Otherwise, it is treated as demand deposits. (Martin, et al., 2018)**
 - **Demand or time deposits that have a maturity date within 30 days:**
 1. **Deposits of stable individuals 5%**



classified by approved institutions, used for liquidity purposes).

The upper limit of the second level assets = 40% of high-quality liquid assets.

Expected net cash outflows over the next 30 days =

- Cash outflows for a month**
- Whichever is less (Net cash inflows during a month or 75% of cash outflows during a month). (Gray,2011)**

Cash outflows for a month

- 1. Cash flows issued from individual deposits**
- 2. Cash flows from other parties not covered**
- 3. Cash flows from financing covered by collateral**
- 4. Other cash outflows**

Cash flows issued from individual deposits

- Individual deposits:**

Deposits of natural persons (including demand deposits and term deposits)

- stable deposits:**

They are deposits covered by a deposit guarantee institution, or there is another relationship with the bank, or deposits for specific purposes (salary).



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- The bank's identification of an entity responsible for liquidity risk management.

In the event that there is an asset among these assets and then as a result of some events it is no longer eligible, the bank can keep it for an additional 30 days. (hkma, 2020)

Level 1 assets:

- Cash at the bank.
- Cash at the Central Bank of Iraq.
- Reserves with the Central Bank of Iraq (amounts that can be withdrawn from the reserves in the event of a need for cash).
- Governmental or central bank debt instruments or guaranteed by them in the local currency (carrying a 0% risk weight according to the standard method, not for financial companies)
- Governmental debt instruments (does not carry a risk weight of 0%) from governments in foreign currencies

Level 2 assets:

- Governments, central banks or PSE eligible for a 20% risk weight
- Debt instruments for companies rated AA- or more or covered debt instruments rated AA- or more (not for financial institutions, not issued by the bank or one of the subsidiaries,



- Loss of a specific part of the companies' deposits
- Loss of a specific part of the short-term financing
- Requirements as a result of a decrease in the bank's rating
- An increase in price fluctuation in the market (for guarantees, financial instruments, derivatives)
- Exploiting unused ceilings for facilities. (Tamplin, 2023)

High quality liquid assets

These assets must bear the following specifications:

First: the basic characteristics:

1. Ease of valuation of these assets.
2. These assets carry low credit risk and market risk.
3. Correlation is weak with riskier assets.
4. There is no restriction or attachment that prevents the bank from disposing of it.

Second: Market Specifications:

It can be easily traded and there is an active market.

Third: operational requirements:

- Manage these portfolios
- Not to be used to hedge other positions



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If the risk weighted assets of the subsidiary bank (S) are assumed to equal 100 million

Basel III requirements for the liquidity standard

Liquidity in the short term	Liquidity in the long term
<i>Liquidity Coverage Ratio</i>	<i>Net Stable Funding Ratio</i>
$\frac{\text{High quality liquid assets}}{\text{Net cash outflow over the coming 30 calendar days}} > 100\%$	$\frac{\text{Available stable funding}}{\text{Need for stable funding}} > 100\%$

Liquidity Coverage Ratio

This percentage represents the highly liquid assets that can be converted into cash to cover the expected cash flows to the bank during the next thirty days

Liquidity Coverage Ratio

= High quality liquid assets

The expected net cash outflows within 30 days.

This percentage consists of:

- The value of high-quality liquid assets under specific stress conditions.
- The value of net cash flows issued within a specific scenario, for the following items:
 - Withdrawal of a specified portion of individual deposits



Minority Interest

Bank P balance sheet		Bank S balance sheet	
Assets	113	Assets	150
Loans to customers	100	Loans to customers	150
Investment in CET1 of Bank S	7	Investment in CET1 of Bank S	
Investment in the AT1 of Bank S	4	Investment in the AT1 of Bank S	
Investment in the T2 of Bank S	2	Investment in the T2 of Bank S	
Liabilities and equity	113	Liabilities and equity	150
Depositors	70	Depositors	127
Tier 2	10	Tier 2	8 0.25
Additional Tier 1	7	Additional Tier 1	5 0.8
Common equity	26	Common equity	10 0.7

Capital issued by Bank S			
	Amount issued to parent (Bank P)	Amount issued to third parties	Total
Common Equity Tier 1 (CET1)	7	3	10
Additional Tier 1 (AT1)	4	1	5
Tier 1 (T1)	11	4	15
Tier 2 (T2)	2	6	8
Total capital (TC)	13	10	23

Minority Interest

Consolidated balance sheet	
Assets	
Loans to customers	250
Liabilities and equity	
Depositors	197
Tier 2 issued by subsidiary to third parties	6
Tier 2 issued by parent	10
Additional Tier 1 issued by subsidiary to third parties	1
Additional Tier 1 issued by parent	7
Common equity issued by subsidiary to third parties (ie minority interest)	3
Common equity issued by parent	26

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Deduction limits The second limit is 15% of the total Starting from 2018

$95-35=60 \times 17.65\%=10.59$	% 15 :Second limit
$35-10.5-5.5=19-10.59=8.41$	The truncation of CET1 that exceeds the second term
$8.41+10.5+5.5=24.41$	Total deductions from CET1
$95-35=60+10.59=70.59$ $10.59/70.59=15\%$	% 15 :Second limit

Minority Interest

- It must meet the two conditions below in order to be recognized in the regulatory capital:
- It meets all regulatory capital requirements (CET1, AT1, T2).
- The affiliated company is a bank

Total minority rights that satisfy the above two conditions
Less surplus in the subsidiary's regulatory capital and return on minority interest

The excess of the principal capital of the subsidiary's ordinary shares and the return on minority interest

- The basic regulatory capital of the subsidiary

Subtracted:

- 7%, 8.5% and 10.5% of the risk weighted assets of the subsidiary. (fdic, 2021)



- Investments in ordinary shares in banks, financial companies and insurance companies that exceed 10% of the capital of these companies.
- Mortgage servicing rights (MSRs)
- Deferred tax assets due to temporary differences
- Any non-deductible items weighed by 250% . (cbben, 2015)

Example

MLN 95	CET1 Common Equity Tier 1 Capital
MLN 20	Investments in banks, financial companies and insurance companies that exceed 10% of the capital of these companies
MLN 15	Within CET1 Tools
MLN 3	Within AT1 Tools
MLN 2	Within T2 Tools
MLN 20	Deferred tax assets due to temporary differences

Deduction limits The second limit is 15% of the total Until 2017

$95 \times 15\% = 14.25$	%15 :Second limit
$35 - 5.5 - 10.5 = 19$ $19 - 14.25 = 4.75$	The truncation of CET1 that exceeds the second term
$10.5 + 5.5 + 4.75 = 20.75$	Total deductions from CET1

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AT1 or the supporting capital T2 are offered in full using the Corresponding Deduction Approach

- **Investments that are within the basic capital of common shares CET1 subtracted from the basic capital of ordinary shares CET1 within the permitted limits.**
- **In the event that a certain segment is not sufficient for the deduction, the deduction is made from the highest segment.**
(morb.bsp, 2013)

Deduction limits - the first limit is 10% of each item

- More than 10% of the basic capital of CET1 common shares shall be deducted for each of:

- 1- Investments in ordinary shares in banks, financial companies and insurance companies that exceed 10% of the capital of these companies.**
- 2- Mortgage servicing rights (MSRs)**
- 3- Deferred tax assets due to temporary differences**

Deduction limits - the second limit is 15% of the total

Starting from 2013, the sum of the below items that exceed 15% of the basic share capital of CET1 common shares must be deducted:



- Investments include:
 - Direct and indirect investments.
 - Investments within the banking portfolio and the trading portfolio.
 - Net long position (within the same maturity period or less than a year).
 - If it does not meet the characteristics of CET1, AT1, or T2, it is considered to be within CET1
 - If the sum of the total investments (in the banking portfolio and the trading portfolio) exceeds 10% of the basic capital of ordinary shares CET1 after adjustments (from 1 to 11), the excess is subtracted using the Corresponding Deduction Approach.
- Investments less than 10% of the basic capital of ordinary shares CET1 are weighted according to its own risk weight (trading portfolio or bank portfolio).
- In the event that a certain segment is not sufficient for the deduction, the deduction is made from the highest segment. (resbank, 2023)

Corresponding Deduction Approach

- Investments in banks, financial companies and insurance companies that exceed 10% of the capital of these companies
- Investments that are included in the additional basic capital

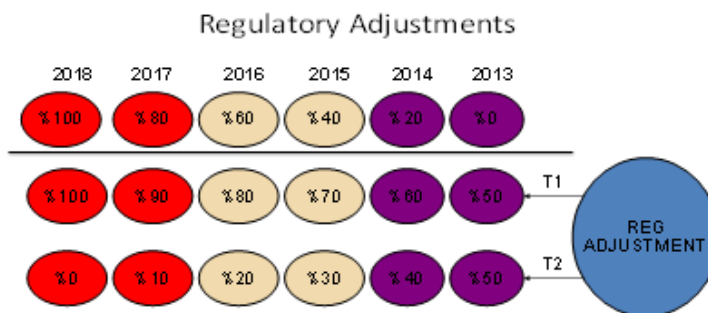


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- Goodwill or any intangible assets.
- Net deferred tax assets.
- Shortage of any of the provisions required by the bank.
- The accumulated change resulting from the change in the fair value of liabilities as a result of the change in the credit risk of the bank itself
- Treasury stocks.
- Investments in banks, financial companies and insurance companies that are less than 10% of the capital of these companies.
- Investments in banks, financial companies and insurance companies that are more than 10% of the capital of these companies.
- Amendment of minority rights. (cornell, 2019)

Regulatory adjustments



Investments in banks, financial companies and insurance companies that are less than 10% of the capital of these companies



- There are no incentives provided by the bank for liquidation.
- Callable can be at the request of the bank, but after a period of at least 5 years and within the following conditions: (CBI, 2004)
 - The approval of the supervisory authority must be obtained to practice Call Option.
 - It should be replaced with better tools of the same value.
 - The bank proves that the capital adequacy ratio will be higher than the limits after executing the Call Option.
- There is no right for the investor to demand early payment of the principal or interest before maturity, except in cases of bankruptcy or liquidation.
- The approval of the supervisory authority must be obtained before making payments, and the bank should not give an indication to the market that there is approval from the supervisory authority.
- The bank should not, directly or indirectly, finance these instruments (subsidiaries, companies in which the bank owns an influential interest, facilities). (eur-lex.europa, 2021)

Regulatory adjustments to regulatory capital

- Period losses.
- Investments in subsidiaries.
- Expropriated real estate to pay off debts.



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non-payment of interest or distributions.

- **Dividends or interest are paid from the distributable items.**
- **That the bank should not, directly or indirectly, finance these instruments (subsidiaries, companies in which the bank owns an effective interest, facilities). (osfi, 2022)**

Third: Supporting Capital T2:

- **Instruments issued by the bank that bear the characteristics of the supporting capital T2.**
- **Issuance premium (discount) for the instruments mentioned in item 1.**
- **Instruments issued by subsidiaries (consolidated) and bearing the characteristics of T2 supporting capital.**
- **Reserve for banking risks. (bbbbank, 2014)**

Regulatory amendments to T2 equity capital.

- **Supporting capital specification T2**
- **In the event of liquidation, priority will be given to deposits and creditors who disagree with them.**
- **It is not guaranteed or covered by a guarantee from the Bank or its subsidiaries.**
- **due date :**
- **The original maturity period should not be less than (5) years.**



Additional core capital specifications AT1

- In the event of liquidation, priority will be given to deposits, various creditors, and supporting debts.
- It is not guaranteed or covered by a guarantee from the Bank or its subsidiaries.
- It has no maturity date.
- It can be Callable at the request of the bank, but after a period of at least 5 years and within the following conditions: (principal, 2023)
 - The approval of the regulatory authority is required to practice Call Option.
 - They must be replaced with better tools of the same value.
 - The bank proves that the capital adequacy ratio will be higher than the limits after executing the Call Option.
- The approval of the supervisory authority must be obtained before making payments, and the bank should not give an indication to the market that there is approval from the supervisory authority.
- Distributions and benefits:
 - The bank has the right, at any time, to stop paying interest or distributions, provided that this is not considered a default by the bank.
 - Not to impose any restrictions on the bank as a result of



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- 4. Accumulated comprehensive income and reserves.**
- 5. Minority rights (allowed limit).**
- 6. Regulatory Amendments to CET1 Common Equity Tier 1 Capital Regular CET1. (Iqbal, et al., 2013)**

Basic capital specifications for common shares

- **It has no priority in distribution upon liquidation**
- **It has no maturity date**
- **The bank is not committed to the repurchase**
- **Distribution of profits (non-binding, from distributable profits)**
- **Not funded directly or indirectly by the Bank**
- **Not guaranteed by the bank**
- **Issued based on the approval of the bank. (Register, 2021)**

Second: Additional Basic Capital AT1:

- **Instruments issued by the bank that carry the characteristics of additional basic capital AT1.**
- **Issuance premium (discount) for the instruments mentioned in item 1.**
- **Instruments issued by subsidiaries (consolidated) and bearing the characteristics of additional basic capital AT1.**
- **Regulatory adjustments to AT1 additional core capital.**



Basel III requirements

Basel III– Transitional arrangements

	2011	2012	2013	2014	2015	2016	2017	2018	2019
Min Common Equity Ratio			3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital conservation buffer						0.625%	1.25%	1.875%	2.5%
Min common equity + cap conservation buffer			3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
Phase in of deductions from Common Equity				20%	40%	60%	80%	100%	100%
Minimum Tier 1	4.0%	4.0%	4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum Total Capital	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Min Total Capital + cap conservation buffer	8.0%	8.0%	8.0%	8.0%	8.0%	8.625%	9.25%	9.875%	10.5%
Capital instruments that no longer qualify as Tier 1 or Tier 2			Phased out over 10 year period starting 2013						

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- Regulatory Capital
- Liquidity Coverage Ratio (LCR).
- NSFR net stable funding ratio
- LR Leverage (ECB, 2016)

Basel III - Transitional arrangements

Regulatory capital

First: the basic capital of ordinary shares CET1:

1. Paid Capital
2. Issuance premium
3. The retained earnings

Basel III, Qualitative Challenges: New Standard Ratios , Higher Capital and Higher risk weights



These requirements included many positive aspects, the most important of which are:

1. Enhancing the quality of banks' capitals through banks' retention of high-quality capitals with a high ability to face risks and absorb losses.
2. Applying additional margins on the minimum levels of capital adequacy ratios in order to enhance the ability of banks to face all the risks that they may be exposed to, including the risks of the financial cycle and the risks of the financial system.
3. The use of standard ratios to monitor the liquidity of banks in order to ensure that banks maintain sufficient liquidity to meet their obligations and continue their business. (banking-supervision, 2019)

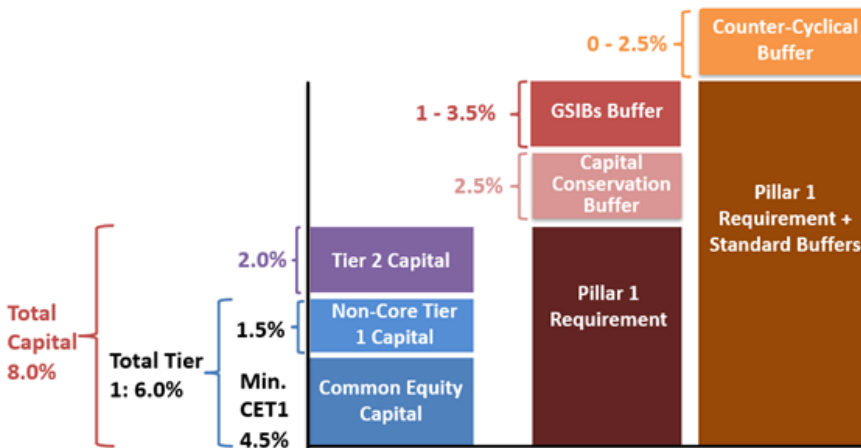
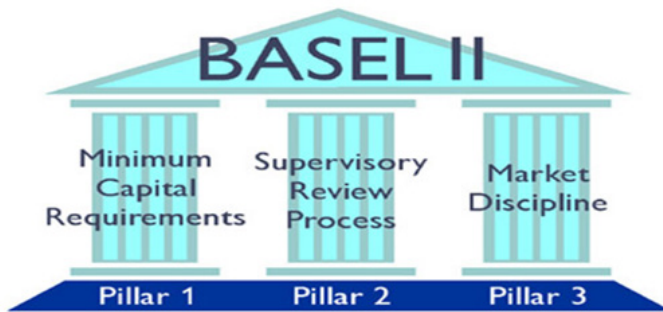
The rules for capital, known as Basel III, require banks to maintain a greater amount of capital and to be mostly in common stock (focusing on the quality of capital). The most important modifications:

- The minimum capital increase to 10.5% in 2019, and banks must keep at least 7% of their capital in common stocks (Paid up Capital). (delphix, 2022) And at the end of 2019, high-quality capital became 67% of the total capital. (CFI, 2020)



Basel III

These requirements came to avoid the weaknesses and gaps created by the global financial crisis in order to enhance the solvency of banks and their ability to face risks, and therefore it is expected that they will positively reflect on the safety and solidity of banks. (BIS, 2022)



Basel III, Qualitative Challenges: New Standard Ratios , Higher Capital and Higher risk weights



1.1 Background of the study

The Basel Committee on Banking Supervision is the committee that was founded and formed from the group of ten industrialized countries at the end of 1974 under the supervision of the Bank for International Settlements in Basel, Switzerland, and this happened after the external debt crisis of developing countries worsened and the volume and percentage of doubtful debts increased. In the collections granted by international banks and the failure of some of these banks, in addition to the strong competition on the part of Japanese banks for American and European banks due to the lack of capital of those banks, taking into account that in light of globalization, those American and European banks are increasing the spread of their branches all over the world outside the home country.

1.2 Motivation of the study

The motivation for this study is to highlight the importance of the Basel III accord in reducing the risks faced by banks through some strict procedures related to liquidity ratios and capital size.

1.3 The Importance of Research

The importance of the research lies in the fact that it sheds light on the importance of the provisions of the Basel III accord.



Abstract

The historical indications of banking crises indicate that any violation of this equation would lead to the signs of the emergence of a banking crisis, and this is what was in fact the concern of many researchers and scholars, as well as international bodies and organizations in this regard, in an attempt to set a number of criteria from It would be a safety valve for banks in the performance of their lending activity. In this context, the decisions of Basel 1 appeared, followed by the decisions of Basel 2, as an attempt to complete the deficiencies in Basel 1. However, despite the importance of what these decisions came with, they were not sufficient to prevent the occurrence of the 2008 financial crisis, which was a strong motive. For the emergence of Basel 3 decisions Which tried to set conditions and standards that many consider strict to the extent that it may hinder the activity of banks in itself, as it requires the availability of a timetable for their implementation, as well as the ability to bear the cost of their implementation, and despite these difficulties, it remains an attempt that deserves appreciation because it has set conditions and restrictions that would To be an end to the recurrence of the crisis of 2008.

Key Words

Basel III , Risk weights , Capital , Tier, Banks



**Basel III, Qualitative Challenges:
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