Basel III

The failure of Basel II regulations in preventing the credit crisis forced the Basel Committee of Banking Supervision (BCBS) to revisit these regulations. So emerged a new set of reform measures (named Basel III) focusing on strengthening the regulatory, supervision and risk management framework.

In more detail, Basel III presents a framework for higher and better-quality capital, better risk coverage, measures to promote the build up of capital that can be drawn down in periods of stress, and, most importantly, the introduction of two global liquidity standards. The objective of this reform is to improve the banking sector's ability to absorb shocks arising from financial or economic stress.

Therefore the Basel Committee has further strengthened its liquidity framework by developing two minimum standards for funding liquidity, the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR).

The Liquidity Coverage Ratio (LCR) will require banks to have sufficient high-quality assets to withstand a 30-day-sttressed funding scenario that is specified by supervisors.

The Net Stable Funding Ratio (NSFR) is a longer term structural ratio designed to address liquidity mismatches. It covers the entire balance sheet and provides incentives for banks to use stable uses of funding.

First we discuss LCR:
At a minimum, the stock of liquid assets should enable the bank to survive until Day 30 of the stress scenario, by which time it is assumed that appropriate corrective actions has been taken by the bank or the supervisors.

The corresponding formula is:

$$\frac{\text{stock of high - quality liquid assets}}{\text{Total cash net outflows over the next 30 calendar days}} \geq 100\,\%$$

Now the NSFR:
The NSFR standard is structured to ensure that long term assets are funded with at least a minimum amount of stable liabilities in relation to their liquidity risk profiles. That means:

$$\frac{\text{available amount of stable funding}}{\text{required amount of stable funding}} \geq 100\%$$

Beside this new standards supplemental Pillar 2 requirements regarding risk management were introduced. Also Basel III has revised some Pillar 3 disclosure requirements.

In Pillar 1 the default credit risk framework was strengthened substantially by more stringent requirements for measuring credit exposure.