

Basel III – what's it all about?

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The world of banking regulation may not be everyone's cup of tea, but given the importance of the financial sector to the economy, it is worth keeping up to date with significant changes.

At its heart the Basel convention, in its various forms, sets standards of practice in the financial sector. It looks to set measures of financial health by which banks can be assessed, laying out a series of risk criteria to be met. This "health check" focuses on the capital structure of each bank, requiring them to hold certain levels of assets to support the business in the event of different scenarios. It follows logically that the stronger a bank's capital base the more able it will be to survive financial downturns and the greater the protection the bank's depositors will have against possible losses.

The way Basel measures this strength is by looking at the various percentages of capital held by each bank as a proportion of overall assets, with the most commonly used being the tier one capital, core tier one and tier two ratios. Basel III relates specifically to the narrowest – core tier one – ratio.

Different levels of capital

Tier one capital typically can be seen as common shares and reserves and has included non redeemable and non cumulative preferred stock. Tier two capital includes preferred stock with a fixed maturity and long term debt with a maturity of over five years.

The tier one ratio is the ratio of the tier one capital to the institution's risk-weighted assets. The risk weighted assets are the total of all of the bank's assets weighted to adjust for credit risk.

Financial health?

Basel established a minimum level of capital that must be held by each bank. Basel III clarifies exactly what is required, materially increasing the minimum levels of capital that need to be held and establishing a timescale for the requirements to be met.

It also brings into focus the financial health of the banking sector – demonstrating that the UK banks are 'healthy' in terms of meeting requirements of the proposals even at their most restrictive point in 2019. For example, Lloyds, Barclays, HSBC and RBS all have a core tier one ratio over 8%, against a final stage target of 7%.

A boost for credit

Basel proposals are designed to ensure the ongoing strength of the financial sector and should be viewed as enhancements to the credit outlook. The changes to what can be included within the core ratios also provide opportunities in bond specific issues and typically should be seen as a positive for subordinated issues.

Source: rlam as at 20th September 2010 unless otherwise stated.

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