BANKING REGULATION · THE FULL SERIES

BANKING METRICS SERIES

The Basel Accords

From 1988 to 2025: how four crises rewrote the rules of global banking.

BANKING METRIC SERIES

The Basel Accords: Origins & Purpose

Source: Basel Committee on Banking Supervision (BCBS), Bank for International Settlements, Basel.

1974	28	1988
Founded	Members	First Accord

Why do the Basel Accords exist?

In 1974, the collapse of Bankhaus Herstatt (Germany) and Franklin National Bank (US) exposed a critical vulnerability: a single bank failure could freeze international payments and trigger a domino effect across borders. There were no common rules on how much capital banks needed to hold.

The BCBS mission

Set minimum global standards for bank capital and risk management. Ensure no jurisdiction can gain an unfair competitive advantage by allowing undercapitalised banks.
The result is a series of international accords (Basel I, II, III, and Finalization), each responding to the failures exposed by the previous crisis.

Basel I (1988): The Capital Accord

The first global minimum standard for bank capital: simple, universal, and deliberately crude.

8%

Min. Capital Ratio

Banks must hold ≥8% capital against total risk-weighted assets.

Credit Risk Weights — 4 Buckets

Assets weighted by 4 fixed categories:

- 0% — sovereign debt (OECD)
- 20% — OECD banks
- 50% — residential mortgages
- 100% — corporates

Basel I's key limitations

Crude risk buckets: a loan to a AAA corporate and a loan to a junk-rated corporate both received a 100% risk weight. This created massive incentives: banks shifted portfolios toward riskier assets at the same capital cost.

No operational risk: Basel I completely ignored losses from failed processes, fraud or systems failures. The collapse of Barings Bank (1995) due to rogue trading exposed this gap dramatically.

KEY TAKEAWAY

Basel I created the 8% capital ratio, still the foundation of bank regulation today.
Its crude buckets and narrow scope set the stage for Basel II.

Basel II (2004): Three Pillars

Risk-differentiation, internal models, and supervisory oversight, addressing Basel I limitations.

PILLAR 1

Minimum Capital Requirements

Extended to credit, market and operational risk. Banks may use Internal Ratings-Based (IRB) models.

8% Capital Ratio

Banks must hold ≥8% capital against Risk-Weighted Assets (RWA).

Internal Models

Banks may use own internal models to calculate RWAs, or rely on the standardised approach.

PILLAR 2

Supervisory Review Process

Banks run internal stress tests. Supervisors review and can impose a higher minimum capital ratio.

ICAAP

Banks quantify capital needs for all risks, including those beyond Pillar 1, under stress scenarios.

Supervisory Review

National regulators evaluate each bank's assessment and overall risk management.

PILLAR 3

Market Discipline

Mandatory public disclosure enables market participants to assess a bank's risk profile independently.

Disclosure

Mandatory public reporting of risk exposures and capital structure.

Pillar III Disclosures

Capital ratios, RWA breakdown by category, risk appetite and management objectives.

KEY TAKEAWAY

Basel II fixed Basel I's crude buckets but introduced excessive discretion in internal models. The 2008 crisis showed model-driven capital was not enough when every model assumed no systemic crisis.

Basel III (2010): The Crisis Response

Fundamental overhaul after the 2008 Global Financial Crisis: capital quality, liquidity, leverage.

CAPITAL

CET1 Ratio ≥ 4.5%

Common Equity Tier 1 became the primary capital measure: the highest-quality capital, mostly common shares and retained earnings.

Additional capital requirements for large banks and outside crisis periods (buffers).

LIQUIDITY

LCR & NSFR

First global liquidity standards.

Liquidity Coverage Ratio: enough liquid assets to survive 30 days of stress.

Net Stable Funding Ratio: stable long-term funding for long-term assets.

LEVERAGE

Leverage Ratio ≥ 3%

Non-risk-based metric: minimum 3% Tier 1 capital over total exposures (including off-balance sheet).

Prevents excessive leverage regardless of how low internal models calculate RWAs.

KEY TAKEAWAY

Basel III fixed Basel II's excessive model discretion: higher capital quality, mandatory buffers, plus new global standards for liquidity and leverage.

Basel IV (2017): The Output Floor

Closes the loop on Basel II's biggest flaw: major difference between banks using internal models and banks using Standardized Approach to report RWAs.

OUTPUT FLOOR

72.5%

Floor on internal-model RWAs, as a percentage of the standardised approach.

The Output Floor mechanism

Banks using internal models (IRB) cannot report RWAs below 72.5% of what the standardised approach would give. This caps the capital reduction from model optimisation.

Revised standardised approaches

A-IRB removed for large corporates and financial institutions. Banks must use F-IRB or the standardised approach.

EU Implementation — Capital Requirements Regulation 3 (CRR3)

Phase-in: the EU implemented Basel III Finalization via CRR3, phased in from January 2025. The output floor steps up from 50% in 2025 to the full 72.5% by 2030, giving banks time to adjust capital and business models.

Capital impact: European banks are estimated to need an additional €20–25bn in capital by full implementation.

This is Episode 1 of the Banking Metrics Series.
Each episode takes one key metric, breaks it down from principles, and illustrates it with real data.