The Road to Resilience
Basel III Challenges Require Immediate Action
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**EXECUTIVE SUMMARY**

During their meeting in Seoul in November 2010, the G-20 countries approved new rules for banking regulation, known as Basel III. The Basel Committee on Banking Supervision (BCBS) first discussed elements of Basel III in 2009 in reaction to the financial crisis to strengthen the resiliency of the global financial industry. While Basel II, in 2004, focused primarily on setting incentives for banks to adopt best practices, Basel III details top-down measures to improve overall resilience on four fronts:

- **Increasing the quantity and quality of capital required**
- **Tightening the rules affecting risk-weighted assets (RWAs)**
- **Introducing short-term liquidity and long-term funding requirements**
- **Applying further qualitative rules**

These capital and liquidity requirements, coupled with required investments to comply with Basel III, will significantly lower banks’ return on equity (ROE). Many bankers realize this, of course, and are already studying how the rules will impact various lines of business. But banks also need to take concrete steps immediately to comply with Basel III. Those steps include improving data quality management programs and reinforcing existing RWA reduction initiatives; upgrading the risk data architecture to better link risk data across silos and enhance the risk model landscape; and creating a centralized implementation management program for all Basel III–related initiatives. Depending on a bank’s current business model and technology standards, considerable investment may be required. Senior managers throughout the organization need to confront these issues immediately, even though portions of Basel III don’t go into effect until 2019. Business partners, regulators, and investors may view institutions that delay implementation as less sophisticated and also riskier than competitors that embrace the changes early on.
The impact of Basel III on financial institutions globally is profound. By increasing the quantity and quality of capital required, tightening the rules that govern risk-weighted assets, introducing short-term liquidity and long-term funding requirements, and applying further qualitative rules, the BCBS is taking measures to bolster the global banking system. First proposed in 2009, Basel III aims to strengthen the resilience of banks to shocks in the global financial system by also implementing additional stress test requirements and setting maximum leverage ratios (see Exhibit 1).

Since its founding in 1974, the BCBS has been a potent force, mandating wide-ranging frameworks: Basel I in 1988 and Basel II in 2004. But today’s efforts are different: While Basel II’s prime objective was to align internal business practices with regulations by creating a framework for measuring capital adequacy, implementing minimum supervision standards, and enhancing risk-based assessment, Basel III is a reaction to the global financial crisis and the structural weaknesses it exposed.

By voting in favor of Basel III at the G-20 meeting in November, the leaders of the world’s largest economies stated unequivocally that it’s vital to protect the global economy against future financial shocks. The overall effect of Basel III could lead to a stronger, more resilient industry. But these measures will be expensive in terms of the new investment in technology and infrastructure needed for compliance, and in terms of lower ROE, given the new capital and liquidity requirements (see Exhibit 2).

The overall effect of Basel III could lead to a stronger, more resilient industry. But these measures will be expensive.
Exhibit 1
Implementation Road Map for Basel III

<table>
<thead>
<tr>
<th>Year</th>
<th>Minimum common equity capital ratio</th>
<th>Capital conservation buffer</th>
<th>Minimum total capital plus conservation buffer</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>3.5%</td>
<td>0.625%</td>
<td>8.0%</td>
</tr>
<tr>
<td>2012</td>
<td>4.0%</td>
<td>1.25%</td>
<td>8.625%</td>
</tr>
<tr>
<td>2013</td>
<td></td>
<td>40%</td>
<td>9.25%</td>
</tr>
<tr>
<td>2014</td>
<td></td>
<td>60%</td>
<td>9.875%</td>
</tr>
<tr>
<td>2015</td>
<td></td>
<td>80%</td>
<td>10.5%</td>
</tr>
<tr>
<td>2016</td>
<td></td>
<td>100%</td>
<td></td>
</tr>
<tr>
<td>2017</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2018</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2019</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Leverage ratio**
- Supervisory monitoring
- Parallel run 2013-2017, disclosure from 2015 onward
- Migration to Pillar 1

**Liquidity coverage ratio**
- Observation period
- Minimum standards

**Net stable funding ratio**
- Observation period
- Minimum standards

Source: Basel Committee on Banking Supervision

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Exhibit 2
Basel III’s Impact on Banks’ Assets and Liabilities

1. Higher quality requirements for Tier 1 capital
2. Higher share of Tier 1 capital in total capital ratio
3. Introduction of a leverage ratio
4. Increasing RWAs for both banking and trading assets
5. Introduction of liquidity coverage ratio (LCR) and net stable funding ratio (NSFR) to ensure short-term liquidity and long-term funding, thereby requiring increase in liquid assets
6. Imposition of further qualitative measures

Source: Booz & Company
CAPITAL REQUIREMENTS AND LEVERAGE RATIOS

Basel III will require higher quality and quantity of capital while also introducing a top-down restriction of the leverage ratio. Some widely used forms of Tier 1 capital under Basel II will be phased out. Silent participations, minority interests, deferred tax assets (DTAs), and hybrid capital will no longer be acceptable.

Common equity and retained earnings are still considered “core” Tier 1 capital. Noncore Tier 1 capital is still permissible, but in lesser amounts (1.5 percent of RWAs compared with 4.5 percent for core). Noncore Tier 1 capital must be subordinated, have fully discretionary noncumulative dividends or coupons, and have neither a maturity date nor an incentive to redeem.

Besides requiring more and higher-quality Tier 1 capital, Basel III addresses other levels of the capital structure (see Exhibit 3). Tier 2 capital, which under Basel II was divided into two subcategories and could satisfy half of a bank’s capital requirements (i.e., 4 percent of RWAs), will be reduced to one category and allowed to contribute just 2 percent of RWAs. Tier 2 capital is supplementary capital, such as undisclosed reserves, revaluation reserves, general provisions, hybrid instruments, and subordinated term debt. Meanwhile, Tier 3 capital, which under Basel II consists of short-term debt and long-term funding, thereby requiring increased RWAs for both banking and trading activities.

Exhibit 3
Changes in Regulatory Capital Minimum Requirements*

<table>
<thead>
<tr>
<th>Source: Basel Committee on Banking Supervision; Booz &amp; Company</th>
<th>Basel I / II</th>
<th>Basel III</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tier 1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tier 3</td>
<td>8.0%</td>
<td></td>
</tr>
<tr>
<td>Lower Tier 2</td>
<td>2.0%</td>
<td></td>
</tr>
<tr>
<td>Upper Tier 2</td>
<td>2.0%</td>
<td></td>
</tr>
<tr>
<td>Innovative hybrid capital</td>
<td>0.6%</td>
<td>0.6%</td>
</tr>
<tr>
<td>Non-innovative hybrid capital</td>
<td>1.4%</td>
<td>1.4%</td>
</tr>
<tr>
<td>Common equity and retained earnings (core Tier 1 capital)</td>
<td>2.0%</td>
<td>2.0%</td>
</tr>
<tr>
<td>Tier 2 capi-</td>
<td>2.0%</td>
<td>2.0%</td>
</tr>
<tr>
<td>Tier 3 capital</td>
<td>2.5%</td>
<td>2.5%</td>
</tr>
<tr>
<td>Capital conservation buffer</td>
<td>10.5%</td>
<td>10.5%</td>
</tr>
<tr>
<td>(possibly supported by contingent capital)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Countercyclical buffer</td>
<td>2.5%</td>
<td>2.5%</td>
</tr>
<tr>
<td>(possibly supported by contingent capital)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other Tier 1 capital</td>
<td>1.5%</td>
<td>1.5%</td>
</tr>
<tr>
<td>Common equity and retained earnings (core Tier 1 capital)</td>
<td>4.5%</td>
<td>4.5%</td>
</tr>
</tbody>
</table>

* Numbers are percentages of RWAs.
term subordinated debt for the sole purpose of meeting a portion of the capital requirements for market risks, will be abolished.

In addition to these capital tier changes, Basel III introduces two entirely new types of capital requirements—called buffers. There will be a “capital conservation buffer,” equal to 2.5 percent of RWAs, and a countercyclical buffer, set at the discretion of the national regulator, that can range up to 2.5 percent. The conservation buffer is meant to help individual banks maintain adequate capital levels during a significant sector-wide downturn. The countercyclical buffer is intended to avoid system-wide risk by discouraging excessive credit growth. It is still unclear if banks will need to build these buffers through retained earnings, or if the BCBS will permit the use of contingent capital. Either way, these buffers increase total capital requirements from 8 percent under Basel II to between 10.5 and 13 percent.

Basel III grants a fairly long phase-in period for these capital requirements, but banks should remember that the BCBS merely sets minimum requirements. Local regulators might accelerate adoption of certain requirements, and some already have. Swiss authorities, for instance, require that banks hold at least 6 percent of total RWAs in contingent convertible capital. This capital will convert if losses reduce common equity and retained earnings to 5 percent of RWAs. For systemically important banks, the Swiss financial regulator is considering additional rules and capital requirements, although final details are not yet clear.

While the increase in minimum capital requirements will affect all banks, banks in some regions need to substantially change their capital structure. In particular, banks with sizable portions of silent participation or with significant shares of hybrid capital will suffer, since both forms of capital will no longer count as core Tier 1. The impact should not be underestimated. For example, in 2009 the top 10 banks in Germany held about a third of their core Tier 1 capital in the form of hybrid capital.

Basel III will also introduce a non-risk-based leverage ratio. This measure will affect all business areas that are perceived as low-risk but that inflate the balance sheet (for example, the repo business). During a test period from 2011 to 2017, the ratio will be set at 3 percent. Then, after a final review, a new ratio will be set for 2018 onward.

The increase in minimum capital requirements will affect all banks, but some will also need to substantially change their capital structure.
The changes to Tier 1 capital rules are significant, but the more conservative rules defining RWAs will be at least as consequential (see Exhibit 4). Depending on a bank’s business model, these rules could significantly expand RWAs—to 80 percent, up from 20 percent—and thus the amount of capital required. Some of these RWA measures were partially implemented in the first half of 2010 in the European Union as the Capital Requirements Directive III (CRD III), otherwise known as Basel 2.5 or IIb. Full implementation is scheduled for 2011.

The Basel 2.5 measures include the following:

- **Stressed value-at-risk (VaR):** Stress scenarios and extreme assumptions reflect the recent financial and economic crisis. Unlike the standard VaR, a low-volatility or low-correlation environment will not diminish the stressed VaR.

- **Incremental risk charge (IRC):** Losses arising from default risk, losses from credit migrations, widening credit spreads, and the loss of liquidity have to be captured for trading book assets.

- **Correlation trading:** These strategies require additional capital, since hedging strategies failed to adequately account for volatility in the correlations between different securities.

- **Securitization:** Securitized assets in a bank’s trading book face the same capital charges as securitized assets underwritten by the bank. The intention is to reduce the potential for regulatory arbitrage between trading and banking book treatment of securitized products.

Basel III will take RWA measures further:

- **End of 50/50 deductions:** Certain troubled or low-quality assets (such as low or unrated securitization exposures, or credit risk exposures from unsettled and failed trades) face more conservative capital treatment. Under Basel III, these assets must be fully deducted from capital; Basel II permitted a 50/50 deduction.

- **Credit valuation adjustment (CVA):** Mark-to-market losses (CVAs) will result in capital charges. The BCBS estimates that CVAs accounted for two-thirds of the counterparty credit risk losses recognized during the crisis; only a third of the losses were due to actual default.

- **Counterparty credit risk (CCR):** The use of central clearinghouses will be encouraged. Correlation assumptions for systemically important institutions will be revised.

How severely the RWA changes hurt a bank will depend on its business model and exposures. Certain business lines, such as correlation trading and securitization, will be especially affected. Each institution will need to conduct a detailed internal analysis to understand the impact of the changes on its business lines, products, and individual transactions.

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**Exhibit 4**

Regulatory Changes Leading to Additional Risk Charges in Major Risk Categories

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**Notes:** The vertical axis symbolizes additional RWA charges. The height of the boxes is no indication of quantitative impact.

**Source:** Booz & Company
Generally speaking, Basel III’s new capital requirements and RWA changes are receiving most of the attention. Less discussed are the new rules regarding short-term liquidity and long-term funding requirements that will force bank executives to pay more attention to liquidity issues than they have in the past. Before the crisis, many bank executives worried little about liquidity risk. But during the crisis, the world experienced the havoc of a frozen interbank market. Many banks got into serious trouble not because of capital shortages, but because of fears that they couldn’t fulfill payment obligations. Now liquidity risk is correctly viewed as a risk as grave to a financial institution as credit, market, and operational risk.

The BCBS issued a paper on sound practices for liquidity management back in 2000. Before the crisis, regulators and lawmakers were introducing legislation to encourage banks to upgrade their liquidity and treasury controlling framework. In light of the recent crisis, the BCBS has made further adjustments and tightened the rules substantially. In addition to general guidelines and further process requirements, Basel III introduces two new quantitative liquidity ratios: a liquidity coverage ratio (LCR) and a net stable funding ratio (NSFR) to strengthen a bank’s resilience to short- and long-term liquidity crises.¹

The LCR formula identifies the amount of high-quality liquid assets an
institution holds that can offset the net cash outflows in an acute short-term stress scenario:

\[
\frac{\text{(high-quality liquid assets)}}{\text{(net cash outflow for 30 days)}} \geq 100\%
\]

The stress scenarios include a three-notch downgrade of an institution’s public credit rating, a runoff of retail deposits, a loss of unsecured wholesale funding, and increases in market volatility. Under Basel III, the high-quality liquid assets needed to endure these shocks must be “unencumbered” (not pledged in any way to secure, collateralize, or credit enhance any transaction and not held as a hedge for any other exposure). Also, these liquid assets should carry a low credit and market risk, be easily valued, exhibit a low correlation to risky assets, and be listed on an established exchange. The industry is still awaiting more details from the BCBS on how to account for these assets. But it’s likely that haircuts will be applied to qualified assets. For example, covered bonds will be allowed to make up as much as 40 percent of the liquid assets.

The NSFR formula measures an institution’s long-term, stable funding sources relative to the liquidity profiles of the assets funded and the potential for contingent calls on funding liquidity from off-balance-sheet commitments and obligations:

\[
\frac{\text{(available stable funding)}}{\text{(required stable funding)}} > 100\%
\]

The NSFR builds on traditional “net liquid asset” and “cash capital” methods used by rating agencies and internally by companies. It attempts to account for potential liquidity risks tied to off-balance-sheet exposures and other maturity mismatches that conventional models often ignore—and that proved to be so problematic in the last financial crisis.

In our opinion, the impact of the new liquidity rules is widely underestimated in the industry. These stricter short-term liquidity and long-term funding requirements will also add to costs, and some institutions will have to revise their business. For instance, commercial real estate lenders that fund their business mainly through covered bonds and unsecured debt will have to develop alternative funding strategies or new deposit generating businesses.

The stricter short-term liquidity and long-term funding requirements will add to costs, and some banks will have to revise their business.
APPLYING NEW QUALITATIVE RULES

In addition to these quantitative elements, Basel III introduces several qualitative measures that banks need to consider, particularly those with securities trading businesses. For example, these banks must determine how the creation of central counterparties (CCPs) for derivatives trading will impact business. And a few institutions may consider becoming CCPs themselves.

Besides the CCPs, Basel III introduces other process requirements around securities trading. New collateral and marginging requirements for large, highly complex, and/or illiquid derivatives exposures will be introduced. Also, regulators are pushing banks to create central collateral management departments, which will greatly influence the valuation of collateral, execution of margin calls, and managing limits.

IMMEDIATE ACTION IS REQUIRED

The effects of the new rules will be dramatic. We believe that the increased quantity and quality of Tier 1 capital will produce a massive capital shortfall, an effect that will be exacerbated by the expansion of RWAs and the introduction of the leverage ratio. In line with industry analysis, we estimate that some of the leading banks in North America, Europe, and Japan will need to raise significant additional core Tier 1 capital—as much as 80 percent more for the most weakly capitalized institutions. For many banks, the necessary capital increase will be primarily due to the increase of RWAs.

While it’s difficult to pinpoint the impact of Basel III on future profits, we estimate that ROEs will decline by 4 to 6 percent. This will force banks to revisit their risk-return expectations for individual business lines and reprioritize how they allocate resources. Some banks will decide to shrink their portfolios; others may exit entire lines of business that become too capital intensive given the expected returns. Correlation trades, structured credits, and OTC derivatives will become less attractive, as will using securitization as an alternative source of funding. Meanwhile, banks focusing on high-volume and low-margin models such as public-sector finance and the repo business may struggle if leverage ratios are permanently capped at 3 percent.

Many banks have begun to analyze the consequences of the new rules on their individual businesses. What most lack, however, is a strict implementation program to direct the nec-
ecessary financial and human resources to create a new, enterprise-wide risk architecture. Ideally, such a program has three dimensions:

- **Upgrade the risk data architecture**, better link risk data across silos, and enhance the risk model landscape.
- **Reinforce existing RWA reduction initiatives**, and improve data quality management.
- **Create a centralized implementation management program** for all Basel III-related initiatives.

### Upgrade Risk Data Architecture and Models

The new regulations will force banks to upgrade their risk data architectures significantly. This is particularly true in the liquidity risk management arena, which at many banks is far less sophisticated than other risk categories. The main challenge for institutions is to develop an infrastructure for group-wide liquidity stress testing as well as new models and methodologies. At a minimum, these models should calculate group-wide liquidity, provide transparency, and include scenario analysis and stress testing. Additionally, better methodologies are needed to calculate contractual mismatches and funding concentrations.

But Basel III’s infrastructure requirements have implications beyond liquidity risk. Risk models in general need a thorough overhaul. For example, counterparty risk has emerged as an important risk category and must be better integrated into credit risk models in the banking and trading books. While Basel II focuses more on the banking book, Basel III affects all business areas in the bank, as well as the trading book and on- and off-balance-sheet elements.

Basel III’s requirements are part of a general trend toward greater data availability. Data (both on- and off-balance-sheet) must be managed in a transparent way, enabling comprehensive management, board and regulatory reporting, steering, and control. Banks will need to produce risk-related reports in a more timely fashion. We see an evolution from weekly to daily to near-time or even real-time data availability in some areas. In addition, the need to run multiple scenarios and stress tests will require further upgrades of systems and procedures. The entire tool set of risk models and methodologies should be integrated into a company’s strategic and annual planning process, performance management, and capital allocation process.

The cost for these upgrades will be substantial. Necessary work includes upgrading existing models, databases and structures as well as implementing more flexible reporting and simulation tools. Some banks might use Basel III and upcoming new accounting rules (e.g. IFRS 9) as a trigger to overhaul their risk and finance architecture in a more comprehensive way. Given the broad range of necessary infrastructure upgrades it is difficult to give a precise estimate of the associated costs. Nevertheless, we reckon that investments in risk infrastructure and operations will range from $10 million to $60 million, depending on the size of the bank, over the next three to four years.

### Reinforce RWA Reduction and Improve Data Quality

Banks also need to reinforce the
RWA optimization programs they have in place or initiate new ones. Banks should focus on all elements of the credit process and analyze levers to reduce RWAs. Examples are optimized allocation of collateral, tighter management of uncommitted credit lines, and the introduction of an early warning tool that can detect potentially problematic loans and give the banks a chance to act early to prevent delinquencies from occurring. This way, banks can boost the overall quality of the portfolio and reduce RWA charges. RWA optimization programs should also make loan loss provisions more accurate and improve claims processing.

It is also critical that banks focus much more on data quality than most have done in the past. The IT landscape for risk and accounting at many institutions is still very heterogeneous, with numerous data feeds from self-developed applications and external partners. Data quality is often degraded by missing entries, as well as incorrect, duplicate, and outdated information. Besides the negative and costly impact on RWAs, poor data management makes creating business reports difficult and impedes timely decision making.

Booz & Company has helped clients tackle this problem by introducing best practices for data quality management. With support from senior management, this top-down approach addresses the root causes of poor data and moves beyond short-term remedies (see Exhibit 5). By embedding data quality management in an institution’s
culture and processes, the entire organization—including front office and origination—can leverage better information to develop customer-segmented products and services.

Our experience shows that programs such as RWA optimization and data quality management can reduce RWAs by as much as 30 percent, depending on a bank’s individual credit portfolio.

Create a Centralized Implementation Management Program

Many banks have already identified how much additional capital they need and how to adjust their funding strategies. It is the next step—the actual implementation—where the real work starts. Based on our experience with Basel II, we believe that a comprehensive implementation management program is critical for success. Such a program consists of four main elements:

1. Comprehensive planning and budgeting: Getting the planning right from the outset and setting an appropriate budget are crucial. Banks should think through the implications and interdependencies of the new rules and how plans will impact individual transactions as well as the bank in aggregate. All relevant department heads should be looped into the process and coordinated with one another to ensure cooperation and buy-in and to identify potential synergies.

2. Experienced program management office (PMO) for project planning and tracking: The importance of experience is often underestimated. Ideally, a PMO should be staffed with experienced project managers and experienced risk management experts. A thorough understanding of the new rules and the broader risk management agenda makes for a more sophisticated PMO, one that can identify early on if the plan is off track, focus on the critical path, and react appropriately.

3. Clear communication with stakeholders: The bank should actively communicate with and seek input from investors, rating agencies, and other stakeholders during the implementation process. The capital markets may be particularly sensitive to some measures taken in response to Basel III, so proactive management of investors will be essential.

4. Preparation for and execution of the regulatory audit process: Banks should pay special attention to the regulatory audit process. We recommend creating a central “examination management” team to handle this process. This team is the first point of contact with regulators to field requests; it coordinates meetings and also makes sure all documents are in place and consistent. This is particularly important for international banks that must deal with regulators in different jurisdictions.
It’s nearly impossible to overstate the impact that Basel III will have on financial institutions around the globe. The new rules will undoubtedly yield a more resilient industry, but the increased capital costs will drive significant changes within individual banks and in the competitive landscape. Even before Basel III won approval at the G-20 meeting in November, many institutions around the globe had taken steps to increase their capital and liquidity levels. For most, however, much more needs to be done. Besides lining up the required capital and liquidity, banks must examine the viability of current business practices with these new risk rules in mind—and this will require the participation of senior managers across the enterprise, not just those in a formal risk management role.

Beyond these long-term strategic decisions, banks need to address three immediate challenges to prepare themselves for Basel III. First, they should focus on programs to improve data quality and reinforce existing RWA reduction initiatives. Next, they need to upgrade their existing risk data architecture, better link risk data across silos, and enhance the risk model and methodologies landscape, especially in the liquidity risk management area. And, finally, banks need to set up a comprehensive central implementation management program for all Basel III–related initiatives in order to plan and budget correctly, track progress, and earn buy-in from stakeholders such as regulators, investors, and rating agencies.

Although the Basel III timeline looks generous at first sight, bank leaders must push implementation forward with alacrity. Institutions that adopt Basel III requirements early on will gain a competitive edge over less nimble peers. Business partners, clients, rating agencies, regulators, and investors will have more confidence in these institutions, giving them greater access to funding and capital. Make no mistake: Basel III is more than a set of rules to improve risk management; it’s a catalyst to change business models no longer sustainable in today’s global business environment.

**ACT NOW**

Endnote


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**About the Authors**

Dr. Peter Gassmann is a partner with Booz & Company’s financial services practice based in Frankfurt. He heads the company’s global risk, pricing, and capital management platform to support banks and other financial institutions. He has 15 years of experience in financial services as a management consultant and as a bank executive in senior risk management positions.

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