

CAMELS – Capital Adequacy / Economic Capital

Whilst Regulatory Capital (RC) is the amount of capital that a bank needs, given regulatory guidance and rules, Economic Capital (EC) refers to the amount of risk capital bank management estimates it may require to remain solvent within a given confidence level (probability) over a certain, pre-defined period.

The amount of EC held and how it is allocated across divisions is a management decision, whilst essential to support a bank's business. EC reflects a bank's own perspective on its business. It therefore differs from RC minimum capital requirements addressing a bank's risk spectrum under a range of regulatory rules. EC, on the other hand, measures risk using economic realities rather than rules or regulations, is bank-specific, an internal measure, whereby no common definitions exist. Whereby, of course, estimates on required EC can be covered by elements of the Basel III-defined capital layers (Tier 1, Tier 2, Tier 3).

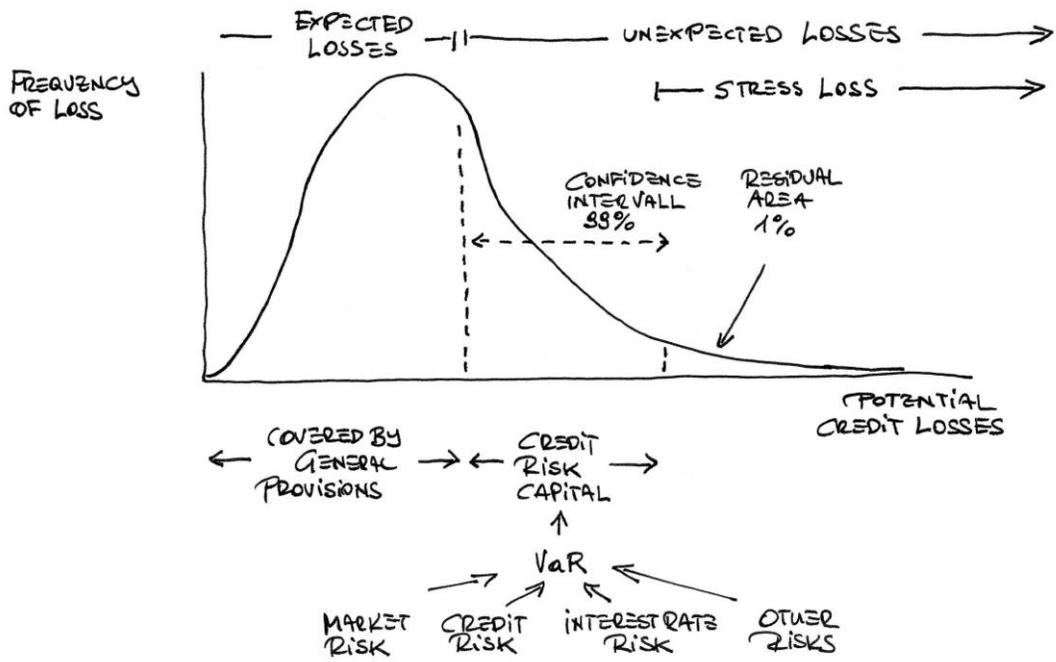
Any bank will have to deal with losses, especially from its loan portfolio, which are the normal cost of doing banking-related business: These "normal", expected losses are covered by a bank's provisioning and its pricing policy. - EC, however, foremost addresses the coverage of so-called unexpected losses, which are rather more unlikely to occur. Whereby, some of those unexpected losses may be extremely unlikely ("black swans"): Covering them as

well would just be too expensive and from a commercial point of view uneconomic, not reasonable. Within these constraints, bank management has to estimate the amount of EC required so that an institution's insolvency happening is extremely unlikely over a certain period of time. For this purpose, management has to set appropriate parameters: Accordingly, the likelihood of an insolvency occurring is usually set with less than 1 per cent (sometimes 5 per cent), whilst such event happening within different periods, such as 1 day, maybe 2 weeks, by times also 20 days.

Value at Risk (VaR) is a commonly applied methodology to estimate the amount of required EC. By calculating VaR (What is the most I can lose with a given certainty over a certain time?), financial institutions can determine whether sufficient capital reserves are in place to cover losses. However, they can also measure whether higher-than-acceptable risks require them to reduce concentrated holdings. Due to the complexity of banks' balance sheets, deriving VaR is an equally complex task, whereby focus is on the downside risk and potential losses.

Hence, the calculation of VaR requires an estimate of probability of each asset's loss, with a confidence interval set over a fixed time period: Thereby individual risks have to be represented in probability distributions, then the correlation across these risks as well as assets assessed as well as their effect on value. Among others, in terms of market risks, interest rate changes, equity market volatility and economic growth is paid special attention to.

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