

CAMELS – Capital Adequacy / Regulatory Capital

Capital adequacy is the level of capital a financial institution must maintain to absorb losses related to credit, market or operational risks. It also signals the degree an institution is expected to continue honoring its obligations. Thereby, focus is on protection of an institution's creditors, especially holders of retail deposits. Besides, the capital adequacy concept shall also ensure the stability of the global financial system.

Capital ratios help tracking the adequate coverage of a bank's most relevant financial risks, such as related to foreign exchange, credit, or interest rates:

Thereby, the Capital Adequacy Ratio (CAR) measures a financial institution's capital as a percentage of its assets, with both input parameters - capital and assets - strictly regulated and defined. Whilst a bank's capital comprises a mix of equity and hybrid capital, its assets are not just added up as per their respective book values: Instead, they are weighted according to their respective risks. Hence, the CAR measures leverage as defined in various laws and regulations.

In the context of the CAR, the capital component is a complex compound of different layers of long-term funding which can absorb losses. The Basel III framework, a widely accepted international regulatory agreement, among others, defines so-called Tier 1 and Tier 2 capital:

- Tier 1 capital is (almost only) ordinary share capital (i.e. straight equity) that can absorb losses without requiring a bank to cease operations.
- Tier 2 capital is composed of all sorts of hybrid instruments / subordinated debt, which can absorb losses, not least in the case of a bank being liquidated.

Next to Tier 1 and Tier 2 capital, there are various additional layers, so-called buffers, which provide extra cushion, with some of them mandatory, such as the capital conservation buffer, whilst others are

or can be imposed by national regulators, as required.

The Basel III framework also determines the calculation of Risk Weighted Assets (RWA), whereby each of a bank's asset position is weighted according to its respective assumed risk profile. - For example, corporate bonds are considered more risky than government bonds or cash: Accordingly, a government bond rated AA comes with a risk weighting of 0 per cent, whilst a corporate loan rated above AA must be weighted with 20 per cent and any ordinary consumer retail loan with 100 per cent. – These examples already illustrate the difficulty in assessing a bank's RWA, also its CAR, even more so from an outsider's position: Hence, two different banks with almost identical asset classes or volumes can have entirely different RWA positions. – Further complexity is added, as financial institutions also hold positions related to swaps, forwards or guarantees, all of which have to be adequately assessed and included in the RWA and CAR calculations.

On top of this, market and operational risks (e.g. systems, infrastructure, technical faults) will also have to be assessed, calculated and supported with sufficient, adequate capital as per laws and regulations.

Since the financial crisis of 2008, the CAR has been a core focus of global regulators: In the aftermath of events it had crystallized that banks' capitalization had not been sufficient. And, this did not only regard common equity, but also various forms of hybrid capital which should have protected senior creditors (including depositors).

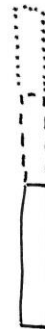
Today, regulations require banks holding permanent capital of at least 8.0 per cent of RWA: With a minimum of 4.5 per cent of RWA, common, straight equity (Core Equity Tier 1 or CET1) is the largest position, even though most banks far exceed this level. On top of that comes Additional Tier 1 capital (AT1), with Tier 2 forming the remainder of the permanent capital. In addition, buffers such as the capital conservation buffer, are either required or recommended.

BANK CAPITAL

CAPITAL ADEQUACY RATIO = CAPITAL | RWA

DEBT EQUITY RATIO = BORROWINGS | CAPITAL + RESERVES
EQUITY | TOTAL ASSETS

1.0 - 2.0 %	BANK'S OWN BUFFER
0 - 2.0 %	PILLAR 2
0 - 5.0 %	SYSTEMIC RISK BUFFER
0 - 2.5 %	COUNTER-CYCLICAL BUFFER
2.5 %	CAPITAL CONSERVATION BUFFER
2.0 %	TIER 2
1.5 %	ADDITIONAL TIER 1
4.5 %	COMMON EQUITY TIER 1



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