Capital Adequacy Ratio and Basel Accord

This article is on Capital Adequacy Ratio and Basel Accord

It contains concepts like -

- Capital Adequacy
- Capital Adequacy Ratio (CAR)
- Benefits of CAR
- Basel Accord Origin
- Basel Accords I, II, III
- Expected Questions for Exams and Interviews

Capital Adequacy :

- This concept is related to banks, normally any bank will keep some capital (amount) with them to run their daily operations and to meet any sudden unexpected losses.
- Thus banks maintain certain level of adequacy of capital, it is called as Capital Adequacy.
- Generally, Capital Adequacy is measured in terms of CAR.

Capital Adequacy Ratio :

- In short it is referred as CAR.
- It is defined as the ratio of banks capital in relation to its current liabilities and risk weighted assets.
- Here Risk weighted assets is a measure of amount of banks assets, adjusted for risks.
- Capital Adequacy Ratio is also known as Capital Risk Weighted Assets Ratio.

Benefits of CAR :

- It protects banks against excess leverage and insolvency
- keeps them out of difficulty from financial crisis
- CAR, ensures that the bank has sufficient capital to run their operations and expand their business
- These norms ensure that capital should be adequate to absorb unexpected losses or risks involved.
- If there is higher risk, then it would be needed to backed up with Capital and vice versa.
- Capital Adequacy measures the strength of the bank.

Basel Accord Origin :

- CAR is measured based on Basel Accord of BCBS.
- The Basel Committee on Banking Supervision was established as the Committee on Banking Regulations and Supervisory Practices by the central bank Governors of the Group of ten countries at the end of 1974 in the aftermath of serious disturbances in international currency and banking markets.
- The first meeting took place in February 1975.
- However from year 2009, the meetings have been held regularly three or four times a year after financial crisis 2008.
- Countries are represented by their central bank and also by the authority with formal responsibility for the prudential supervision of banking business where this is not the central bank.
- BCBS have more than 40 nations, few notable members of BCBS -

India, Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, U.K. and USA.

- The most important issue for the regulatory authorities to design a sound banking system.
- Because, before 1990s almost all of the bank's measure its soundness by the leverage ratio.

Leverage Ratio = Capital / Total assets

- If leverage ratio result is high it means banks are very strong against the risk and vice versa.
- However, Leverage Ratio was suffering from severe drawback , that we cannot find difference between assets and risk.

- With advent of globalization, the risk against assets became increased that impacted the bank soundness, insolvency issues.
- After thorough discussions, in the year 1988, Basel Committee for Bank Supervision (BCBS) has prescribed a set of norms for the capital requirement for the banks, it is popularly known as " Basel Accord".

Note - Basel is a place in Switzerland, where BIS- Bank of International Settlements Located

- These norms of Basel provide a 'safe-lending' platform for banks.
- So far, Basel provided three sets of norms. They are -

- Basel I
- Basel II
- Basel III

Basel Accords I, II, III :

Basel I

- It is first Basel Accord, referred as known as Basel I
- These were issued in the year 1988.
- Focuses was on the Credit Risk of financial institutions.
- According to Basel I , banks must maintain capital (Tier 1 and Tier 2) equal to at least 8% of its risk-weighted assets.
- The CAR is calculated based on below formula -

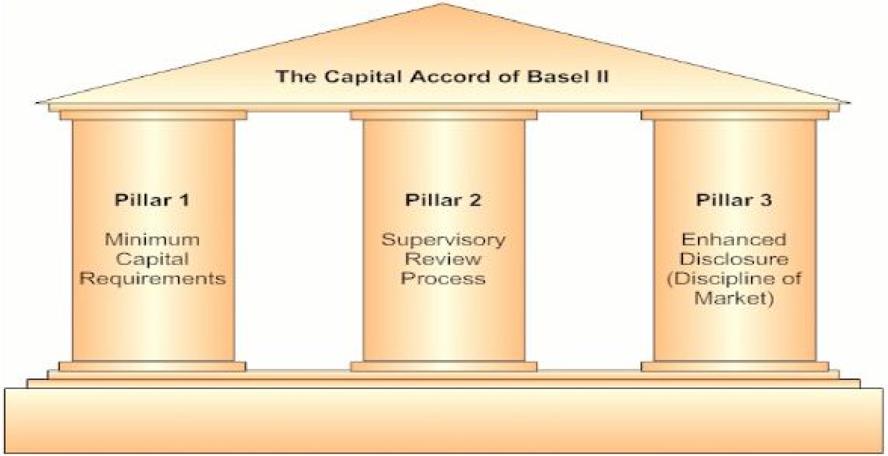
CAR = (Total Capital)/ Risk Weighted Assets

- For example, if a bank has risk-weighted assets of $100 million, it is required to maintain capital of at least $8 million.

Basel II -

- Basel Committee has revised Basel I norms, they released new version or guidelines of it, in the year June 2004.
- These new norms were called as Basel II.
- Basel II, focused on three parameters -

(i). Minimum Capital Requirement (1st Pillar)
(ii). The Supervisory Review Process (2nd pillar)
(iii). Market Discipline (3rd Pillar)



- The above three parameters are referred as Three Pillars of Basel II.
- Banks should maintain a minimum capital adequacy requirement of 8% of risk weighted assets
- Basel II classified, three types of risk are - operational risk, market risk, capital risk.
- It made mandatory for banks, to disclose their risk exposure information to the central bank.
- CAR formula as per Basel II

$$CAR = \frac{\text{Tier One Capital} + \text{Tier Two Capital}}{\text{Risk Weighted Assets}}$$

Here,

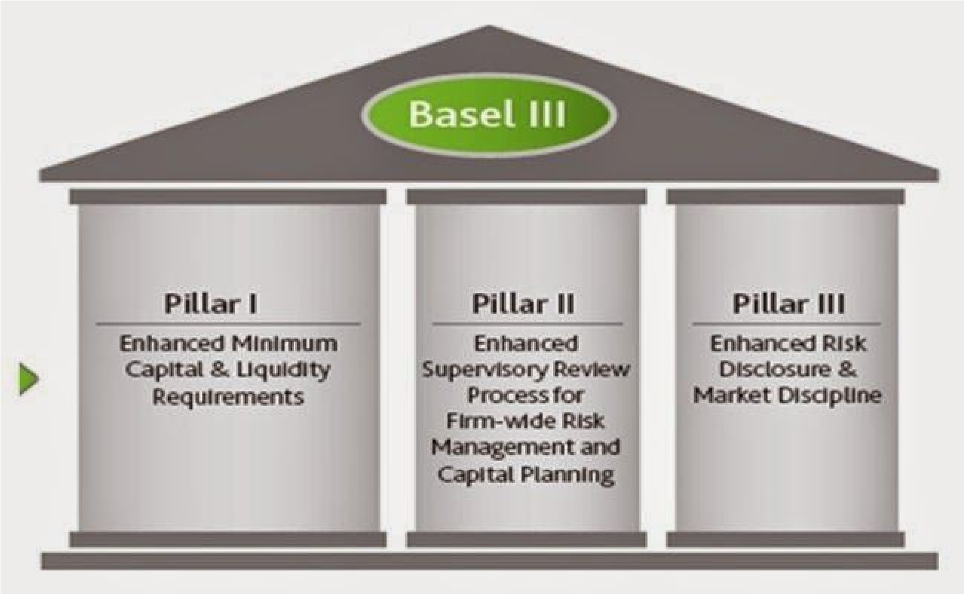
Risk Weighted Assets(R.W.A) = Market Risk + Credit Risk + Operational Risk

Tier I Capital = Ordinary Capital + Retained Earnings Share Premium - Intangible assets.

Tier II Capital = Undisclosed Reserves + General Bad Debt Provision Revaluation Reserve + Subordinate debt + Redeemable Preference shares

Basel III -

- Due to failure of Basel II norms to face the financial crisis of the year 2008, Basel norms were revised again.
- A new revised Basel III norms came in the year 2010.
- Basel III Focused on - making most banking activities better. Like -
    - Improve Banking sector absorb shocks from both financial and economical stress
    - Improve Risk management
    - Improve Goverance
    - Improve Bank's transparency and Risk disclosures.
- Basel III, guidelines aims to promote a more resilient banking system by focusing on four vital banking parameters that is, capital, leverage, funding and liquidity.
- Basel III continued with Basel II norms pillars , however additional support systems were added for better banking system.
- CAR should be 8 % of RWA.
- Basel III, introduced a new concept called LCR, Liquidity Coverage Ratio. The purpose is banks must maintain high quality assets that can converted into cash, for banks cash requirements for 30 days.


Basel III
Pillar I
Enhanced Minimum Capital & Liquidity Requirements
Pillar II
Enhanced Supervisory Review Process for Firm-wide Risk Management and Capital Planning
Pillar III
Enhanced Risk Disclosure & Market Discipline

Expected Questions for Exams and Interviews -

Exams -

Q. Explain CAR and its role ?
Q. Discuss about Basel Accord I, II, III ?
Q. Importance and need of Basel Accord ?

Interviews -

Q. What is usage of CAR ?
Q. What is difference between Basel II and Basel III ?
Q. Tell us about guidelines of CAR under Basel III ?
Q. What are pillars of Basel II and Basel III ?

Thank you

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