Capital Adequacy Ratio

The Committee on Banking Regulations and Supervisory Practices (Basel Committee) had released the guidelines on capital measures and capital standards in July 1988 which were been accepted by Central Banks in various countries including RBI. In India it has been implemented by RBI w.e.f. 1.4.92

Capital Adequacy Ratio or CAR or CRAR: Capital adequacy ratio is the ratio

which determines the capacity of the bank in terms of meeting the time liabilities and other  
risk such as credit risk, operational risk, etc. In the simplest formulation, a bank's capital is  
the "cushion" for potential losses, which protect the bank's depositors or other lenders.  
Banking regulators in most countries define and monitor CAR to protect depositors, thereby  
maintaining confidence in the banking system.

CAR is similar to leverage; in the most basic formulation, it is comparable to the inverse of

debt-to-equity leverage formulations (although CAR uses equity over assets instead of debt-  
to-equity; since assets are by definition equal to debt plus equity, a transformation is  
required). Unlike traditional leverage, however, CAR recognizes that assets can have  
different levels of risk.

It is ratio of capital fund to risk weighted assets expressed in percentage terms i.e.

Minimum requirements of capital fund in India:

\*

Existing Banks 09 %

\*

New Private Sector Banks 10 %

\*

Banks undertaking Insurance business

10 %

\*

Local Area Banks

15%

Tier I Capital should at no point of time be less than 50% of the total capital. This implies

that Tier II cannot be more than 50% of the total capital.

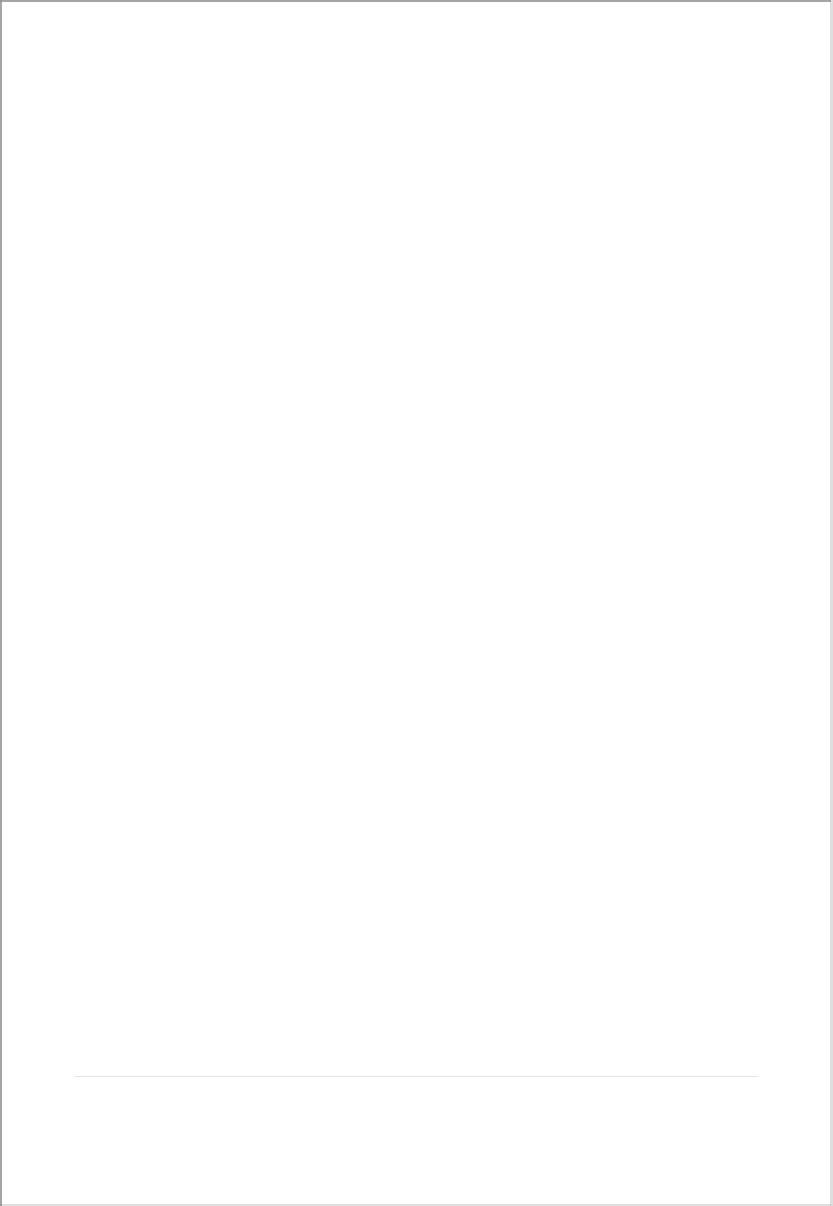
Capital fund

Capital Fund has two tiers –

Tier I capital include

\*paid-up capital  
\*statutory reserves  
\*other disclosed free reserves

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\*capital reserves representing surplus arising out of sale proceeds of assets.

Minus

\*equity investments in subsidiaries,  
\*intangible assets, and  
\*losses in the current period and those brought forward from previous periods to work out the

Tier I capital.

Tier II capital consists of:

\*Un-disclosed reserves and cumulative perpetual preference shares:

\*Revaluation Reserves (at a discount of 55 percent while determining their value for

inclusion in Tier II capital)  
\*General Provisions and Loss Reserves upto a maximum of 1.25% of weighted risk assets:  
\*Investment fluctuation reserve not subject to 1.25% restriction  
\*Hybrid debt capital Instruments (say bonds):  
\*Subordinated debt (long term unsecured loans:

Risk weighted assets:

Fund Based: Risk weighted assets mean fund based assets such as cash, loans, investments and other assets. Degrees of credit risk expressed as percentage weights have been assigned by RBI to each such assets.

Non-funded (Off-Balance sheet) Items:

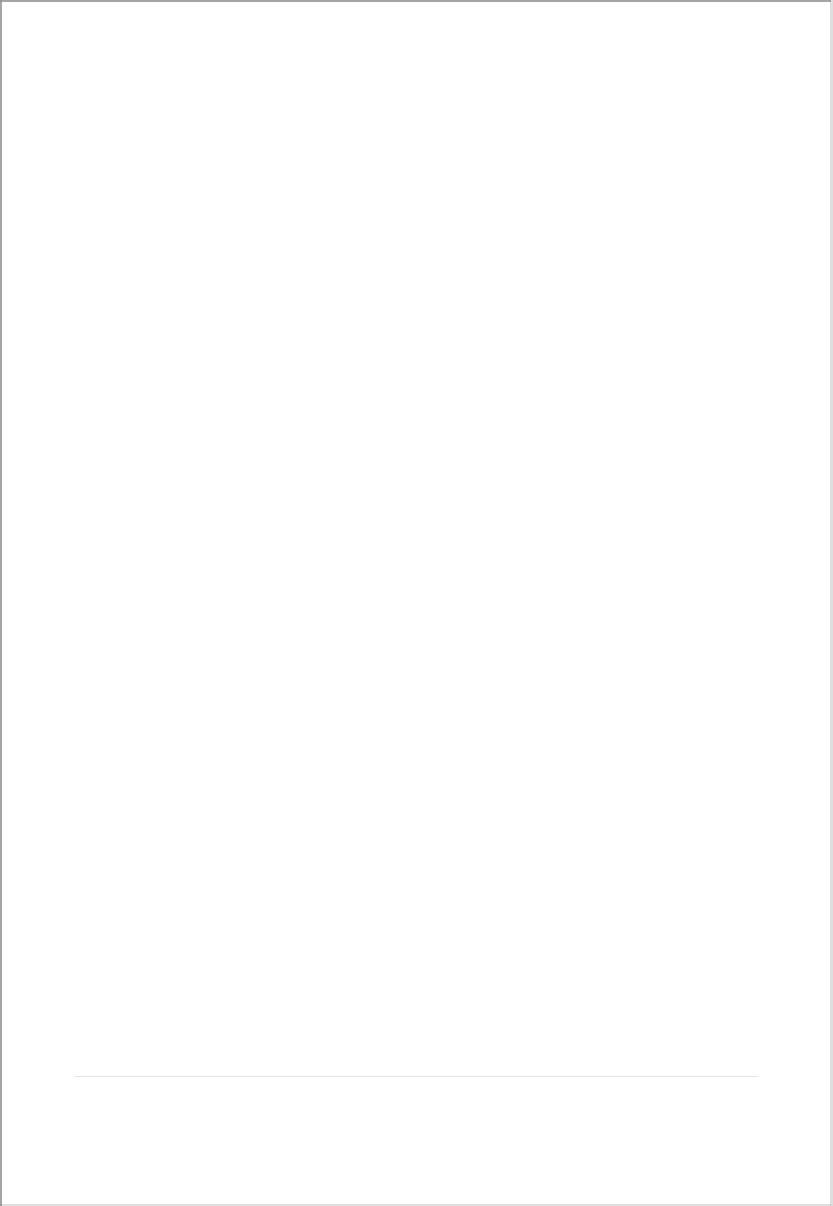
The credit risk exposure attached to off-balance sheet items has to be first calculated by  
multiplying the face amount of each of the off-balance sheet items by the credit conversion  
factor. This will then have to be again multiplied by the relevant weightage.

Reporting requirements:

Banks are also required to disclose in their balance sheet the quantum of Tier I and Tier II

capital fund, under disclosure norms.

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An annual return has to be submitted by each bank indicating capital funds, conversion of  
off-balance sheet/non-funded exposures, calculation of risk -weighted assets, and calculations  
of capital to risk assets ratio

A Note About Minimum Ratio Values

Because risk-based capital ratios do not take explicit account of the quality of individual asset  
portfolios or of other types of risk to which a bank may be exposed (including interest rate,  
liquidity, market and operational risks), banks are generally expected to operate with  
positions above the minimums. In determining capital adequacy, various risks and exposures  
need to be taken into account:

Higher-risk banks, in particular, should maintain capital well above the minimums. Higher-  
risk banks include those growing aggressively as well as those with weaker asset quality,  
earnings or management.  
Large exposures from litigation or from off-balance-sheet items also require additional  
capital.  
It also may be helpful to compare your bank’s ratios with those of a peer bank. If your bank  
compares unfavourably with its peer in terms of earnings or past-dues and nonaccruals, you  
likely need to have higher capital ratios. Similarly, if your bank is growing faster than its  
peer, you likely need higher capital ratios than the peer bank. The word “likely” is used here  
because there could be mitigating factors at your individual bank or because a peer bank  
could be a poor example for your bank to follow. At some point, this can become a judgment  
call, and the exact point at which a bank becomes less than adequately capitalized can also be  
a judgment call. At any rate, your bank’s comparison with a peer bank is useful information,  
and consideration of trends (in capital and asset growth, earnings or asset quality, for  
example) can also be helpful. Also, if your bank is experiencing a downward trend in capital  
ratios, as a director you should work with executive management to develop a plan to restore  
capital before the downward trend gets out of hand.  
The tier 1 leverage ratio is tier 1 capital divided by average total consolidated assets. An  
average total consolidated asset equal’s quarterly average assets from a bank's most recent  
Call Report less goodwill and other intangible assets.

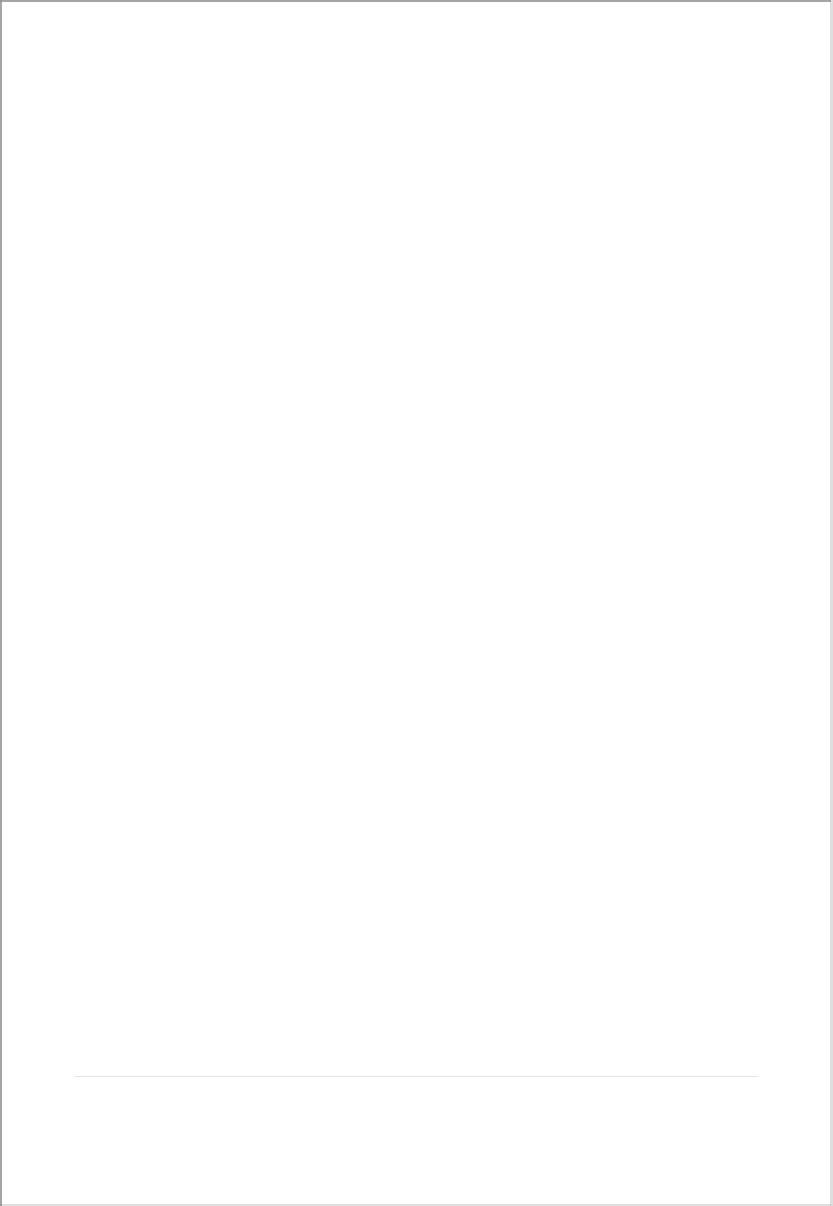
The minimum tier 1 leverage ratio is 4 percent, unless the bank is highly rated by its  
supervisors. Again, this is just a minimum, and banks—especially higher-risk banks—should  
operate with a leverage ratio above the minimum.

Advantages of using the Capital Adequacy Ratio CAR

In early phases of Basel implementations, bank's capital adequacy was calculated as assets  
times’ ratio. This approach did not take risk profiles of assets into account. It is obvious that  
a bank should keep more capital in reserves for riskier assets.

Since different types of assets have different risk profiles, CAR primarily adjusts for assets that are less risky by allowing banks to "discount" lower-risk assets. So, for example, in the most basic application, government debt is allowed a 0% "risk weighting". This also means that government debt is subtracted from total assets for purposes of calculating the CAR.

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On the other hand, investments in junior tranches of instruments collateralized with subprime

mortgages are very risky, and would be assigned 100% risk weighting.

Conclusion

Therefore, Capital Adequacy Ratio (CAR) is a ratio that regulators in the banking system use to watch bank's health, specifically bank's capital to its risk. Regulators in the banking system track a bank's CAR to ensure that it can absorb a reasonable amount of loss.

Regulators in most countries define and monitor CAR to protect depositors, thereby

maintaining confidence in the banking system.

Capital adequacy ratio is the ratio which determines the capacity of a bank in terms of  
meeting the time liabilities and other risk such as credit risk, market risk, operational risk,  
and others. It is a measure of how much capital is used to support the banks' risk assets.

Bank's capital with respect to bank's risk is the simplest formulation; a bank's capital is the

"cushion" for potential losses, which protect the bank's depositors or other lenders.

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**Capital Adequacy Ratio**

Capital Adequacy Ratio or CAR or CRAR: Capital adequacy ratio is the ratio which determines the capacity of the bank in terms of meeting the time l... ([More](javascript:void(0))) Capital Adequacy Ratio or CAR or CRAR: Capital adequacy ratio is the ratio which determines the capacity of the bank in terms of meeting the time liabilities and other risk such as credit risk, operational risk, etc. In the simplest formulation, a bank's capital is the "cushion" for potential losses, which protect the bank's depositors or other lenders. Banking regulators in most countries define and monitor CAR to protect depositors, thereby maintaining confidence in the banking system.  
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