

# The importance of own funds in relative terms (capital adequacy)

Dr. Johannes Engels.

*The Federal Financial Supervisory Authority (BaFin), Bonn*

(Folie 1) **The question of own funds in the banking sector**

- I. In old time ... (1969/ 85)
- II. First amendments (1985/ 92)
- III. Basel I Accord (1992 ff)
  - III.1 Excursion: small banks and the question of own funds
- IV. Basel II Accord (2005 ff)
- V. Empirical analysis
- VI. Summary

(Folie 2) **Risk Weighting**

0 %            claims on public-law legal entities in the area of validity on the BA (with the exception of public-law banks) and on a Federal special fund;

20 %            claims on, discounts to, and contingent claims arising from guarantees, surety instruments and from the provision of security for third-party liabilities on banks domiciled in the area of validity of the BA; this weighting also applies to public-law banks and to branches of foreign banks;

50 %            loans secured against real estate and ship loans within the meaning of § 20 (2) Nos. 1 and 2; claims on customers which are guaranteed by a domestic public-law legal entity or are secured in some other way; guarantees and surety instruments in favour of and contingent claims from the provision of security for third-party liabilities on non-banks and banks domiciled outside the area of validity of the BA; claims on and discounts to banks domiciled outside the area of validity of the BA;

70 %            building savings loans from funds awarded and loans for the prefinancing and interim financing of payments by building and loan associations on their savers' building savings contracts; contingent claims of building and loan associations arising from unconditional obligations to take over third-party interim loans to building savers;

100 %           all other claims on customers; objects for which a bank, as lessor has concluded leasing agreements;

(Folie 3) **Principle**

**Principle required additionally the overall limitation of risks of counterparty failure arising from**

- **financial swaps**
- **forward contracts and**
- **option rights**

**to eighteen times the bank's liable capital.**

(Folie 4) **Composition of own funds**  
**(section 10 of the Banking Act)**

- Tier 1 capital (core capital)**
- + Tier 2 capital (additional capital)**
- Deduction 1 positions**
- = Liable capital**
- + Tier 23 capital**
- = Own funds**

**1 Deductions of participating interests (sections 10 and 12 of the Banking Act); breaches of the large exposure limits (section 13, 13a and 13b of the Banking Act). -**

**Tier 2 capital is only eligible to the extent that it does not exceed 2.5 times the tier 1 capital not needed to cover banking book counterparty risks or for other purposes (e. g. as capital backing for large exposure (unused tier 1 capital)).**

(Folie 5) **Renewed principle**

This in 1992 renewed principle deliberately takes a simple approach to measuring credit risk (standardised measurement method) in order to limit institutions' administrative outlay and to avoid excessive interference in bank's individual risk management strategies. The level of the credit risk arising from balance-sheet and off-balance-sheet positions (risk assets) is determined using different borrower-related risk weights (100%, 70%, 50%, 20%, 10%, 0%), with a privileged status being granted to exposures to most OECD countries (so-called "Zone A").

## (Folie 6) Co-operative banks

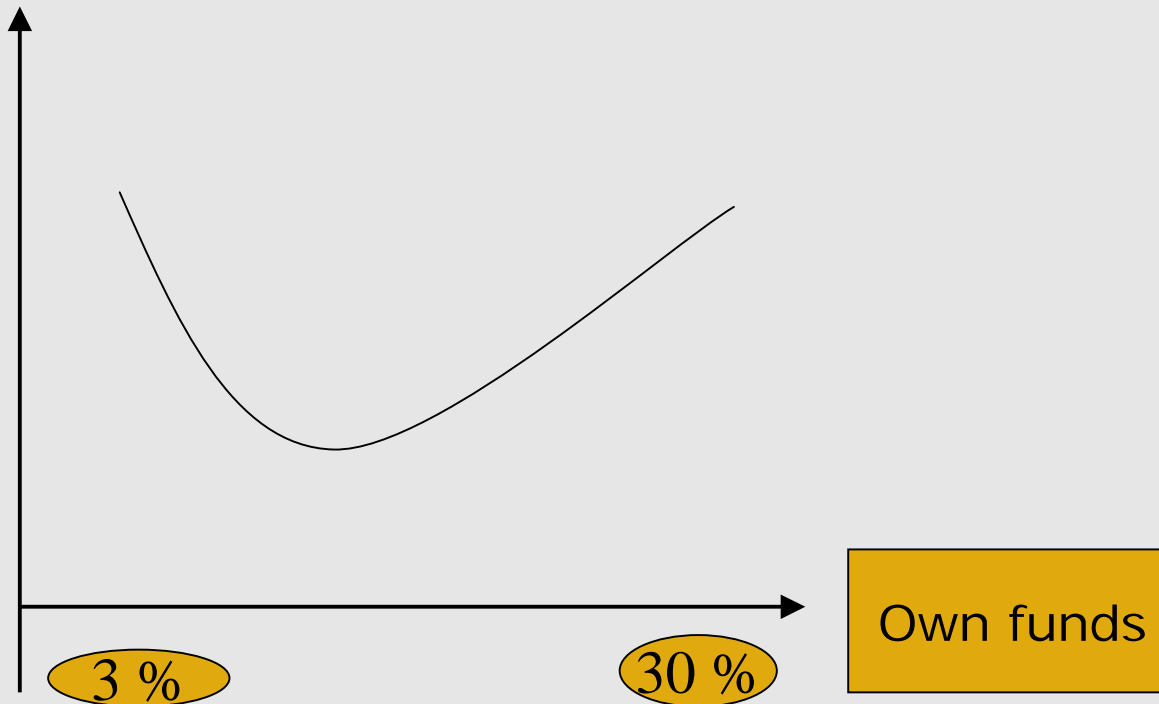
All the 1500 co-operative Banks have round about 15,3 million members; that is a lot if you remark that Germany in total has 80 million citizens. The co-operative banks have a very different size; there are some smaller banks with total assets of 50 million Euro. The biggest co-operative bank has total assets of more than 7 Bill. Euro. Some of the smaller banks, mostly in rural regions, are so-called mixed banks; that means that they – besides banking – have another business like selling rural goods. The market share in the field of banking business is around 20 %.

## (Folie 7) Savings banks

Today, around 500 savings banks are operating in Germany; they are in rural regions the major competitors to the co-operative banks. Generally savings banks are in the average, according the sum of balance, around three up to five times bigger than cooperative banks. The market share is around 45 %.

(Folie 8) Good level for bank`s own funds

Risk



(Folie 9) **Basel quota**

**Capital**

---

**Total risk – weighted assets credit risk + (capital charges  
market risk + operational risk X 12.5**

(Folie 10) **Two hypotheses**

a) Per se the banks' capital base fluctuates procyclically: losses tend to rise in a down-swing, which means that the existing capital base shrinks.

b) By contrast, the banks' commercial capital needs relative to their loan portfolio change anticyclically. In a downturn the banks have to offset the increased losses and, furthermore, make greater risk provisioning through a larger capital cover.

(Folie 11) **Summary**

**On the one hand, there is to regret the fact, that the definition of banks' own funds is very complexity. On the other there seems to be – apart from the advantage of the international harmonization – the fact, that the running 8 % ratio according Basel II (including the standardized approach for small banks) is probably close to an optimum.**

(Folie 12) **Conclusion (1)**

**The banking supervision has to check:**

- **How is the average of own funds ratio of all credit institutions?**
- **Exists in this context a specification (type of banks, size of banks)?**
- **How is the trend of the own funds ratio according longer statistical series?**

(Folie 13) **Conclusion (2)**

## **What can a banking supervision do?**

- **Publication in the bulletin**
- **Publication of an announcement**
- **Publication of an administrative practice ("1% barrier" / extra-ordinary inspections and intensive speeches with the management)**