Tier 1 Capital Ratios

History

The 2008 financial crisis exposed significant weaknesses in the global banking system, particularly around capital adequacy. Many banks were highly leveraged and held too little high-quality capital to absorb losses during periods of stress. As defaults rose – especially on complex products like mortgage-backed securities – banks faced mounting losses that quickly eroded their capital bases.

Common Equity Tier 1 (CET1) was introduced as part of the Basel III reforms to strengthen bank capital and improve financial stability, particularly in the aftermath of the 2008 financial crisis. The goal was to ensure banks had sufficient capital to absorb losses and prevent similar systemic crises in the future. CET1 capital is considered the highest quality capital because it's the first to be absorbed in a crisis, making it a key indicator of a bank's financial health.

The Basel III accord introduced a regulation that requires commercial banks to maintain a minimum capital ratio of 8%, 6% of which must be Common Equity Tier 1. The Tier 1 capital ratio should comprise of at least 4.5% of CET1. The Basel III accord was introduced in 2010 as a response to the 2008 Global Financial Crisis and as part of continuous efforts to improve the banking regulatory framework.

Whilst the Accord is a voluntary arrangement, its acceptance by the global banking community makes this an effective measure of stability and strength.

How are the ratios calculated?

The Tier 1 Capital Ratio is calculated by taking a bank's core capital relative to its risk-weighted assets. The risk-weighted assets are the assets that the bank holds and that are evaluated for credit risks. The assets are assigned a weight according to their level of credit risk. For example, cash on hand would be weighted 0%, while a mortgage loan would carry weights of 20%, 50%, or 100%.

$$\text{Tier 1 Capital Ratio} = \frac{Core\ Capital}{Risk\ Weighted\ Assets} \times 100\%$$

The elements of the calculation method are being toughened, with some previously accepted forms of top-notch capital, such as deferred tax assets, being phased out. The commitment to upholding these agreements shows that banks are working towards a position where the events of 2008 should not recur, and investor confidence is fully restored. Of course, for those of us with investments supported by these banks this is nothing but good news. To find out how the Issuers we work with are faring in this respect, please go to the 'News' section of our website and read our latest Counterparty CDS and Rating report.