Risk-Based Capital Adequacy Regulations

The globalisation of financial institutions and the resultant change in their risk profiles, necessitated regulatory requirements for firms to maintain, at all times, adequate capital commensurate with the level of risk inherent in their business activities. The Basel Committee on Banking Supervision (BCBS), which operates through the Bank for International Settlements, has led regulatory efforts at establishing risk-based capital adequacy standards with the introduction of Basel I in 1988. The BCBS has enhanced its standards over the years taking into consideration the growing complexity of banking activities and gaps in regulations that was most evident given the financial crisis of 2007/ 2008. Basel II was introduced in 2004 and Basel III in 2010. The Basel III Accord is based on three pillars:

- Pillar 1 states the minimum capital requirements for banks and outlines how these requirements are to be calculated;
- Pillar 2 covers the review process for supervisors which includes ensuring that banks have implemented proper risk management processes and controls; and
- Pillar 3 covers the public disclosure of bank's risk exposures, risk management practices and their capital adequacy.

In this week's article, we will focus on Pillar 1 or risk-based capital adequacy requirements. Next week, we will explore the risk management process for financial institutions and the role of supervisors, the core elements of Pillar 2.

Risk-based capital adequacy requirements are designed to mitigate against the insolvency of a firm, to protect depositors or creditors and investors, to promote financial stability and to ensure efficiency and confidence in the financial sector. These requirements ensure that shareholders, as Warren Buffet stated, have enough "*Skin in the Game*."

Risk-based capital adequacy standards are comprised of three fundamental elements.

1. A definition of regulatory capital;

2. The determination of the risk-weights for assets; and
3. A specification of the minimum capital requirements which is generally in the form of a capital adequacy ratio; that is, the ratio of regulatory capital to risk-weighted assets. Under Basel III, banks must maintain a minimum capital adequacy ratio of 8%.

Regulatory Capital

Under risk-based capital adequacy standards, regulators specify the eligible capital items, which usually includes Tier 1 and Tier 2 capital. Tier 1 capital, , includes shareholders' equity, retained earnings and reserves. Tier 1 capital is more loss absorbent and liquid than Tier 2 capital; which includes hybrid securities and subordinated debt.

Risk Categories

Risk-based capital requirements generally consider the following categories of risk:

1. **Credit risk** – The potential for a borrower, or counterparty, to fail to satisfy its obligations in accordance with the agreed contractual terms. Under risk-based capital adequacy requirements, the capital charge applied to credit exposures are usually based on the credit ratings assigned to counterparties. Most regulators stipulate that their regulated entities should use the ratings assigned by the top internationally recognised rating agencies, such as S&P Global Ratings and Moody's Investors Service. The higher the credit risk associated with the exposure, the greater the capital required.
2. **Market risk** – The possibility of a decline in the value of on and off-balance sheet assets[1] due to adverse movements in market prices, such as interest rates and foreign exchange rates. Under risk-based capital adequacy requirements, a capital charge is applied to assets, such as equities and bonds, as well as the liabilities on a firm's balance sheet that are exposed to market risk.
3. **Operational risk** – The potential for losses due to inadequate or failed internal processes, systems, people, or external events. Under risk-based capital adequacy requirements, a capital charge is also applied for the operational risk inherent in a firm's activities.
4. **Liquidity risk** – The risk that a firm may be unable to dispose of an asset at a fair value or within a reasonable time period so as to satisfy its financial commitments. Under Basel III, assets are not risk-weighted for liquidity risk like they are for credit, market,

[1] Off-balance sheet assets are not owned by the company and as such, are not recorded on the institution's balance sheet. For securities firms, such assets may include bonds and equities managed on behalf of clients.

and operational risks. Rather, firms are required to maintain a liquidity coverage and net stable funding ratios of 100% respectively. The objective of these standards is to ensure that banks have sufficient liquid assets to meet both their short-term and long-term obligations.

Total risk-weighted assets are the sum of the individual risk-weighted assets. Once regulatory capital is at least equal to total risk-weighted assets, a firm is considered to have sufficient capital to absorb potential losses and thus be less likely to become insolvent and lose creditors' and clients' monies.

The Trinidad and Tobago Securities and Exchange Commission

The Trinidad and Tobago Securities and Exchange Commission (TTSEC) currently stipulates fixed minimum capital requirements for entities registered under Section 51(1) of the Securities Act, Chapter 83:02 of the Laws of the Republic of Trinidad and Tobago. These requirements are detailed in Section 27(1) of the Securities (General) By-Laws, 2015, and have been summarised in Table 1 below.

Table 1: Minimum Capital Requirements

Registrant Category	Description of activities conducted	Capital Required (TTD)	Minimum Regulatory Capital Requirement (TTD)
Investment Advisor	Investment advisory services	50,000	50,000
Underwriter	Underwriting	5,000,000	2,000,000
Broker-Dealer	Executing transaction for clients only (not for own account)	2,000,000	1,000,000
	Executing transaction for clients and for own account	5,000,000	2,000,000
	Executing transactions for clients and for own account, and offering underwriting services	6,000,000	3,000,000

The TTSEC has recently embarked on a plan to enhance its current capital requirements to take into consideration the risks inherent in the activities of its registered entities and by so doing, align its framework with international standards. Risk-based capital adequacy requirements not only seek to protect registered entities and investors but also assist with ensuring stability in the local securities sector. An initial quantitative impact study was conducted, and discussions were held with the Securities Dealers Association of Trinidad and Tobago as well as the Mutual Fund Association of Trinidad and Tobago. This year, registered entities can look forward to consultation on the proposed framework and will be invited to provide their feedback.

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For more information on the securities market and the role and functions of the TTSEC, please visit our corporate website at www.ttsec.org.tt. To become a smart investor, download our IPA via the Google Play and Apple Stores. You can also take the investor education online course on our investor education website, www.InvestUcateTT.com, and test your knowledge in our interactive investing game InvestorQuestTT at www.InvestorQuest-tt.com, and remember, to connect with us via Facebook; Twitter, Instagram, LinkedIn or You Tube.

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