What is Capital Adequacy Ratio (CAR)?

Capital Adequacy Ratio (CAR) is the ratio of a bank's capital to its risk. It is also known as the Capital to Risk (Weighted) Assets Ratio (CRAR). In other words, it is the ratio of a bank's capital in relation to its risk weighted assets and current liabilities. This ratio is utilised to secure depositors and boost the efficiency and stability of financial systems all over the world.

This is an important topic from the economics segment of the UPSC exam.

What is the Capital Adequacy Ratio Formula?

The CAR or the CRAR is computed by dividing the capital of the bank with aggregated risk-weighted assets for credit risk, operational risk and market risk.

This is calculated by summing a bank's tier 1 capital and tier 2 capitals and dividing the total by its total risk-weighted assets. That is:

Tier 1 CAR = (Eligible Tier 1 capital funds) = (Market Risk RWA + Credit Risk RWA + Operational Risk RWA)

Total CAR = (Eligible Total capital funds) ÷ (Credit Risk RWA + Market Risk RWA + Operational Risk RWA)

CAR Formula:

CAR = (Tier 1 capital + Tier 2 capital)/risk weighted assets

Note that two types of capitals are measured here.

Tier 1 capital: This can absorb the losses without a bank being required to stop trading. Also called core capital, this consists of ordinary share capital, equity capital, audited revenue reserves and intangible assets. This is permanently available capital and readily available to absorb losses incurred by a bank without it having to cease operations.

Tier 2 capital: This can absorb losses if the bank is winding-up and so gives depositors a lesser measure of protection. This consists of unaudited reserves, unaudited retained earnings and general loss reserves. This capital cushions losses if the bank is winding up and is used to absorb losses after a bank loses all its tier 1 capital.

Risk-weighted assets: These assets are used to fix the least amount of capital that should be possessed by banks to lower the insolvency risk. The capital requirement for all types of bank assets depends on the risk assessment.

Why is Capital Adequacy Ratio important?

The CAR is decided by central banks and bank regulators to prevent commercial banks from taking excess leverage and becoming insolvent in the process. The CAR is important to ensure that banks have enough room to take a reasonable amount of losses before they become insolvent and, as a result, lose depositors' funds.

In general terms, a bank with a high CRAR/CAR is deemed safe/healthy and likely to fulfil its financial obligations.

When a bank is winding-up, depositors' funds are accorded a greater priority than the bank's capital, so depositors will lose their savings only if a bank has a loss higher than the capital it has. So, higher the CAR, greater is the protection for depositors' funds with the bank.

The CAR helps keep an economy's financial system stable by ensuring that the risk of banks going insolvent is low.

What is the current Capital Adequacy Ratio in India?

The Basel III Norms have prescribed a CAR of 8%. In India, the Reserve Bank of India (RBI) mandates the CAR for scheduled commercial banks to be 9% and for public sector banks, the CAR to be maintained is 12%.