



**LET'S TALK ABOUT...**

FINANCIAL LEXICON EDITED BY THE SWISS ASSOCIATION OF ASSET MANAGERS

## Tier 1 Capital

(Part one) We have just considered the contents of Basel 2 and Basel 3 agreements, aimed at strengthening the banks' capitalization requirements, better assessing the various types of risks, in order to avoid – or at least better face – future financial crisis, and stabilize their operations through the economic cycles and the markets' volatilities. We have also cited the term "Tier 1", literally the first row or section, in a theatre parquet for instance. But in this sphere it means the "core" of a bank's capital and is supposed to gauge the institution's financial strength, at least according to the Basel 2-3 indications. The Tier 1 Capital includes common stocks and disclosed reserves, that are retained earnings, as well as certain types of preferred stocks (equity instruments with fixed dividends, just like the coupons bonds) and other kinds of hybrid products. In such sense the concept of Tier 1 Capital is pretty different from the ordinary meaning of shareholders' equity, and also differs from the Tier 2 "the second section", the latter being related to deposits and other forms of financing, such as special preferred stocks with fixed expiration terms and bonds with maturities over five years. However the instruments which form the mentioned categories of capital may differ from one country to another according to different legal systems.

The essential factor in setting standardized rules on banking capitalization is to assure a certain level of protection, at least in theory, should extraordinary and unforeseen losses arise. Indeed, for expected losses or the ones already identified according to the implemented risk management models, ordinary provisions and reserves should prove sufficient. Basel 2-3 agreements not only define the components of the different categories of capital, but also set ratios between capitalization levels and assets at risks, those being weighted according to new criteria. *(to be continued)*

- GLT

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(Part two) The purpose of the new capitalization criteria in the banking sector, as well as their ratios in relation to risk weighted assets, is to increase the sector's safety level and avoid critical events as the ones we have seen during the past financial meltdown.

The capital core in order to reach such goal should be for a bank – according to regulators - the portion of equity shares (4.5% at least) plus reserves and some other special instruments, the whole being called Tier 1 and amounting to 6% of assets. Indeed such stricter rules have been criticized by some bankers, in that more capital and stringent ratios could negatively affect the credit operations and slow the economic growth. But the regulators' view is quite opposite, as more safety and guaranteed liquidity may be only good for the economic and financial environments, all the more in difficult times. However due to the weak and erratic economic cycle, the times for a full implementation of the new rules have been diluted, up to eight years at least, including the Tier 1 section.

Actually Tier 1 capital is the portion of it which is out of the availability and decision of third parties, so that it may not be redeemed by them in "critical" moments, and so making the bank's position more risky and financially weak. There are several Tier1 ratios which relate to other balance sheet entries and they may vary according to the different types of banks and their prevailing operations. We just remind that Basel 3 agreements also set buffers in order to favour operational continuity and better afford adverse cycles, as well as consider additional capitalization in case of significant transactions of sensitive instruments, such as repos and derivatives, particularly if they are traded over-the-counter. Moreover the Basel 3 new rules and capitalization requirements are taking to the creation of new financial products, now coming to the market and doomed to be under the spot of investors in the coming months and years. We will consider them next. *(the end)- GLT*

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