

Prompt (19 October 2023) what exactly is CET1 capital for a bank

GPT-4: CET1 capital, which stands for Common Equity Tier 1 capital, is a core measure of a bank's financial strength from a regulator's point of view. It is one of the main components of a bank's regulatory capital framework. Here's a detailed look:

1. **Composition:** CET1 capital comprises the highest quality capital resources, primarily because these are the most permanent and readily available to absorb losses. Common components include:
 - Ordinary shares issued by the bank
 - Retained earnings
 - Other comprehensive income and other disclosed reserves
 - Some regulatory adjustments are made to this raw total, like the deduction of goodwill, other intangibles, and certain deferred tax assets.
2. **Importance:** CET1 capital is the most important metric in the Basel III regulatory framework, which was developed by the Basel Committee on Banking Supervision (BCBS) in response to the 2007-2009 financial crisis. The crisis exposed vulnerabilities in the financial sector, emphasizing the need for banks to hold higher quality capital that could absorb losses more effectively.
3. **Risk Weighted Assets (RWA):** CET1 capital ratios are calculated as CET1 capital divided by Risk Weighted Assets. RWA are assets adjusted for their associated risks. For instance, a government bond might carry a lower risk weight than a personal loan because it's seen as less risky.
4. **Minimum Requirement:** Under Basel III, the minimum CET1 capital ratio requirement is set at 4.5% of RWA. However, many national regulators require banks to hold more than this minimum. Additionally, there are other layers of capital and additional buffer requirements on top of the CET1 requirement, like the Tier 2 capital and the capital conservation buffer.
5. **Countercyclical and Macroprudential Measures:** The CET1 capital requirement can be adjusted by regulators depending on economic conditions. For instance, during boom times, regulators might require banks to hold additional CET1 capital as a buffer for potential downturns.
6. **Implications of Falling Below Minimums:** If a bank's CET1 capital ratio falls below the minimum, it could face restrictions on paying dividends, buying back shares, or paying discretionary bonuses until its capital position is restored.

In essence, CET1 capital is a crucial measure of a bank's ability to withstand financial shocks and is central to ensuring the stability of the global banking system.