Weaknesses in Regulatory Capital Models and Their Implications

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2012 Enterprise Risk Management Symposium
April 18-20, 2012

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Abstract

Following the global financial crisis in 2008 and the collapse of large financial institutions, increased attention was paid to regulatory capital. Having an adequate level of capital based on regulatory requirements is one way to provide protection against bankruptcies. There are certain weaknesses in the regulatory capital model, such as its limitation in facilitating risk-based decisions. This article examines some weaknesses in the regulatory capital model and ways regulators and/or companies can handle the weaknesses. One way to address weaknesses in the regulatory capital model is for companies to adopt and use economic capital that can facilitate risk-based business decisions and encourage companies to implement risk management controls. Having effective risk management and risk-based capital determination are ways to prevent company failures and bankruptcies.

Keywords: regulatory capital, economic capital, Basel and risk management