CFA Credit Section — Field Notes

Bank supervision, regulatory capital, and expected-loss accounting in two pages. Companion download to Module 7 — Bank Supervision & CAMELS.

CAMELS in one table

Letter	Measures	Representative evidence	Direction
C — Capital	Loss-absorbing cushion	CET1 ratio, leverage ratio, capital quality, access to new capital	higher = better
A — Asset quality	Embedded loss in the book	NPL ratio, classified assets, concentrations, reserve adequacy	lower NPLs = better
M — Management	Governance & risk control	Controls, audit findings, strategy discipline; dominates composites in practice	judgmental
E — Earnings	Capacity to rebuild capital	ROA, margin, earnings quality and sustainability through a cycle	higher/stabler = better
L — Liquidity	Meeting obligations without fire sales	Liquid buffers, deposit stability, contingency funding	higher buffers = better
S — Sensitivity	Exposure to market moves	Interest-rate risk in the banking book (EVE/NII), FX, trading	lower sensitivity = better

Scale: 1 strong … 5 critically deficient. Composite 1–2 routine; 3 = watchlist; 4–5 = enforcement/resolution. Ratings are confidential — disclosure could trigger the run they warn about.

The capital stack (most to least loss-absorbing)

Layer	What it is	Absorbs losses…
CET1	Common shares + retained earnings – deductions (goodwill, most intangibles, certain DTAs)	continuously, while operating — the binding metric
AT1	Perpetual instruments (CoCos) converting/writing down at a trigger	discontinuously, at the trigger
Tier 2	Subordinated debt	only in failure (gone concern)

Requirements & buffers (CET1, % of RWA): 4.5% minimum + 2.5% capital conservation buffer (breach = restricted dividends/bonuses, not failure) + countercyclical buffer 0–2.5% (on in booms) + G-SIB surcharge 1–3.5%. Practical CET1 for a large bank: ~9–13%. Backstop: leverage ratio (Tier 1 / unweighted exposure) ≥ 3% because every risk-weighting scheme can be gamed.

RWA: exposures × risk weights. Standardized approach = weights from regulatory tables keyed to external ratings. IRB = bank's own PD (and LGD/EAD if advanced) into a regulator-fixed formula (the Vasicek single-factor model). Basel III endgame output floor: IRB results ≥ 72.5% of standardized at full phase-in.

Liquidity pair: LCR — high-quality liquid assets ≥ 100% of 30-day stressed net outflows (survive a month). NSFR — available stable funding ≥ required stable funding (fund long assets with stable money).

Stress testing

CCAR / DFAST (US Fed): supervisor publishes an adverse macro scenario; banks project losses, revenue and capital quarter by quarter through it. Binding via the **stress capital buffer**: worse projected depletion = more capital required today. **EBA/ECB**: European equivalent. Purpose: not the number (scenarios are always wrong) but the demonstrated capability to trace a macro story through the book — and credible public results (SCAP 2009) can end a panic.

IFRS 9 / CECL — expected-loss accounting

Stage	Trigger	Provision	Interest accrues on
1	Performing, no significant deterioration	12-month expected loss	gross carrying amount

Stage	Trigger	Provision	Interest accrues on
2	Significant increase in credit risk since origination	Lifetime expected loss (the cliff)	gross carrying amount
3	Credit-impaired	Lifetime expected loss	net (amortized cost – allowance)

CECL (US GAAP): lifetime expected loss for everything from day one — no staging. Both standards replaced the incurred-loss model that provisioned “too little, too late” in 2008. Estimates must be point-in-time, forward-looking, probability-weighted across scenarios.

Exam traps, quick hits

Trap	The correct statement
“12-month EL = losses on loans maturing within 12 months”	No — it is lifetime loss from default events *possible in the next 12 months*.
“Stage 2 loans are non-performing”	No — Stage 2 loans are still performing; the risk has merely increased significantly since origination.
“EL is what capital is for”	No — EL is priced into the loan (a cost); capital absorbs *unexpected* loss, the volatility around EL.
“Agency ratings failed because they lagged”	Partly by design: ratings are through-the-cycle (stable, filter the cycle); market measures (EDF, spreads) are point-in-time and move daily. Different questions.
“Total capital is what markets watch”	Markets and supervisors focus on CET1 — the only layer that absorbs losses seamlessly while the bank operates.
“The leverage ratio is risk-sensitive”	Deliberately not — it is the non-risk-weighted backstop against model gaming.

Full module with the CAMELS scorer widget: rodoslay.com/credit-models/07-bank-supervision-camels