CCAR 14A

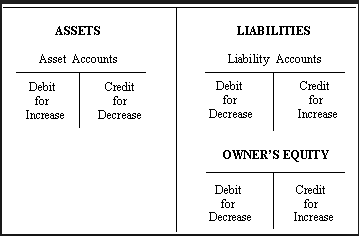
Car: capital adequacy ratio:

The capital adequacy ratio (CAR) is a measure of a bank's capital

Car = bank capital / RWAs

Bank Capital = (Tier 1 capital + tier 2 captial)

In the banking world, bank capital is



A **balance sheet** (aka **statement of condition**, **statement of financial position**) is a financial report that shows the value of a company's assets, liabilities, and owner's equity on a specific date, usually at the end of an accounting period, such as a quarter or a year. An **asset** is anything that can be sold for value. A **liability** is an obligation that must eventually be paid, and, hence, it is a claim on assets. The owner's equity in a bank is often referred to as **bank capital**, which is what is left when all assets have been sold and all liabilities have been paid. The relationship of the assets, liabilities, and owner's equity of a bank is shown by the following equation:

**Bank Assets = Bank Liabilities + Bank Capital**

A bank uses liabilities to buy assets, which earns its income. By using liabilities, such as deposits or borrowings, to finance assets, such as loans to individuals or businesses, or to buy interest earning securities, the owners of the bank can leverage their bank capital to earn much more than would otherwise be possible using only the bank's capital.

What is the 'Basel Accord'

The Basel Accords are three sets of banking regulations (Basel I, II and III) set by the [Basel Committee on Bank Supervision](http://www.investopedia.com/terms/b/baselcommittee.asp) (BCBS), which provides recommendations on banking regulations in regards to [capital risk](http://www.investopedia.com/terms/c/capitalrisk.asp), market risk and [operational risk](http://www.investopedia.com/terms/o/operational_risk.asp). The purpose of the accords is to ensure that financial institutions have enough capital [on account](http://www.investopedia.com/terms/o/on-account.asp) to meet obligations and absorb unexpected losses.

BREAKING DOWN 'Basel Accord'

The BCBS was founded in 1974 as a forum for regular cooperation between its member countries on banking supervisory matters. The BCBS describes its original aim as the enhancement of "financial stability by improving supervisory knowhow and the quality of banking supervision worldwide." Later on, it turned its attention to monitoring and ensuring the capital adequacy of banks and the banking system.

Basel I

The first Basel Accord, known as [Basel I](http://www.investopedia.com/terms/b/basel_i.asp), was issued in 1988 and focuses on the capital adequacy of financial institutions. The capital adequacy risk (the risk that a financial institution will be hurt by an unexpected loss), categorizes the assets of financial institutions into five risk categories (0%, 10%, 20%, 50% and 100%). Under Basel I, banks that operate internationally are required to have a risk weight of 8% or less.

Basel II

The second Basel Accord, called Revised Capital Framework but better known as [Basel II](http://www.investopedia.com/terms/b/baselii.asp), served as an update of the original accord. It focuses on three main areas: minimum [capital requirements](http://www.investopedia.com/terms/c/capitalrequirement.asp), supervisory review of an institution's capital adequacy and internal assessment process, and

effective use of disclosure as a lever to strengthen [market discipline](http://www.investopedia.com/terms/m/market-discipline.asp) and encourage sound banking practices including supervisory review. Together, these areas of focus are known as the three pillars.

Basel III

In the wake of the Lehman Brothers collapse of 2008 and the ensuing financial crisis, the BCBS decided to update and strengthen the Accords. It saw poor governance and risk management, inappropriate incentive structures and an overleveraged banking industry as reasons for the collapse. In July 2010, an agreement was reached regarding the overall design of the capital and liquidity reform package. This agreement is now known as Basel III.

Basel III is a continuation of the three pillars, along with additional requirements and safeguards, including requiring banks to have minimum amount of common equity and a minimum liquidity ratio. Basel III also includes additional requirements for what the Accord calls "systemically important banks," or those financial institutions that are colloquially called "too big to fail."

The implementation of Basel III has been gradual and began in January 2013. It is expected to be completed by Jan. 1, 2019.

**What is the difference between tier 1 capital and tier 2 capital?**

Under the [Basel Accord](http://www.investopedia.com/terms/b/basel_accord.asp), a bank's capital consists of tier 1 capital and tier 2 capital, and the two types of capital are different. Tier 1 capital is a bank's [core capital](http://www.investopedia.com/terms/c/core-capital.asp), whereas tier 2 capital is a bank's supplementary capital. A bank's total capital is calculated by adding its tier 1 and tier 2 capital together. Regulators use the capital ratio to determine and rank a bank's capital adequacy.

Tier 1 Capital

[Tier 1 capital](http://www.investopedia.com/terms/t/tier1capital.asp) consists of [shareholders' equity](http://www.investopedia.com/terms/s/shareholdersequity.asp) and [retained earnings](http://www.investopedia.com/terms/r/retainedearnings.asp). Tier 1 capital is intended to measure a bank's [financial health](http://www.investopedia.com/terms/f/financial-health.asp) and is used when a bank must absorb losses without ceasing business operations. Under [Basel III](http://www.investopedia.com/terms/b/basell-iii.asp), the minimum [tier 1 capital ratio](http://www.investopedia.com/terms/t/tier-1-capital-ratio.asp) is 6%, which is calculated by dividing the bank's tier 1 capital by its total risk-based assets.

For example, bank ABC has $600,000 in equity and retained earnings and has $10 million in [risk-weighted assets](http://www.investopedia.com/terms/r/riskweightedassets.asp). Its tier 1 capital ratio is 6% ($600000/$10 million), which meets the minimum Basel III requirement.

Tier I is capital comprising largely pure cash. For instance money raised from shareholders or money ploughed back from profits

Tier 2 Capital

[Tier 2 capital](http://www.investopedia.com/terms/t/tier2capital.asp) includes [revaluation reserves](http://www.investopedia.com/terms/r/revaluationreserves.asp), hybrid capital instruments and subordinated term debt, general loan-loss reserves, and [undisclosed reserves](http://www.investopedia.com/terms/u/undisclosedreserves.asp). Tier 2 capital is supplementary capital because it is less reliable than tier 1 capital. In 2015, under Basel III, the minimum total capital ratio is 8%, which indicates the minimum tier 2 capital ratio is 2%, as opposed to 6% for the tier 1 capital ratio.

For example, bank ABC has tier 2 capital of $100,000 and risk-weighted assets of $10 million. Therefore, the tier 2 capital ratio is 1% ($100000/$10 million). Thus, bank ABC's total capital ratio is 7% (6%+1%). Under Basel III, bank ABC would not meet the minimum total capital ratio of 8%.

Tier 2 Capital includes supplementary capital such as undisclosed reserves, revaluation reserves, general loan loss reserves, hybrid (debt/equity) capital and subordinated debt.

Tier II: This is funds that the regulator recognises as capital. It could be long-term subordinated debt where the return is fixed but investors has lower priority than depositors and bond holders. It could also include a part of appreciation in value of assets without actually encashing them.