Tier 1 Capital Ratio

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What is the 'Tier 1 Capital Ratio'

The tier 1 capital ratio is the comparison between a banking firm's core equity capital and its total risk-weighted assets. A firm's core equity capital is known as its tier 1 capital and is the measure of a bank's financial strength based on the sum of its equity capital and disclosed reserves, and sometimes non-redeemable, non-cumulative preferred stock. A firm's risk-weighted assets include all assets that the firm holds that are systematically weighted for credit risk.

BREAKING DOWN 'Tier 1 Capital Ratio'

Tier 1 capital for a banking firm includes the value of its common stock, retained earnings, accumulated other comprehensive income (AOCI), noncumulative perpetual preferred stock and any adjustments to those accounts. The amount of tier 1 capital a bank holds and its proportion to its risk-weighted assets are important. In times of financial distress or recession, tier 1 capital is the first to absorb losses before other investors, such as debt holders, experience losses. The tier 1 capital ratio signifies how well a bank can withstand financial distress before it becomes insolvent.

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Central banks typically develop the weighting scale for different asset classes, such as cash and government securities, which have zero risk, versus a mortgage loan, which carries more risk. A banking firm's cash on hand and government securities would receive a weighting of 0% when calculating its risk-weighted assets, for example, while its mortgage loans would be assigned a 50% weighting.

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The Importance of the Tier 1 Capital Ratio

Regulators use the tier 1 capital ratio to grade a firm's capital adequacy as well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized or critically undercapitalized. To be classified as well-capitalized, a firm must have a tier 1 capital ratio of 6% or greater under Basel III requirements and must not pay any dividends or distributions that would affect its capital. The original threshold for the tier 1 capital ratio under Basel I was 4%. Firms that are ranked as undercapitalized or below are prohibited from paying any dividends or management fees. In addition, they are required to file capital restoration plans.

Calculating a Tier 1 Capital Ratio

A bank has $10 billion in common stock and $2 billion in retained earnings. Adding these two values together, the bank has $12 billion in tier 1 capital. After weighing its assets according to risk, the bank has $120 billion in risk-weighted assets. Dividing the $12 billion in tier 1 capital by the $120 billion in risk-weighted assets gives the bank a tier 1 capital ratio of 10%.

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