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# What is the difference between a bank's liquidity and its capital?

Capital and liquidity are distinct but related concepts. Each plays an essential role in understanding a bank's viability and solvency.

Liquidity is a measure of the ability and ease with which assets can be converted to cash. Liquid assets are those that can be converted to cash quickly if needed to meet financial obligations; examples of liquid assets generally include cash, central bank reserves, and government debt. To remain viable, a financial institution must have enough liquid assets to meet its near-term obligations, such as withdrawals by depositors.

Capital acts as a financial cushion to absorb unexpected losses and is the *difference* between all of a firm's assets and its liabilities. To remain solvent, the value of a firm's assets must exceed its liabilities.

A typical family's household finances help to illustrate the differences between these two concepts. On the liquidity side, money in a family's checking account can be used to quickly and easily pay its bills, so a gauge of the family's *liquidity* position would include how much money is in the checking account as well as how much cash the family has on hand.

On the capital side, the family's assets include not just the money in the checking account, but also its home, savings accounts, and other investments. The family debt, or money it owes, such as a mortgage, are its liabilities. So the difference between the family's debt and its assets would provide a measure of the family's *capital* position.

Over time, banks have failed or required government assistance because they had inadequate capital, a lack of liquidity, or a combination of the two.

The Federal Reserve since the financial crisis has worked to increase the levels of both liquidity and capital at banking organizations.

- The Federal Reserve issued a proposal in October 2013 to implement the Basel III Liquidity Coverage Ratio, which was formulated with other U.S. and global regulators and would require large firms to hold levels of liquid assets sufficient to protect against constraints on their funding during times of financial turmoil.

- The Federal Reserve has implemented the Basel III capital standards, which also were formulated with other U.S. and global regulators. Also, through the Federal Reserve's annual stress tests and capital planning processes, large financial institutions are required to hold enough capital to absorb losses in a severely adverse economic environment and continue to lend to households and businesses. For the largest banks, the amount of high-quality capital they hold has more than doubled from the end of 2008 to the end of 2012, in part as a result of these efforts.

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