

# RESCINDED

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## Capital Adequacy

Capital absorbs losses, promotes public confidence, and provides protection to depositors and the FDIC insurance funds. It provides a financial cushion that can allow a savings association to continue operating during periods of losses or other adverse conditions. This Handbook Section provides guidance in determining a savings association's capital adequacy.

Federal banking law requires banking organizations to achieve and maintain adequate capital. The law authorizes federal banking agencies to set minimum capital levels to ensure that banking agencies maintain adequate capital. The law also gives federal banking agencies broad discretion with respect to capital regulation by authorizing them to also use many other methods that they deem appropriate to ensure capital adequacy. If federal savings associations fail to maintain adequate capital, federal law authorizes the OTS to take prompt corrective or other enforcement action (12 USC 1464(s)).

### LINKS

[Program](#)

[Appendix A](#)

[Appendix B](#)

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A savings association's capital is adequate when it meets its mandated regulatory requirements, **and** is commensurate with the savings association's risk profile and strategic business goals. The capital level should be sufficient to support current business activities, future growth, and periods of economic stress. While minimum regulatory capital requirements provide a consistent starting point for determining capital adequacy, most savings associations should, and in fact do, exceed well-capitalized standards. (See Prompt Corrective Action (PCA) Categories below.)

There is a direct relationship between the amount of capital an association needs and the risk profile of the association. Savings associations are expected to hold capital commensurate with the size, complexity, and risk of their business and business goals. Minimum regulatory capital requirements focus primarily on credit risk and assume that a savings association primarily engages in relatively lower risk activities. Higher risk activities require more capital, especially if the activities are conducted at significant concentration levels. Moreover, the minimum risk-based capital requirements do not take into account other risks or factors that can affect a savings association's financial condition. These factors include operational risks, interest rate exposure, liquidity, funding and market risks, the level and quality of earnings, loan and investment strategies, the adequacy of the allowance for loan and lease losses (ALLL), and quality of risk management – all of which can impact an institution's risk profile and capital adequacy. In sum, the final supervisory judgment on capital adequacy may differ significantly from an evaluation of compliance with the *minimum* risk-based capital requirements.

In assessing the capital adequacy of a savings association, you must ensure that the savings association is in compliance with the OTS minimum regulatory capital requirements as set forth in 12 CFR Parts 565 and 567 or other capital requirements imposed by the OTS consistent with its enforcement and other regulatory authority. You must then ensure that the savings association's capital levels are

consistent with the strategic business goals of the savings association. And finally, and most importantly, you must ensure that the savings association is holding capital adequate for its risk profile.

## SECTION OVERVIEW

This Handbook Section provides guidance in four main areas:

- Assessing Compliance with Minimum Regulatory Capital Requirements.
- Assessing Overall Capital Adequacy.
- Rating the Capital Factor.
- Addressing Capital Deficiencies.

Appendices to this Handbook Section provide additional guidance:

- Capital Components (Tier 1 and Tier 2 Capital) ([Appendix A](#)).
- Risk-Weighted Assets and Risk-based Capital (Basel I) ([Appendix B](#)).
- Prompt Corrective Action (PCA) Restrictions ([Appendix C](#)).
- Questions and Answers on Risk Weighting 1-to-4 Family Residential Mortgage Loans ([Appendix D](#)).

## ASSESSING COMPLIANCE WITH REGULATORY CAPITAL REQUIREMENTS

OTS capital rules are substantially similar to those of the other banking regulators. In addition, the federal banking agencies must work together to develop and refine uniform rules implementing common statutory or supervisory policies, including capital requirements. Many of the agencies' uniform capital rules are based on the framework set forth in the "International Convergence of Capital Measurement and Capital Standards" (Basel I).

### Background

In 1989, the banking agencies implemented a risk-based capital framework for the U.S. banking organizations based on the Basel I framework. The general risk-based capital rules remain in effect and are described in detail in [Appendix B](#). The risk-based capital requirement captures primarily credit risk from on-balance-sheet assets and most off-balance-sheet commitments and obligations.

In June 2004, the Basel Committee on Bank Supervision introduced a new capital adequacy framework, known as Basel II that is designed to promote improved risk measurement and management processes and better align minimum risk-based capital with risk. Basel II includes several options for calculating

risk-based capital requirements for credit risk and for operational risk. For credit risk, the Basel II includes three approaches for calculating regulatory capital: the Standardized, the Foundation, and the Advanced Internal Ratings Based (AIRB) approaches. For operational risk, Basel II includes three approaches: Basic Indicator, Standardized, and the Advanced Measurement (AMA) approaches. The federal banking agencies are not currently planning to adopt all of these Basel II approaches for the United States. Instead, the banking agencies have focused on the AIRB and AMA (together referred to as the Advanced Approaches) which have already been adopted, and the agencies are developing a U.S. version of the Standardized Approach.

In December 2007, the federal banking agencies published a final rule implementing the Advanced Internal Ratings Based approach for credit risk and the Advanced Measurement Approach for operational risk. The Basel II Advanced Approaches Rule is mandatory only for certain banking organizations and voluntary for others that may choose to use them. In general, the Basel II Advanced Approaches Rule is mandatory for banking organizations that have consolidated total assets of \$250 billion or more, consolidated on-balance sheet foreign exposure of \$10 billion or more, or are a subsidiary or parent of an Advance Approaches organization. Certain savings associations that are subsidiaries of larger banking organizations are subject to the Advanced Approaches on a mandatory basis. The Basel II Advanced Approaches can be found at 12 CFR Part 567, Appendix C. The Advanced Approaches are NOT covered in this handbook section.

## Regulatory Capital Requirements

All savings associations are subject to two overlapping sets of minimum regulatory capital requirements established by federal statutes. They are subject to the tangible, core/leverage, and risk-based capital requirements set forth in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), as well as the Prompt Corrective Action capital categories set forth in the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA).

### ***Tangible, Core, and Risk-based Capital Requirements (FIRREA)***

The FIRREA-based requirements for tangible, leverage, and risk-based capital are defined in 12 CFR Part 567. Savings associations must satisfy all three of the following minimum capital requirements:

<u>Capital Ratio</u>	<u>Minimum Capital Requirement</u>
Tangible Capital Ratio	Tangible capital of at least 1.5% of adjusted total assets*
Leverage Ratio	Tier 1 capital of at least 4% of adjusted total assets (3% for savings associations with a composite CAMELS rating of 1)
Risk-Based Capital Ratio	Total Risk-Based Capital of at least 8% of total risk-weighted assets

\* While all three capital requirements exist as a matter of law, the tangible capital requirement has effectively been eclipsed by the more stringent PCA requirements (see below). Therefore, Thrift Financial Report (TFR) instructions do not include a calculation for tangible capital. Tangible capital is defined in 12 CFR § 567.9.

A savings association's total risk-based capital is the sum of its Tier 1 (core) capital and Tier 2 (supplementary) capital, less certain deductions. Tier 2 capital may not exceed Tier 1 capital.

The composition and calculation of Tier 1 and Tier 2 capital is fully discussed in [Appendix A](#). The risk-based capital calculation and the calculation of total risk-weighted assets is fully discussed in [Appendix B](#).

Schedule CCR of the TFR also includes detailed computational instructions for calculating Tier 1, Tier 2, total risk-based capital, and total risk-weighted assets.

Adjusted total assets are defined in 12 CFR § 567.1. Adjusted total assets are calculated on Schedule CCR of the TFR, which adjusts Total Assets from Schedule SC of the TFR for investment in subsidiaries, gains and losses on available-for-sale (AFS) securities, certain hedges, and certain other adjustments. (See Schedule CCR and corresponding TFR instructions.)

### **Prompt Corrective Action (PCA) Categories (FDICIA)**

The FDICIA-based capital standards are set forth in 12 CFR Part 565.

The PCA minimum capital requirements are as follows:

	<b><u>Leverage Ratio</u></b> (tier 1 capital to adjusted total assets)		<b><u>Tier 1 Risk-Based Capital Ratio</u></b> (tier 1 capital to total risk-weighted assets)		<b><u>Total Risk-Based Capital Ratio</u></b> (total risk based capital to total risk-weighted assets)
Well Capitalized	5% or greater	and	6% or greater	and	10% or greater
Adequately Capitalized	4% or greater (3% for 1-rated)	and	4% or greater	and	8% or greater
Undercapitalized	Less than 4% (except for 1-rated)	or	Less than 4%	or	Less than 8%
Significantly Undercapitalized	Less than 3%	or	Less than 3%	or	Less than 6%
Critically Undercapitalized	Has a ratio of tangible equity capital* to total assets that is equal to or less than 2%				

\* The definition of tangible equity capital under PCA differs from the definition of tangible capital under FIRREA. You may find the definition of tangible equity capital in 12 CFR § 565.2(f). Essentially, tangible equity capital equals: **Core capital** (Tier 1) + cumulative perpetual preferred stock – intangible assets (defined in 12 CFR § 567.1, except for mortgage servicing assets that are otherwise includable under 12 CFR § 567.12) and nonmortgage servicing assets that have not been previously deducted in calculating core capital. For purposes of the tangible equity capital ratio, total assets is defined at 12 CFR 565.2 as adjusted total assets (defined in 12 CFR § 567.1) less intangible assets (defined in 12 CFR § 567.1).

Savings associations are expected to remain at least adequately capitalized at all times and should strive for well capitalized standards and above, since failing to do so may subject an institution to various operating restrictions, such as those on brokered deposits. During periods of economic stability, a savings association should hold capital in excess of minimum requirements, and maintain a capital buffer sufficient to continue to maintain a well-capitalized status during economic downturns or other periods when losses occur.

## Other Regulatory Capital Requirements

In addition to the minimum regulatory capital requirements, a savings association may be subject to other regulatory capital requirements. If OTS makes a supervisory determination that a savings association's capital is deficient in relation to its risk profile, a savings association may be subject to higher capital requirements imposed by OTS via **Reservation of Authority**, the imposition of an **IMCR**, or via **Formal Enforcement Action** to address capital deficiencies. (See discussions below on "Assessing Overall Capital Adequacy" and "Addressing Capital Deficiencies".) Also, see the TFR instructions for Schedule CCR that describe where a savings association should report other regulatory capital requirements related to a Reservation of Authority, an IMCR, or a Formal Enforcement Action.

## Capital For Subprime Lending Programs

In accordance with [CEO Memo 137](#), *Expanded Guidance for Subprime Lending Programs*, issued February 2, 2001, and the *Interagency Guidance on Non-traditional Mortgage Products*, Volume 70, No. 249 Federal Register 77249, issued December 25, 2005, examiners must evaluate the capital adequacy of subprime lenders on a case-by-case basis, and determine the appropriate level of capital needed to support subprime lending activities. Generally subprime portfolios should be supported by capital equal to **one and one-half to three times** greater than what is appropriate for prime assets of a similar type as a starting point. This is not meant to imply that additional capital is always required. Some subprime loans may be only marginally more risky than prime loans and, thus, may warrant increased supervisory scrutiny and monitoring, *but not necessarily additional capital*. Conversely, examiners may determine that savings associations that originate or purchase high-risk subprime loan pools, such as unsecured or poorly documented loans, or loans to very high-risk borrowers, may need significantly higher levels of capital depending on the level and volatility of risk. A savings association's ALLL should also be adequate to address its subprime program. More information about subprime lending and risk analysis for capital adequacy is available in guidance issued by the four federal banking agencies and available on the OTS website. It applies to subprime lending programs that exceed 25 percent of a savings association's Tier 1 capital.

Although the subprime guidance applies specifically to subprime programs as defined in that guidance, it should be noted that OTS may assign other portfolios or assets higher risk weights where appropriate. This would be done under the reservation of authority or by use of an IMCR.

## **Regulatory Capital Requirements for Investments in Subsidiaries<sup>1</sup>**

OTS capital regulations define a subsidiary as an entity in which the parent savings association has a majority ownership interest and, for purposes of GAAP, consolidates the entity's assets. Such an entity could be either a service corporation or an operating subsidiary. [Examination Handbook Section 730](#) and 12 CFR Part 559 discuss savings association investments in subsidiaries, including service corporations and operating subsidiaries, and the differences between these types of subsidiaries.

For purposes of OTS capital rules (Part 567) and Schedule CCR, a subsidiary is either includable or nonincludable. **A savings association must deconsolidate and deduct from Tier 1 capital any subsidiary that is a nonincludable subsidiary.**

An includable subsidiary means a subsidiary of a savings association that is:

- Engaged solely in activities permissible for a national bank;
- Engaged in activities not permissible for a national bank, but only if acting solely as agent for its customers;
- Engaged solely in mortgage banking activities;
- Itself an insured depository institutions or a holding company whose sole investment is an insured depository institution (acquired before May 1, 1989);
- A subsidiary of a federal savings association existing as such on August 9, 1989, and was either previously chartered by a state savings bank prior to October 15, 1982, or acquired its principal assets from a state savings banks prior to this date.

Note that a savings association's **operating subsidiary** is always considered an includable subsidiary for regulatory capital purposes, unless the operating subsidiary is itself a savings association that is engaged in activities impermissible for national banks. (See 57 Federal Register 48944 (October 29, 1992).)

Includable subsidiaries are consolidated with the parent savings association for capital purposes. Investment, including both debt and equity investment, in nonincludable subsidiaries is deducted from both assets and capital (12 CFR § 567.5(a)(1)(iv)).

## **Documentation Requirements**

Savings associations must have adequate systems in place to compute their capital requirements and capital levels. Supporting documentation should establish how a savings association tracks and reports

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<sup>1</sup> Refer to the definitions of includable subsidiary and equity investment in 12 CFR § 567.1, the requirement for deduction of nonincludable subsidiaries in § 567.5(a), the preapproved activities for service corporations in 12 CFR § 559.4, and the list of activities permissible for a national bank available on the website of the Office of Comptroller of the Currency at: [www.occ.treas.gov](http://www.occ.treas.gov).

its capital components, how it risk weights its assets, and how it calculates each of its capital levels. Where a savings association has inadequate documentation to support its assignment of a risk weight to a given item, examiners may assign an appropriate risk weight to that item. You should verify that savings associations are correctly reporting the information requested in Schedule CCR of the TFR that is used in computing the capital requirements. In addition, you should determine whether a savings association is in compliance with:

- Minimum regulatory capital requirements.
- Other capital requirements established by a PCA capital restoration plan, conditions to approval of an application(s), an IMCR, enforcement action, other applicable agreement or plan, or through use of the OTS reservation of authority.
- Capital levels established by a business plan or the Board of Directors.

## Prompt Corrective Action

A savings association that becomes *undercapitalized, significantly undercapitalized, or critically undercapitalized*, as defined for purposes of PCA, must file a capital restoration plan and, among other things, is subject to certain mandatory and discretionary supervisory actions pursuant to 12 CFR 565—Prompt Corrective Action. (See Appendix C and 12 CFR Part 565.) See also [Examination Handbook Section 080](#) on Enforcement Actions.

## ASSESSING OVERALL CAPITAL ADEQUACY

Capital helps protect savings associations from insolvency, thereby promoting safety and soundness in the overall U.S. banking system, and serves as a buffer in an economic downturn. Minimum risk-based capital requirements establish a threshold below which a sound savings association's risk-based capital must not fall. Risk-based capital ratios permit some comparative analysis of capital adequacy across banks and savings associations because they are based on certain common assumptions. However, examiners must perform a more comprehensive review of capital adequacy that considers the risks that are specific to each individual institution, including those not incorporated in the risk based capital requirements. In short, supervisors must ensure that a savings association's overall capital does not fall below the level required to support its entire risk profile. OTS generally expects savings associations to hold capital above their minimum risk-based capital levels, commensurate with their risk profiles, to account for all material risks. In determining the extent to which savings associations should hold capital in excess of risk-based capital minimums, whether under a formal action or an informal agreement, you should consider: compliance with the minimum regulatory capital requirements; the quality and results of a savings association's own process for determining whether its capital is adequate; and its risk management processes, control structure, and other relevant information relating to the savings association's risk profile and capital level. (See discussion below on "Factors Impacting Capital Adequacy".)

## **Internal Capital Adequacy Assessment**

Savings associations should be able to identify and manage material risks to which the association is exposed. Savings associations should also be able to conduct an internal assessment of capital adequacy considering the material risks to which the association is exposed, the capital needs relative to those risks, and the strategic business and capital goals of the association. The sophistication of this analysis will depend on the size and complexity of the association's activities. OTS generally expects institutions with large, sophisticated, and complex business operations to employ a rigorous process for identifying and measuring material risks and for determining appropriate capital relative to those risks. Those internal capital adequacy assessment processes should be capable of: identifying and measuring material risks; setting and assessing internal capital adequacy goals that relate directly to risk; and ensuring the integrity of internal capital adequacy assessments. All institutions should set internal capital targets and should be able to demonstrate that those capital targets are well-founded and consistent with the savings association's overall risk profile and current operating environment. In assessing capital adequacy, management should be mindful of the particular stage of the business cycle in which they are operating, and should consider (preferably through some form of forward-looking stress testing) possible events or changes in market conditions that could adversely impact the savings association.

## **Factors Impacting Capital Adequacy**

In evaluating an association's capital adequacy, you should consider a number of factors that can impact the risk profile and thus the capital adequacy of a savings association. You should refer to the relevant Examination Handbook sections for further discussion on these specific topics and should rely on examination findings and other pertinent information in assessing the risk and capital impact of the following factors:

### ***Quality of Risk Management and Internal Control Processes***

While capital is not a substitute for inadequate control or inadequate risk management processes, there is a relationship between the amount of capital held by a savings association and the strength and effectiveness of the savings association's risk management and internal control processes. In addition, to proactively addressing these weaknesses, you should consider whether savings associations with less than satisfactory control or risk management processes need more capital or whether there are other sufficient options to address these risks.

### ***Asset Quality***

Asset quality is a key factor in evaluating capital adequacy. When assessing capital adequacy, you should evaluate the nature of and the risks associated with each lending and investment program. For example, is the lending program nontraditional (e.g., high-LTV option ARMS) with higher risk loans? Are the underwriting standards appropriate for the type of lending? Is the association heavily concentrated in a certain product or market? You should consider the extent to which individual assets or portfolios of assets exhibit serious weaknesses or loss of value. Key indicators of overall asset quality are the dollar value of assets subject to adverse classification and the severity of those classifications relative to capital. You should consider delinquency and foreclosure trends, the level of nonaccrual or

nonperforming loans, and market depreciation of securities. Savings associations with higher risk lending should maintain sufficient ALLL to offset expected losses and a higher capital base to absorb unanticipated losses. (Refer to [Asset Quality, Section 200](#), of the Examination Handbook and related guidance.)

### ***Off-Balance Sheet Activities and Exposures***

A savings association may engage in off-balance sheet activities such as outstanding commitments, guarantees, derivatives, or recourse obligations that are not reflected on the savings association's balance sheet. In such cases, you must determine whether the savings association is exposed to economic risks or potential legal liabilities that are not fully captured by generally accepted accounting principles (GAAP) or regulatory capital rules. Note that while risk-based assets include many off-balance sheet risk exposures, the Tier 1 leverage capital requirement does not address off-balance sheet risk.

### ***Earnings and Dividends***

Consider earnings performance and dividend practices. You should consider the quality, stability, and trend of earnings. Good earnings performance enables a savings association to fund its growth, build and maintain a strong capital position, absorb unexpected losses, and remain competitive in the marketplace. Dividend practices and policies can impact capital. For example, excessive dividends can negate even exceptional earnings performance and result in a weakened capital position. In addition, hybrid capital instruments at the holding company level, including trust preferred securities and cumulative and noncumulative preferred shares, may place pressure on the savings association to pay dividends to its holding company so that the holding company has funds to service debt on these instruments. Such practices at the holding company can indirectly and negatively impact the savings association's capital. Generally, management should first apply earnings to the elimination of losses and the establishment of necessary reserves and prudent capital levels; and then, after full consideration of those needs, management may disburse dividends in a reasonable amount.

### ***Interest Rate Risk***

Savings associations with excessive interest rate risk exposure may experience a significant decline in earnings and capital levels as a result of unfavorable changes in interest rates. Therefore, savings associations with relatively high interest rate risk may require higher capital levels to offset that risk to the extent that that risk is not adequately managed.

### ***Liquidity and Funds Management***

Savings associations that are experiencing financial problems and are in a constricted liquidity situation may have no alternative but to dispose of assets at a loss in order to honor funds outflows; and such losses must be absorbed by the capital accounts. Generally, the lower a savings association's level of liquidity or the more limited and volatile its funding sources, or the absence of contingency funding sources, the more seriously you should consider higher capital requirements. Be aware that liquidity

needs may be greater for some business plans, such as mortgage banking operations and trading activities.

### ***Deposit Structure***

You may analyze capital in light of the historical and projected rate of growth of the savings association's deposit accounts. If a savings association is located in a strongly developing market where earnings retention is unable to keep pace with deposit growth, management should take all reasonable steps to augment the capital accounts, or find other means to maintain capital ratios. In addition to growth trends, the presence of volatile deposit accounts or concentrations in the deposit structure is also relevant. The greater the instability of the deposit base, the greater the need for a strong level of capital.

### ***Contingent Liabilities***

Lawsuits involving the savings association as defendant or other contingent liabilities may indicate a need for a greater level of capital protection. You should determine whether the savings association has significant contingent liabilities that have the potential to materially impact the capital level.

### ***Peer Comparison***

You should also assess capital adequacy by comparing a savings association with similar (peer) institutions, although you should not rely on this information exclusively.

### ***New Products and Activities***

The financial marketplace is dynamic and innovative. Many savings associations create new products and engage in new activities to meet customers' needs. You should determine whether a savings association has properly analyzed the risks related to new products and activities, and whether capital levels are appropriate to match these risks.

### ***Local Characteristics***

The stability and diversification of local population, business, industry, or agriculture are important considerations. In evaluating capital adequacy, you should consider potential changes in the savings association's operating environment as well as the pressures of competition.

### ***Risk Diversification***

Generally, a greater degree of asset and liability concentrations increases the need for capital at most savings associations. You should review on- and off-balance-sheet assets for concentrations in industries, product lines, customer types, geographic areas, funding sources, and nontraditional activities.

## ***Relationships with Affiliates***

A holding company's policies and practices can significantly affect the capital levels of its savings association subsidiary. It is critical that a savings association's dividend policies, tax-sharing agreements, consulting arrangements, and other transactions with its holding company do not lead to an unsafe or unsound condition for the savings association.

Double-leveraging occurs when a savings association's parent organization borrows funds to purchase newly issued stock of the subsidiary savings association. If the principal means of servicing the parent company's debt consists of the cash dividends from the savings association, you should consider the potential effect of this obligation on future earnings and capital. In particular, you should ascertain whether the savings association has the ability to maintain an adequate level of capital given the cash dividend demands of the parent holding company.

When you evaluate capital adequacy, you should generally discount the savings association's capital level by the amount of any loans or other credits or investments outstanding to the savings association's holding company or to affiliates that are not subordinate organizations of the savings association.

## ***Subordinate Organizations***

Subordinate organizations can significantly affect the operations and overall financial condition of their parent savings association. Therefore, it is important to determine if subordinate organizations pose risk to the capital adequacy of the parent. Where a regulator other than OTS regulates the subordinate organization, it is important to consider whether capital from the subordinate organization would actually be available to the parent savings association in a time of stress. Furthermore, it is important to consider whether the parent savings association has obligated itself, either formally or informally, to fund obligations of its subsidiary.

You should pay particular attention to functionally regulated subsidiaries<sup>2</sup> as well as most subsidiary depository institutions that have a primary regulator other than OTS. In analyzing the capital adequacy of a savings association that owns these subordinate organizations, you should consider the capital needed to meet the requirements of the primary regulator and whether that capital is actually available to the savings association. Or, whether the excess capital in the subsidiary (that is, capital in excess of that required by the subsidiary's primary regulator) is available to the entities above it in the organizational hierarchy. In these situations, you should review the examination reports of the subsidiary's primary regulator (and engage in discussions with the subsidiary's primary regulator) in order to determine whether the subsidiary's excess capital is transferable and available to support the parent. Depending upon the outcome of this analysis, you should decide whether to permit inclusion of the subsidiary's excess capital in your consideration of the capital adequacy of a savings association.

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<sup>2</sup> Functionally regulated subsidiaries include: registered broker-dealers, registered investment advisors, registered investment companies, insurance companies, or entities subject to regulation by the Commodity Futures Trading Commission.

## ***Quality of Management***

The ability, experience, depth, integrity, and record of management are important in your assessment of a savings association's capital adequacy. In fact, it is difficult to conceive of a capital structure capable of withstanding the deterioration that eventually results from inept or dishonest management. Sound management practices include the formulation and implementation of robust, rigorous, and adequate policies and procedures relative to loans, investments, interest rate risk, operations, internal controls, audits, and other functional areas. Deficiencies in these policies or their implementation can have an adverse impact on the savings association's capital position. See [Examination Handbook Section 340](#) on Internal Controls and [Section 355](#) on Internal Audit for more general information.

## ***Future Plans***

Consider reasonable expectations of what may occur in the foreseeable future. It is not sufficient to simply consider that capital is adequate as of the examination date. Conditions on which you base that judgment can change materially. You should consider the savings association's business plan or capital plan and its underlying assumptions. Such a review is largely a reasonableness check of the forecasted numbers and their underlying assumptions. Specifically you should consider the following:

- Whether the plans are consistent with the trend of historical performance.
- The volume of nonaccrual and renegotiated debt and other nonearning or marginally earning assets.
- Loan demand.
- Deposit growth.
- Competition.
- General composition and strength of the local economy.
- Expansion plans.
- Other pertinent factors.

Management's plans and projections should be realistic in terms of the economic outlook, previous performance, and industry averages. Management should apply stress testing to their projections using a methodology commensurate with the complexity of their organizations activities. An analysis of the ratio of equity growth to asset growth can be helpful in your analysis of capital trends. When this ratio is less than one, it signifies that assets are expanding faster than capital growth, hence a declining equity position and increasing financial leverage.

## Composition and Quality of Capital

In your assessment of capital adequacy, it is also important to consider both the composition and quality of a savings association's capital. For regulatory capital purposes, a savings association's total capital consists of two components: Tier 1 (or core) capital and Tier 2 (or supplementary) capital. Tier 2 capital is limited to 100 percent of Tier 1 capital. Tier 1 capital components generally consist of common stockholder's equity, including capital stock, surplus, and retained earnings; qualifying non-cumulative perpetual preferred stock; and allowable noncontrolling (or minority) interests in the equity accounts of consolidated subsidiaries. Tier 2 capital components include perpetual preferred stock that does not qualify for Tier 1 capital; certain other hybrid instruments; mandatory convertible securities; long-term preferred stock; and limited amounts of subordinated debt and intermediate preferred stock. [Appendix A](#) discusses in detail each of the components that comprise Tier 1 and Tier 2 capital.

OTS expects that the predominant form of Tier 1 capital be voting common stockholder's equity (common stock plus retained earnings). Common stockholder's equity best serves the purpose and function of capital: the capacity to absorb losses, the availability to absorb losses (permanence), the ability to conserve a savings association's resources in times of stress, and the ability to influence a savings association's risk taking. A savings association should not rely excessively on nonvoting elements in capital that do not provide similar capital support.

For example, noncontrolling interests in consolidated subsidiaries may be includable in Tier 1 capital; however, they are only includable to the extent that: (1) the subsidiary capital instrument issued to the investors has the terms and features that would allow the instrument to qualify as a tier 1 capital instrument if issued directly by the parent savings association, and (2) the noncontrolling interest absorbs losses in the subsidiary commensurate with the subsidiary's capital needs, and does not represent an essentially risk-free or low-risk investment for the holders of the subsidiary capital instrument. (See discussion in [Appendix A](#).)

Banking organizations in the United States rely to some extent on hybrid capital instruments and other innovative instruments for capital funding. Sources of hybrid capital funding are evolving. The quality of capital provided by hybrids varies widely depending on the type of hybrid instrument. Hybrid capital instruments have both debt and equity features. These sources of funding, especially if double leveraged,<sup>3</sup> can increase a savings association's risk profile by generating substantial pressure to maintain earnings to support dividend payments. An institution's over-reliance on double leverage will trigger increased supervisory scrutiny.

Hybrid instruments offer the advantages of a lower cost of capital, tax deductibility, regulatory and rating agency equity credit recognition, and diversification in funding source. However, the overuse of hybrid instruments could lead to increased levels of risk that warrant management's close attention. Risks may include increased leverage, a thinner capital base for the consolidated organization (including both the savings association and its holding company), increased interest rate risk, and increased

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<sup>3</sup> For a source of capital, savings associations sometimes rely on debt the holding company issues. Double leverage exists when a holding company invests funds it obtains from debt proceeds into the savings association as equity. Increasing the capital base allows the savings association to increase its borrowings as well, thereby compounding the original holding company debt resulting in higher consolidated leverage.

funding and liquidity risks. During the savings association and holding company examinations, as well as through ongoing supervisory monitoring, OTS will review capital levels and the ability to service debt both individually and on a consolidated basis. While hybrid capital instruments can help banking organizations manage their capital structure, OTS expects parent-infused Tier 1 capital to derive predominantly from voting common stock and retained earnings. In addition, OTS considers the following features as guiding principles when evaluating whether to allow inclusion of certain hybrid instruments in capital: loss absorption ability, permanence of the instrument, ability to suspend dividend payments, and certainty in cost of funding.

Other major items which reduce the quality of capital include the add back to regulatory capital for unrealized losses on AFS debt securities, as well as concentrations in assets that are intangible or otherwise have values that can be volatile. Examples include deferred taxes and excessive concentrations in servicing assets.

## ADDRESSING CAPITAL DEFICIENCIES

If, notwithstanding minimal capital adequacy, a supervisory determination is made that a savings association's capital is deficient as described above, and the savings association has not yet taken sufficient steps to address the deficiency, you should reflect this concern in your overall rating of the capital component during an examination and request corrective action. In addition, to address capital deficiencies, OTS may:

- Use its **reservation of authority** to determine, on a case-by-case analysis based on the substance of a transaction, an appropriate risk weight for any asset or credit-equivalent amount, or off-balance sheet credit conversion factor if OTS finds that the risk weights assigned under 12 CFR 567.6 do not appropriately reflect the risks imposed on the savings association;
- Impose a higher IMCR in cases where the problem or risk is more systemic;
- Initiate **formal enforcement action** based on the severity of the problems and the inability or unwillingness of management to initiate corrective action.

For additional discussion on OTS authority to impose higher capital requirements, see [Examination Handbook Section 080](#) on Enforcement Actions.

## RATING THE CAPITAL COMPONENT

Based on your assessment of the savings association's risk profile, your supervisory judgment of a savings association's capital adequacy may differ significantly from conclusions that might be drawn solely from the determination of compliance with the minimum regulatory capital requirements. This conclusion might be based on an assessment of the risk associated with certain assets or asset class, or may be based on an overall assessment of an institution's risk profile, financial condition, and loss exposure. This determination is a judgmental process that requires you to consider all of the objective and subjective variables, concepts, and guidelines discussed above. You should evaluate capital relative to a savings association's risk profile, rather than simply to a minimum regulatory requirement. These

are the standards set by the Uniform Financial Institutions Rating System. We include examples to provide you with a better understanding of a particular rating.

- A rating of “1” indicates a strong capital level relative to the savings association’s risk profile. For example, a “1” rating typically indicates a high degree of confidence that unexpected losses pertaining to credit risk, interest rate risk, and operational risk, among other risks are not expected to adversely affect the institution’s ability to meet regulatory well capitalized standards as well as maintain a strong buffer of additional capital to carry the institution through economic downturns or periods of losses.
- A rating of “2” indicates a satisfactory capital level relative to the savings association’s risk profile. For example, a 2-rated institution is typically well capitalized; has sufficient capital relative to its risk profile; and a sufficient buffer to maintain capital through most economic downturns.
- A rating of “3” indicates a less than-satisfactory level of capital that does not fully support the savings association’s risk profile. For example, there is generally some uncertainty as to the institution’s ability to withstand a degree of unexpected losses and maintain solvency and regulatory capital compliance. Thus, the rating typically indicates a need for improvement, even if the savings association’s capital level exceeds minimum regulatory and statutory requirements.
- A rating of “4” indicates a deficient level of capital. In light of the savings association’s risk profile, viability of the savings association may be threatened. The savings association may need assistance from shareholders or other external sources of financial support.
- A rating of “5” indicates a critically deficient level of capital that threatens the savings association’s viability. The savings association needs immediate assistance from shareholders or other external sources of financial support.

## REFERENCES

### United States Code (12 USC)

§ 1464(s)	Minimum Capital Requirements
§ 1464(t)	Capital Standards
§ 1831o	Prompt Corrective Action

### Code of Federal Regulations (12 CFR)

§ 560.101	Real Estate Lending Standards
§ 563.74	Mutual Capital Certificates

§ 563.81	Issuance of Subordinated Debt Securities and Mandatorily Redeemable Preferred Stock
Part 565	Prompt Corrective Action
Part 567	Capital

## **OTS Issuances**

### ***Regulatory and Savings association Bulletins***

RB 3b	Policy Statement on Growth of Savings Associations
RB 18	Enforcement Series
RB 33a	FDIC “Pass-Through” Deposit Insurance Coverage Disclosure Rule
TB 23a	Sales of Securities
TB 56	Regulatory Reporting of Net Deferred Tax Assets
TB 72a	Interagency Guidance on High Loan-to-Value Residential Real Estate Lending
TB 73a	Investing in Complex Securities

### ***CEO Memos***

No. 137	Expanded Guidance for Subprime Lending Programs
No. 141	Joint Agency Advisory on Brokered and Rate-Sensitive Deposits
No. 160	Regulatory Capital Treatment for Accrued Interest Receivable in Credit Card Securitizations
No. 161	Unsafe and Unsound Use of Covenants Tied to Supervisory Actions in Securitization Documents
No. 162	Implicit Recourse in Asset Securitizations
No. 163	Questions and Answers on the Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations
No. 169	Accounting Treatment of Accrued Interest Receivable Related to Credit Card Securitizations
No. 192	ALLL Update on Accounting for Loan and Lease Losses

No. 217	Asset-Backed Commercial Paper (ABCP) Program Guidance
No. 220	Interagency Advisory on Accounting and Reporting for Commitments to Originate and Sell Mortgage Loans
No. 223	Guidance to Clarify the Asset-Backed Commercial Paper Final Rule.
No. 257	Statement on Subprime Mortgage Lending
No. 304	ALLL-Observed Thrift Practices Including Sound Practices
No. 307	Risk-weighting Down Graded Securities
No. 310	Guidance on California Registered Warrants
No. 311	Risk Management and Liability Concentrations
No. 315	Regulatory and Accounting Issues Related to Modifications and TDR of 1-4 Residential Mortgage Loans
No. 320	Accounting Considerations Related to OTT Impairment of Securities
No. 329	Accounting for Credit Losses and Impairments
No. 337	Risk Weighting of Claims on and Guarantees of the FDIC
No. 344	Risk Weighting of Early Default Provisions
No. 350	Interagency Supervisory Guidance on Bargain Purchases and FDIC- and NCUA-Assisted Acquisitions

**Additional Interagency Guidance**

Interim Regulatory Reporting and Capital Guidance on FAS 133, "Accounting for Derivative Instruments and Hedging Activities." (December 29, 1998).

Interim and Regulatory Capital Reporting Guidance on FAS 158, "Employers' Accounting For Defined Benefit Pension and Other Postretirement Plans."(Interagency Joint Release, December 15, 2006).

Interagency Guidance on Non-traditional Mortgage Products, Volume 70, No. 249 Federal Register 77249 (December 25, 2005).

Final Rule on "Risk-based Capital and Capital Adequacy Guidelines, Capital Maintenance, Capital-Residential Mortgage Loans Modified pursuant to the Making Home Affordable Program, Volume 74, No. 223 Federal Register 60137 (November 20, 2009).

Final Rule on “Risk-based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Regulatory Capital; Impact of Modifications to Generally Accepted Accounting Principles; Consolidation of Asset-backed Commercial Paper Programs; and other related issues (Volume 75, No. 18 Federal Register 4636 (January 28, 2010)).

## **Statements of Financial Accounting Standards (SFAS)**

SFAS No. 65, “Accounting for Certain Mortgage Banking Activities,” as amended by SFAS No. 140, “Accounting for the Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,” and SFAS No. 156, “Accounting for Servicing of Financial Assets” as codified in ASC Topic 948, “Financial Services—Mortgage Banking” and ASC Topic 860, “Transfers and Servicing.”

SFAS No. 109, “Accounting for Income Taxes (SFAS 109)” as codified in ASC Topic 740, “Accounting for Income Taxes.”

SFAS No. 114, “Accounting by Creditors for Impairment of a Loan (SFAS 114)” as codified in ASC Topic 310, “Receivables.”

SFAS No. 115, “Accounting for Certain Investments in Debt and Equity Securities (SFAS 115)” as codified in ASC Topic 320, “Investments-Debt and Equity Securities.”

FASB Staff Position (FSP) FAS No. 115-2 and No. 124-2, “Recognition and Presentation of Other-than Temporary Impairments” as codified in ASC Topic 320, “Investments—Debt and Equity Securities.”

SFAS No. 133, “Accounting for Derivative Instruments and Hedging Activities (SFAS 133),” codified in ASC Topic 815, “Derivatives and Hedging.”

SFAS No. 158, “Employer’s Accounting For Defined Benefit Pension and Other Postretirement Plans (SFAS 158)” as codified in ASC Topic 715, “Compensation-Retirement Benefits.”

SFAS No. 160, “Non-controlling Interests in Consolidated Financial Statements (SFAS 160)” as codified in ASC Topic 810, “Consolidation.”

SFAS No. 166, “Accounting for Transfers of Financial Assets – An Amendment of FASB Statement No. 140 (SFAS 166)” as codified in ASC Topic 860, “Transfers and Servicing.”

SFAS No. 167, “Amendments to FASB Interpretation No. 46(R)” as codified in ASC Topic 810, “Consolidation.”