## INTRODUCTION

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 thrift to continue operating during periods of losses or other adverse conditions. This Handbook Section provides guidance in determining a thrift's capital adequacy.

### Capital Adequacy

A thrift's level of capital is adequate when it meets regulatory requirements, *and* is commensurate with the thrift's risk profile. The capital level should also be sufficient to support future growth. While minimum regulatory capital requirements provide a consistent starting point for determining capital adequacy, most thrifts should, and in fact do, exceed well capitalized standards (see Prompt Corrective Action (PCA) Categories below).

The various OTS capital requirements assume that a thrift primarily engages in traditional, relatively low risk activities. Higher risk permitted activities require more capital, especially if the activities are conducted at significant concentration levels. Lenders engaged in higher risk activities should also have higher Allowances for Loan and Lease Losses (ALLL) and risk management expertise appropriate to the risk.

OTS maintains, revises, and interprets its capital regulations in collaboration with the other federal banking agencies. OTS capital rules are substantively similar to those of the other banking regulators as a result of various statutory requirements. Federal statute requires that OTS capital regulations may be no less stringent than the capital regulations of the Office of the Comptroller of the Currency (OCC). In addition, the federal banking agencies must work together on an interagency basis to develop uniform rules implementing common statutory or supervisory policies, including capital requirements. Many of the agencies' uniform capital rules are based on the principles set out in an international agreement known as the Basel Accord.

You should review recent proposed and final regulations for the most current regulatory guidelines. You may also check with your OTS regional accountant or access guidance on the OTS Internet (www.ots.treas.gov). In addition, Schedule CCR (Consolidated Capital Requirement) of the Thrift Financial Report (TFR) Instruction Manual contains specific accounting and reporting instructions related to capital. OTS also posts on its website a series of Questions and Answers that help further clarify the reporting instructions. You should note however that the TFR instructions, as well as the Questions and Answers are to help inform and provide for a meaningful reporting function. They are generalized and abbreviated for readability. Ultimately the regulations (and statutes) have the controlling force of law.

## SECTION OVERVIEW

This Handbook Section provides guidance in three main areas:

- Capital Requirements.
- Evaluating Capital Adequacy.
- Rating the Capital Factor.

Appendices to this Handbook Section provide additional guidance:

- Capital Components & Risk-Based Capital (Appendix A).
- Supplementary Information and Issues (Appendix B).
- Prompt Corrective Action (PCA) Restrictions (Appendix C).

## CAPITAL REQUIREMENTS

Thrifts must meet two overlapping sets of capital rules required by different federal statutes. Thrifts must meet tangible, core, and risk-based standards required by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA).

In addition, the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) established Prompt Corrective Action capital categories.

**Tangible, Core, and Risk-based Capital**

The FIRREA-based requirements for tangible, core, and risk-based capital are defined in 12 CFR §567. OTS requires thrifts to satisfy three capital levels as follows:

| Type of Capital | Percentage of Assets |
|---|---|
| Tangible Capital | 1.5% of adjusted total assets |
| Leverage Ratio | 4% of adjusted total assets (3% for thrifts with a composite CAMELS rating of 1) |
| Risk-Based Capital | 8% of risk-weighted assets |

Notes: We also refer to the leverage ratio requirement as the Tier 1 or core requirement. Adjusted total assets are defined in 12 CFR § 567.1. It is based on TFR assets adjusted for investment in subsidiaries, gains and losses on available-for-sale securities, certain hedges, and other adjustments.

*Composition of Capital*

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

Appendix A summarizes the composition of Tier 1 and Tier 2 capital, and provides an explanation of the risk-based capital calculation.

*Tangible Capital*

Schedule CCR of the TFR includes detailed computational instructions for calculating core and risk-based capital. The TFR instructions do not include a calculation for tangible capital. 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). Tangible capital is defined in 12 CFR § 567.9.

**Prompt Corrective Action (PCA) Categories**

You may find these FDICIA-based capital measurements in 12 CFR §565.

Thrifts fall into one of five PCA categories. The PCA minimum requirements are as follows:

| | Tier 1/Leverage | | Tier 1/Risk-Based | | Total Risk-Based |
|---|---|---|---|---|---|
| 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* to total assets that is equal to or less than 2% | | | | |

* The definition of tangible equity under PCA differs from the definition of tangible capital under FIRREA. You may find the definition of tangible equity in 12 CFR § 565.2(f).

**Minimum Standards vs. Capital Adequacy**

The regulatory capital requirements are minimum standards designed for soundly managed thrifts that do not present credit or other risks requiring more capital. *Compliance with the minimum capital requirements does not automatically ensure an adequate level of capital. Thrifts with higher risk should hold capital well in excess of the minimum requirements, and in fact, well in excess of the FDICIA well capitalized standards.* In addition, OTS has the authority to establish a capital requirement for a thrift that is higher than its normal minimum regulatory capital requirement.

*Capital For Subprime Lending Programs*

Thrifts with subprime lending programs are responsible for quantifying the amount of capital they need to offset the additional risk for these programs. As a starting point you should reasonably expect a thrift to hold capital against subprime portfolios in an amount that is one and one half to three times greater than for nonsubprime assets of a similar type. A thrift'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 thrift's Tier 1 capital. (Refer to CEO Memo No. 137, Expanded Guidance for Subprime Lending Programs, issued February 2, 2001.)

*Individual Minimum Capital Requirement (IMCR)*

OTS may impose an IMCR in accordance with 12 CFR § 567.3. The regulation includes an extensive (but not all-inclusive) list of the reasons that may support imposition of an IMCR. There are no formal policies or procedures governing the IMCR process, but OTS would generally take the following steps:

- Determine that a thrift should have capital above the minimum regulatory standard.
- Notify the thrift of the determination and provide a general explanation.
- Provide an opportunity for the thrift to respond (generally within 30 days, but OTS may shorten this timeframe if circumstances warrant).
- Consider the thrift's response.
- Determine the appropriate minimum capital level for the thrift.

Whenever you find capital to be insufficient relative to a thrift's risk profile, you should discuss with your regional management the appropriateness of an IMCR.

*Reservation of Authority*

OTS may use its reservation of authority to target a higher capital level for specific assets or conditions, or to eliminate or limit the inclusion of a capital component, or to otherwise achieve a higher capital level. Through the reservation of authority, OTS may require the discounting or deduction of an asset or capital component, or may assign a higher risk weight or conversion factor than an asset or risk exposure normally receives. Refer to 12 CFR § 567.11. Whenever you find that a capital instrument, an asset, or a portfolio of assets does not provide meaningful capital support (and where the asset classification process does not address the problem), you should discuss the use of the reservation of authority with your regional management.

**Documentation Requirements**

Thrifts must have adequate systems in place to compute their capital requirements and capital levels. Supporting documentation should establish how a thrift tracks and reports its capital components, how it risk weights its assets, and how it calculates each of its capital levels. Where a thrift 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. Examiners should verify that thrifts are correctly reporting the information requested in Section CCR of the Thrift Financial Report that is used in computing the capital requirements.

## EVALUATING CAPITAL ADEQUACY

In order to determine whether a thrift has sufficient capital at a specific point in time, you should first consider whether the thrift complies with the following requirements:

- Regulatory capital requirements.
- Capital levels established by a business plan or the Board of Directors.
- Capital levels established by a capital plan, approved application, IMCR, enforcement action, other applicable agreement or plan, or through use of the OTS reservation of authority.

You should then determine if the thrift holds capital that is sufficient relative to its risk profile. This process evolves during your examination. You should consider all of the following factors, as well as any other important factors that you note.

### Asset Quality

Asset quality is a key factor in evaluating capital adequacy. You should consider the extent to which individual 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. When assessing capital adequacy, you should evaluate the risks associated with each lending and investment program. Thrifts with higher risk lending programs should maintain sufficient ALLL to offset expected losses and a higher capital base to absorb unanticipated losses.

### Earnings

Consider earnings performance and dividend practices. Good earnings performance enables a thrift to fund its growth and remain competitive in the marketplace while at the same time retaining sufficient equity to maintain a strong capital position. However, excessive dividends can negate even exceptional earnings performance and result in a weakened capital position. 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.

### Subordinate Organizations

Subordinate organizations can significantly affect the operations and overall financial condition of their parent thrift. 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 thrift in a time of stress. Furthermore, it is important to consider whether the parent thrift has obligated itself, either formally or informally, to fund obligations of its subsidiary. As with other assets, OTS examiners may classify as substandard, doubtful or loss, a thrift's investment in its subordinate organizations including loans to subordinate organizations. In some instances, OTS requires deduction (and deconsolidation where applicable) of a parent's investment in its subordinate organization. (See Appendix B for further details.)

### Relationships with Affiliates

A holding company's policies and practices can significantly affect the capital levels of its thrift subsidiary. It is critical that a thrift'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 thrift.

Double-leveraging occurs when a thrift's parent organization borrows funds to purchase newly issued stock of the subsidiary thrift. If the principal means of servicing the parent company's debt consists of the cash dividends from the thrift, you should consider the potential effect on earnings. In particular, you should ascertain whether the thrift has the ability to sustain 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 thrift's capital level by the amount of any loans or other credits or investments outstanding to the thrift's holding company or to affiliates that are not subordinate organizations of the thrift.

**Interest Rate Risk**

Thrifts with excessive interest rate risk exposure may experience a significant decline in capital levels as a result of unfavorable changes in interest rates. Therefore thrifts with relatively high interest rate risk should have correspondingly high capital levels to offset that risk.

**Liquidity and Funds Management**

Thrifts that 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 thrift's level of liquidity, the more seriously you should consider higher capital requirements.

**Deposit Structure**

You may analyze capital in light of the historical and projected rate of growth of the thrift's deposit accounts. If a thrift 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 thrift as defendant or other contingent liabilities may indicate a need for a greater level of capital protection. You should determine whether the thrift has significant contingent liabilities that have the potential to materially impact the capital level.

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

A thrift may engage in off-balance-sheet activities such as trust administration, mortgage banking, or construction lending. In such cases, you must determine whether the thrift 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 capital requirement does not address off-balance-sheet risk.

**New Products and Activities**

The financial marketplace is dynamic and innovative. Many thrifts constantly formulate new products and engage in new activities to meet customers' needs. You should determine whether a thrift 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 thrift'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 thrifts. You should review on- and off-balance-sheet assets for concentrations in industries, product lines, customer types, geographic areas, funding sources, and nontraditional activities.

**Quality of Management**

The ability, experience, depth, integrity and record of management are important in your assessment of a thrift'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 includes the formulation and implementation of strong 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 readily have an adverse effect on the thrift's capital position.

**Future Plans**

Consider reasonable expectations of what may occur in the 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 thrift'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.

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.

**Peer Comparison**

You should also assess capital adequacy by comparing a thrift with similar (peer) institutions, though you should not rely on this information exclusively. For example, while strong management practices or stringent internal controls may reduce the need for additional capital in some cases, weak management practices or controls may indicate a need for higher capital elsewhere. You should make an independent, case-specific judgment on the capital adequacy for each thrift you examine.

## RATING THE CAPITAL COMPONENT

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 thrift's risk profile, rather than simply to a minimum regulatory requirement. These are the standards set by the Uniform Financial Institutions Rating System:

- A rating of "1" indicates a strong capital level relative to the thrift's risk profile.
- A rating of "2" indicates a satisfactory capital level relative to the thrift's risk profile.
- A rating of "3" indicates a less than satisfactory level of capital that does not fully support the thrift's risk profile. The rating indicates a need for improvement, even if the thrift's capital level exceeds minimum regulatory and statutory requirements.
- A rating of "4" indicates a deficient level of capital. In light of the thrift's risk profile, viability of the thrift may be threatened. The thrift 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 thrift's viability. The thrift 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)

| | |
|---|---|
| § 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 |

### Office of Thrift Supervision Bulletins and CEO Letters

*Regulatory and Thrift Bulletins*

| | |
|---|---|
| RB 18 | Enforcement Series |
| RB 33a | FDIC “Pass-Through” Deposit Insurance Coverage Disclosure Rule |
| TB 56 | Regulatory Reporting of Net Deferred Tax Assets |

*CEO Letters*

| | |
|---|---|
| No. 135 | The New Basel Capital Accord |
| 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 |

### Additional Interagency Guidance

Interim Regulatory Reporting and Capital Guidance on FAS 133, “Accounting for Derivative Instruments and Hedging Activities,” 12/29/1998