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## INTRODUCTION

Capital serves four essential functions:

- **Absorbs Losses**: Capital allows institutions to continue operating as going concerns during periods when operating losses or other adverse financial results are experienced.
- **Promotes Public Confidence**: Capital provides a measure of assurance to the public that an institution will continue to provide financial services even when losses have been incurred, thereby helping to maintain confidence in the banking system and minimize liquidity concerns.
- **Restricts Excessive Asset Growth**: Capital, along with minimum capital ratio standards, can act as a constraint on expansion by requiring that asset growth be funded by a commensurate amount of capital.
- **Protects Depositors and the Deposit Insurance Fund**: Placing owners at significant risk of loss, should the institution fail, helps to minimize the potential for moral hazard, and promotes safe and sound banking practices.

As federal deposit insurer and supervisor of state nonmember institutions, the FDIC places high importance on capital adequacy. Capital supports prudent asset growth and promotes public confidence, while helping banking institutions absorb unexpected losses and remain viable in times of stress. In addition, capital is the lifeblood of the credit intermediation process as it provides institutions with the capacity to gather deposits and make loans in their markets. Since capital adequacy assessments are central to the supervisory process, examiners evaluate all aspects of a financial institution's risk profile and activities to determine whether its capital levels are appropriate and in compliance with minimum regulatory requirements.

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## CAPITAL PLANNING

Institution management performs capital planning to ensure that capital protection is commensurate with the institution's financial condition, business and growth plans, holding company support (if applicable), and projected capital distributions. The sophistication of capital planning can vary depending on an institution's size and complexity, as well as its products and business lines. In many cases, institutions base their strategic planning and budget processes on expectations for capital levels and earnings retention. Therefore, capital planning is essential for setting an institution's capital cushion, establishing asset growth and funding targets, pursuing new products or markets, and determining whether dividends returning capital to shareholders are appropriate and reasonable.

Institution management typically supports capital plans with realistic assumptions about prospective asset quality, earnings performance, and other business considerations. Management has a number of matters to consider when devising a capital plan, including budgets and strategic plans, expectations for loan quality through a full economic cycle, merger and acquisition objectives, and competition within the institution's markets. Management of large and complex institutions, in particular, use stress testing to help inform their capital plans by assessing the impact of plausible events or circumstances that could increase exposure to losses. Community institutions are not subject to capital stress testing, but some institutions have developed their own analyses of asset concentrations or commercial real estate loan exposures to better inform their planning.

During supervisory reviews, examiners discuss the capital planning process with management to understand how they established current and prospective capital levels. Examiners consider the board of directors' involvement in developing these plans, and whether capital levels can support asset exposures, various business cycles, and potential stress conditions.

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## REGULATORY CAPITAL REQUIREMENTS

Regulatory capital requirements have evolved as innovations in financial instruments and investment activities introduced greater complexity to the banking industry. Regulatory capital rules set forth minimum capital ratio requirements and generally follow a framework of standards adopted by the Basel Committee on Banking Supervision (BCBS), an international standard-setting body that deals with various aspects of bank supervision. The FDIC is a member of the BCBS and works with the Board of Governors of the Federal Reserve System (FRB) and the Office of the Comptroller of the Currency (OCC) to establish domestic capital regulations. Additionally, statutory actions by Congress can set the direction and content of regulatory capital regulations and policy for banking organizations in the United States. Standards set forth by the Financial Accounting Standards Board may also influence domestic regulatory capital regulations.

In 2013, the FDIC, FRB, and OCC issued a comprehensive set of post-crisis regulations for U.S. institutions that align with Basel III capital standards (2013 capital rule). These regulations are designed to strengthen the quality and quantity of capital, and promote a stronger financial industry that is more resilient to economic stress. The purpose of these regulations is to promote the highest

quality forms of perpetual, loss absorbing capital (like common equity, related surplus, and retained earnings), while limiting the reliance on and permissibility of lower quality forms of capital (such as hybrid or debt-like issuances and trust preferred securities). The 2013 capital rule promotes the use of capital instruments that have no maturity, no obligation to make cash or cumulative cash dividend payments, no liquidation preference, and expose shareholders to loss.

Therefore, the 2013 capital rule emphasizes common equity tier 1 capital as the predominant form of institution capital. Common equity tier 1 capital is widely recognized as the most loss-absorbing form of capital, as it is permanent and places shareholders' funds at risk of loss in the event of insolvency. Moreover, the 2013 capital rule strengthens minimum capital ratio requirements and risk-weighting definitions, increases Prompt Corrective Action (PCA) thresholds, establishes a capital conservation buffer, and provides a mechanism to mandate counter-cyclical capital buffers for the largest U.S. institutions. Some of the requirements have since been revisited to make technical amendments and incorporate statutory changes, but the overarching provisions of the 2013 capital rule remain intact.

The 2013 capital rule applies to all insured depository institutions. For FDIC-supervised institutions, the capital rules are contained in Part 324 of the FDIC Rules and Regulations. Part 324 defines capital elements, establishes risk-weighting approaches for determining capital requirements under the standardized and advanced approaches, and sets PCA standards that prescribe supervisory action for institutions that are not adequately capitalized. Part 324 also established requirements to maintain a capital conservation buffer that affects capital distributions and discretionary payments. The capital requirements included in Part 324 that apply to all insured depository institutions are collectively referred to as the generally applicable requirements or the generally applicable capital rule. Capital requirements such as the supplementary leverage ratio (SLR) or the requirement to use internal models to calculate risk-weighted assets (advanced approaches) are additional requirements that apply only to a subset of the largest U.S. institutions and are not part of the generally applicable capital rule.

This chapter is only meant to provide an overview of the capital rules; examiners should refer to Part 324 for detailed requirements.

## ← COMPONENTS OF CAPITAL

Part 324 establishes two broad components of capital which are known as tier 1 capital and tier 2 capital. Tier 1 capital is the predominant form of capital in the U.S. and represents the sum of common equity tier 1 capital and additional tier 1 capital. Tier 2 capital includes several less subordinated capital instruments (i.e., less subordinated than tier 1 capital instruments) and balance sheet items that are not allowable in tier 1 capital.[1] Components of tier 1 and tier 2 capital are used to calculate minimum regulatory capital ratios described in Part 324 and are described in more detail below.

### Common Equity Tier 1 Capital

Common equity tier 1 capital is the most loss-absorbing form of capital. It includes qualifying common stock and related surplus net of treasury stock; retained earnings; certain accumulated other comprehensive income (AOCI) elements if institution management does not make an AOCI opt-out election, plus or minus regulatory deductions or adjustments as appropriate; and qualifying common equity tier 1 minority interests. The federal banking agencies expect the majority of common equity tier 1 capital to be in the form of common voting shares and retained earnings.

Part 324 allowed all non-advanced approach institutions to make a permanent, one-time opt-out election, enabling them to calculate regulatory capital without AOCI. Such an election neutralizes the impact of unrealized gains or losses on balance sheet instruments, including available-for-sale bond portfolios, in the context of regulatory capital levels. To opt-out, institutions must have made a one-time permanent election on the March 31, 2015 Call Report. For institutions that did not or cannot opt-out, the AOCI adjustment to common equity tier 1 capital could have an impact on regulatory capital ratios if significant bond portfolio appreciation or depreciation is encountered.

Part 324 requires that several items be fully deducted from common equity tier 1 capital, such as goodwill, deferred tax assets (DTAs) that arise from net operating loss and tax credit carry-forwards, other intangible assets (except for mortgage servicing assets (MSAs)), certain DTAs arising from temporary differences (temporary difference DTAs), gains on sale of securitization exposures, and certain investments in another financial institution's capital instruments. Additionally, management must adjust for unrealized gains or losses on certain cash flow hedges.

[1] Institutions that elect the Community Bank Leverage Ratio (CBLR) framework do not calculate tier 2 capital (refer to the Community Bank Leverage Ratio section for details about the CBLR).

Finally, non-advanced approaches institution management must consider threshold deductions for three specific types of assets: investments in the capital of unconsolidated financial institutions, MSAs, and temporary difference DTAs. Generally, management must deduct the amount of exposure to these types of assets, by category that exceeds 25 percent of a base common equity tier 1 capital calculation. The amounts of MSAs and temporary difference DTA threshold items not deducted are assigned a 250 percent risk-weight, while investments in the capital of unconsolidated financial institutions that are not deducted get assigned a risk-weight determined by the type of asset exposure (e.g., common stock, preferred stock, sub-debt).

## Additional Tier 1 Capital

Additional tier 1 capital includes qualifying noncumulative perpetual preferred stock, bank-issued Small Business Lending Fund (SBLF) and Troubled Asset Relief Program (TARP) instruments that previously qualified for tier 1 capital,[2] and qualifying tier 1 minority interests, less certain investments in other unconsolidated financial institutions' instruments that would otherwise qualify as additional tier 1 capital.

## Tier 2 Capital

Under the generally applicable rule, tier 2 capital includes the allowance for loan and lease losses (ALLL)[3] up to 1.25 percent of risk-weighted assets, qualifying preferred stock, subordinated debt, and qualifying tier 2 minority interests, less any deductions in the tier 2 instruments of an unconsolidated financial institution. Effective April 1, 2019, the agencies revised the regulatory capital rules to include a new term, adjusted allowances for credit losses (AACL), which replaces the term ALLL in the capital rules upon an institution's adoption of Accounting Standards Codification (ASC) Topic 326, Financial Instruments – Credit Losses, which includes the Current Expected Credit Losses or CECL allowance methodology. The term allowance for credit losses (ACL) as used in ASC Topic 326 applies to most financial assets, including available-for-sale (AFS) debt securities. In contrast, the term AACL, as used in the regulatory capital rules, excludes credit loss allowances on purchased credit deteriorated assets and AFS debt securities.[4] The AACL also excludes an institution's allocated transfer risk reserves, if any.

Part 324 eliminates previous limits on term subordinated debt, limited-life preferred stock, and the amount of tier 2 capital includable in total capital.

## Deductions and Limits

The 2013 capital rule introduced a number of limitations and deductions that were generally in response to issues recognized during the financial crisis of 2008 and were adopted to enhance the quality of capital. Investments in the capital instruments of another financial institution, such as common stock, preferred stock, subordinated debt, and trust preferred securities might need to be deducted from each tier of capital.

For advanced approaches institutions only, investments in the capital of unconsolidated financial institutions must be analyzed to determine whether they are significant or non-significant, which depends on the percentage of common stock that an institution owns in the other financial institution. If the institution owns 10 percent or less of the other institution's common shares, then all of that investment is non-significant. If an institution owns more than 10 percent, then all of the investment in that company is significant. Part 324 contains separate deduction requirements for significant and non-significant investments.

In most cases, threshold-based deductions for all institutions will be made from the tier of capital for which an investment would otherwise be eligible. To illustrate, if an institution's investment is an instrument that qualifies as tier 2 capital, it is deducted from tier 2 capital. If it qualifies as an additional tier 1 capital instrument, it is deducted from additional tier 1 capital. If it qualifies as a common equity tier 1 capital instrument, it is deducted from common equity tier 1 capital. If the institution does not have sufficient tier 2 capital to absorb a deduction, then the excess amount is deducted from additional tier 1 capital or from common equity tier 1 capital if there is insufficient additional tier 1 capital.

Part 324 limits the amount of minority interest in a subsidiary that may be included in each tier of capital. To be included in capital, the instrument that gives rise to minority interest must qualify for a particular tier of capital. Non-advanced approaches institutions are allowed to include common equity tier 1, tier 1, and total capital minority interest up to 10 percent of the banking organization's total capital (before the inclusion of any

[2] SBLF and TARP were federal financial stability programs that provided capital support to financial institutions in response to the 2008 financial crisis.

[3] Adjusted allowances for credit losses replaces the term ALLL for institutions that have adopted ASC Topic 326. Such institutions may also elect to apply a Current Expected Credit Losses (CECL) transition provision over three or five years, if applicable. See the section below titled CECL Transition Period.

[4] Purchased credit deteriorated assets and AFS debt securities are risk-weighted net of credit loss allowances as measured under ASC Topic 326.

minority interest). Minority interest is further limited for non-advanced approaches institutions to 10 percent of each tier of capital (before the inclusion of any minority interest).

For advanced approaches banking organizations, limitations for common equity tier 1 minority interest, tier 1 minority interest, and total capital minority interest are based on the capital requirements and capital ratios of each of the banking organization's consolidated subsidiaries that have issued capital instruments held by third parties.

## CECL Transition Period

The capital rule provides the option to phase in over a three-year period the day-one adverse effects on regulatory capital that may result when an institution adopts the new accounting standard ASC Topic 326, which includes the CECL methodology. Institutions can elect the CECL transition provision to transition the day-one impact of adopting ASC Topic 326 in regulatory capital through transition adjustments to retained earnings, average total consolidated assets, temporary difference DTAs, and the AACL. The date of CECL adoption by institutions may range between 2019 for early adopters, to as late as 2023 for some institutions. An institution that does not elect to use the CECL transition provision in the regulatory report for the quarter in which it first reports its credit loss allowances as measured under CECL will not be permitted to make an election in subsequent reporting periods.

Institutions that adopted CECL in 2020 had the option to mitigate the estimated regulatory capital effects of CECL for two years, followed by a three-year transition period. Taken together, these measures offered these institutions a transition period of up to five years.

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# CAPITAL RATIOS

Minimum regulatory capital requirements for insured depository institutions are based on a combination of risk-based and leverage ratio calculations. Part 324's risk-based requirements set minimum ratios for the Common Equity Tier 1, Tier 1 Risk-Based, and Total Risk-Based Capital Ratios as described in the following sections. A single leverage ratio of Tier 1 Capital to Average Total Assets is also required. If an institution qualifies for and elects the CBLR framework, it only has one minimum regulatory capital ratio—the CBLR.

A major difference between risk-based and leverage capital ratios is the denominator. The three risk-based ratios use risk-weightings to measure on- and off-balance sheet exposures and are aggregated as "total risk-weighted assets." These risk-weightings can vary across asset classes and exposures depending on their inherent risk. For instance, U.S. Treasury securities have a 0 percent risk weight, while a commercial loan to a private business would generally receive a risk-weight of 100 percent under the Standardized Approach. Separately, leverage ratios are based on average total assets. The numerator for the leverage capital ratio is tier 1 capital. The numerators for the risk-based capital ratios are common equity tier 1 capital, additional tier 1 capital, and total capital. Total capital includes the ALLL or AACL up to regulatory limits, as applicable.

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# RISK-WEIGHTED ASSETS

Part 324 prescribes two approaches to risk weighting assets. The standardized approach, which all institutions must use, and the advanced approaches, which are used by larger, more complex institutions. This section is not applicable to institutions electing the CBLR framework, since those institutions are not required to calculate or report risk-based capital. As a result, examiners should not apply risk-based calculations to CBLR-electing institutions or indicate to management in any way that such computations are required. The CBLR is described in more detail below.

## Standardized Approach

An institution's balance sheet assets and credit equivalent amounts of off-balance sheet items are generally assigned to one of four risk categories (0, 20, 50, and 100 percent) according to the obligor, or if relevant, the guarantor or the nature of the collateral. Part 324, Subpart D (Risk-weighted Assets-Standardized Approach) sets forth the criteria for categorizing non-advanced approach institutions' assets and off-balance sheet exposures for risk-weighting purposes.

Since the risk-weighting system was first introduced in the United States in the early 1990s, the general process of risk weighting assets has not changed. However, several changes implemented by the standardized approach involve risk-weights other than the 0, 20, 50, and 100 percent categories. These changes are individually outlined below and include high volatility commercial real estate (HVCRE) loans; past due asset exposures; securitizations or structured investments; equity exposures; and collateralized and guaranteed exposures.

## HVCRE Loans

An HVCRE loan generally refers to a subset of acquisition, development, and construction loans that is assigned a risk-weight of 150 percent. HVCRE loans include:

- A credit facility that is secured by real property and primarily finances, has financed, or refinances acquisition, development, or construction of real property;
- An extension of credit that provides financing to acquire, develop, or improve such real property into income-producing property; and
- A credit facility that is dependent on future income or sales proceeds from, or refinancing of, such real property for repayment.

The HVCRE definition provides several exclusions, including:

- One-to four-family residential properties;
- Community development projects;
- Agricultural land;
- Existing income-producing property secured by permanent financings;
- Certain commercial real property projects where the borrower has contributed at least 15 percent of the as-completed value of the project;
- Real property where the loan has been reclassified as a non-HVCRE loan; and
- Real estate where the loan was made before January 1, 2015.

The HVCRE definition does not apply in any manner to institutions that elect the CBLR.

## Past-Due Asset Risk-Weights

The standardized approach requires financial institutions to transition assets that are 90 days or more past due or on nonaccrual from their original risk-weight to 150 percent. For example, if the institution held a revenue bond that was on nonaccrual, Part 324 requires the bond to be risk weighted at 150 percent compared to its original 50 percent risk-weight. This treatment could potentially apply to commercial, agricultural, multi-family, and consumer loans as well as fixed-income securities. However, this requirement does not apply to past due 1-4 family residential real estate loans (which would be risk weighted at 100 percent), HVCRE (risk weighted at 150 percent), exposures to sovereign entities, and the portion of loan balances with eligible guarantees or collateral where the risk-weight can vary.

## Structured Securities and Securitizations

Part 324 establishes sophisticated risk-weight approaches for securitization exposures and structured security exposures that are retained on- or off-balance sheet. Typical examples of securitization exposures include private label collateralized mortgage obligations (CMOs), trust preferred collateralized debt obligations, and asset-backed securities, provided there is tranching of credit risk. Generally, pass-through and government agency CMOs are excluded from the securitization exposure risk-weight approaches. In general, Part 324 requires FDIC-supervised institutions to calculate the risk-weight of securitization exposures using either the *gross-up approach* or the *Simplified Supervisory Formula Approach* (SSFA) consistently across all securitization exposures, except in certain cases. For instance, the institution can, at any time, risk weight a securitization exposure at 1,250 percent.

The gross-up approach is similar to earlier risk-based capital rules, where capital is required on the credit exposure of the institution's investment in the subordinate tranche, as well as its pro rata share of the more senior tranches it supports. The gross-up approach calculates a capital requirement based on the weighted-average risk-weights of the underlying exposures in the securitization pool.

The SSFA is designed to assign a lower risk-weight to more senior-class securities and higher risk-weights to support tranches. The SSFA is both risk sensitive and forward looking. The formula adjusts the risk-weight for a security's underlying collateral based on key risk factors, such as incurred losses, nonperforming loans, and the ability of subordinate tranches to absorb losses. In any case, a securitization is assigned at least a minimum risk-weight of 20 percent.

## Securitization Due Diligence

Section 324.41(c) implements due diligence requirements for securitization exposures. The analysis must be commensurate with the complexity of the securitization exposure and the materiality of the exposure in relation to capital.

Under these requirements, management must demonstrate a comprehensive understanding of the features of a securitization exposure that would materially affect its performance. The due diligence analysis must be conducted prior to acquisition and at least quarterly as long as the instrument is in the institution's portfolio.

When conducting analysis of a securitization exposure, management typically considers structural features, such as:

- Credit enhancements,
- Performance of servicing organizations,
- Deal-specific definitions of default, and
- Any other features that could materially impact the performance of the exposure.

Management also typically assesses relevant performance information of the underlying credit exposures, such as:

- Past due payments;
- Prepayment rates;
- Property types;
- Average loan-to-value ratios;
- Geographic and industry diversification;
- Relevant market data information, such as bid-ask spreads;
- Recent sale prices;
- Trading volumes;
- Historic price volatility;
- Implied market volatility; and
- The size, depth, and concentration level of the market for the securitization.

For re-securitization exposures, management will typically assess the performance on underlying securitization exposures.

If management is not able to demonstrate sufficient understanding of a securitization exposure, per Section 324.41(c)(1) the institution must assign the exposure a 1,250 percent risk-weight.

## Equity Risk-Weights

Part 324 assigns various risk-weights for equity investments. For institutions that are permitted to hold publicly traded equities, the risk-weight for these assets ranges from 100 to 300 percent. A risk-weight of 400 percent is assigned to non-publicly traded equity exposures. A risk-weight of 600 percent is assigned to investments in a hedge fund or investment fund that has greater than immaterial leverage. In addition, under Part 324, institutions may assign a 100 percent risk-weight to the aggregate adjusted carrying value of certain equity exposures that do not exceed 10 percent of the institution's total capital. To qualify for the 100percent risk-weight, an institution must include the following equity exposures in the following order up to 10 percent of total capital: first include equity exposures to unconsolidated small business investment companies or held through consolidated small business investment companies described in section 302 of the Small Business Investment Act, then include publicly traded equity exposures (including those held indirectly through investment funds), and then include non-publicly traded equity exposures (including those held indirectly through investment funds). For non-advanced approaches institutions, the equity exposure risk-weights similarly apply to investments in the capital of unconsolidated financial institutions that are not deducted from capital.

Part 324 also contains various look-through approaches for equity exposures to investment funds. For example, if an institution has an equity investment in a mutual fund that invests in various types of bonds, the regulation directs how to assign proportional risk-weights based on the underlying investments. In addition, generally lower risk-weights apply to a few specific classes of equity securities. The risk-weight for Federal Reserve Bank stock is 0 percent, Federal Home Loan Bank stock receives a 20 percent risk-weight, and community development exposures, including Community Development Financial Institutions, are assigned 100 percent risk-weights. Examiners should refer to Sections 324.51, 324.52, and 324.53 for additional information regarding risk-weights for equity exposures.

## Collateralized Transactions

In certain circumstances, management has the option to recognize the risk-mitigating effects of financial collateral to reduce the risk-based capital requirements associated with a collateralized transaction. Financial collateral includes cash on deposit (or held for the institution by a third party trustee), gold bullion, certain investment grade[5] securities, publicly traded equity securities, publicly traded convertible bonds, and certain money market fund shares.

Part 324 permits two general approaches to recognize financial collateral for risk-weighting purposes. The simple approach generally allows substituting the risk-weight of the financial collateral for the risk-weight of any exposure. In order to use the simple approach, the collateral must be subject to a collateral agreement for at least the life of the exposure, the collateral must be revalued at least every six months, and the collateral (other than gold) and the exposure must be denominated in the same currency. The second approach, the collateral haircut (discount) approach, allows management to calculate the exposure for repo-style transactions, eligible margin loans, collateralized derivative contracts, and single-product netting sets of such transactions using a mathematical formula and supervisory haircut factors. Refer to Section 324.37 for additional details.

Most institutions are likely to use the simple approach; however, regardless of the approach chosen, it must be applied consistently for similar exposures or transactions.

The following are examples under the simple approach. Management may assign a 0 percent risk-weight to the

[5] *Investment grade* means that the issuer has adequate capacity to meet financial commitments for the projected life of the asset or exposure.

collateralized portion of an exposure where the financial collateral is cash on deposit. Management may also assign a 0 percent risk-weight if the financial collateral is an exposure to a sovereign[6] that qualifies for a 0 percent risk-weight and management has discounted the market value of the collateral by 20 percent. Transactions collateralized by debt securities of government-sponsored entities receive a 20 percent risk-weight, while risk-weights for transactions collateralized by money market funds will vary according to the funds' investments. Finally, for transactions collateralized by investment grade securities, such as general obligation municipal, revenue, and corporate bonds, management may use collateral risk-weights of 20, 50, and 100 percent, respectively.

## Treatment of Guarantees

Under Part 324, management has the option to substitute the risk-weight of an eligible guarantee or guarantor for the risk-weight of the underlying exposure. For example, if the institution has a loan guaranteed by an eligible guarantor, management can use the risk-weight of the guarantor. Eligible guarantors include entities such as depository institutions and holding companies, the International Monetary Fund, Federal Home Loan Banks, the Federal Agricultural Mortgage Corporation, entities with investment grade debt, sovereign entities, and foreign institutions. An eligible guarantee must be written, be either unconditional or a contingent obligation of the U.S. government or its agencies, cover all or a pro rata share of all contractual payments, give the beneficiary a direct claim against the protection provider, and meet other requirements outlined in the definition of eligible guarantees under Section 324.2.

## Off-Balance Sheet Exposures

The risk-weighted amounts for all off-balance sheet items are determined by a two-step process. First, the "credit equivalent amount" is determined by multiplying the face value or notional amount of the off-balance sheet item by a credit conversion factor. A table contained in Part 324 shows the conversion factors. This process effectively turns an off-balance sheet exposure into an on-balance sheet amount for risk-based calculation purposes only. Next, the appropriate risk-weight (based on the risk category of the exposure) is applied to the credit equivalent amount, like any other balance sheet asset. Refer to Part 324 for more details.

[6] *Sovereign* means a central government (including the U.S. government) or an agency, department, ministry, or central bank.

[7] Total assets means the quarterly average total assets as reported in an FDIC-supervised institution's Call Report, minus amounts deducted from tier 1 capital under Sections 324.22(a), (c), and (d).

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## REGULATORY CAPITAL REQUIREMENTS

As defined by Section 324.10(a), FDIC-supervised institutions must maintain the following minimum capital ratios under the generally applicable capital rule. These requirements are identical to those for national and state member institutions.

- Common equity tier 1 capital to total risk-weighted assets ratio of 4.5 percent,
- Tier 1 capital to total risk-weighted assets ratio of 6 percent,
- Total capital to total risk-weighted assets ratio of 8 percent, and
- Tier 1 capital to average total assets ratio (tier 1 leverage ratio) of 4 percent.

Qualifying institutions that elect the CBLR framework are subject to a single leverage ratio of greater than 9 percent. Institutions meeting or exceeding these minimum requirements are considered to be compliant with the generally applicable capital rule. Therefore, risk-based capital requirements would not apply; refer to the section below titled, Community Bank Leverage Ratio for more information.

Section 324.4(b) indicates that any insured institution that has less than its minimum leverage capital requirement may be deemed to be engaged in an unsafe and unsound practice pursuant to Section 8 of the FDI Act, unless the institution has entered into and is in compliance with a written agreement or has submitted and is in compliance with a plan approved by the FDIC to increase its leverage capital ratio and take other action as may be necessary. Separately, Section 324.4(c) mandates that any insured depository institution with a tier 1 capital to total assets[7] ratio of less than 2 percent may be deemed to be operating in an unsafe and unsound condition.

Notwithstanding the minimum capital requirements under the generally applicable capital rule and the CBLR, an FDIC-supervised institution must maintain capital commensurate with the level and nature of all risks to which the institution is exposed. Furthermore, an FDIC-supervised institution must have a process for assessing its overall capital adequacy in relation to its risk profile and a

At its discretion, the FDIC may calculate total assets using an FDIC-supervised institution's period-end assets rather than quarterly average assets.

comprehensive strategy for maintaining an appropriate level of capital. The FDIC is not precluded from taking formal enforcement actions against an insured depository institution with capital above the minimum requirements if the specific circumstances indicate such action is appropriate.

Additionally, FDIC-supervised institutions that fail to maintain capital at or above minimum leverage capital requirements may be issued a capital directive by the FDIC. Capital directives generally require institution management to restore the institution's capital to the minimum leverage requirement within a specified time period. Refer to this manual's Section 15.1 – Formal Administrative Actions for further discussion on capital directives.

## Capital Conservation Buffer

The capital conservation buffer is designed to strengthen an institution's financial resilience during economic cycles. Financial institutions under the generally applicable capital rule are required to maintain a capital conservation buffer of greater than 2.5 percent in order to avoid restrictions on capital distributions and other payments. Part 324 requires institutions to meet their capital conservation buffer requirement with common equity tier 1 capital. Again, because qualifying institutions using the CBLR framework are considered in compliance with the generally applicable capital rule, they are not subject to the capital conservation buffer.

Under Section 324.11, if an institution's capital conservation buffer falls below the amount listed in the table below, its maximum payout amount for capital distributions and discretionary payments declines to a set percentage of eligible retained income based on the size of the institution's buffer.

| Capital Conservation Buffer (% of RWA) | Maximum Payout Ratio (% of Eligible Retained Income) |
|---|---|
| Greater than 2.5% | No payout limitation |
| Less than or equal to 2.5% and greater than 1.875% | 60% |
| Less than or equal to 1.875% and greater than 1.25% | 40% |
| Less than or equal to 1.25% and greater than 0.625% | 20% |
| Less than or equal to 0.625% | 0% |

The types of payments subject to the restrictions include dividends, share buybacks, discretionary payments on tier 1 instruments, and discretionary bonus payments. It is important to note that the FDIC maintains the authority to impose further restrictions to help ensure that capital is commensurate with the institution's risk profile.

An institution cannot make capital distributions or certain discretionary bonus payments during the current calendar quarter if its eligible retained income is negative and its capital conservation buffer was less than 2.5 percent as of the end of the previous quarter. Eligible retained income is the greater of (1) an institution's net income, calculated in accordance with the instructions to the Call Report, for the four calendar quarters preceding the current calendar quarter, net of any distributions and associated tax effects not already reflected in net income; and (2) the average of the institution's net income, calculated in accordance with the instructions to Call Report, for the four calendar quarters preceding the current calendar quarter.

To calculate the capital conservation buffer for a given quarter, each minimum risk-based capital requirement in Part 324 is subtracted from the institution's corresponding capital ratios. The following ratios would be subtracted from the institution's corresponding ratio to derive the buffer amount:

- Common equity tier 1 risk-based capital ratio minus 4.5 percent;
- Tier 1 risk-based capital ratio minus 6 percent; and
- Total risk-based capital ratio minus 8 percent.

The lowest of the three measures would represent the institution's capital conservation buffer and is used to determine its maximum payout for the current quarter. To the extent an institution's capital conservation buffer is 2.5 percent or less of risk-weighted assets, the institution's maximum payout amount for capital distributions and discretionary payments would decline. Examiners should be aware that an institution's minimum capital ratios plus a capital conservation buffer of 2.5 percent results in a capital requirement that is 50 basis points greater than the PCA well-capitalized ratio levels. For example, to avoid restrictions under the capital conservation buffer, an institution must have a total risk-based capital ratio of 10.5 percent, whereas to be well-capitalized under PCA an institution must have a total risk-based capital ratio of 10 percent.

The FDIC may permit an FDIC-supervised institution that is otherwise limited from making distributions and discretionary bonus payments to make a distribution or discretionary bonus payment upon an institution's request, if the FDIC determines that the distribution or discretionary bonus payment would not be contrary to the purposes of this section, or to the safety and soundness of the FDIC-supervised institution. The FDIC issued Financial

Institution Letter 40-2014 (Requests from S-Corporation Banks for Dividend Exceptions to the Capital Conservation Buffer) to describe how the FDIC will consider requests from S-corporation banks or savings associations to pay dividends to shareholders to cover taxes on their pass-through share of the bank's earnings, when these dividends would otherwise not be permitted under the capital conservation buffer requirements.

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# COMMUNITY BANK LEVERAGE RATIO

## Statutory and Regulatory Background

The Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018 introduced the CBLR framework for qualifying institutions as a simple, optional methodology for calculating a single regulatory capital ratio. These institutions would receive burden relief by not having to calculate and report risk-weighted assets. Qualifying institutions may elect the CBLR framework at any time through their Call Report filings. To be a qualifying community banking organization, an insured depository institution must not be an advanced approaches banking organization and must meet the following qualifying criteria:

- A leverage ratio of greater than 9 percent;
- Total consolidated assets of less than $10 billion;
- Total off-balance sheet exposures (excluding derivatives other than sold credit derivatives and unconditionally cancelable commitments) of 25 percent or less of total consolidated assets; and
- The sum of total trading assets and trading liabilities of 5 percent or less of total consolidated assets.

If an institution has a ratio above the CBLR requirement, the regulatory agencies would consider it to have met:

- The generally applicable risk-based and leverage capital requirements;
- The capital ratio requirements to be considered well capitalized under the PCA framework, with some exclusions (see the PCA and CBLR Institutions section); and
- Any other applicable capital or leverage requirements, such as the capital conservation buffer.

As long as they meet the requirements, electing institutions will not be required to report any risk-based or capital conservation buffer calculations, including for example risk-based capital requirements for HVCRE loan exposures.

## The CBLR Calculation

The CBLR is calculated as the ratio of tier 1 capital divided by average total consolidated assets, consistent with the generally applicable leverage ratio. The calculation takes into account the modifications made in relation to the capital simplifications rule and the CECL transitions final rule, and it is anticipated that the numerator will reflect any future modifications to the tier 1 capital definition applicable to non-advanced approaches organizations.

## Maintaining CBLR Eligibility

Under the CBLR framework, there are four ways that an electing institution might be required to revert to the risk-based capital requirements in the generally applicable capital rule:

- Failing to meet any of the CBLR eligibility requirements and not returning to compliance by the end of the two-quarter grace period which includes:
  - Reporting a CBLR of 9 percent or lower but greater than 8 percent,
  - Holding trading assets and liabilities exceeding 5 percent of total consolidated assets,
  - Reporting off-balance sheet exposures of more than 25 percent of total consolidated assets, or
  - Exceeding $10 billion in total consolidated assets;
- Becoming an advanced approaches banking organization;
- Reporting a CBLR of 8 percent or less; or
- Ceasing to satisfy the qualifying criteria due to consummation of a merger transaction.

Management weaknesses, non-capital financial problems, or the existence of a corrective program, as well as other supervisory issues that are significant for capital adequacy assessment purposes, are not qualifying conditions for the CBLR and have no bearing on whether an institution can remain eligible for the CBLR framework. Supervisory issues with no bearing on CBLR eligibility can include:

- Adverse CAMELS component and composite ratings or downgrades,
- Consent orders,
- Undue concentrations,
- Adverse consumer protection and Community Reinvestment Act ratings,
- Anti-Money Laundering/Counter the Financing of Terrorism deficiencies, or
- Information technology weaknesses.

## Additional Capital and Administrative Actions

In certain circumstances, the FDIC can direct electing institutions to hold additional capital above the 9 percent

CBLR to address high-risk exposures or significant supervisory matters in accordance with Part 324. CBLR implementation has no effect on the FDIC's authority to pursue administrative actions or require a higher CBLR when appropriate to promote safety and soundness.

## Compliance Grace Period

If an electing institution does not satisfy one or more of the qualifying criteria but continues to report a leverage ratio of greater than 8 percent, it can continue to use the CBLR and be deemed to meet the "well-capitalized" capital ratio requirements for a grace period of up to two quarters. If the institution is able to return to compliance with all the qualifying criteria within two quarters, it will continue to meet the "well-capitalized" ratio requirements and the generally applicable capital rule.

An electing institution will be required to comply with the generally applicable capital rule, including risk-based and capital conservation buffer requirements, and must file relevant regulatory reports if it meets any of the following:

- Is unable to restore compliance with all qualifying criteria during the two-quarter grace period (including compliance with the greater than 9 percent leverage ratio requirement),
- Reports a leverage ratio of 8 percent or less, or
- Does not satisfy the qualifying criteria due to consummation of a merger transaction.

There is no grace period for institutions with a CBLR of 8 percent or less as the CBLR framework automatically makes such institutions ineligible. These institutions may re-elect the CBLR framework once their CBLR is back above 9 percent, assuming all other qualifying criteria are met.

## Discretionary Opt Out from the CBLR

An electing institution can opt out of the CBLR framework at any time, without restriction, and revert to the generally applicable capital rule by providing the required leverage and risk-based capital ratios to its primary federal regulator at the time of opting out. This means that an FDIC-supervised institution may opt out of the framework through its Call Report filing, and also between quarters by providing a letter notice to the regional director that details the institution's applicable leverage and risk-based capital ratios at the time of opting out.

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# PROMPT CORRECTIVE ACTION

## Institutions that are Subject to the Generally Applicable Capital Rule

Part 324, Subpart H (Prompt Corrective Action) was issued by the FDIC pursuant to Section 38 of the FDI Act. Its purpose is to establish the capital measures and levels that are used to determine supervisory actions authorized under Section 38 of the FDI Act. Subpart H also outlines the procedures for the submission and review of capital restoration plans and other directives pursuant to Section 38. Neither Subpart H nor Section 38 limits the FDIC's authority to take supervisory actions to address unsafe or unsound practices or conditions, deficient capital levels, or violations of law. Actions under this Subpart and Section 38 may be taken independently of, in conjunction with, or in addition to any other enforcement action available to the FDIC.

The following table summarizes the PCA categories for non-CBLR institutions.

| PCA Category | Total RBC Ratio | Tier 1 RBC Ratio | Common Equity Tier 1 RBC Ratio | Tier 1 Leverage Ratio |
|---|---|---|---|---|
| Well Capitalized | ≥ 10% | ≥ 8% | ≥ 6.5% | ≥ 5% |
| Adequately Capitalized | ≥ 8% | ≥ 6% | ≥ 4.5% | ≥ 4% |
| Undercapitalized | < 8% | < 6% | <4.5% | < 4% |
| Significantly Undercapitalized | < 6% | < 4% | < 3% | < 3% |
| Critically Undercapitalized | Tangible Equity/Total Assets ≤ 2% | | | |

Any institution that does not meet the minimum PCA requirements may be deemed to be in violation of Part 324, and engaged in an unsafe or unsound practice, unless institution management has entered into and is in compliance with a written plan approved by the FDIC. In addition, under Subpart H, the FDIC may reclassify a well-capitalized FDIC-supervised institution as adequately capitalized, or require an adequately capitalized or undercapitalized FDIC-supervised institution to comply with certain mandatory or discretionary supervisory actions as if the institution were in the next lower PCA category. Refer to Part 324, Subpart H for further details.

## CBLR Institutions

Institutions electing the CBLR framework are considered to have met the "well-capitalized" ratio requirements for PCA purposes. However, an electing institution can meet the PCA "well-capitalized" ratio requirements but be classified as something other than well-capitalized. For example, if an electing institution is subject to a consent order with a capital maintenance provision, it would be reclassified as "adequately capitalized" for PCA purposes pursuant to Section 324.403(b)(1)(i)(E) of the capital rule. In such situations, the electing institution can remain in the CBLR framework as long as it continues to meet the qualification standards.

Additionally, pursuant to Section 324.403(d) of the capital rule, the FDIC can reclassify a qualified, electing institution to "adequately capitalized" for PCA purposes based on supervisory criteria *other* than capital. Again, such an "adequately capitalized" institution can remain in the CBLR framework.

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## CAPITAL RULES APPLICABLE TO THE LARGEST INSURED DEPOSITORY INSTITUTIONS

While all banking organizations are subject to the generally applicable capital rule, beginning in 2020, the applicability of certain capital requirements are tailored for the largest banking organizations with total consolidated assets of $100 billion or more. These regulatory changes apply to capital as well as liquidity requirements and are often referred to as the "tailoring rule." The tailoring rule sets forth four categories for large banking organizations (depending on size and other factors), and institution subsidiaries are included in the same category as their parent. The rule applies more complex aspects of the capital rule, such as the advanced approaches according to risk profile. Category I institutions are U.S. Global Systemically Important Banks (GSIBs) and are considered the most complex and systemic in the hierarchy of the tailoring rule. As such, Category I organizations are subject to the most stringent requirements. The table below summarizes the additional capital requirements for Category I – IV institutions.

| Category | Requirements |
|---|---|
| **Category I:** U.S. Global Systemically Important Banks (GSIBs) | Advanced approaches; countercyclical capital buffer; no opt out of accumulated other comprehensive income (AOCI) capital impact; GSIB surcharge for BHCs; enhanced SLR; Total Loss Absorbing Capacity and Long Term Debt requirements for BHCs; Federal Reserve's Comprehensive Capital Analysis and Review process for BHCs. |
| **Category II:** Banking organizations with $700 billion or more in total assets or $75 billion or more in cross-jurisdictional activity that are not GSIBs. | Advanced approaches; countercyclical capital buffer; no opt out of AOCI capital impact; SLR; Federal Reserve's Comprehensive Capital Analysis and Review process for BHCs. |
| *Banks in Categories I and II are known as "advanced approaches banks"* | |
| **Category III:** Banking organizations that are not subject to Category I or Category II thresholds and that have either: $250 billion or more in total assets; or $100 billion but less than $250 billion in total assets and $75 billion or more of any of the following nonbank assets, weighted short-term wholesale funding (STWF), or off-balance-sheet exposures | Countercyclical capital buffer; allow opt out of AOCI capital impact; SLR; Federal Reserve's Comprehensive Capital Analysis and Review process for BHCs. |
| **Category IV:** Banking organizations that are U.S. depository institution holding companies or U.S. intermediate holding companies with at least $100 billion in total assets that do not meet any of the thresholds specified for Categories I-III. | Allow opt out of AOCI capital impact; Federal Reserve's Comprehensive Capital Analysis and Review process for BHCs. |

## Supplementary Leverage Ratio

For advanced approaches institutions, as well as institutions that are part of a Category III banking organization, an SLR ratio of 3 percent is required. The SLR is calculated differently than the tier 1 leverage ratio. The SLR is a stand-alone ratio that must be calculated by dividing tier 1 capital by total leverage exposure. Total leverage exposure consists of on-balance sheet items, less amounts deducted from tier 1 capital, plus certain off-balance sheet exposures including:

- Potential future credit exposure related to derivatives contracts;
- Cash collateral for derivative transactions not meeting certain criteria;
- Effective notional amounts of sold credit derivatives;

- Gross value of receivables of repo-style transactions not meeting certain criteria;
- Ten percent of the notional amount of unconditionally cancellable commitments; and
- The notional amount of all other off-balance sheet exposures multiplied by standardized credit conversion factors, excluding securities lending and borrowing transactions, reverse repurchase agreements, and derivatives.

The supplementary leverage ratio is derived by calculating the arithmetic mean of this measure for the last day of each month in the reporting period.

**Custody Banks**

Certain deposits of custody banks with qualifying central banks are excluded from the supplementary leverage ratio. For purposes of the supplementary leverage ratio, a custody bank is defined as any U.S. top-tier depository institution holding company with a ratio of assets-under-custody-to-total-assets of at least 30:1. Any depository institution subsidiary of such a holding company would be considered a custody bank. The amount of central bank deposits that can be excluded from total leverage exposure cannot exceed the amount of deposit liabilities that are linked to fiduciary or custody and safekeeping accounts.

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## OTHER REGULATORY REQUIREMENTS

Examiners should be aware of other regulatory requirements that may address capital, which include but are not limited to:

| Topic | Rule |
|---|---|
| Risk-Based Insurance Premiums | Part 327 of the FDIC Rules and Regulations |
| Brokered Deposits and Interest Rate Restrictions | Sections 337.6 and 337.7 of the FDIC Rules and Regulations |
| Limits on Extensions of Credit to Insiders | Section 337.3 of the FDIC Rules and Regulations and FRB Regulation O |
| Activities and Investments Insured State Nonmember | Part 362 of the FDIC Rules and Regulations |
| Limitations on Interbank Liabilities | Part 206 of FRB Regulations |
| Limitations on Federal Reserve Discount Window Advances | Section 10B of the Federal Reserve Act |
| Grounds for Appointing of Conservator or Receiver | Section 11(c)(5) of the Federal Deposit Insurance Act (FDI Act) |

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## EXAMINATION-IDENTIFIED DEDUCTIONS FROM COMMON EQUITY CAPITAL

### Identified Losses and Insufficient Allowances

Part 324 provides that, on a case-by-case basis and in conjunction with supervisory examinations of an FDIC-supervised institution, deductions from capital may be required. The definition of common equity tier 1 capital specifically provides for the deduction of identified losses, such as items classified Loss, any provision expenses that are necessary to replenish the ALLL or ACL, as applicable, to an appropriate level, estimated losses in contingent liabilities, differences in accounts which represent shortages, and liabilities not shown on books. Losses attributed to a criminal violation may also need to be deducted from capital. Additionally, for the calculation of capital ratios, assets may need to be adjusted for certain identified losses. Refer to this manual's Section 16.1 – Report of Examination Instructions for the Capital Calculations page for details.

When it is deemed appropriate during an examination to adjust capital for items classified Loss or for an insufficient ALLL or ACL, as applicable, the following method should be used.

- Deduct the amount of Loss for items other than held-for-investment loans and leases in the calculation of common equity tier 1 capital. If other real estate (ORE) valuation allowances exist, refer to the discussion of Other Real Estate Valuation Allowances below.
- Deduct the amount of Loss for held-for-investment loans and leases from the ALLL or ACL, as applicable, in the calculation of tier 2 capital.
- If the ALLL or ACL, as applicable, is considered insufficient, an estimate of the provision expense needed for an appropriate ALLL or ACL, as applicable, should be made. The estimate is made after identified losses have been deducted from the ALLL or ACL, as applicable. Loans and leases classified Doubtful should not be directly deducted from capital. Rather, any deficiency in the ALLL or ACL, as applicable, related to assets classified Doubtful should be included in the evaluation and accounted for as part of the insufficient ALLL or ACL adjustment. An adjustment from common equity tier

1 capital to tier 2 capital for the provision expenses necessary to adjust the ALLL or ACL, as applicable, to an appropriate level should be made when the amount is significant.

This method avoids adjustments that may otherwise result in a double deduction (e.g., for loans classified Loss), particularly when common equity tier 1 capital already has been effectively reduced through provision expenses recorded in the ALLL or ACL, as applicable. Additionally, this method addresses situations where institution management overstated the amount of common equity tier 1 capital by failing to take necessary provision expenses to establish and maintain an appropriate ALLL or ACL, as applicable.

## Other Real Estate Valuation Allowances

ORE valuation allowances are not recognized as a component of regulatory capital. However, these valuation allowances should be considered when accounting for ORE that is classified Loss. To the extent ORE valuation allowances appropriately cover the risks inherent in any individual ORE properties classified Loss, there would not be a deduction from common equity tier 1 capital. The ORE Loss in excess of ORE valuation allowances should be deducted from common equity tier 1 capital under Assets Other Than Held-for-Investment Loans and Leases Classified Loss.

## Liabilities Not Shown on Books

Non-book liabilities have a direct bearing on capital adjustments. These definite and direct, but unbooked liabilities (contingent liabilities are treated differently) should be carefully verified and supported by factual comments. Examiners should recommend that institution records be adjusted so that all liabilities are properly reflected. Deficiencies in an institution's accrual accounting system, which are of such magnitude that the institution's capital accounts are significantly overstated, constitutes an example of non-book liabilities for which an adjustment should be made in the examination capital analysis. Similarly, an adjustment to capital should be made for material, deferred tax liabilities or for a significant amount of unpaid items that are not reflected on the institution's books.

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# CAPITAL ADEQUACY

The FDIC's authority to enforce capital standards at financial institutions includes the use of written agreements, capital directives, and discretionary actions. A discussion on the use of these powers is included in this manual's Section 15.1 - Formal Administrative Actions. Specific recommendations regarding capital adequacy should not be made solely on the examiner's initiative. Coordination between the examiner and the regional office is essential in this area. If the level or trend of the institution's capital position is adverse, the matter should be discussed with management with a comment included in the examination report. It is particularly important that management's plans to correct the capital deficiency be accurately assessed and noted in the report, along with the examiner's assessment of the feasibility and sufficiency of those plans.

## Fundamentally Sound and Well-Managed Institutions

Minimum capital ratios are generally viewed as the minimum acceptable standards for institutions where the overall financial condition is fundamentally sound, which are well-managed, and which have no material or significant financial weaknesses. While the FDIC will make this determination based on each institution's own condition and specific circumstances, the definition generally applies to those institutions evidencing a level of risk which is no greater than that normally associated with a CAMELS Composite rating of 1 or 2. Institutions meeting this definition, which are in compliance with the minimum capital requirements, will not generally be required by the FDIC to raise new capital from external sources.

## Less Than Adequately Capitalized Institutions

Institutions that fail to meet the applicable minimum capital requirements are often subject to CAMELS component and composite downgrades, corrective programs with a provision to increase capital, and other supervisory measures. Less than well capitalized institutions can increase risk to the FDIC's Deposit Insurance Fund and are usually subject to heightened examination coverage. The key supervisory objective is to help management return the institution to a well-capitalized, safe and sound financial position.

## Problem Institutions

Institutions evidencing a level of risk at least as great as that normally associated with a Composite rating of 3, 4, or 5 will be required to maintain capital higher than the minimum regulatory requirement and at a level deemed appropriate in relation to the degree of risk within the institution. These higher capital levels should normally be addressed through informal actions, such as Memoranda of Understanding, between the FDIC and the institution or, in cases of more pronounced risk, through the use of formal enforcement actions under Section 8 of the FDI Act.

## Capital Requirements of Primary Regulator

All insured depository institutions are expected to meet any capital requirements established by their primary federal or state regulator that exceed the minimum capital requirements set forth by regulation. The FDIC will consult with the institution's primary state or federal regulator when establishing capital requirements higher than the minimum set forth by regulation.

## Capital Plans Required by Corrective Programs

Institutions with insufficient capital in relation to their risk profile are often required to submit a capital plan to the FDIC in conjunction with a formal enforcement action or other directive. The development of a capital plan is frequently recommended by the FDIC to help boards of directors formulate a plan for restoring capital adequacy. Capital plans may be requested informally through the supervisory process, a Memorandum of Understanding, or other mandatory or discretionary supervisory action. Examiners should consider the necessity of recommending a capital plan if the adequacy of the capital position is in question. If a capital plan is in place, examiners should assess compliance with the plan and whether the outstanding capital plan remains appropriate and, if necessary, recommend revisions to the regional office.

### Disallowing the Use of Bankruptcy

Section 2522(c) of the Crime Control Act of 1990 amended the Bankruptcy Code to require that in Chapter 11 bankruptcy cases the trustee shall seek to immediately cure any deficit under any commitment by a debtor to maintain the capital of an insured depository institution. Chapter 11 cases are those in which a debtor company seeks to reorganize its debt. In addition, Section 2522(d) provides an eighth priority in distribution for such commitments. These provisions place the FDIC in a strong, preferred position with respect to a debtor if a commitment to maintain capital is present and the institution is inadequately capitalized.

This provision will only be useful to the FDIC if commitments to maintain capital can be obtained from owners of institutions, such as holding companies, or other corporations or financial conglomerates. Examples of situations where opportunities might exist include situations where a prospective owner might be attempting to mitigate a factor, such as potential future risk to the insurance funds or when the FDIC is providing assistance to an acquirer. In addition, in accordance with the PCA provisions in Part 324, undercapitalized FDIC-supervised institutions are required to file a capital plan with the FDIC and, before such a capital plan can be accepted, any company having control over the institution would need to guarantee the institution's compliance with the plan. However, a commitment to maintain capital should be considered only as an additional enhancement and not as a substitute for actual capital.

## Increasing Capital in Operating Institutions

To raise capital ratios, management of an institution must increase capital levels or reduce asset growth to the point that the capital formation rate exceeds asset growth. The following sections describe alternatives to increasing the capital level in institutions.

### Increased Earnings Retention

Management may attempt to increase earnings retention through a combination of higher earnings or lower cash dividend rates. Earnings may be improved, for example, by tighter controls over certain expense outlays; repricing of loans, fees, or service charges; upgrading credit standards and administration to reduce loan or investment losses, or through various other adjustments. An increase in retained earnings will improve capital ratios assuming the increase exceeds asset growth.

### Sale of Additional Capital Stock

Sometimes increased earnings retention is insufficient to address capital requirements and the sale of new equity must be pursued. One adverse effect of this option is shareholder dilution. If the sale of additional stock is a consideration, examiners should indicate in the examination report the sources from which such funds might be obtained.[8] This notation will be helpful as background data for preliminary discussions with the state banking supervisor and serves to inform the regional director as to the practical possibilities of new stock sales. The following information could be incorporated into the report, at the examiner's discretion:

- A list of present shareholders, indicating amounts of stock held and their financial worth. Small holdings may be aggregated if a complete listing is impractical.
- Information concerning individual directors relative to their capacity and willingness to purchase stock.

[8] For an institution that is part of a holding company, the holding company will typically sell additional stock and downstream capital to the institution.

- A list of prominent customers and depositors who are not shareholders, but who might be interested in acquiring stock.
- A list of other individuals or possible sources of support in the community who, because of known wealth or other reasons, might desire to subscribe to new stock.

Any other data bearing upon the issue of raising new capital, along with the examiner's opinions regarding the most likely prospects for the sale of new equity, should be included in the confidential section of the examination report.

**Reduce Asset Growth**

Institution management may also increase capital ratios by reducing asset growth to a level below that of capital formation. Some institutions will respond to supervisory concerns regarding the institution's capitalization level by reducing the institution's total assets. Sometimes this intentional asset shrinkage will be accomplished by disposing of short-term, marketable assets and allowing volatile liabilities to run off. This reduction may result in a relatively higher capital-to-assets ratio, but it may leave the institution with a strained liquidity posture. Therefore, it is a strategy that can have adverse consequences from a safety and soundness perspective and examiners should be alert to the possible impact this strategy could have in institutions that are experiencing capital adequacy problems.

## Contingent Liabilities

Contingent liabilities reflect potential claims on institution assets. Any actual or direct liability that is contingent upon a future event or circumstance may be considered a contingent liability. Contingent liabilities are divided into two general categories. Category I contingent liabilities result in a concomitant increase in institution assets if the contingencies convert to actual liabilities. These contingencies usually result from off-balance sheet lending activities, such as loan commitments and letters of credit. For example, when an institution funds an existing loan commitment or honors a draft drawn on a letter of credit, it generally originates a loan for the amount of liability incurred.

Category II contingent liabilities include those in which a claim on assets arises without an equivalent increase in assets. For example, pending litigation in which the institution is defendant or claims arising from trust operations could reduce an institution's cash or other assets.

Examination interest in contingent liabilities is predicated upon an evaluation of the impact contingencies may have on an institution's condition. Contingent liabilities that are significant in amount or have a high probability of becoming direct liabilities must be considered when the institution's component ratings are assigned. For example, the amount of contingent liabilities and the extent to which they may be funded must be considered in the analysis of liquidity. Determination of the management component may appropriately include consideration of contingencies, particularly off-balance sheet lending practices. Contingent liabilities arising from off-balance sheet fee producing activities may enhance earnings. In rating earnings, the impact of present and future fee income should be analyzed.

The extent to which contingent liabilities may ultimately result in a charge to earnings resulting in a decrease of capital is always part of the examination process and an important consideration in rating capital. Examiners should consider the degree of off-balance sheet risk in their analysis of the institution's overall capital adequacy and the determination of compliance with Part 324 of the FDIC Rules and Regulations.

**Potential and Estimated Losses**

As described above, Category I contingent liabilities are defined as those that will give rise to a concomitant increase in institution assets if the contingencies convert into actual liabilities. Such contingencies should be evaluated for credit risk and, if appropriate, listed for Special Mention or subjected to adverse classification. If a Category I contingent liability is classified Loss, it would be included in the *Other Adjustments to and Deductions from Common Equity Tier 1 Capital* category on the Capital Calculations page if an allowance has not been established for the classified exposure. To the extent the off-balance sheet credit exposure classified Loss has an associated allowance, the Loss is charged to the allowance on off-balance sheet credit exposures, prior to making any other adjustment to common equity tier 1 capital.

An institution's exposure to Category II contingent liabilities normally depends solely on the probability of the contingencies becoming direct liabilities. To reflect the degree of likelihood that a contingency may result in a charge to the capital accounts, the terms potential loss and estimated loss are used. A loss contingency is an existing condition, situation, or set of circumstances that involves uncertainty as to possible loss that will be resolved when one or more future events occur or fail to occur. Potential loss refers to contingent liabilities in which there is substantial and material risk of loss to the institution. An estimated loss from a loss contingency (for example, pending or threatened litigation) should be recognized if it is probable that an asset has been impaired or a liability incurred as of the examination date and the amount of the loss can be reasonably estimated.

For further information, examiners should refer to ASC Subtopic 450-20, Contingencies– Loss Contingencies.

The memorandum section of the Capital Calculations page of the Report of Examination includes two contingent liability items. The first item, Contingent Liabilities, refers to Category I contingent liabilities. The second item, Potential Loss, refers only to Category II contingent liabilities. Estimated losses related to Category II contingent liabilities are reflected in the Other Adjustments to and Deductions from Common Equity Tier 1 Capital line item. Contingent liability losses are not included as adjustments to assets.

**Common Forms of Contingent Liabilities**

Common types and characteristics of contingent liabilities encountered in examinations are discussed below. In all cases, the examiner's fundamental objectives are to ascertain the likelihood that such contingencies may result in losses to the institution and assess the pending impact on its financial condition.

**Litigation**

If the institution is involved in a lawsuit where the outcome may affect the institution's financial condition, the examiner should include the facts in the examination report. Comments should address the essential points upon which the suit is based, the total dollar amount of the plaintiff's claim, the basis of the institution's defense, the status of any negotiations toward a compromise settlement, and the opinion of institution management or counsel relative to the probability of a successful defense. In addition, corroboration of information and opinions provided by institution management regarding significant lawsuits should be obtained from the institution's legal counsel. At the examiner's discretion, reference to suits that are small or otherwise of limited consequence may be omitted from the examination report.

Determination of potential or estimated losses in connection with lawsuits is often difficult. There may be occasions where damages sought are of such magnitude that, if the institution is unsuccessful in its defense, it could be rendered insolvent. In such instances, examiners should consult their regional office for guidance. All potential and estimated losses must be substantiated by comments detailing the specific reasons leading to the conclusion.

**Trust Activities**

Contingent liabilities may develop within a financial institution's trust department or affiliate due to actions or inactions of the institution acting in its fiduciary capacity. These contingencies may arise from failure to abide by governing instruments, court orders, generally accepted fiduciary standards, or controlling statutes and regulations. Deficiencies in administration by the trust department can lead to lawsuits, surcharges, or other penalties that must be absorbed by the institution's capital accounts. Therefore, the dollar volume and severity of such contingencies must be analyzed during the safety and soundness examination.

## ← EVALUATING CAPITAL ADEQUACY

Institutions are expected to meet all minimum capital requirements that are established by law and their primary federal and state regulators. Once minimum capital requirements are met, the evaluation of capital adequacy relies on factors that require a combination of analysis and judgment. Institutions are too dissimilar to apply a minimum set of standards based on one or only a few criteria. Rather, each institution's capital is evaluated on its risk profile and overall financial condition. Generally, management of each institution maintains capital commensurate with the nature and extent of the institution's risks, and the ability of management to identify, measure, monitor, and control those risks.

It is important to understand that what is considered an adequate level of capital for safety and soundness purposes may differ significantly from Part 324's minimum leverage and risk-based standards, the definitions used for Prompt Corrective Action (PCA), and certain other capital-based rules. The minimums set forth in the leverage and risk-based capital standards may be sufficient for sound, well-run institutions. However, problem institutions and those with higher risk characteristics often require capital levels that are higher than the regulatory minimums to sufficiently absorb unexpected losses. In all cases, examiners should assess whether financial institution management maintains capital commensurate with the institution's risk profile.

After determining that an institution meets Part 324's minimum leverage or risk-based capital requirements, examiners should use judgment and financial analysis to assess capital adequacy. This analysis is based in large part on the following factors:

- Financial condition of the institution,
- Quality of capital,
- Emerging needs for additional capital,
- Problem assets,
- Balance sheet composition,
- Off-balance sheet risk exposures,
- Earnings and dividends,
- Asset growth, and
- Access to capital sources.

## Financial Condition of the Institution

The institution's overall financial condition and risk management practices are important considerations when assessing capital adequacy. For example, asset quality problems can cause losses that deplete capital, and poor earnings can hinder capital formation. Additionally, institutions with weak policies, procedures, or management oversight may be unable to address financial risks. Furthermore, risk may not always be reflected in the current financial condition. Therefore, examiners should not rely solely on an institution's current financial condition when determining capital adequacy and must assess management's ability to identify, measure, monitor, and control all material risks that may affect capital.

Examiners should also review institutions' internal capital adequacy assessments and stress testing, if applicable. Stress tests may be appropriate for certain large or complex institutions, and their results can help examiners understand management's perspective on credit, liquidity, earnings, and market risk. These analyses can also provide insight on an institution's capital planning and distribution (dividends and stock buybacks) strategies.

## Quality of Capital

The composition and quality of capital are important considerations when assessing capital adequacy. Higher quality capital that is available to absorb losses on a going-concern basis can enhance an institution's resiliency. For instance, common equity is higher quality than debt instruments because common equity is available to absorb losses as they occur, through retained earnings for example. Debt instruments are limited in their ability to absorb loss because they are not perpetual and so the institution returns the capital to the investors at maturity. Additionally, the institution must impose losses on debt holders by defaulting on coupon payments.

## Emerging Needs for Additional Capital

Management's ability to address emerging needs for additional capital depends on many factors. A few of these factors include earnings performance and growth plans, the financial capacity of the directorate, and the holding company's ability to inject capital. A combination of ratio analysis and examiner judgment is needed to evaluate these issues. As part of assessing capital adequacy, the impact of growth and strategic objectives should be considered.

## Problem Assets

The nature, trend, and volume of problem assets and the appropriateness of the ALLL or the ACL, as applicable, are vital factors in determining capital adequacy.

Items to consider include:

- The type and level of problem assets,
- The efficacy of loan origination processes and portfolio administration,
- The level of the ALLL or ACL , as applicable, and
- The institution's methodology for establishing an appropriate ALLL or ACL, as applicable.

Examiners should consider current examination findings relative to asset quality when assessing capital adequacy. Uniform Bank Performance Reports can also be useful to review when considering the level and trend of various credit quality indicators. When assessing the appropriateness of the ALLL or ACL, as applicable, examiners should review the institution's methodology in accordance with outstanding regulatory expectations and accounting pronouncements.

## Balance Sheet Composition

The quality, type, and diversification of on- and off-balance sheet items must be considered when reviewing capital adequacy. Applicable capital guidelines and minimum regulatory ratios can help examiners determine the level of capital protection, but examiner judgment is required to assess overall capital adequacy. For example, a portfolio of 150 percent risk-weighted high volatility commercial real estate (HVCRE) loans at two different institutions may have different risk characteristics. Additionally, regulatory capital ratios alone do not account for concentration risk, market risk, or risks associated with nontraditional banking activities. Examiner judgment is therefore an integral part of assessing an institution's level of risk and management's ability to oversee those exposures.

## Off-Balance Sheet Risk Exposures

Examiners should consider the risks associated with off-balance sheet activities when evaluating capital. For example, an institution's capital needs can be significantly affected by the volume and nature of activities conducted in a fiduciary capacity. Fiduciary activities or other non-banking activities can expose an institution to losses that could affect capital. Similarly, lawsuits against the institution or other contingent liabilities, such as off-balance sheet credit commitments may indicate a need for greater capital protection and must be carefully reviewed.

## Earnings and Dividends

An institution's current and historical earnings record is one of the key elements to consider when assessing capital adequacy. Good earnings performance enables an institution to fund asset growth and remain competitive in the marketplace while at the same time retaining sufficient equity to maintain a strong capital position.

The institution's capital distribution practices are also important. Excessive dividends or share repurchases can negate strong earnings performance and result in a weakened capital position. Generally, earnings are first applied to eliminating losses and establishing necessary allowances and prudent capital levels. Thereafter, capital can be distributed in reasonable amounts. Examiners should also consider the extent that the parent relies on cash dividends to service debt and return capital to shareholders, and how this could affect the institution's capital position in both good economic times and periods of stress.

## Asset Growth

Management's ability to adequately plan for and manage growth is important with respect to assessing capital adequacy. A review of recent growth and future plans is a good starting point for this review. The examiner may want to compare asset growth to capital formation rates during recent periods, and evaluate current budget and strategic planning in terms of growth plans and their potential impact on capital adequacy. At institutions experiencing rapid asset growth, examiners should closely review capital adequacy in relation to loan seasoning and potential loss exposure, concentrations of credit, and the effect of continued growth.

## Access to Capital Sources

An institution's access to capital sources, including existing shareholders and holding company support, is an important factor in analyzing capital. If management has ample access to capital on reasonable terms, the institution may be able to operate with less capital than an institution without such access. Indeed, the financial capacity of existing shareholders and strength of a holding company factor into capital access. If a holding company previously borrowed funds to purchase newly issued stock of a subsidiary institution (a process referred to as double leverage), the holding company may be less able to provide additional capital because of its own debt service requirements. In such instances, the examiner's review should extend beyond standard ratio analysis to assess the institution's access to capital sources including current market conditions for raising capital.

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# RATING THE CAPITAL FACTOR

The adequacy of an institution's capital is one of the elements that examiners must determine to arrive at a composite rating in accordance with the Uniform Financial Institutions Rating System. This determination is a judgmental process that requires examiners to consider all of the subjective and objective variables, concepts, and guidelines that have been discussed throughout this section. Ratings are based on a scale of 1 through 5, with a rating of 1 indicating the strongest performance and risk management practices relative to the institution's size, complexity, and risk profile; and the level of least supervisory concern. A 5 rating indicates the most critically deficient level of performance; inadequate risk management practices relative to the institution's size, complexity, and risk profile; and the greatest supervisory concern.

## Uniform Financial Institution Rating System

A financial institution is expected to maintain capital commensurate with the nature and extent of risks to the institution and the ability of management to identify, measure, monitor, and control these risks. The effect of credit, market, and other risks on the institution's financial condition should be considered when evaluating the adequacy of capital. The types and quantity of risk inherent in an institution's activities will determine the extent to which it may be necessary to maintain capital at levels above required regulatory minimums to properly reflect the potentially adverse consequences that these risks may have on the institution's capital. The capital adequacy of an institution is rated based upon, but not limited to, an assessment of the following evaluation factors:

- The level and quality of capital and the overall financial condition of the institution.
- The ability of management to address emerging needs for additional capital.
- The nature, trend, and volume of problem assets, and the adequacy of allowances for loan and lease losses and other valuation reserves.
- Balance sheet composition, including the nature and amount of intangible assets, market risk, concentration risk, and risks associated with nontraditional activities.
- Risk exposure represented by off-balance sheet activities.
- The quality and strength of earnings, and the reasonableness of dividends.
- Prospects and plans for growth, as well as past experience in managing growth.
- Access to capital markets and other sources of capital, including support provided by a parent holding company.

## Ratings

A rating of 1 indicates a strong capital level relative to the institution's risk profile.

A rating of 2 indicates a satisfactory capital level relative to the financial institution's risk profile.

A rating of 3 indicates a less than satisfactory level of capital that does not fully support the institution's risk profile. The rating indicates a need for improvement, even if the institution's capital level exceeds minimum regulatory and statutory requirements.

A rating of 4 indicates a deficient level of capital. In light of the institution's risk profile, viability of the institution may be threatened. Assistance from shareholders or other external sources of financial support may be required.

A rating of 5 indicates a critically deficient level of capital such that the institution's viability is threatened. Immediate assistance from shareholders or other external sources of financial support is required.