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## INTRODUCTION

### Purpose of Capital

Bank capital performs several very important functions. It absorbs losses, promotes public confidence, helps restrict excessive asset growth, and provides protection to depositors and the deposit insurance funds.

### 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, restrains unjustified asset expansion by requiring that asset growth be funded by a commensurate amount of additional 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.

The FDIC, as the primary insuring agency, has a responsibility to protect depositors and the deposit insurance fund. Consequently, the FDIC focuses attention on the adequacy of capital during bank examinations and in supervisory programs. For example, examiners carefully review asset and liability accounts to determine adjusted equity levels, as compared to simply identifying book capital. Similarly, examiners identify higher-risk assets, such as adversely classified loans, and assets listed for special mention or as concentrations, because the assets may contribute to losses or weaken capital in the future. Additionally, examiners review bank policies and procedures, and management's qualifications and performance, to identify weaknesses that could hinder earnings or reduce capital. And finally, to assess the potential effect on capital, examiners review bank's earnings, capital-distribution plans, and contingent liabilities that may arise from banking relationships, trust activities, or litigation.

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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. To ensure regulatory requirements keep pace with these changes, federal banking agencies revised the rules governing qualifying capital instruments and minimum capital levels. Capital rules in the U.S. generally follow a framework of rules 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.

In 2013, the FDIC, FRB, and OCC issued regulations for insured depository institutions in the U.S. that align with Basel III capital standards (Basel III). The standards and regulations are designed to strengthen the quality and quantity of bank capital and promote a stronger financial industry that is more resilient to economic stress. Basel III capital standards emphasize common equity tier 1 capital as the predominant form of bank 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, Basel III 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.

Basel III standards apply 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 guidelines 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 establishes requirements to maintain a capital conservation buffer that affects capital distributions and discretionary payments. The phase-in of Part 324 began on January 1, 2014 for advanced approach institutions<sup>1</sup> and January 1, 2015 for community banks and

<sup>1</sup> Generally, an advanced approach institution is an institution that has consolidated total assets of \$250 billion or more or has on-balance sheet foreign exposure of \$10 billion or more. Refer to Section 324.100.

other non-advanced approaches institutions. Full implementation of the rules for all institutions begins on January 1, 2019.

This chapter provides an overview of the rule; however examiners should refer to Part 324 for specific rule text.

**Other Regulatory Requirements**

Examiners should be aware of other regulatory requirements that address capital requirements, such as:

<b>Topic</b>	<b>Rule</b>
Risk-Based Insurance Premiums	Part 327 of the FDIC Rules and Regulations
Brokered Deposits	Section 337.6 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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**COMPONENTS OF CAPITAL**

Part 324 establishes three components of regulatory capital: common equity tier 1 capital, additional tier 1 capital, and tier 2 capital. Tier 1 capital is the sum of common equity tier 1 capital and additional tier 1 capital. Total capital is the sum of tier 1 and tier 2 capital. Common equity tier 1 capital, tier 1 capital, and total capital serve as the numerators for calculating regulatory capital ratios. An institution’s risk-weighted assets, as defined by Part 324, serve as the denominator for these ratios. Average total assets with certain adjustments serve as the denominator for the tier 1 leverage capital ratio.

**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 the institution does not make an AOCI opt-out election (refer to opt-out election discussion in next

paragraph), plus or minus regulatory deductions or adjustments as appropriate; and qualifying common equity tier 1 minority interests. It is important to note that the federal banking agencies expect the majority of common equity tier 1 capital to be in the form of common voting shares.

Part 324 allows 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 available-for-sale bond portfolios in the context of regulatory capital levels. To opt-out, institutions must make a one-time permanent election on the March 31, 2015 Call Report. For institutions that do not or cannot opt-out, the AOCI adjustment to common equity tier 1 capital could have a significant impact on regulatory capital ratios if significant bond portfolio appreciation or depreciation occurs.

Part 324 requires that several items be fully deducted from common equity tier 1 capital such as goodwill, deferred tax assets that arise from net operating loss and tax credit carry-forwards, other intangible assets (except for mortgage servicing assets), gains on sale of securitization exposures, and certain investments in another financial institution’s capital instruments. Additionally, banks must adjust for unrealized gains or losses on certain cash flow hedges. Finally, banks must consider threshold deductions for three specific types of assets: mortgage servicing assets, deferred tax assets related to temporary timing differences, and significant investments in another unconsolidated financial institution’s common stock. Generally, banks must deduct the amount of exposure to these types of assets, by category, that exceeds 10 percent of a base common equity tier 1 capital calculation. In addition, there is a 15 percent aggregate limit on these three threshold deduction items. The amounts of threshold items not deducted will be assigned a 250 percent risk weight when Part 324 is fully phased in.

**Additional Tier 1 Capital**

Additional tier 1 capital includes qualifying noncumulative perpetual preferred stock, bank-issued Small Business Lending Fund and Troubled Asset Relief Program instruments that previously qualified for tier 1 capital, 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**

Tier 2 capital includes the allowance for loan and lease losses 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. 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

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. Investments must be analyzed to determine whether they are significant or non-significant, which depends on the percentage of common stock that a bank owns in the other financial institution. If the bank owns 10 percent or less of the other institution's common shares, then all of that investment is non-significant. If a bank 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 many cases, deductions will be made from the tier of capital for which an investment would otherwise be eligible. To illustrate, if a bank'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 bank 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.

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## RISK-WEIGHTED ASSETS

Part 324 prescribes two approaches to risk weighting assets. The standardized approach is generally designed for community banks, while the advanced approach is used by larger, more complex institutions.

### Standardized Approach

A bank'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 U.S. 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 loans; past due asset exposures; securitizations or structured investments; equity exposures; and collateralized and guaranteed exposures.

### High Volatility Commercial Real Estate Loans (HVCRE)

Loans designated as HVCRE loans generally refer to a subset of acquisition, development, and construction (ADC) loans that are assigned a risk-weighting of 150 percent. HVCRE loans do not include 1-4 family residential ADC projects, loans to finance agricultural properties, or community development projects. HVCRE loans also exclude ADC projects where:

- The loan-to-value is at or below supervisory maximums,
- The borrower contributed at least 15 percent of the as-completed value in cash or unencumbered marketable assets, and
- The contributed capital is contractually required to remain throughout the project life.

### 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 bank 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), and the portion of loan balances with eligible guarantees or collateral where the risk weight can vary.

## Structured Securities and Securitizations

Part 324 establishes 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 bank 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 bank's investment in the subordinate tranche, as well as its pro rata share of the more senior tranches it supports. It 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 should 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, the bank should consider 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.

The analysis should also assess 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, the analysis should assess the performance on underlying securitization exposures.

If management is not able to demonstrate sufficient understanding of a securitization exposure, regulators may require the bank to assign the exposure a 1,250 percent risk weight.

## Equity Risk Weights

Part 324 assigns various risk weights for equity investments. Significant investments in the common shares of an unconsolidated financial institution that are not deducted from common equity tier 1 capital, are assigned a 250 percent risk weight when Basel III is fully phased in. For banks that are allowed 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. To the extent that the aggregate adjusted carrying value of certain equity exposures does not exceed 10 percent of the bank's total capital, a 100 percent risk weight may be applied.

Part 324 also contains various look-through approaches for equity exposures to investment funds. For example, if a bank 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, there is special treatment for a few classes of equity securities. Risk weights 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, an institution 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 bank by a third party trustee), gold bullion, certain investment grade<sup>2</sup> 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 6 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 a bank 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 expected 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. A bank may assign a zero percent risk weight to the collateralized portion of an exposure where the financial collateral is cash on deposit. A bank may also assign a zero percent risk weight if the financial collateral is an exposure to a sovereign<sup>3</sup> that qualifies for a zero percent risk weight and the bank has discounted the market value of the collateral by 20 percent. Transactions collateralized

<sup>2</sup> *Investment grade* means that the issuer has adequate capacity to meet financial commitments for the projected life of the asset or exposure.

<sup>3</sup> *Sovereign* means a central government (including the U.S. government) or an agency, department, ministry, or central bank of a central government.

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, banks may use collateral risk weights of 20, 50, and 100 percent, respectively.

### Treatment of Guarantees

Under Part 324, banks have 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 bank has a loan guaranteed by an eligible guarantor, the bank 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 banks. 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. Second, the credit equivalent amount is assigned to the appropriate risk category, like any other balance sheet asset.

### Advanced Approaches

An institution that has consolidated total assets equal to \$250 billion or more; that has consolidated total on-balance sheet foreign exposures equal to \$10 billion or more; is a subsidiary of a depository institution or holding company that uses the advanced approaches; or elects to use the advanced approaches is generally subject to the advanced approaches which are described in Part 324, Subpart E (Risk-weighted Assets - Internal Ratings-Based and Advanced Measurement Approaches) and Subpart F (Risk-weighted Assets - Market Risk). These subparts outline requirements for risk weighting a complex institution's assets and other exposures, including trading accounts. The advanced approaches are not described in this Manual. Please refer to Part 324 and other pertinent materials for detailed information.

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## MINIMUM REGULATORY CAPITAL RATIOS

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

- 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.

Section 324.4(b) indicates that any insured institution which 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. Section 324.4(c) indicates that any insured depository institution with a tier 1 capital to total assets ratio of less than 2 percent may be deemed to be operating in an unsafe and unsound condition.

Notwithstanding the minimum capital requirements, 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 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 requirement if the specific circumstances indicate such action 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 an institution to restore its capital to the minimum leverage requirement within a specified time period. Refer to Section 15.1 – Formal Administrative Actions for further discussion on capital directives.

## Supplementary Leverage Ratio

For advanced approach institutions, a supplementary leverage ratio of 3 percent will be required as of January 1, 2018. This supplemental ratio is not related to the four minimum capital ratios applicable to all insured institutions. The supplemental ratio 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:

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

In addition, the largest banking organizations will be subject to an enhanced supplementary leverage ratio beginning January 1, 2018. To avoid restrictions on capital distributions and discretionary bonus payments, bank holding companies (BHCs) with more than \$700 billion in consolidated total assets or more than \$10 trillion in assets under custody must maintain a leverage buffer greater than 2 percentage points above the minimum supplementary leverage ratio requirement of 3 percent, for a total of more than 5 percent. Insured depository institution subsidiaries of such BHCs must maintain at least a 6 percent supplementary leverage ratio to be considered well capitalized under the PCA framework.

## Capital Conservation Buffer

The capital conservation buffer is designed to strengthen an institution's financial resilience during economic cycles. Beginning January 1, 2016, financial institutions will be required to maintain a capital conservation buffer as shown in the table below in order to avoid restrictions on capital distributions and other payments.

<b>Year</b>	<b>CET1 Capital Conservation Buffer</b>
2016	0.625%
2017	1.25%
2018	1.875%
2019	2.50%

If a bank’s capital conservation buffer falls below the amount listed in the table above, 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 bank’s buffer. The following table reflects the maximum payout ratio for the fully phased in capital conservation buffer beginning January 1, 2019. For the maximum payout ratios during the transition period (January 1, 2016 through December 1, 2018), refer to Section 32.400(a)(2).

<b>Capital Conservation Buffer (% of RWA)</b>	<b>Maximum Payout Ratio (% of Eligible Retained Income)</b>
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 and require capital to be commensurate with the bank’s risk profile.

A bank 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 2.50 percent as of the end of the previous quarter. Eligible retained income is a bank’s net income as reported in its Call Reports for the four calendar quarters preceding the current quarter, net of any capital distributions, and certain discretionary bonus payments that were made during those four quarters.

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 a bank’s capital conservation buffer is 2.50 percent or less of risk-weighted assets, the bank’s maximum payout amount for capital distributions and discretionary payments would decline.

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.

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**PROMPT CORRECTIVE ACTION**

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. Notably, 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.

<b>PCA Category</b>	<b>Total RBC Ratio</b>	<b>Tier 1 RBC Ratio</b>	<b>CET1 RBC Ratio</b>	<b>Tier 1 Leverage Ratio</b>
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 bank 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 the bank 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.

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## **EXAMINATION-IDENTIFIED DEDUCTIONS FROM COMMON EQUITY CAPITAL**

### **Identified Losses and Inadequate Reserves**

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 Allowance for Loan and Lease Losses (ALLL) to an adequate 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; refer to Section 16.1 – Report of Examination Instructions for the Capital Calculations page instructions. Also, for the calculation of capital ratios, assets may need to be adjusted for certain identified losses; refer to the 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 inadequate ALLL, the following method should be used by examiners. 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. Additionally, the following method addresses situations where an institution overstated the amount of common equity tier 1 capital by failing to take necessary provision expenses to establish and maintain an adequate ALLL.

- 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) general reserves exist, refer to the discussion of Other Real Estate Reserves below.

- Deduct the amount of Loss for held-for-investment loans and leases from the ALLL in the calculation of tier 2 capital.
- If the ALLL is considered inadequate, an estimate of the provision expense needed for an adequate ALLL should be made. The estimate is made after identified losses have been deducted from the ALLL. Loans and leases classified Doubtful should not be directly deducted from capital. Rather, they should be included in the evaluation of the ALLL and, if appropriate, accounted for by the inadequate ALLL adjustment. An adjustment from common equity tier 1 capital to tier 2 capital for the provision expenses necessary to replenish the ALLL to an adequate level should be made when the amount is significant.

### **Other Real Estate Reserves**

Other real estate reserves, whether considered general or specific reserves, are not recognized as a component of regulatory capital. However, these reserves should be considered when accounting for ORE that is classified Loss. Examiners should consider the existence of any general ORE reserves when deducting ORE classified Loss. To the extent ORE reserves adequately cover the risks inherent in the ORE portfolio as a whole, including 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 reserves 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 bank records be adjusted so that all liabilities are properly reflected. Deficiencies in a bank'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 bills that are not reflected on the bank's books.

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## CAPITAL ADEQUACY

The FDIC's authority to enforce capital standards in financial institutions includes the use of written agreements, capital directives, and discretionary actions. A discussion on the use of these powers is included in Section 15.1 - Formal Administrative Actions, of this manual. 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 bank'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 determined and noted in the report, along with the examiner's assessment of the feasibility and sufficiency of those plans.

Supervisory assessments of capital adequacy will generally be based on the following factors.

### Less Than Adequately Capitalized Institutions

Banks that fail to meet minimum capital ratios are often subject to capital directives or other formal enforcement action by the FDIC to increase capital. Moreover, such institutions may have any application submitted to the FDIC denied if such application requires the FDIC to evaluate the adequacy of the institution's capital structure.

### Fundamentally Sound and Well-Managed Banks

Minimum capital ratios are generally viewed as the minimum acceptable standards for banks whose 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 bank's own condition and specific circumstances, the definition generally applies to those banks evidencing a level of risk, which is no greater than that normally associated with a Composite rating of 1 or 2. Banks 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.

### Problem Banks

Banks 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 bank 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 state or federal regulator that exceed the minimum capital requirement set forth by regulation. The FDIC will consult with the bank's primary state or federal regulator when establishing capital requirements higher than the minimum set forth by regulation.

### Capital Plans

Banks 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 bank's compliance with the plan. However, in any case, 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 Banks**

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 banks.

#### **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. 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 complete 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.
- 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**

Bank 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 bank's capitalization level by attempting to reduce 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 bank 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 banks that are experiencing capital adequacy problems.

#### **Contingent Liabilities**

Contingent liabilities reflect potential claims on bank 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 bank 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 a bank 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 bank is defendant or claims arising from trust operations could reduce an institution's cash or other assets.

#### **Examination Policies**

Examination interest in contingent liabilities is predicated upon an evaluation of the impact contingencies may have on a bank's condition. Contingent liabilities that are significant in amount or have a high probability of becoming direct liabilities must be considered when the

bank'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 charges against capital accounts 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 bank'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 bank 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 deducted from the allowance for credit losses on off-balance sheet credit exposures, not Common Equity Tier 1 Capital.

A bank'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 bank. 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 the Statement of Financial Accounting Standards Codification (ASC) 450 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 bank 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 bank and assess the pending impact on its financial condition.

### Litigation

If the bank is involved in a lawsuit where the outcome may affect the bank'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 bank's defense, the status of any negotiations toward a compromise settlement, and the opinion of bank management or counsel relative to the probability of a successful defense. In addition, corroboration of information and opinions provided by bank management regarding significant lawsuits should be obtained from the bank'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 bank 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 the trust department due to actions or inactions of the bank 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 bank's capital accounts. Therefore, the dollar volume and severity of such contingencies must be analyzed during the safety and soundness examination.

### **Consigned Items and Nonledger Control Accounts**

Banks sometimes provide customer services that do not result in transactions entered on the general ledger. These customer services include safekeeping, rental of safe deposit box facilities, purchase and sale of investments for customers, sale of traveler's checks, and collection department services. It is management's responsibility to ensure that collateral and other nonledger items are properly recorded and protected by effective custodial controls. Proper insurance protection must be obtained to protect against claims arising from mishandling, negligence, or other unforeseen occurrences. Failure to take protective steps may lead to contingent liabilities. The following is a brief description of customer service activities involving consigned items.

#### **Customer Safekeeping**

*Safe Deposit Boxes* - The bank and its customers enter into a contract whereby the bank receives a fee for renting safe deposit boxes and assumes responsibility of exercising reasonable care against loss of the box's contents. When a loss does occur, unless the bank can demonstrate that it employed reasonably prudent care, it could be held liable. Safe deposit box access should be granted only after verifying the lessee's signature at each visit. The bank generally cannot gain access to a customer's safe deposit box except as allowed under certain statutes or court orders.

*Safekeeping* - In addition to items held as collateral for loans, banks occasionally hold customers' valuables. To limit potential liabilities, banks should attempt to discourage this practice by emphasizing the benefits of a safe deposit box, but when not possible or practical to do so, the same procedures employed in handling loan collateral must be followed.

*Custodial Accounts* - Banks may act as custodian for customers' investments such as stocks, bonds, or gold. When serving as custodian, the bank has only the duties of safekeeping the property involved and performing ministerial acts as directed by the principal. As a rule, no management or advisory duties are exercised. Before providing such services, the bank should seek advice of legal counsel concerning applicable state and federal laws governing this type of relationship. In addition, use of

signed agreements or contracts, which clearly define the bank's duties and responsibilities is an important part in limiting potential liability.

#### **Collection Items**

The collection department may act as an agent for others in receiving, collecting, and liquidating items. In consideration for this service, a fee is generally received. An audit trail must be in place to substantiate proper handling of all items to reduce the bank's potential liability.

#### **Consigned Items**

Consigned items typically include traveler's checks. Banks share a fee with the consignor of traveler's checks. A working supply is generally maintained at the selling station(s) and the reserve supply should be maintained under dual control in the bank's vault.

#### **Reserve Premium Accounts**

The American Bankers Association (ABA) sponsored the creation of the American Bankers Professional and Fidelity Insurance Company Ltd. (ABPFIC). The ABPFIC is a mutual insurance company that reinsures a portion of Progressive Company's directors and officers liability and fidelity bond insurance programs, which are available to banks that are ABA members. Banks that obtain insurance coverage from Progressive become members of ABPFIC. As a mutual reinsurance company, ABPFIC established a mechanism (a Reserve Premium Account) by which its members are required to provide additional funds to ABPFIC to cover losses.

The Reserve Premium Account Agreement between the bank and the ABPFIC provides for the bank to deposit into the Account an amount equal to the insurance premiums quoted by Progressive for the bank's first year combined Director and Officer Liability insurance, Financial Institution Bond, and such other coverages written by Progressive. No funds are actually placed with or transferred to ABPFIC when a Reserve Premium Account is established. Rather, a bank can satisfy this deposit requirement by pledging or otherwise earmarking specific bank assets for this purpose.

Unless ABPFIC makes a demand for payment from Reserve Premium Accounts to cover losses, the assets in such accounts remain bank assets and any associated earnings are the banks'. Any demand for payment would reportedly be made on a pro rata basis to all banks that must maintain a Reserve Premium Account. Establishing a Reserve Premium Account results in a Category II

contingent liability equal to the bank's deposit into the account.

Under ASC 450 a bank would accrue an estimated loss from the contingent liability resulting from having entered into a Reserve Premium Account Agreement with ABPFIC when and if available information indicates that (1) it is probable that ABPFIC will make a demand for payment from the account and (2) the amount of the payment can be reasonably estimated.

The asset used to satisfy the Reserve Premium Account requirement should be shown in the proper balance sheet category and considered a pledged asset. If a bank pledged or otherwise earmarked any short term and marketable assets (e.g., securities) for its Reserve Premium Account, the amount of the bank's contingent liability should be reflected in management's internal liquidity analysis since the assets used to satisfy Reserve requirement are not available to meet liquidity needs.

## ← EVALUATING CAPITAL ADEQUACY

Banks are expected to meet any capital requirements properly established by its primary state or federal regulator, which exceed the minimum capital requirement set forth in the regulation. Once these minimum capital requirements are met, the evaluation of capital adequacy extends to factors that require a combination of analysis and judgment. Banks are too dissimilar to permit use of standards based on one or only a few criteria. Generally, 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.

It is important to note that what is adequate capital for safety and soundness purposes may differ significantly from the minimum leverage and risk-based standards and the *Well Capitalized* and *Adequately Capitalized* definitions that are used in the PCA regulations and certain other capital-based rules. The minimums set forth in the leverage and risk-based capital standards apply to sound, well-run institutions.

In all cases, a financial institution is expected to maintain capital commensurate with the risks to which it is exposed, especially the volume and severity of adversely classified assets.

After determining that an institution meets the minimum capital requirements, examiners should use judgment and financial analysis to assess the overall adequacy of an institution's capital. The capital adequacy of an institution

is rated based upon, but not limited to, an assessment of the following factors.

### 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 teams 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.

### Quality of Capital

The composition of 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 enhances the institution's resiliency. For instance, all things being equal, voting common equity is higher quality than hybrid capital instruments because voting common equity is available to absorb losses as they occur while hybrid capital instruments have debt-like features that may limit its ability to absorb losses.

### 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 strength of a holding company. A combination of ratio analysis and examiner judgment is required to evaluate these types of 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 adequacy of the ALLL are vital factors in determining capital adequacy. Items to consider include:

- The type and level of problem assets,
- Loan-origination and portfolio-administration activities,
- The level of the ALLL, and
- The institution's methodology for establishing the ALLL level.

Examiners should consider current, and when applicable prior, examination findings when assessing capital adequacy. Examiners should also review Uniform Bank Performance Reports and perform appropriate level and trend analysis. In assessing the ALLL adequacy, examiners should review the institution's ALLL methodology in accordance with outstanding regulatory and accounting pronouncements.

### **Balance Sheet Composition**

The quality, type, and diversification of on- and off-balance sheet items must be considered when reviewing the adequacy of an institution's capital. Risk-weighted capital guidelines and ratios can help examiners determine the adequacy of capital protection, but examiner judgment is required to assess overall capital adequacy. For example, a portfolio of 150 percent risk-weighted 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 adequately manage such risks.

### **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 nontraditional-banking initiatives, can expose the bank to losses that could affect capital. Similarly, lawsuits against the bank, or other contingent liabilities such as off-balance sheet lending, may indicate a need for greater capital protection and must be carefully reviewed.

### **Earnings and Dividends**

A bank's current and historical earnings record is one of the key elements to consider when assessing capital adequacy. Good earnings performance enables a bank 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 dividend policy is also of importance. Excessive dividends can negate strong earnings performance and result in a weakened capital position, while excessively low dividends may lower the attractiveness of the stock to investors, which can be a detriment should the bank need to raise additional equity. Generally, earnings should first be applied to the elimination of losses and the establishment of necessary reserves and prudent capital levels. Thereafter, dividends

can be disbursed in reasonable amounts. Consideration should be given to the extent affiliates rely on or require dividends and other support and the potential impact to the institution's capital position, including in 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 past performance and future prospects is a good starting point for this review. The examiner may want to compare asset growth to capital formation during recent periods. The examiner should review the current budget and strategic plan to review growth plans and potential impact to capital adequacy.

### **Access to Capital Sources**

Management's access to capital sources, including existing shareholders and holding company support, is a vital 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. Also, the financial capacity of existing shareholders and strength of a holding company will factor into capital access. If a holding company previously borrowed funds to purchase newly issued stock of a subsidiary bank (a process referred to as double leverage), the holding company may be less able to provide additional capital. The examiner would need to extend beyond standard ratio analysis of the bank to assess management's access to capital sources. For example, examiners can consider current market conditions when assessing the institution's ability to raise 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.