Office of Thrift Supervision **November 20, 2003**

Department of the Treasury

Regulatory Bulletin
RB 32-31

Handbook: **Thrift Activities**

Subject: **Capital** **Section: 120**

Thrift Activities Regulatory Handbook Update

Summary: This bulletin provides an update to Thrift Activities Regulatory Handbook Section 120, Capital Adequacy. Please replace the existing handbook section with the enclosed revised section.

For Further Information Contact: Your Office of Thrift Supervision (OTS) Regional Office or the Supervision Policy Division of the OTS, Washington, DC. You may access this bulletin at our web site: www.ots.treas.gov.

Regulatory Bulletin 32-31

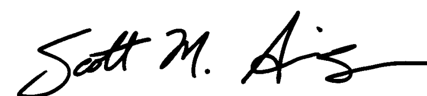
SUMMARY OF CHANGES

OTS is issuing an update to Thrift Activities Handbook Section 120, Capital Adequacy. In general, we rewrote and reorganized Section 120 in its entirety. This handbook section is in plain language.

We provide a summary of all substantive changes below.

120 Capital Adequacy

- Updated the handbook section and examination program to reflect current OTS rules and policies.
- Added an appendix to discuss capital components and risk-based capital, including a description and examples of capital treatment for recourse, residual interests, and direct credit substitutes.
- Added an appendix of supplementary issues and information.



—Scott M. Albinson

Managing Director, Supervision

INTRODUCTION

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

Capital Adequacy

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

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

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

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

SECTION OVERVIEW

This Handbook Section provides guidance in three main areas:

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

Appendices to this Handbook Section provide additional guidance:

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

CAPITAL REQUIREMENTS

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

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

Tangible, Core, and Risk-based Capital

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

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

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

Composition of Capital

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

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

Tangible Capital

Schedule CCR of the TFR includes detailed computational instructions for calculating core and risk-based capital. The TFR instructions do not include a calculation for tangible capital. While all three capital requirements exist as a matter of law, the tangible capital requirement has effectively been eclipsed by the more stringent PCA requirements (see below). Tangible capital is defined in 12 CFR § 567.9.

Prompt Corrective Action (PCA) Categories

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

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

	Tier 1/Leverage		Tier 1/Risk-Based		Total Risk-Based
Well Capitalized	5% or greater	*and*	6% or greater	*and*	10% or greater
Adequately Capitalized	4% or greater (3% for 1-rated)	*and*	4% or greater	*and*	8% or greater
Undercapitalized	Less than 4% (except for 1-rated)	*or*	Less than 4%	*or*	Less than 8%
Significantly Undercapitalized	Less than 3%	*or*	Less than 3%	*or*	Less than 6%
Critically Undercapitalized	Has a ratio of tangible equity* to total assets that is equal to or less than 2%				

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

Minimum Standards vs. Capital Adequacy

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

Capital For Subprime Lending Programs

Thrifts with subprime lending programs are responsible for quantifying the amount of capital they need to offset the additional risk for these programs. As a starting point you should reasonably expect a thrift to hold capital against subprime portfolios in an amount that is one and one half to three times greater than for nonsubprime assets of a similar type. A thrift's ALLL should also be adequate to address its subprime program. More information about subprime lending and risk analysis for capital adequacy is available in guidance issued by the four federal banking agencies and available on the OTS website. It applies to subprime lending programs that exceed 25 percent of a thrift's Tier 1 capital. (Refer to CEO Memo No. 137, Expanded Guidance for Subprime Lending Programs, issued February 2, 2001.)

Individual Minimum Capital Requirement (IMCR)

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

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

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

Reservation of Authority

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

Documentation Requirements

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

EVALUATING CAPITAL ADEQUACY

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

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

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

Asset Quality

Asset quality is a key factor in evaluating capital adequacy. You should consider the extent to which individual assets exhibit serious weaknesses or loss of value. Key indicators of overall asset quality are the dollar value of assets subject to adverse classification and the severity of those classifications relative to capital. You should consider delinquency and foreclosure trends, the level of nonaccrual or nonperforming loans, and market depreciation of securities. When assessing capital adequacy, you should evaluate the risks associated with each lending and investment program. Thrifts with higher risk lending programs should maintain sufficient ALLL to offset expected losses and a higher capital base to absorb unanticipated losses.

Earnings

Consider earnings performance and dividend practices. Good earnings performance enables a thrift to fund its growth and remain competitive in the marketplace while at the same time retaining sufficient equity to maintain a strong capital position. However, excessive dividends can negate even exceptional earnings performance and result in a weakened capital position. Generally, management should first apply earnings to the elimination of losses and the establishment of necessary reserves and prudent capital levels; and then, after full consideration of those needs, management may disburse dividends in a reasonable amount.

Subordinate Organizations

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

Relationships with Affiliates

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

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

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

Interest Rate Risk

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

Liquidity and Funds Management

Thrifts that are in a constricted liquidity situation may have no alternative but to dispose of assets at a loss in order to honor funds outflows, and such losses must be absorbed by the capital accounts. Generally, the lower a thrift's level of liquidity, the more seriously you should consider higher capital requirements.

Deposit Structure

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

Contingent Liabilities

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

Off-Balance-Sheet Activities and Exposures

A thrift may engage in off-balance-sheet activities such as trust administration, mortgage banking, or construction lending. In such cases, you must determine whether the thrift is exposed to economic risks or potential legal liabilities that are not fully captured by generally accepted accounting principles (GAAP) or regulatory capital rules. Note that while risk-based assets include many off-balance-sheet risk exposures, the Tier 1 capital requirement does not address off-balance-sheet risk.

New Products and Activities

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

Local Characteristics

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

Risk Diversification

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

Quality of Management

The ability, experience, depth, integrity and record of management are important in your assessment of a thrift's capital adequacy. In fact, it is difficult to conceive of a capital structure capable of withstanding the deterioration that eventually results from inept or dishonest management. Sound management includes the formulation and

implementation of strong policies and procedures relative to loans, investments, interest rate risk, operations, internal controls, audits, and other functional areas. Deficiencies in these policies or their implementation can readily have an adverse effect on the thrift's capital position.

Future Plans

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

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

An analysis of the ratio of equity growth to asset growth can be helpful in your analysis of capital trends. When this ratio is less than one, it signifies that assets are expanding faster than capital growth, hence a declining equity position and increasing financial leverage.

Peer Comparison

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

RATING THE CAPITAL COMPONENT

This determination is a judgmental process that requires you to consider all of the objective and subjective variables, concepts and guidelines discussed above. You should evaluate capital relative to a thrift's risk profile, rather than simply to a minimum regulatory requirement. These are the standards set by the Uniform Financial Institutions Rating System:

- A rating of "1" indicates a strong capital level relative to the thrift's risk profile.
- A rating of "2" indicates a satisfactory capital level relative to the thrift's risk profile.
- A rating of "3" indicates a less than satisfactory level of capital that does not fully support the thrift's risk profile. The rating indicates a need for improvement, even if the thrift's capital level exceeds minimum regulatory and statutory requirements.
- A rating of "4" indicates a deficient level of capital. In light of the thrift's risk profile, viability of the thrift may be threatened. The thrift may need assistance from shareholders or other external sources of financial support.
- A rating of "5" indicates a critically deficient level of capital that threatens the thrift's viability. The thrift needs immediate assistance from shareholders or other external sources of financial support.

REFERENCES

United States Code (12 USC)

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

Code of Federal Regulations (12 CFR)

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

Office of Thrift Supervision Bulletins and CEO Letters

Regulatory and Thrift Bulletins

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

CEO Letters

No. 135	The New Basel Capital Accord
No. 137	Expanded Guidance for Subprime Lending Programs
No. 141	Joint Agency Advisory on Brokered and Rate-Sensitive Deposits
No. 160	Regulatory Capital Treatment for Accrued Interest Receivable in Credit Card Securitizations
No. 161	Unsafe and Unsound Use of Covenants Tied to Supervisory Actions in Securitization Documents
No. 162	Implicit Recourse in Asset Securitizations
No. 163	Questions and Answers on the Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations

Additional Interagency Guidance

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

Capital Adequacy
Program

Examination Objectives

To determine the adequacy and composition of the thrift's current and planned level of capitalization, considering the thrift's unique risk characteristics, overall condition, and planned direction.

To determine the effectiveness of management and the board of directors in actively monitoring, maintaining, and planning for capital adequacy.

To determine if the thrift's capital-related policies and procedures are adequate and are being adhered to by thrift personnel.

To determine the adequacy of audit and accounting practices and procedures, including the system of internal controls, as they relate to capital accounts.

To determine compliance with laws, rulings, regulations, and specific agreements with OTS, FDIC, or state authorities.

To ascertain the need for, or to initiate, corrective action (including acting under prompt corrective action provisions) when policies, practices, procedures, or internal controls are deficient, or when there are violations of laws, rulings, directives, or regulations.

Examination Procedures

Wkp. Ref.

Level I

1. Obtain and review the information on capital provided in the UTPR, off-site monitoring reports, report of examination spreadsheets, latest examination report, latest audit reports, latest SEC reports, business plan, and correspondence with the OTS and other regulatory authorities. Consult with the examiner(s) reviewing the board of directors and committee minutes for any other items pertinent to the review of capital.

_______________________________________ __________

2. Through discussions with management and review of documents, determine if management has taken corrective action relative to:

   - Prior examination report comments and exceptions.

Exam Date: ____________
Prepared By: ____________
Reviewed By: ____________
Docket #: ____________

Wkp. Ref.

- Internal and external audit exceptions.
- Any enforcement/supervisory actions and directives.

3. Review the thrift's compliance with relevant capital standards.
   - Compare capital levels with minimum PCA capital requirements, and determine the institution's PCA capital category.
   - Is the institution subject to any capital plan, capital directive, supervisory action, written agreement, or application condition regarding capitalization? If so, is the institution in compliance?
   - Is the institution in compliance with its internal business plan or board imposed capital targets?
   - Evaluate the thrift's risk profile including asset composition, interest rate risk, and other risks including off-balance-sheet risk.

4. Review trends in capital levels and ratios. Consider the prospects for continuing capital compliance, and consider whether management has planned for capital adequacy in line with anticipated growth. Consider whether the risk orientation of the institution is changing.

5. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.

Exam Date: __________
Prepared By: __________
Reviewed By: __________
Docket #: __________

Wkp. Ref.

Level II

6. Verify the reliability and accuracy of the institution's capital calculations. If necessary, revise the capital calculations and recheck the PCA level.

   - Identify and reconcile capital accounts for activity since the last examination. Verify the accuracy of entries and outstanding balances. Be alert for changes in the capital accounts that the thrift has not recorded in the income statement.

   - Identify and investigate any material differences between capital reported to OTS in the TFR, and capital reported in the audited financial statements and SEC filings (as applicable).

   - Obtain the latest quarter-end TFR Schedule CCR including the institution's corresponding worksheet for calculating its capital levels. Obtain related work papers and review them for reliability. Refer to the TFR instructions, Schedule CCR, for additional guidance.

   - Consult with the examiner completing Program 410, Financial Records and Reports, to determine if there are any reporting errors that could affect the institution's capital requirement calculations.

   - Verify that the institution's capital calculations are accurate. Some of the following areas may be material to the reliability of the capital calculations:

     — Subsidiary activities

       ✓ Are the activities permissible?

       ✓ Has the institution properly excluded or deducted its nonincludable subsidiaries?

       ✓ Have loans and advances to impermissible subsidiaries been deducted from capital and assets as required?

     — Has the thrift deducted goodwill and intangible assets from capital and assets?

     — Are assets subject to limitation appropriately handled?

Exam Date: __________
Prepared By: __________
Reviewed By: __________
Docket #: __________

Wkp. Ref.

- ✓ Servicing assets
- ✓ Purchased credit card relationships
- ✓ Deferred tax assets
- ✓ Credit enhancing IO strips

— Are unrealized gains and losses on AFS securities properly handled?

— Are maturing capital instruments properly handled?

— Is the ALLL free of specific reserves?

— Has the thrift institution properly excluded from risk-based capital items that are not includable (for example, equity investments, reciprocal holdings of capital instruments)?

— Are delinquent single-family and multi-family loans properly risk weighted?

— Are high LTV loans properly risk weighted?

— Are LIP and commitments properly handled?

— Are post-period-end adjustments correct?

— Has the thrift properly treated assets sold with recourse?

— Is the thrift properly holding dollar-for-dollar capital against most residual interests? (And, is the thrift deducting any credit-enhancing interest-only strips that exceed 25 percent of Tier 1 capital?)

---

7. Determine a level of capital that is appropriate for the risk profile. Where applicable, apply the capital guidance for subprime lending programs. If appropriate, recommend an individual minimum capital requirement, or use of the OTS reservation of authority.

- Consider the risk orientation and diversification of loan and investment portfolios. Do portfolios present excessive risk? Is the institution's risk orientation changing?

Exam Date: ____________
Prepared By: ____________
Reviewed By: ____________
Docket #: ____________

Wkp. Ref.

- Identify and analyze the risks associated with off-balance-sheet activities. Analyze the economic risks or legal liability associated with activities such as asset securitization, trust administration, mortgage banking, or construction lending.

- Consider the institution's growth trends and goals. Review the effect of earnings and dividends on capital. Does the institution have the quality and level of earnings or balance sheet flexibility to support planned growth, structural changes, or new activities?

- Confer with the examiners assigned to Program 260, Classification of Assets, and Program 261, Valuation Allowances, to determine if specific allowances and ALLL are adequate. If not, determine the effect on capital. Ascertain the effect of current and potential losses.

- Consider whether asset portfolios have a higher than normal risk level for the particular type of asset. Protection against unanticipated or unidentified credit losses should be reflected in the institution's capital position. If an institution has a relatively high risk profile, its capital level should be commensurately higher.

- Evaluate capital adequacy of the thrift insitution after deducting assets of regulated subsidiaries and the capital needed to meet regulatory capital requirements at those subsidiaries.

- Consider the effect that service corporation and other subsidiary activities may have on the need for capitalization, including the potential liability of the parent thrift for obligations of the subsidiary.

- Evaluate the parent holding company's reliance on dividend payments from the subsidiary institution. Review related SEC filings for transactions between the institution and the holding company. Consider the appropriateness of earnings retention and dividend policies.

- Review the most recent external audit report (including management and internal control letter) and consult with the examiners assigned to Internal Controls and Internal Audit. Determine if deficiencies in internal controls and audit systems exist. Does an above normal level of operational risk require a higher level of capital?

Exam Date: ____________
Prepared By: ____________
Reviewed By: ____________
Docket #: ____________

Wkp. Ref.

8. Assess management's capital planning process.

   - Review management reports, such as the budget, strategic business plan, and capital plan to assess the adequacy and effectiveness of the institution's planning efforts.
   - Evaluate the institution's access to capital markets. Consider the probability of success of planned capital-raising strategies.

---

9. If capital falls below the PCA well capitalized standards or if you determine that capital is inadequate or marginal relative to the institution's risk profile:

   - Identify the appropriate PCA category. Discuss your determination with the EIC and OTS regional management.
   - Determine if a supervisory or enforcement action is appropriate to address the capital deficiency or whether an IMCR Directive should be imposed. Discuss your recommendation with the EIC and OTS regional management. See Appendix A, Prompt Corrective Action Guidelines in Section 370, Enforcement Actions, for guidance.
   - Confirm with your regional office that they are following PCA guidelines.
   - Review any Guarantee of Controlling Parties for adequacy.
   - Identify the need for any additional operating restrictions.
   - Inform management of your conclusions, and the restrictions that apply to an institution that is less than well capitalized. The following restrictions apply:
     - — The mandatory and discretionary supervisory actions that apply to an institution that is less than adequately capitalized (Number 10 below).
     - — The pass-through insurance restrictions (Number 11 below).
     - — The broker deposit restrictions (Number 12 below).

Exam Date: ____________
Prepared By: ____________
Reviewed By: ____________
Docket #: ____________

Wkp. Ref.

10. If the institution is less than adequately capitalized (as reflected in its TFR report, a final report of examination, or disclosed in a notice from OTS – see §565.3), you should review for compliance with the mandatory and discretionary supervisory actions. You can refer to §565.6 for a description of the mandatory and discretionary actions.

---

11. If the thrift institution is less than well capitalized, or if based upon your examination findings, you believe it may become less than well capitalized in the near future, review for notification of account holders subject to losing FDIC pass-through insurance coverage (see Regulatory Bulletin 33a):

- Determine whether the thrift has any employee benefit plan deposits or intends to accept any employee benefit plan deposits.
- If so, review the procedures developed to ensure compliance with FDIC regs at 12 CFR §330.14. This would include:
  - — A determination that sample disclosures have been developed and shared with appropriate thrift personnel.
  - — A determination that procedures have been developed to provide the appropriate disclosures to employee benefit plan depositors when opening a new account and when an existing empoyee benefit plan depositor (administrator or manager) makes a request for information.

---

12. Check for compliance with brokered deposit restrictions. Only well capitalized institutions may accept brokered deposits without restriction. If the thrift institution is not well capitalized, you may refer to Thrift Activities Handbook Section 560, Deposits and Borrrowed Funds, for the applicable restrictions and prohibitions on brokered deposits.

Exam Date: __________
Prepared By: __________
Reviewed By: __________
Docket #: __________

Wkp. Ref.

13. Ensure that your review meets the Objectives of this Handbook Section. State your findings and conclusions, and appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages.

Examiner's Summary, Recommendations, and Comments

Exam Date: ____________
Prepared By: ____________
Reviewed By: ____________
Docket #: ____________

CAPITAL COMPONENTS & RISK-BASED CAPITAL

This appendix is an abbreviated summary from the Capital Regulation. Refer to the regulation in 12 CFR §567 for important details and other items not included in this appendix. You will find relevant definitions in §567.1. We have organized this Appendix as follows:

- Composition of Capital.
- Risk-based Capital.
- Risk-based Capital Treatment for Recourse Exposures, Direct Credit Substitutes, and Residual Interests.

COMPOSITION OF CAPITAL

Tier 1 (Core) Capital

Tier 1 (core) capital includes:

- GAAP capital.

<u>Less</u>

- Investments in and advances to nonincludable subsidiaries.
- Goodwill and other intangible assets.
- Equity instruments not qualifying for Tier 1 capital[1] (for example, cumulative preferred stock).
- Servicing assets and purchased credit card relationships (PCCRs) in excess of limitations (see §567.12).
- Disallowed deferred tax assets (see Thrift Bulletin No. 56).
- Credit-enhancing interest-only strips in excess of 25 percent of Tier 1 capital (see §567.5 and §567.12).
- Accumulated gains on certain available-for-sale debt and equity securities[1] and qualifying cash-flow hedges.[2]

<u>Plus</u>

- Minority interests in equity accounts of fully consolidated includable subsidiaries.
- Mutual thrift nonwithdrawable and pledged deposit accounts.
- Accumulated losses on certain available-for-sale debt securities,[1] and accumulated losses on qualifying cash-flow hedges.[2]

Tier 2 (Supplementary) Capital

Tier 2 (supplementary) capital includes:

- Permanent capital instruments such as:
  - Mutual capital certificates and nonwithdrawable accounts not counted for Tier 1 capital.
  - Cumulative perpetual preferred stock.
  - Qualifying subordinated debt.
- Maturing capital instruments (for example, non-perpetual preferred stock).
- Allowance for loan and lease losses (ALLL) up to 1.25 percent of risk-weighted assets.
- Up to 45 percent of unrealized gains, net of unrealized losses on available-for-sale equity securities with readily determinable fair values.

<u>Note</u>: Tier 2 capital may not exceed Tier 1 capital.

Total (Risk-based) Capital

A thrift's total (risk-based) capital is the sum of:

---

[1] Refer to the TFR instructions. The purpose is to exclude certain components of GAAP capital that are not part of common stockholders' equity under regulatory capital definitions.

[2] Refer to the December 1998 interagency statement, "Interim Guidance on the Regulatory Reporting and Capital Treatment of Derivatives."

- Tier 1 capital.

Plus

- Tier 2 capital (to the extent that Tier 2 capital does not exceed 100 percent of Tier 1 capital).

Less

- Reciprocal holdings of the capital instruments of another depository institution.
- Equity investments (using the definition of equity investments in §567.1).
- Low-level recourse exposures and residual interests that the thrift chooses to deduct using the simplified/direct deduction method excluding:
  - — The credit-enhancing interest-only strips already deducted from Tier 1 capital. (See low-level recourse and residual examples further below.)

RISK-BASED CAPITAL

General Description

The risk-based capital requirement captures primarily credit risk from on-balance-sheet assets and most off-balance-sheet commitments and obligations. OTS requires a thrift to maintain a total risk-based capital ratio equal to at least 8 percent of assets after risk weighting. Most thrifts have a risk-based capital ratio of 10 percent or higher in order to manage a well capitalized status.

You determine a thrift's risk-weighted assets by allotting assets among the risk-weight categories. There are four standard risk-weight categories: 0 percent, 20 percent, 50 percent, and 100 percent.[3] The risk weight depends upon the nature of the assets, obligors, and collateral. In general, if a particular item can be placed in more than one risk category, you may assign it to the category that has the lower risk weight. However, the following procedures apply:

- You convert off-balance-sheet commitments and exposures to credit equivalent amounts by a conversion factor. You then risk weight the credit equivalent amounts in accordance with the rules used for on-balance-sheet assets.
- Many recourse exposures and direct credit substitutes generally require a gross-up capital treatment.
- Most residual interests receive a dollar-for-dollar capital treatment.

Assuming the PCA category of adequately capitalized, the effect of this risk weighting approach is the following:

Risk Weight Bucket	Effective Capital Charge
0%	No capital charge
20%	1.6%
50%	4.0%
100%	8.0%
200%	16.0%
Dollar-for dollar	100.0%

Risk Weights: On-Balance-Sheet Assets

Asset types not specifically addressed in the regulation automatically receive a 100 percent risk weight unless OTS determines that a different risk weight, or a different capital treatment is appropriate. Below is a general summary of the risk weight buckets:

0 Percent Risk-Weight Category

This category is for the lowest risk assets. This category includes:

- Cash.

[3] There is also a 200% risk weight-category used in the ratings-based approach. In addition, certain items receive a dollar-for-dollar capital treatment, equivalent to a risk weighting of 1250% (the reciprocal of 8%). See the Recourse section later in this Appendix.

- Obligations of, or fully guaranteed by, the full faith and credit of the United States Government (includes most GNMA obligations).
- Balances at Federal Reserve Banks.

20 Percent Risk-Weight Category

This category is for very high credit-quality assets. The 20 percent risk-weight category includes:

- Securities issued by or guaranteed by government sponsored agencies (including Fannie and Freddie for example), *except for their principal only securities (POs), interest-only securities (IOs)*, and their equity securities.
- Claims on, balances due from, and stock of the Federal Home Loan Banks.
- Items collateralized by cash held in a segregated deposit account at the thrift.
- The portion of assets collateralized by the current market value of U.S. Government securities.
- Assets conditionally guaranteed by the U.S. Government or its agencies.
- General obligations of state and local governments.
- Claims on domestic depository institutions.
- Asset-backed securities rated AAA or AA under the ratings-based approach, but excluding stripped securities.
- Certain claims on, or guaranteed by, qualifying securities firms.

  A *qualifying securities firm* in the United States is a broker-dealer registered with the Securities and Exchange Commission (SEC) that complies with the SEC's net capital regulations. A different definition applies to foreign-based firms. (See § 567.1.)

  For a claim on, or guaranteed by, a qualifying securities firm to qualify for 20 percent risk weight, the firm must have a long-term issuer credit rating, or a rating on at least one issue of long-term unsecured debt, from a nationally recognized statistical rating organization (NRSRO). The rating must be in one of the three highest investment grade categories used by the NRSRO. If two or more NRSROs assign ratings to the firm, the thrift must use the lowest rating to determine whether it meets the rating requirement. The firm may rely on the rating of its parent consolidated company *if the parent guarantees the claim.*

  A collateralized claim on a qualifying securities firm does not have to comply with the rating requirement if it meets all of the following requirements:

  — It is a reverse repurchase/repurchase agreement or securities lending/borrowing transaction executed using standard industry documentation.

  — It is collateralized by debt or equity securities that are liquid and readily marketable.

  — It is marked to market daily.

  — It is subject to a daily margin maintenance requirement under the standard industry documentation.

  — It can be liquidated, terminated or accelerated immediately in bankruptcy or similar proceeding, and the security or collateral agreement will not be stayed or voided under applicable law.

50 Percent Risk-Weight Category

This risk-weight category is for high credit quality assets. The 50 percent risk-weight category includes:

- Qualifying mortgage loans.
- Qualifying multifamily mortgage loans.
- Qualifying residential construction loans.
- Privately issued securities (excluding stripped or subordinated securities) backed by qualifying one- to four- family or multifamily mortgage loans – where the underlying loans are eligible for 50 percent risk weight.
- Most state and local revenue bonds.

- Asset-backed securities rated "A" under the ratings-based approach, but excluding stripped securities.

Qualifying mortgage loans are residential first mortgage loans on houses, condominiums, cooperative units, and manufactured homes. You do not include boats, motor homes, and time-share properties, even if they are a primary residence. Loans must not be over 90 days past due. You include mortgage loans on mixed-use properties that are primarily one- to four-family if they meet the qualifying criteria. If a thrift holds the first and junior lien(s) on a property, and no other party holds an intervening lien, you treat the transaction as a single loan secured by a first lien. Refer to 12 CFR §567.1 for the definition of qualifying mortgage loans. Note that the definition refers to and incorporates loan to value (LTV) criteria from the real estate lending guidelines in §560.101. Loans above 90 percent LTV will not typically qualify for 50 percent risk weight unless they have acceptable private mortgage insurance or other appropriate credit enhancement to effectively reduce their LTV to 90 percent or less.

Qualifying multifamily mortgage loans must meet the specific criteria of the regulation that tracks a federal statute. (Refer to the definition in 12 CFR §567.1.)

Qualifying residential construction loans must meet the specific criteria of the regulation. (Refer to 12 CFR §567.1.)

100 Percent Risk-Weight Category

This is the standard risk-weight category. You place assets not assigned another risk weighting in this category (excluding assets deducted from capital and residual interests which have a dollar-for-dollar capital requirement). You include the following in the 100 percent risk-weight category:

- Commercial loans and commercial real estate loans.
- Consumer loans.
- Second mortgage and home equity loans (except where you combine them with a qualifying first mortgage – see qualifying mortgage loan explanation above).
- Single-family and multifamily housing loans that do not qualify for the 50 percent risk-weight category.
- Construction loans.
- Mortgage-backed securities not qualifying for a lower risk-weight category, including most stripped securities (POs and IOs) issued by government sponsored agencies (but excluding subordinated classes, and excluding securities backed by subprime assets).
- Corporate debt securities.
- Bonds issued by a state or local government where a private party is responsible for payment.
- Repossessed assets and loans 90 days past due.
- Asset-backed securities rated "BBB" under the ratings-based approach, but excluding stripped securities.

Ownership in Mutual Funds (and other pooled assets)

For investments in investment companies, such as mutual funds, there are two alternatives:

- You may assign the entire investment to the risk-weight category applicable to the riskiest asset held in the investment company portfolio.
- You may assign different risk weights to the fund on a pro-rata basis, according to the investment limits for the different investment categories in the fund's prospectus.

The lowest risk weight for a mutual fund is 20 percent.

Off-Balance-Sheet Risk Exposures

Credit Conversion Factors for Off-Balance-Sheet Items

You determine risk weights for most off-balance-sheet items in a two-step process. First, you multiply the face amount of the item by a credit conversion factor to get the balance sheet credit

equivalent amount. You then risk weight the credit equivalent amount based on the nature of the collateral, the obligor, or type of asset.

Example: Conversion of an off-balance-sheet item

The thrift has extended a $30,000 home equity line of credit with a multi-year term. The borrower has not yet drawn the $30,000 and the line of credit remains unfunded. As shown in the bulleted list below, the conversion factor for home equity lines of credit for terms over one year is 50 percent. Assume that the line qualifies for 50 percent risk weight under the definition of qualifying mortgage loan (that is, where it may be combined with the first mortgage and there is no intervening lien – explained above in the 50 percent risk weight section).

- You multiply the unfunded line by the 50 percent conversion factor: $30,000 x 50% = $15,000.
- You then risk weight the $15,000 that you calculated. $15,000 x 50% risk weight = a $7,500 risk-weighted asset.
- You multiply the risk-weighted asset x the 8% risk-based capital requirement. $7,500 x 8% = $600.

As a result, the thrift must hold $600 in capital for the unfunded $30,000 line.

Note: For recourse exposures, direct credit substitutes, and subordinate exposures (other than residual interests), you generally must first gross-up the entire group of assets or total exposure that the off-balance-sheet item supports.

There are four credit conversion factor groups: 0 percent, 20 percent, 50 percent, and 100 percent.

0 Percent Credit Conversion Factor Group

This group includes:

- The unused portion of unconditionally cancelable retail credit card lines.
- Unused commitments (including LIP) with an original maturity of one year or less. (*This applies to most commitments to originate 1-4 family loans*).

LIP and other unused commitments with an original maturity over one year *if* they are unconditionally cancelable at any time at the thrift's option *and* the thrift either: (1) makes a separate credit decision before honoring each draw, or (2) at least annually performs a credit review to determine whether or not the lending facility will continue.

20 Percent Credit Conversion Factor Group

This group is for a narrow set of trade-related contingencies. That is, short-term, self-liquidating instruments used to finance the movement of goods and collateralized by the underlying shipment. A commercial letter of credit is an example of such an instrument.

50 Percent Credit Conversion Factor Group

This group includes:

- Unused portions of commitments, including home equity lines of credit, with an original maturity exceeding one year.
- Most LIP commitments with an original maturity over one year.
- Transaction-related contingencies such as performance bonds and performance-based standby letters of credit related to a particular transaction. For example, arrangements backing subcontractors' and suppliers' performance, labor and materials contracts, and construction bids.

100 Percent Credit Conversion Factor Group

This group includes:

- Guarantees or financial guarantee-type standby letters of credit.
- Recourse arrangements.
- Forward agreements with a certain drawdown. For example, legally binding agreements to purchase assets at a specified future date.

- Risk participations purchased in bankers acceptances.

Interest-Rate and Foreign Exchange-Rate Contracts

The credit equivalent amount of an interest-rate or exchange-rate contract is the sum of the current credit exposure (that is, the replacement cost of the contract) and the potential future credit exposure of the contract. You calculate this as follows:

Begin with: Replacement value of the contract, that is, the fair value of the contract, but not less than zero.

Add: Potential future credit exposure. To obtain potential future credit exposure you multiply the notional principal amount of the contract by the appropriate credit conversion factor. You can find the conversion factors from the chart:

Remaining Maturity	Interest rate contracts	Foreign exchange rate contracts
One year or less	0.0%	1.0%
Over one year	0.5%	5.0%

Then: Once you determine the credit equivalent amount, you assign it to the risk-weight category appropriate to the counterparty, or, if relevant, to the nature of any collateral or guarantee. However, the maximum risk weight is 50 percent.

Note: There are certain exceptions to the above calculation for foreign exchange contracts with an original maturity of less than 14 days, and for interest rate and exchange rate contracts traded on an exchange requiring the daily payment of variations in the market value of the contract. Thrifts may use bilateral netting to compute the net replacement value for multiple contracts with the *same* counterparty under certain conditions specified in the regulation.

RISK-BASED CAPITAL TREATMENT FOR RECOURSE, DIRECT CREDIT SUBSTITUTES, AND RESIDUAL INTERESTS

On November 29, 2001, OTS and the other federal banking agencies issued a capital rule for recourse, direct credit substitutes, and residual interests in asset securitizations. The capital rule addresses many aspects of risk resulting from asset securitization. While it integrates some aspects of OTS's previously existing capital rules and guidance for recourse and direct credit substitutes, the rule is far more extensive in order to address a very complex, evolving securitization marketplace. This section outlines and highlights some aspects of the rule that should be of interest to many thrifts. However, because of the complex nature of the rule, we recommend that you refer to the rule itself and its extensive preamble published in the federal register, which are available through the OTS web site at: *www.ots.treas.gov/docs/73135.pdf.*.

You can find the definitions pertaining to the rule along with other terms used in the OTS capital regulations in 12 CFR §567.1. The capital treatment from the rule is in §567.6(b). Refer also to CEO Letter No. 162, "Implicit Recourse in Asset Securitizations," and to CEO Letter No. 163, "Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations." OTS issued these CEO letters on May 23, 2002. They provide important supplementary information.

Through the rule's reservation of authority, OTS looks to the substance of a transaction regardless of how others categorize the allocation of risk. OTS may find that the proposed capital treatment by the thrift does not appropriately reflect risk to the thrift. OTS may then require the thrift to apply another risk weight, conversion factor, or treatment that OTS deems appropriate.

This part contains three sections:

- Capital Treatment for Recourse and Direct Credit Substitutes.
- Capital Treatment for Residual Interests.
- The Ratings-based Approach.

Capital Treatment for Recourse and Direct Credit Substitutes

Recourse

The term recourse refers to a thrift's retention, in form or in substance, of any credit risk directly or indirectly associated with an asset it has sold. A recourse obligation typically arises when a thrift transfers an asset in a sale (a sale according to generally accepted accounting principles) and retains an obligation to repurchase the asset or to otherwise absorb losses on the asset. Examples of recourse obligations include:

- Assets sold under an agreement to repurchase.
- Credit-enhancing representations and warranties related to sold assets.
- Retained loan servicing with an agreement under which the thrift is responsible for losses associated with the loans serviced (except for servicer cash advances as defined in §567.1).
- Clean-up calls on assets sold (except for clean-up calls that are 10 percent or less of the original pool balance and that are exercisable at the option of the thrift).
- Credit derivatives that absorb more than the thrift's pro rata share of losses on transferred assets.
- Loan strips sold where the maturity of the transferred portion of the loan is shorter than the commitment under which the loan is drawn.

Recourse can also exist implicitly. Implicit recourse arises when a thrift repurchases assets, absorbs losses, or otherwise supports assets that it has sold, in instances where it is *not contractually required* to do so. Refer also to CEO Letter No. 162.

As with other off-balance-sheet exposures, you must convert a recourse exposure to an on-balance-sheet asset by obtaining a credit equivalent amount. In the case of a simple loan sale with recourse, which may or may not involve asset securitization, you convert the entire balance of the loans sold to an on-balance-sheet asset using the 100 percent conversion factor.

In many instances a thrift retains a recourse exposure that is limited in dollar amount or as a percentage of assets transferred, but is designed to absorb the first losses that occur for the entire pool of transferred assets. The recourse exposure thus absorbs *more than its pro rata share of losses*. As a result, the general capital treatment for recourse exposures is gross-up, whereby the thrift must hold capital for the full amount of the transferred assets as if they were still on the balance sheet. OTS applies this relatively rigorous capital treatment because the recourse exposure receives more than its pro rata share of risk; it has the concentrated risk of all of the assets senior to it in the pool.

Therefore using the required gross-up approach, you obtain the credit equivalent amount by multiplying the *full amount of the credit-enhanced assets* for which the thrift directly or indirectly retains or assumes credit risk by a *100 percent conversion factor*. You assign this credit equivalent amount to the risk-weight category appropriate to the obligor in the underlying transaction after considering any associated guarantees or collateral. However, the following points apply:

- A thrift does not have to hold recourse capital for qualifying mortgage loans (50 percent risk weight 1-4 family loans) that it has sold, if the sales contract allows only a 120-day period for return of those loans. The thrift must have originated the loans within one year before sale. This exception would apply to a simple loan sale as well as a sale of loans into a securitization.
- There is an exception to the gross-up treatment for low-level recourse exposures where recourse is legally and contractually limited to an amount less than the on-balance-sheet capital requirement. OTS limits the capital requirement to the maximum exposure rather than the full ordinary capital requirement.

- A ratings-based approach allows a thrift to reduce its capital requirement for lower-risk, highly-rated recourse exposures.

Example: Recourse sale of loans

A thrift has sold $100 in qualifying mortgage loans (that is, 50 percent risk weight 1-4 family loans) into a securitization with an agreement to repurchase them for up to 180 days. Until the recourse period expires, total risk-weighted assets must include: ($100) x (100 percent conversion factor) x (50 percent r.w.) = $50. Thus, the capital requirement is: $50 x 8% = $4

Note: If the sales agreement limited the recourse to 120 days or less, there would be no capital requirement.

Example: Low-level recourse

A thrift contractually limits its maximum recourse exposure to less than the normal on-balance-sheet capital requirement for the assets sold with recourse. For example, if a thrift sells a $100,000 mortgage loan with 1 percent recourse, it is liable for $1,000 in losses, OTS requires the thrift to deduct $1,000 in computing the numerator for risk-based capital.

(This is in lieu of the thrift holding $4,000 in capital - assuming the loan qualifies for 50 percent risk weight).

The thrift may report this capital requirement in either of two ways: (1) a simplified/direct deduct approach where the thrift deducts the amount for computing total risk-based capital; or (2) a risk-weighted approach where the thrift multiplies the exposure by 12.5 (the reciprocal of 8%). In the risk-weighted method the thrift multiplies the $1,000 capital requirement by 12.5 for a risk-weighted asset of $12,500. Then, when the thrift multiplies $12,500 times the 8% risk-based capital requirement, the result is a $1,000 capital charge.

Direct Credit Substitutes

A thrift can guaranty, purchase, or assume a recourse exposure from another organization. We generally refer to these exposures as *direct credit substitutes*. A purchased subordinated security is an example of a direct credit substitute. Direct credit substitutes can be on- or off-balance-sheet. Examples of direct credit substitutes include:

- Financial standby letters of credit that support financial claims on a third party that exceed the thrift's pro rata share of the financial claim.
- Purchased subordinated interests that absorb more than their pro rata share of losses from the underlying assets.

When a thrift purchases a *subordinated asset-backed security* or similar interest, the thrift generally must gross-up the risk exposure in order to determine the capital requirement. This means that the thrift must hold capital against the total amount of the subordinated security plus all assets senior to it. However, the low-level recourse rule can apply to direct credit substitutes, and the ratings-based approach may also apply.

Example: Direct credit substitute – gross-up treatment

A thrift has purchased the first dollar loss subordinated interest of $5 in a securitization of $100 in qualifying mortgage loans (1-4 family 50% risk weight loans). The thrift must gross-up its exposure to include all exposures that are more senior to the security that the thrift owns. Thus the thrift must convert the $100 balance of the pool to an on-balance sheet asset at a 100% conversion factor. Then, the thrift risk weights the loans at 50%, resulting in $50 in risk-weighted assets. The capital requirement is $50 times 8 percent = $4.

Note: This example assumes that the first dollar loss position is **not** a credit-enhancing I/O strip (see Residual Interests below).

Capital Treatment for Residual Interests

Residual interests are on-balance-sheet risk exposures arising from sales (transfers) of financial assets that expose a thrift to credit risk on those transferred assets that exceeds a pro rata share of any claim that the thrift has on the assets. Residual interests do not include interests purchased from a third party, except for credit-enhancing interest-

only strips. A primary example of a residual is a *retained* subordinated interest in assets formerly owned by the thrift.

The standard capital treatment for most residual interests is *dollar-for-dollar*. That is, the thrift must hold one dollar in capital for every one dollar in residual interests.

Example: Residual interests

A thrift has retained the first dollar loss subordinated interest of $15 in *its own securitization* of $100 in qualifying mortgage loans (50% risk weight 1-4 family). The risk-based capital requirement is $15, that is, $1 of capital for $1 of residual interests – dollar-for-dollar capital.

Similar to the low-level recourse example, the thrift may report this capital requirement in either of two ways:

- A simplified/direct deduct approach where the thrift deducts the amount for computing total risk-based capital.
- A risk-weighted approach where the thrift multiplies the exposure by 12.5 (the reciprocal of 8%).

In the risk-weighted method the thrift multiplies the $15 capital requirement by 12.5 for a risk-weighted asset of $187.5. Then, when the thrift multiplies $187.5 times the 8% risk-based capital requirement, the result is a $15 capital charge.

Credit-enhancing Interest-only Strips

Credit-enhancing interest-only strips (CE I/Os), whether retained or purchased, pose higher risk than most other residuals. If a thrift has a concentration of more than 25 percent of Tier 1 capital in CE I/Os, it must *deduct from Tier 1 capital*, the portion of CE I/Os that exceeds 25 percent of Tier 1 capital.

Example: Credit-enhancing I/O strip:

A thrift has the first dollar loss subordinated interest (whether retained or purchased) that is a credit-enhancing I/O strip, of $15 in a securitization of subprime auto loans. Tier 1 capital is $40 at onset. The thrift does not have any other CE I/Os.

- 25 percent of $40 is $10. $15 exceeds $10 by $5, so you deduct $5 in computing Tier 1 capital.
- Tier 1 capital is $35. ($40 - $5 = $35.)
- The thrift must also hold $10 in *risk-based* capital for this exposure because you deduct the same amount, $5, as above from the $15 I/O strip. The thrift must hold dollar-for-dollar risk-based capital against the remaining balance.

The Ratings-based Approach

The ratings-based approach allows for the possibility of a lower risk-based capital requirement (reflecting less risk) for certain recourse, direct credit substitutes, and residual interests arising from asset securitization. Ratings must be from one or more NRSROs, for example Standard & Poors, Moody's, and Fitch Ratings. Exceptions to the ratings-based approach include:

- Credit-enhancing I/O strips are *not* eligible for the ratings-based approach.
- Bonds not in security form are not eligible.
- Bonds not backed by assets are not eligible.

In general, the following schedule applies to long-term ratings:

Long-Term Rating Category	Examples	Risk Weight
Highest or second highest investment grade	AAA or AA	20%
Third highest investment grade	A	50%
Lowest investment grade	BBB	100%
One category below investment grade	BB	200%
More than one category below investment grade, or unrated	B or unrated	Not eligible for ratings-based approach.

Note: There is also a separate short-term rating table. Refer to the regulation.

The ratings-based approach makes a distinction between "traded" and "nontraded" positions. Nontraded positions require:

- An external rating by more than one NRSRO.
- Minimum rating assigned by each NRSRO that meets all of the following:
  - Long term: no worse than one category below investment grade.
  - Short term: investment grade.
  - Rating must be publicly available.
  - Rating must be based on the same criteria as for traded positions.

Note: The capital regulations allow for use of a thrift's internal ratings in limited circumstances *after* initial and ongoing OTS approval. The thrift must use software and ratings that correspond credibly and reliably to the NRSRO ratings.

Program Ratings

A thrift can use *program ratings* for certain risk exposures in particular secondary market loan programs. A thrift may make use of program ratings *after* OTS has reviewed the nature of the program and accepts, under specific conditions, a rating assigned to a particular risk exposure that the thrift retains. The rating must correspond credibly and reliably with an NRSRO rating, for example AA.

SUPPLEMENTARY INFORMATION AND ISSUES

Allowance for Loan and Lease Losses (ALLL)

A valuation allowance is a contra-asset account, established and maintained through charges against current earnings to absorb losses in a thrift's portfolio. Valuation allowances established to absorb the losses inherent in a thrift's overall loan and lease portfolio are the Allowance for Loan and Lease Losses, or ALLL. A thrift's ALLL is part of Tier 2 (supplementary) capital, up to 1.25 percent of risk-weighted assets. Thrift's may *not* use the ALLL to cover losses that are not credit-related or losses on other types of assets (that is, assets other than loans or leases). Valuation allowances established to absorb losses identified for specific assets are Specific Valuation Allowances, or SVAs. For capital purposes, the ALLL does not include SVAs. SVAs require a separate deduction from capital.

ALLL only covers *incurred credit-related losses* in the asset portfolio. Thrifts with higher risk activities should maintain higher capital levels to protect against unanticipated losses.

Impact of Subordinate Organizations on Capital Requirements[1]

OTS capital regulations classify a subordinate organization as either a *subsidiary* or an *investment*. Generally, subsidiaries are entities in which the parent thrift has a majority ownership interest. The regulations also distinguish whether or not a subsidiary is an *includable subsidiary*. An includable subsidiary engages only in activities that are permissible for a national bank.[2] Note that a thrift's operating subsidiary is typically an includable subsidiary. The capital treatment for a subordinate organization depends on its status as follows:

Capital Treatment for Subordinate Organizations Having Another Regulator

This section applies to most functionally regulated subsidiaries[3] as well as most subsidiary depository institutions that have a primary regulator other than OTS. In analyzing the capital of a thrift that owns these subordinate organizations, OTS deducts capital needed to meet the requirements of the primary regulator[4]. Then, OTS makes a determination as to whether the excess capital in the subsidiary (that is, capital in excess of the stated formal requirements of the subsidiary's primary regulator) is available to the entities above it in the organizational hierarchy. In these situations, OTS will review the examination reports of the subsidiary's primary regulator (and engage in discussions with the subsidiary's primary regulator) in order to determine whether the subsidiary's excess capital is transferable and available to support the parent. Depending upon the outcome of this analysis, OTS decides whether to permit inclusion of the subsidiary's excess capital.

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

[2] This refers to the activities of a national bank itself, not to the activities permissible for a national bank's subsidiary.

[3] Functionally regulated subsidiaries include: registered broker-dealers, registered investment advisors, registered investment companies, insurance companies, or entities subject to regulation by the Commodity Futures Trading Commission.

[4] A small number of thrifts have established subsidiaries to reinsure first mortgage residential loans originated by the thrift and insured with private mortgage insurance (PMI). These subsidiaries are consolidated onto the thrift's balance sheet for regulatory capital; however, the PMI reinsurance risk assumed by the subsidiary will count as part of the parent thrift's exposure on the loan for risk-based capital purposes; and where the thrift sells a loan with PMI retained, the loan is then treated as sold with recourse for risk-based capital purposes. A thrift can avoid these additional requirements on PMI reinsurance by deconsolidating and deducting its investment in the PMI subsidiary, after review and concurrence by the OTS.

Capital Treatment for Subsidiaries

Includable Subsidiaries

For GAAP and TFR reporting purposes, the thrift ordinarily consolidates the assets of its includable subsidiary into the parent. For Tier 1 capital, the subsidiary's assets comprise part of the parent's adjusted total assets on schedule CCR. For risk-based capital, the thrift risk weights the subsidiary's assets on schedule CCR along with its own.

Nonincludable Subsidiaries

When a GAAP-consolidated subsidiary is not includable for regulatory capital purposes, the thrift must deconsolidate the subsidiary's assets and liabilities, and deduct for Tier 1 capital its investment in that subsidiary.[5] The thrift makes the deduction on Schedule CCR according to the instructions and this does not affect Schedule SC or reporting under GAAP. This deconsolidation and deduction approach means that the subsidiary will be ignored for capital purposes: its assets not included with those of the thrift, and its capital not included in the thrift's capital base. The capital deduction will include the following:

- The parent's equity investment in the subsidiary.
- The parent's loans and other advances to the subsidiary.
- Where applicable, an amount representing any guarantees by the parent of the subsidiary's debt made on behalf of a third party.

Capital Treatment for Equity Investments

When a thrift does not have majority ownership of a subordinate organization, it generally does not consolidate the assets of the subordinate organization with the parent. Instead, the thrift uses the equity method to account for its investment in that subordinate organization. In the equity method, the thrift's investment in the subordinate organization is a thrift asset for GAAP and for Schedule SC. The capital treatment, however, will generally depend upon whether or not the subordinate organization engages solely in activities permissible for a national bank.

Includable Activities Only

The thrift's investment in the subordinate organization is a component of adjusted total assets for regulatory capital purposes. When computing the risk-based capital requirement on Schedule CCR, the thrift risk weights its investment in the subordinate organization at 100 percent. The thrift does not risk weight the subordinate organization's assets, only the parent's investment in the subordinate organization.

Nonincludable Activities

If the subordinate organization engages in activities that are nonincludable, the thrift should deduct its investment in the nonincludable activity for Tier 1 capital. The capital deduction will include the following:

- The parent's equity investment in the subsidiary.
- The parent's loans and other advances to the subsidiary.
- Where applicable, an amount representing any guarantees by the parent of the subsidiary's debt made on behalf of a third party.

The use of intermediate organizations, or the legal form of organization, will not affect the deduction.

Reservation of Authority

In some instances, OTS uses its reservation of authority to require (or permit) deduction, or deconsolidation *and* deduction, of a subordinate organization that would not otherwise be so treated. Where OTS uses its reservation of authority, a simple deduction from Tier 1 capital would apply to a subordinate organization reported under the equity method of accounting per GAAP; whereas, decon-

[5] There is an exception to this automatic deduction treatment. Section 12 USC 1464(t)(5) exempts from automatic deduction those subsidiary depository institutions acquired before May 1, 1989, even though they may be engaged in activities not permissible for a national bank.

solidation *and* deduction would apply to subsidiaries consolidated under GAAP.

You may consider whether to recommend to your regional office deduction of *investment in or loans to* a subordinate organization using the reservation of authority. In some instances, a thrift requests a deduction approach. OTS reviews the request and then decides whether to approve it.

Construction Loans

Construction loans receive a 100 percent risk weight unless they meet the definition of qualifying residential construction loans (below), or the definition of qualifying mortgage loans (that is, loans to individual borrowers for the construction of their own homes that meet the definition in §567.1).

Qualifying Residential Construction Loans

Qualifying residential construction loans, also referred to as residential bridge loans, have similar credit risk to single-family residential mortgage loans. Residential construction loans must meet specific criteria in order to qualify for a 50 percent risk weight. You may review the definition of qualifying residential construction loans in §567.1.

Loans-in-Process

Many thrifts initially record a construction loan as a debit entry to loans receivable equal to the gross amount of the loan. They in turn make a credit entry to a contra-asset account called, "loans in process of disbursement" (LIP). A thrift then reduces the LIP balance with each disbursement of funds. Therefore, the LIP represents the undisbursed portion of the loan and is off-balance-sheet. For capital purposes, the thrift needs to convert the LIP to an on-balance-sheet credit equivalent amount as described below. If a thrift does not set up a loans-in-process account, the thrift should still treat the unfunded (undisbursed) loan commitment in the same manner as an off-balance-sheet item for capital purposes. LIP or other unfunded construction loan balances will either:

- Convert at 0 percent (that is, there is no capital requirement).
- Convert at 50 percent to an on-balance-sheet credit equivalent (that is, a risk-weighted asset).

If the original maturity of the construction loan is one year or less, LIP (or the unfunded construction commitment) should generally convert at 0 percent. When the original maturity of the loan exceeds one year, the LIP (or unfunded commitment) should generally convert at 50 percent, in which case the thrift then risk weights the credit equivalent amount based on the type of loan: for example, 50 percent for qualifying residential construction loans or qualifying mortgage loans, 100 percent for most other types of loans.

Notes:

- Thrifts should not split LIP (or the unfunded commitment) on a single loan into a component that matures within one year and a component that matures after one year.
- Thrifts may apply a 0 percent conversion factor to a loan with more than a one-year term if they actively evaluate the credit relationship and structure the terms of the loan to comply with §567.6(a)(2)(iv). Specifically the thrift must have a contractual right to separately underwrite each disbursement and the thrift does so, or the thrift has a contractual right to reevaluate the lending relationship at least annually and the thrift does so.

(See also Appendix A, Credit Conversion Factors for Off-Balance-Sheet Items.)

Nonwithdrawable (Pledged) Deposit Accounts of Mutual Institutions

Directors or officers of mutual savings associations, or other interested individuals or organizations, may pledge personal deposits held by the institution. These deposits can count as Tier 1 capital. The individuals must formally subordinate the deposits to the institution's creditors, including the FDIC. The deposits must satisfy the same criteria as noncumulative perpetual preferred stock. The pledge must affirm that the deposits have no maturity, allow no option for withdrawal of the funds, and allow the suspension of interest payment obligations. Sections 561.31, 567.5(a)(1)(iv), and 567.9(b)(3) describe

how mutual institutions may use these accounts for regulatory capital purposes. Note that this form of regulatory capital is relatively uncommon.

Preferred Stock

General limitation on preferred stock: OTS has a general policy that the majority of a thrift's equity should be common voting shares. Preferred stock should not comprise the majority of a thrift's capital base.

REIT Preferred Stock

General limitation on REIT preferred stock: OTS generally limits REIT preferred stock to 25 percent of Tier 1 capital.

REIT (real estate investment trust) preferred stock is a hybrid instrument that combines traits of both debt and equity and offers special tax treatment. REIT preferred stock pays dividends like an equity investment, but is backed by collateral similar to certain debt instruments. Under certain conditions, REIT preferred stock may receive favorable capital treatment.

In a typical REIT preferred stock transaction, a thrift or holding company establishes a separate legal entity that owns 100 percent of the entity's common stock. In most cases, the value of the common stock is nominal. After establishing the new separate legal entity, the thrift sells real-estate-related assets, usually mortgages or mortgage-back securities, to this separate entity. The new entity pays for the real estate-related assets with cash proceeds from a simultaneous preferred stock issuance to independent third parties.

If the issuing entity is a subsidiary of the thrift, the subsidiary is fully consolidated with the thrift for TFR purposes. In the consolidated statements, the thrift reports the REIT preferred stock as minority interest in includable consolidated subsidiaries, a component of Tier 1 (core) capital.

The issuing entity can also be a subsidiary of a thrift's holding company. In these situations, some or all of the cash proceeds received by the holding company is down-streamed to the thrift. This generally represents an additional investment in the thrift and counts as Tier 1 capital.

The asset-backed nature of REIT preferred stock raises supervisory concerns, especially when the thrift issues the stock through a subsidiary of the thrift. If the thrift faces operating difficulties, *all* assets of the consolidated entity should be available for the thrift's use. Therefore, *OTS requires thrift subsidiaries to include certain restrictive covenants in REIT preferred stock offerings*. OTS requires that the stock be permanent (or perpetual) and noncumulative as to dividends. Additionally, OTS requires that the terms of the REIT preferred stock allow OTS to do both of the following:

- Restrict the payment of dividends on the REIT preferred stock.
- Require the conversion of the REIT preferred stock to common stock.

These restrictive covenants must be present for a thrift to include REIT preferred stock as Tier 1 capital.

Trust Preferred Securities

Trust preferred securities (TPS) are nonperpetual cumulative preferred stock issued by a wholly owned trust subsidiary of a corporation (typically insurance companies and bank or savings and loan holding companies). Cash raised through a trust preferred issuance by a thrift holding company can be down-streamed to the thrift institution. And then, at the thrift institution level, the cash received from the holding company can count as Tier 1 capital.

For more information and guidance on TPS refer to Thrift Bulletin 73a, Investing in Complex Securities.

Tier 2 Capital Instruments

Section 567.5(b) describes the components of Tier 2 capital, including *permanent capital instruments* and *maturing capital instruments*. These groups include certain types of debt instruments that are like capital in their capacity to absorb losses.

Permanent Capital Instruments

A thrift can generally include permanent capital instruments in its Tier 2 capital. Permanent capital instruments may include: cumulative and other perpetual preferred stock,[6] mutual capital certificates, perpetual subordinated debt, and mandatory convertible subordinated debt (capital notes). Refer to the regulation for qualifications and other instruments in this group.

Maturing Capital Instruments

Maturing capital instruments include:

- Subordinated debt (excluding perpetual subordinated debt – see above).
- Intermediate-term preferred stock and any related surplus (additional paid-in capital).
- Mandatory convertible subordinated debt (commitment notes).

Refer to the regulation for additional details. The degree to which a thrift can include these instruments in Tier 2 capital decreases according to the formulas and criteria described in §567.5(b)(3).

Thrifts that issue maturing capital instruments must choose between two options for regulatory capital treatment. Once a thrift selects an option, it must use that same option for all issuances outstanding at that time and for any subsequent issuances for as long as there is a balance outstanding. Once the thrift repays all outstanding issuances, it may elect a different option for future issuances.

Limits on Pass-Through Insurance Coverage

Normally, FDIC deposit insurance coverage ($100,000 per account) passes through financial intermediaries such as employee benefit plans to each beneficial owner (for example, to each employee participant in a plan). However if a thrift falls below PCA well capitalized status, the FDIC aggregates for deposit insurance purposes, any deposit that the thrift accepts (new, rolled-over, or renewed) through an employee benefit plan. The FDIC aggregates the deposits at the plan-administrator or fund-manager level, and then the deposits do not qualify individually for pass-through insurance.[7] The limitation affects the following types of employee benefit accounts and plans:

- 401(k) retirement accounts
- Deferred compensation plans
- Keough plan accounts
- Corporate pension plans
- Profit-sharing plan accounts

Simplified Employee Pension plan accounts (SEPs) are not subject to the limitation.

If a thrift falls below well capitalized status, it must notify affected account holders. Management should have procedures in place to monitor capital and notify affected parties. Additional information is in Regulatory Bulletin 33a, available on the OTS website. The relevant regulation section is §330.14, especially §330.14(h).

Net Deferred Tax Assets

OTS places limits on the inclusion of deferred tax assets in a thrift's Tier 1 capital. You may find OTS policy in Thrift Bulletin No. 56. To the extent that the realization of deferred tax assets depends on a thrift's future taxable income (exclusive of reversing temporary differences and carry-forwards), or its tax-planning strategies, deferred tax assets may not exceed the lesser of:

- The amount that the thrift can realize within one year of the quarter-end report date.
- Ten percent of Tier 1 (core) capital.

[6] A thrift may not include in capital preferred stock that is, in effect, collateralized by assets of the thrift or one of its subsidiaries, or issued by a nonincludable subsidiary.

[7] This general rule applies unless: the institution is at least adequately capitalized, and has either obtained a brokered deposit waiver from the FDIC or provides specific notice to the plan depositor each time a deposit is accepted. Refer to RB 33a for more detail.

Prompt Corrective Action Restrictions 12 CFR §565.6

Capital Category	*Restriction*
Well and adequately capitalized	Cannot pay dividends or management fees to controlling persons if it would result in undercapitalization.
Undercapitalized	**Mandatory actions:** • Capital distributions and management fees restricted. • Capital plan required. • Monitoring of condition and capital plan. • Growth restricted. • Prior approval of certain expansion proposals such as acquisitions, branching and new lines of business.
Significantly Undercapitalized	**Mandatory actions:** • Activities restricted. • Payments on subordinated debt restricted. **Discretionary actions:** • Require recapitalization: — Issue stock. — Require acquisition (if grounds exist for appointing a conservator or receiver). • Restrict interest rates paid. • Impose more stringent asset growth restrictions (or require shrinkage). • Restrict activities. • Improve management by requiring the election of directors or employment of qualified senior executive officers. • Prohibit deposits from correspondent banks. • Require prior approval for capital distributions by a bank holding company. • Require divestiture. • Require other actions the regulator determines appropriate.
Critically Undercapitalized	**Mandatory actions:** • Activities restricted - Associations may not: — Enter into any material transactions other than in the usual course of business. — Extend credit for any highly leveraged transaction. — Amend the association's charter or bylaws, except to the extent necessary to carry out any other requirement of any law, regulation, or order. — Make any material change in accounting methods. — Engage in any covered transaction. — Pay excessive compensation or bonuses. • Payments on subordinated debt prohibited.