

INTRODUCTION**Purpose of Capital**

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

Provides Protection to Depositors and the FDIC Insurance Funds

Placing owners at significant risk of loss, should the institution fail, helps to minimize the potential "moral hazard" and promotes safe and sound banking practices.

As the insuring agency whose primary purpose is the protection of depositors, the FDIC has a direct and obvious financial stake in the last-mentioned function. Consequently, the FDIC focuses a great deal of attention in examination and supervisory programs relating to capital positions. For example, the appraisal of assets provides a determination of adjusted, as opposed to book, capital. Similarly, Substandard and Doubtful assets, or those listed for Special Mention or as Concentrations, are identified because these may have the potential of resulting in losses and a weakened capital position at some future point. Moreover, review of the policies and practices of management can disclose weaknesses that may bring about losses and dissipation of capital. An institution's earnings performance and dividend policies are analyzed for impact on the present and expected capitalization level. Also, serious contingent liabilities that may arise in conjunction

with trust department activities, litigation in which the institution is the defendant, or that emanate from other sources, are carefully scrutinized since they may lead to capital depletion.

CAPITAL**Capital-based Regulations and Guidance**

The FDIC issued several capital-based regulations affecting either insured state nonmember banks or all insured institutions. These regulations establish minimum capital standards, a framework for taking supervisory actions for institutions that are not adequately capitalized, a risk-related deposit insurance premium system based, in part, on capital levels, and restrictions prohibiting certain bank related activities.

An introduction to these capital-based regulations is as follows with more detail following later in this section:

Minimum Leverage Capital Standard

Part 325 of the FDIC Rules and Regulations establishes the criteria and standards the FDIC will use in calculating the minimum leverage capital requirement and in determining capital adequacy.

Minimum Risk-Based Capital Standard

Part 325 Appendix A - Statement of Policy on Risk-Based Capital, establishes a risk adjusted capital framework, which, together with the leverage capital standard, is used in the examination and supervisory process. The risk-based framework includes a definition of capital for risk-based capital purposes, a system for calculating risk-weighted assets by assigning assets and off-balance sheet items to broad risk categories, and a minimum supervisory ratio of capital to risk-weighted assets.

Statement of Policy on Capital Adequacy

Part 325 Appendix B – Statement of Policy on Capital Adequacy, provides some interpretational and definitional guidance as to how Part 325 will be administered and enforced.

Risk-Based Capital Standard - Market Risk

Part 325 Appendix C – Risk-Based Capital for State Non-Member Banks: Market Risk, was established to ensure that banks with significant exposure to market risk maintain adequate capital to support that exposure. This

Appendix supplements and adjusts the risk-based capital ratio calculations under Appendix A of Part 325.

Prompt Corrective Action (PCA)

Part 325 of the FDIC Rules and Regulations implements Section 38 of the Federal Deposit Insurance (FDI) Act by establishing a framework for taking prompt supervisory actions against insured state nonmember banks that are not adequately capitalized. A more thorough discussion is presented later in this section, as well as within the Formal Administrative Actions Section of this manual. Certain provisions of the FDIC's PCA rules apply to all insured depository institutions that are critically undercapitalized.

Other Areas

Capital-based standards are used in the following regulations to restrict or prohibit an institution's activities.

Risk-Related 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 & FRB Regulation O
Activities and Investments of Insured State Nonmember	Part 362 of the FDIC Rules and Banks 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 Conservator or Receiver	Section 11(c)(5) of the FDI Act

Capital-based Guidance

The FDIC issued substantive capital-based guidance and rules affecting either insured state nonmember banks or all insured institutions. A few of the more recent FILs are presented below. Examiners should refer to the Capital

Markets Website (Resources) for more complete and up-to-date information.

FIL 54-2002: Capital Standards/Interagency Questions and Answers on the Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations

This document clarifies several issues arising from the final rule on the capital treatment of these exposures as originally presented in FIL 99-2001.

FIL 52-2002: Capital Standards/Interagency Guidance on Implicit Recourse in Asset Securitizations

This guidance highlights the fundamental concern that implicit recourse may expose a bank's earnings and capital to potential losses. The guidance sets forth a range of supervisory actions that may be taken against a bank that provides implicit support to its securitizations.

FIL 48-2002: Capital Standards/Interagency Advisory on the Regulatory Capital Treatment of Accrued Interest Receivable Related to Credit Card Securitizations

This Advisory clarifies the appropriate risk-based capital treatment for banking organizations that securitize credit card receivables and record an on-balance sheet asset commonly referred to as Accrued Interest Receivable (AIR). The advisory describes how the AIR asset is created, explains why this asset is considered a subordinated retained interest for regulatory capital purposes, and describes the regulatory capital treatment that applies to the AIR asset.

FIL 31-2002: Capital Standards/Final Rule Lowers Risk-Weightings for Claims on Securities Firms

This rule lowers the risk weight applied to certain claims on qualifying securities firms from 100 percent to 20 percent.

FIL 06-2002: Capital Standards/Final Capital Rule for Nonfinancial Equity Investments

Under this rule, covered equity investments are subject to a Tier 1 capital charge (for both risk-based and leverage capital purposes) that increases in steps as the banking organization's level of concentration in equity investments increases.

FIL 99-2001: Capital Standards (Final Rule to Amend the Regulatory Capital Treatment of Recourse Arrangements, Direct Credit Substitutes, Residual

Interests in Asset Securitizations, and Asset-Backed and Mortgage-Backed Securities)

This rule amends the regulatory capital treatment of recourse arrangements, direct credit substitutes, residual interests in asset securitizations, and asset- and mortgage-backed securities, better aligning regulatory capital requirements with the risk associated with these positions. The rule primarily affects banks involved in securitization-related activities. However, it also includes banks that service assets, guarantee the performance of a third party's assets, or invest in asset-backed and mortgage-backed securities.

Components of Capital

Leverage Capital

Banks must maintain at least the minimum leverage ratio requirement set forth in Part 325. The minimum leverage ratio requirement consists only of Tier 1 (Core) Capital.

Tier 1 Capital or Core Capital is defined in Part 325 and means the sum of:

- **common stockholders' equity** – the sum of common stock and related surplus, undivided profits, disclosed capital reserves that represent a segregation of undivided profits, and foreign currency translation adjustments, less net unrealized losses on available-for-sale equity securities with readily determinable fair values;
 - **noncumulative perpetual preferred stock** – perpetual preferred stock (and related surplus) where the issuer has the option to waive payment of dividends and where the dividends so waived do not accumulate to future periods nor do they represent a contingent claim on the issuer. Preferred stock issues where the dividend is reset periodically based, in whole or in part, upon the bank's current credit standing, including but not limited to, auction rate, money market and remarketable preferred stock, are excluded from this definition of noncumulative perpetual preferred stock, regardless of whether the dividends are cumulative or noncumulative;
 - **minority interests in consolidated subsidiaries** – minority interests in equity capital accounts of those subsidiaries that have been consolidated for the purpose of computing regulatory capital, except that minority interests which fail to provide meaningful capital support are excluded from this definition;
- minus
- **all intangible assets other than mortgage servicing assets, nonmortgage servicing assets, and purchased**

credit card relationships eligible for inclusion in core capital as prescribed in Section 325.5. (F) – Intangible assets represent those assets that are required to be reported as intangible assets in a banking institution's "Reports of Condition and Income" (Call Report) or in a savings association's "Thrift Financial Report." Mortgage servicing assets and nonmortgage servicing assets (collectively servicing assets) as well as purchased credit card relationships (PCCRs) are eligible for inclusion in core capital with certain limitations. Generally, servicing assets and PCCRs are limited to 100 percent of Tier 1 capital. In addition, nonmortgage servicing assets and PCCRs are subject to a separate sublimit of 25 percent of Tier 1 capital. Section RC-R of the Call Report Instructions provides a worksheet that banks may use to determine the amount of disallowed servicing assets and PCCRs;

- **noneligible credit-enhancing interest-only strips** – A credit-enhancing interest-only strip is defined in the capital guidelines as "an on-balance sheet asset that, in form or in substance represents the contractual right to receive some or all of the interest due on transferred assets; and exposes the bank to credit risk directly or indirectly associated with the transferred assets that exceeds a pro rata share of the bank's claim on the assets, whether through subordination provisions or other credit enhancement techniques." Credit-enhancing interest-only strips include other similar "spread" assets and can be either retained or purchased. In general, credit-enhancing interest-only strips are limited to 25 percent of Tier 1 capital. Section RC-R of the Call Report Instructions provides a worksheet that banks may use to determine the amount of noneligible credit-enhancing interest-only strips;
- **deferred tax assets in excess of the limit set forth in Section 325.5(g)** – Deferred tax assets represent reductions in future taxes payable as a result of "temporary differences" and net operating loss or tax credit carryforwards that exist at the reporting date. Generally, deferred tax assets that are dependent upon future taxable income are limited to the lesser of: (i) the amount of such deferred tax assets that the bank expects to realize within one year of the calendar quarter-end date, based on its projected future taxable income for that year or (ii) 10% of the amount of the bank's Tier 1 capital; prior to deductions.
- **identified losses (to the extent that Tier 1 capital would have been reduced if the appropriate accounting entries to reflect the identified losses had been recorded on the institution's books)** – Identified losses represent those items that have been determined by an evaluation made by a state or federal examiner to be chargeable against income, capital, and/or

general valuation allowances such as the allowance for loan and lease losses (examples of identified losses would be assets classified loss, off-balance sheet items classified loss, any provision expenses that are necessary for the institution to record in order to replenish its general valuation allowances to an adequate level, liabilities not shown on the institution's books, estimated losses in contingent liabilities, and differences in accounts which represent shortages);

- **investments in financial subsidiaries subject to 12 CFR Part 362 (Subpart E)**– Any insured state bank that wishes to conduct or continue to conduct as principal activities through a subsidiary that are not permissible for a subsidiary of a national bank must deduct from its Tier one capital the investment in equity investment of the subsidiary as well as the bank's pro rata share of any retained earnings of the subsidiary; and
- **the amount of the total adjusted carrying value of nonfinancial equity investments subject to deduction as set forth in Appendix A of Part 325** – If a bank has nonfinancial equity investments that are subject to Tier 1 capital deductions, these deductions should be reported in this item. Under the capital rules on nonfinancial equity investments, a nonfinancial equity investment is any equity investment that a bank holds in a nonfinancial company through a small business investment company (SBIC), under the portfolio investment provisions of Federal Reserve Regulation K, or under section 24 of the Federal Deposit Insurance Act. The capital rules impose Tier 1 capital deductions on nonfinancial equity investments that increase as the aggregate amount of nonfinancial equity investments held by a bank increases. These marginal capital charges are based on the adjusted carrying value of the investments as a percent of the bank's Tier 1 capital as presented in the Call Report Instructions.

Risk-Based Capital

While the leverage capital standard serves as a useful tool for assessing capital adequacy, there is a need for a capital measure that is more explicitly and systematically sensitive to the risk profiles of individual banks. As a result, the Statement of Policy on Risk-Based Capital (Appendix A to Part 325) was adopted to supplement the existing Part 325 leverage capital regulation.

Under the risk-based framework, a bank's qualifying total capital base consists of two types of capital elements, "core capital elements" (Tier 1) and "supplementary capital elements" (Tier 2). To qualify as an element of Tier 1 or Tier 2 capital, a capital instrument should not contain or be subject to any conditions, covenants, terms, restrictions, or

provisions that are inconsistent with safe and sound banking practices.

Tier 1 Capital for risk-based capital standards is the same as under the leverage capital standard.

Tier 2 (Supplementary) Capital consists of:

- **allowances for loan and lease losses (ALLL), up to a maximum of 1.25 percent of gross risk-weighted assets** – For risk-based capital purposes, the allowance for loan and lease losses equals Schedule RC, item 4.c, "Allowance for loan and lease losses," less Schedule RI-B, part II, Memorandum item 1, "Allocated transfer risk reserve included in Schedule RI-B, part II, item 7, above," plus Schedule RC-G, item 3, "Allowance for credit losses on off-balance sheet credit exposures";
- **cumulative perpetual preferred stock, long-term preferred stock (original maturity of at least 20 years) and any related surplus** – Perpetual preferred stock is defined as preferred stock that does not have a maturity date, that cannot be redeemed at the option of the holder, and that has no other provisions that will require future redemption of the issue. The cumulative nature entails that dividends, if omitted, accumulate until paid out. Long-term preferred stock is preferred stock with an original weighted average maturity of at least 20 years. The portion of qualifying long-term preferred stock includible in Tier 2 capital is discounted in accordance with the worksheet in the Call Report Instructions. The discounting begins when the remaining maturity falls below five years;
- **perpetual preferred stock where the dividend is reset periodically based, in whole or part, on the bank's current credit standing** – This entails perpetual preferred stock issues that were excluded from Tier 1 capital such as noncumulative perpetual preferred where the dividend is reset periodically based, in whole or in part, upon the bank's current credit standing (including, but not limited to, auction rate, money market, and remarketable preferred stock);
- **hybrid capital instruments, including mandatory convertible debt** – Hybrid capital instruments include instruments that are essentially permanent in nature and that have certain characteristics of both equity and debt. Such instruments may be included in Tier 2 without limit. This category also includes mandatory convertible debt, i.e., equity contract notes, which is a form of subordinated debt that obligates the holder to take the common or perpetual preferred stock of the issuer in lieu of cash for repayment of principal;
- **term subordinated debt and intermediate-term preferred stock (original average maturity of five years or more and not redeemable at the option of**

the holder prior to maturity, except with the prior approval of the FDIC) – Subordinated debt is debt over which senior debt takes priority. In the event of bankruptcy, subordinated debtholders receive payment only after senior debt claims are paid in full. Intermediate-term preferred stock is preferred stock with an original weighted average maturity of between five and twenty years. The portion of qualifying term subordinated debt and intermediate-term preferred stock includible in Tier 2 capital is discounted in accordance with the worksheet in the Call Report Instructions. The discounting begins when the remaining maturity falls below five years. The portion of qualifying term subordinated debt and intermediate-term preferred stock that remains after discounting and is includible in Tier 2 capital is limited to 50 percent of Tier 1 capital; and

- **net unrealized holding gains on equity securities, up to 45%, pretax** – the pretax net unrealized holding gain (i.e., the excess of fair value as reported in Schedule RC-B, item 7, column D, over historical cost as reported in Schedule RC-B, item 7, column C), if any, on available-for-sale equity securities is subject to the limits specified by the capital guidelines of the reporting bank's primary federal supervisory authority. The amount reported in this item cannot exceed 45 percent of the bank's pretax net unrealized holding gain on available-for-sale equity securities with readily determinable fair values.

The maximum amount of Tier 2 capital that may be recognized for risk-based capital purposes is limited to 100 percent of Tier 1 capital. Additionally, the combined amount of term subordinated debt and intermediate-term preferred stock that may be treated as Tier 2 capital is limited to 50 percent of Tier 1 capital.

Tier 3 Capital is limited in use to situations where the market risk risk-based capital rules apply. The market risk risk-based capital rules and calculations only apply to insured state nonmember banks whose trading activity (on a worldwide basis) equals 10 percent or more of total assets or \$1 billion or more (the FDIC can apply the rules to other institutions if necessary for safe and sound banking practices). The rules supplement and adjust calculations under Appendix A of Part 325. The calculations are used to ensure that banks with significant exposures have adequate capital allocated for market risk. Appendix C to Part 325 outlines how risk-based capital calculations are adjusted for banks with applicable trading activity and introduces Tier 3 capital. Tier 3 capital includes subordinated debt with specific characteristics and just applies to these market risk rules. Tier 3 capital is used in conjunction with Tier 1 and Tier 2 capital (subject to certain limitations) to calculate a market risk capital

measure that is based on value-at-risk capital charges, specific add-ons, and de minimis exposures.

A bank subject to the market risk rules must:

- use a value-at-risk model to estimate the maximum amount that the bank's covered positions could decline during a fixed holding period,
- have a risk management system, which defines a risk control unit that reports directly to senior management and is independent from business trading units, and
- have an internal risk measurement model that is integrated into the daily management process, and must have policies and procedures that identify appropriate stress tests and back tests, which the bank must conduct.

Total Capital (used in the risk-based calculation) is calculated by summing Tier 1 capital and Tier 2 capital, less investments in unconsolidated banking and finance subsidiaries and reciprocal holdings of capital instruments of other banks. The FDIC may also consider deducting investments in other subsidiaries, either on a case-by-case basis or, as with securities subsidiaries, based on the general characteristics or function nature of the subsidiaries.

Capital Account Adjustments

Various adjustments need to be made when calculating the capital elements based on the rules outlined in the regulations.

Deductions from Tier 1 Capital for Identified Losses and Inadequate ALLL

Part 325 provides that, on a case-by-case basis and in conjunction with supervisory examinations, other deductions from capital may be required, including any adjustments deemed appropriate for assets classified Loss. Further, the definition of Tier 1 capital under the Part 325 leverage capital standard specifically provides for the deduction of identified losses (which may include items classified Loss and any provision expenses that are necessary to replenish the ALLL to an adequate level).

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 Tier 1 capital already has been effectively reduced through provision expenses recorded in establishing an adequate ALLL. Additionally, the following method addresses those situations where an

institution overstated the amount of Tier 1 capital by failing to take necessary provision expenses to establish and maintain an adequate ALLL.

Method

- Deduct the amount of Loss for items other than loans and leases in the calculation of Tier 1 capital. If Other Real Estate (ORE) general reserves exist, see the following discussion of "Capital Treatment of ORE Reserves."
- Deduct the amount of Loss for 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 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, will be accounted for by the inadequate ALLL adjustment.
- An adjustment from Tier 1 capital to Tier 2 capital for an inadequate ALLL should be made only when the amount is considered significant. The decision as to what is significant is a matter of judgment.

Capital Treatment of Other Real Estate Reserves

ORE reserves, whether considered general reserves or specific reserves, are not recognized as a component of capital for either risk-based capital or leverage capital standards. However, these reserves would be considered when accounting for ORE that is classified Loss. Examiners should take into account 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 be no actual deduction from Tier 1 capital. The ORE Loss in excess of ORE reserves should be deducted from Tier 1 capital under "Assets Other Than Loans & Leases Classified Loss."

Liabilities Not Shown on Books

Non-book liabilities have a direct bearing on the adjusted capital computation. These definite and direct, but unbooked liabilities (contingent liabilities are treated differently) should be carefully verified and supported by factual comments. Examiners are to 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.

Regulatory Capital Minimum and Categories

Institutions are expected, at a minimum, to maintain capital levels that meet both the leverage capital ratio requirement and the risk-based capital ratio requirement.

Part 325 sets forth minimum acceptable capital requirements for fundamentally sound, well-managed institutions having no material or significant weaknesses. The FDIC is not precluded from requiring an institution to maintain a higher capital level based on the institution's particular risk profile. Where the FDIC determines that the financial history or condition, managerial resources and/or the future earnings prospects of an institution are not adequate, or where an institution has sizeable off-balance sheet or funding risks, significant risks from concentrations of credit or nontraditional activities, excessive interest rate risk exposure, or a significant volume of assets adversely classified, the FDIC may determine that the minimum amount of capital for that institution is greater than the minimum standards outlined below.

Minimum Leverage Capital Requirement:

- Not less than 3 percent Tier 1 capital to total assets if the bank has a composite "1" rating and is not anticipating or experiencing any significant growth and has well-diversified risk, including interest rate risk, excellent asset quality, high liquidity, and good earnings.
- All others not meeting the above criteria should maintain a ratio of Tier 1 capital to total assets of not less than 4 percent.

Any bank that has less than the minimum leverage capital requirement is deemed to be in violation of Part 325 and engaged in an unsafe or unsound practice pursuant to section 8(b) and/or 8(c) of the FDI Act, unless the bank has entered into and is in compliance with a written plan approved by the FDIC.

If a bank has a leverage ratio less than two percent, it is deemed to be operating in an unsafe or unsound condition pursuant to section 8(a) of the FDI Act.

Minimum Risk-Based Capital Requirement:

- Qualifying total capital to risk-weighted assets must be at least 8 percent, at least half of which (4 percentage points) must be comprised of Tier 1 capital.

Capital Categories

Part 325 Subpart B – Prompt Corrective Action (PCA) is issued by the FDIC pursuant to Section 38 of the FDI Act. The purpose is to define, for FDIC-insured state-chartered nonmember banks, the capital measures and capital levels used for determining the supervisory actions authorized under Section 38 of the FDI Act. This Subpart also establishes procedures for submission and review of capital restoration plans and for issuance and review of directive and orders pursuant to Section 38.

The following chart summarizes the PCA categories; refer to Section 10 of this manual for a discussion of PCA directives.

Prompt Corrective Action Categories			
	Leverage	Tier 1 Risk-Based	Total Risk-Based
Well Capitalized	≥ 5% and And is not subject to any written agreement, order, capital directive, or prompt corrective action directive to meet and maintain a specific capital level for any capital measure.	≥ 6% and	≥ 10%
Adequately Capitalized	≥ 4%* and And does not meet the definition of a well capitalized bank. *or a Leverage ratio of ≥ 3% if the bank is rated a composite 1 and is not experiencing or anticipating significant growth	≥ 4% and	≥ 8%
Undercapitalized	< 4%* or *or < 3% if the bank is rated composite 1 and is not experiencing or anticipating significant growth	< 4% or	< 8%
Significantly Undercapitalized	< 3% or	< 3% or	< 6%
Critically Undercapitalized	Tangible equity capital ratio that is ≤ 2%		

Risk-Weight Calculations

Under the risk-based capital framework, a bank’s balance sheet assets and credit equivalent amounts of off-balance sheet items are generally assigned to one of four broad risk categories (0, 20, 50, and 100 percent) according to the obligor, or if relevant, the guarantor or the nature of the collateral. At each bank’s option, assets and the credit

equivalent amounts of derivative contracts and off-balance sheet items that are assigned to a risk weight category of less than 100 percent may be included in the amount reported for a higher risk weight category (e.g., the 100 percent category) than the risk weight category to which the asset or credit equivalent amount of the off-balance sheet item would otherwise be assigned.

Although the majority of assets and off-balance sheet items fall within one of the four broad risk categories, there are exceptions that fall outside of the general categories. Other off-balance sheet credit equivalent conversions are available for derivative contracts and short-term liquidity facilities supporting asset-backed commercial paper programs. There is also a ratings-based approach that applies only to recourse obligations, direct credit substitutes, residual interests, and asset- and mortgage-backed securities in connection with asset securitizations and structured financings. In a 1999 Financial Institution Letter (FIL-99-2001), the agencies introduced a 200 percent risk weight category. This category applies to externally rated recourse obligations, direct credit substitutes, residual interest (other than credit-enhancing interest-only strips), and asset- and mortgage-backed securities that are rated one category below the lowest investment grade category or non-rated positions for which the bank deems that the credit risk is equivalent to one category below investment grade (e.g., BB).

The term recourse refers to the credit risk that a bank organization retains in connection with the transfer of its assets. Today, recourse arrangements frequently are also associated with asset securitization programs. Depending on the type of securitization transaction, the sponsor of a securitization may provide a portion of the total credit enhancement internally. When internal enhancements are provided, the enhancements are residual interests for regulatory capital purposes. Such residual interests are a form of recourse. A residual interest is an on-balance sheet asset created in an asset sale that exposes a bank to credit risk in excess of its pro rata claim on the asset. Examples of residual interests include credit-enhancing interest-only strips receivable; spread accounts; cash collateral accounts; retained subordinated interests; accrued but uncollected interest on transferred assets that, when collected, will be available to serve in a credit-enhancing capacity; and similar on-balance sheet assets that function as a credit enhancement.

A seller may also arrange for a third party to provide credit enhancement in an asset securitization. If the third-party enhancement is provided by another banking organization, that organization assumes some portion of the assets’ credit risk. All arrangements in which a banking organization assumes credit risk from third-party assets or other claims

that it has not transferred, are referred to as direct credit substitutes.

For a residual interest or other recourse exposure in a securitization that qualifies for the ratings-based approach, the required amount of risk-based capital is determined based on its relative risk of loss. The face amount of the position is multiplied by a risk weight that ranges from 20 percent to 200 percent, depending upon the ratings assigned by one or more nationally recognized statistical rating organizations and whether the position is traded. Additionally, when certain banks engage in trading activities, they must refer to Appendix C of Part 325 to calculate their risk-based capital ratio, which incorporates capital charges for certain market risks.

Note: Typically, any asset deducted from a bank's capital accounts when computing the numerator of the risk-based capital ratio will also be excluded from risk-weighted assets when calculating the denominator for the ratio.

Ratings-Based Approach

The risk-based capital guidelines include a ratings-based approach that sets requirements for asset- and mortgage-backed securities and other positions in securitization transactions (except credit-enhancing interest-only strips) using credit ratings from nationally recognized statistical rating organizations. (The ratings-based approach does **not** apply to corporate bonds, municipal bonds, or other debt securities that have been rated by a rating agency.) In general, under the ratings-based approach, the risk-based capital requirement is computed by multiplying the face amount of the position by the risk-weight appropriate for the external credit rating of the position as presented in the Call Report Instructions. There is also specific guidance for the regulatory capital treatment of recourse obligations, direct credit substitutes, and residual interests in asset securitizations.

Recourse and Direct Credit Substitutes

A recourse obligation typically arises when an institution transfers assets in a sale and retains an obligation to repurchase the assets or absorb losses due to a default of principal or interest or any other deficiency in the performance of the underlying obligor or some other party. Recourse may also exist implicitly where a bank provides credit enhancement beyond any contractual obligation to support assets it sold. In general, a bank must hold risk-based capital against the entire outstanding amount of assets sold with recourse; however, there are some exceptions to this general rule.

The risk-based capital standards include a low-level exposure rule, which states that if the maximum exposure to loss retained or assumed by a bank in connection with a recourse arrangement, a direct credit substitute, or a residual interest, is less than the effective risk-based capital requirement for the credit-enhanced assets (generally, four percent for qualifying first lien 1-4 family residential mortgages and eight percent for most other assets), the risk-based capital requirement is limited to the bank's maximum contractual exposure, less any recourse liability account established in accordance with generally accepted accounting principles. However, for residual interests (other than credit-enhancing interest-only strips that have been deducted from Tier 1 capital and assets) not eligible for the ratings-based approach, a bank must maintain risk-based capital equal to the face amount of the residual interest, even if the amount of risk-based capital required to be maintained exceeds the full risk-based capital requirement for the assets transferred. The effect of this requirement is that, notwithstanding the low level exposure rule, a bank must hold one dollar in total risk-based capital against every dollar of the face amount of its residual interests, which are not eligible for the ratings based approach (a dollar-for-dollar capital requirement).

When an examiner encounters these items (commonly found in securitization and mortgage banking operations) they should refer to the outstanding Financial Institution Letters, the Call Report Instructions, and Part 325 of the FDIC Rules and Regulations for more information.

Off-Balance Sheet Items

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.

Enforcement of Capital Standards

The Statement of Policy on capital adequacy, which is Appendix B to Part 325, provides some interpretational and definitional guidance as to how the regulation will be administered and enforced by the FDIC. Additionally, the PCA provisions of Section 38 of the FDI Act and the previously discussed Subpart B of Part 325 also provide guidance regarding institutions with inadequate capital levels.

Banks failing to meet the minimum leverage and/or risk-based capital ratios normally can expect to have any

application submitted to the FDIC denied (if such application requires the FDIC to evaluate the adequacy of the institution's capital structure) and also can expect to be subject to the use of capital directives or other formal enforcement action by the FDIC to increase capital.

Capital Adequacy

Capital adequacy in banks that have capital ratios at or above the minimums will be assessed based on the following factors.

Banks which are Fundamentally Sound and Well-Managed

The minimum leverage and risk-based capital ratios generally will be 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 in each case based on the 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 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

Notwithstanding the above, all banks will be expected to meet any capital requirements established by their primary State or Federal regulator, which 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

Section 325.4(b) specifies that any bank that has less than its minimum leverage capital requirement is deemed to be engaging in an unsafe and unsound banking practice unless it has submitted, and is in compliance with, a plan approved by the FDIC to increase its Tier 1 leverage capital ratio to a level that the FDIC deems appropriate. Under the PCA regulations, a bank must file a written capital restoration plan within 45 days of the date that the bank receives notice or is deemed to have notice that the bank is undercapitalized, significantly undercapitalized, or critically undercapitalized, unless the FDIC notifies the bank in writing that the plan is to be filed within a different period.

Written Agreements

Section 325.4(c) provides that any insured depository institution with a Tier 1 capital to total assets ratio of less than 2 percent must enter into and be in compliance with a written agreement with the FDIC (or with its primary Federal regulator with the FDIC as a party to the agreement) to increase its Tier 1 leverage capital ratio to a level that the FDIC deems appropriate or may be subject to a Section 8(a) termination of insurance action by the FDIC. Except in the very rarest of circumstances, the FDIC will require that such agreements contemplate immediate efforts by the depository institution to acquire the required capital. The guidance in this section is not intended to preclude the FDIC from taking Section 8(a) or other enforcement action against any institution, regardless of its capital level, if the specific circumstances deem such action to be appropriate.

Regulatory Authority to Enforce Capital Standards

The FDIC's authority to enforce capital standards in operating banks includes the use of written agreements and capital directives, as well as discretionary action in connection with FDI Act Section 18 matters (capital retirements, capital adjustments, branch bank applications, and changes in location) and recourse to the enforcement provisions of Section 8(a) and 8(b) of the FDI Act and the PCA provisions in Section 38 of the FDI Act and FDIC's Part 325 Regulation. A discussion on the use of these powers is included in the Formal Administrative Actions Section. Specific recommendations regarding capital adequacy should not be made solely on the examiner's initiative; coordination between the examiner and Regional Director is essential in this often sensitive 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.

Disallowing the Use of Bankruptcy to Evade Commitment to Maintain the Capital of a Federally Insured Depository Institution

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. Also, in accordance with the PCA provisions in Part 325, undercapitalized state nonmember banks 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 and/or reduce asset growth to the point that the capital formation rate exceeds asset growth. The following is a description of alternatives available for increasing the capital level in banks.

Increased Earnings Retention

Management may attempt to increase earnings retention through a combination of higher earnings and 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 securities 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 on corrective programs to be developed 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, insofar as available. 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 possibly be interested in acquiring stock.
- A list of other individuals or possible sources of support in the community who, because of known wealth or for 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 examination report. Obviously, the more severe the capital deficiency, the more detailed these background facts and circumstances need to be.

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 results 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 may be described as potential claims on bank assets for which any actual or direct liability is contingent upon some future event or circumstance. For examination purposes, contingent liabilities are divided into two general categories: Category I and Category II. Category I contingent liabilities are those that will 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. When a bank is required to fund a loan commitment or honor a draft drawn on a letter of credit, it generally originates a loan for the amount of liability incurred. Additional information on off-balance sheet lending activities is contained in the Off-Balance Sheet Activities section of this Manual.

Category II contingent liabilities include those in which a claim on assets arises without an equivalent increase in assets. Common examples of this category are pending litigation in which the bank is defendant and contingent liabilities arising from trust operations.

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 and/or have a high probability of becoming direct liabilities must be considered when the bank's component ratings are assigned. The amount of contingent liabilities and the extent to which they may be funded must be considered in the analysis of liquidity, for example. 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 have increased in significance as a means of enhancing bank earnings. In rating earnings, the impact of this type of fee income should be analyzed with consideration given to the present amount, quality, and expected future level.

The extent to which contingent liabilities may ultimately result in charges against capital accounts is always part of

the examination process and this analysis is important in the assessment of the capital rating. 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 325 of the FDIC Rules and Regulations. Part 325 does not explicitly include off-balance sheet activities in the leverage capital calculations, but it does indicate that off-balance sheet risk is one of the factors that will be considered in determining whether a higher minimum amount of capital should be required for any particular bank. Off-balance sheet risks are explicitly included in the risk-based capital calculations. The total dollar amount of all contingent liabilities is included in the memorandum section of the Capital Calculations schedule of the examination report.

A distinction is made between Category I and Category II contingent liabilities in determining adjustments to be made to capital. The examination procedures for adversely classified Category I contingent liabilities are described under the heading for Adversely Classified Contingent Liabilities in the Off-Balance Sheet Activities section, while procedures for Category II contingencies are included below under the heading for Potential and Estimated Losses in Contingent Liabilities.

Potential and Estimated Losses in Contingent Liabilities

As described above, Category I contingent liabilities are defined as those which 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 Assets Other Than Loans & Leases Classified Loss category on the Capital Calculations page. This examination treatment does not apply to Category II contingent liabilities since there is no equivalent increase in assets if a contingency becomes a direct liability.

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 Statement of Financial Accounting Standards No. 5 (FAS 5) Accounting for Contingencies.

The memorandum section of the Capital Calculations page includes the dollar amount of Category II contingent liabilities, as well as the Category I contingencies. Any Potential Loss identified is also reflected in the memorandum section and only refers to Category II contingent liabilities. Estimated Losses related to Category II contingent liabilities are reflected in this schedule as adjustments to capital by including them in the Other Adjustments to (from) Tier 1 capital line item. Estimated Losses are not included as adjustments to assets.

Common Forms of Contingent Liabilities

It is impossible to enumerate all the types and characteristics of contingent liabilities encountered in bank examinations. Some of the more common ones 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 the financial condition.

Litigation

If the bank is involved in a lawsuit where the outcome may impact 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 and/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 no 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 from actions or inactions on the part of the bank 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, which 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. For further information refer to the Trust Examination Manual.

Consigned Items and Other Nonledger Control Accounts

Banks often provide a large number of customer services that normally do not result in transactions subject to entry 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, sale of United States Savings Bonds, 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, mysterious disappearance, 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 customer enter into a contract whereby the bank receives a fee for renting safe deposit boxes and assumes responsibility of exercising reasonable care and precaution 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 and/or court orders.
- *Safekeeping* - In addition to items held as collateral for loans, banks occasionally hold customers' valuables. 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 and the functions it is to perform, is a vitally important first step 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

These typically include traveler's checks and United States Savings Bonds. Banks share a fee with the consignor of traveler's checks. Savings Bond proceeds are retained until remitted to the Federal Reserve. 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 FAS 5 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.

EVALUATION OF A BANK'S 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 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. Most banks do, and generally are expected to, maintain capital levels above the minimums, based on the institution's particular risk profile. In all cases, institutions should maintain capital commensurate with the level and nature of risks to which they are exposed, including the volume and severity of adversely classified assets.

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

Capital, like all of the CAMELS components, cannot be reviewed in a vacuum. The institution's overall condition is vitally important to the assessment of capital adequacy. Asset quality problems can quickly deplete capital. Poor earnings performance can hinder internal capital formation. Examiner judgment is required to review capital adequacy in relation to the institution's overall condition. Additionally, all capital is not created equally. While two institutions may have very similar regulatory capital ratios, the composition of such capital is important. For instance, all things being equal, voting common equity is a preferred capital source compared to hybrid capital instruments given the debt-like features inherent in the latter.

The Ability of Management to Address 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 prospects, the financial capacity of the directorate, and the strength of a holding company. A combination of ratio analysis and examiner judgment is required to address this evaluation factor.

The Nature, Trend, and Volume of Problem Assets, and the Adequacy of the ALLL and Other Valuation Reserves

The nature, trend, and volume of problem assets (including off-balance sheet activity) and the ALLL adequacy are vital factors in determining capital adequacy. The examiner should reference prior Reports of Examination and Uniform Bank Performance Report ratios to perform a level and trend analysis. The review of the nature of

problem assets will require a careful analysis of examination findings. The examiner may find the optional Analysis of Loans Subject to Adverse Classification page of the Report helpful in performing this analysis. In reviewing the ALLL adequacy, the examiner will review the bank's ALLL methodology in accordance with outstanding regulatory and accounting pronouncements.

Balance Sheet Composition, Including the Nature and Amount of Intangible Assets, Market Risk, Concentration Risk, and Risks Associated with Nontraditional Activities

The quality, type, and diversification of on- and off-balance sheet items are important with respect to the review of capital adequacy. Examiners should ensure that management identifies, measures, monitors, and controls the balance sheet risks and that the economic substance of the risks are recognized and appropriately managed. Risk-weighted capital ratios will help the examiner to a degree, but judgment is required to adequately address capital adequacy. Specifically, a portfolio of 100 percent risk-weighted commercial loans at two different institutions may have different risk characteristics depending on the risk tolerance of the management teams. Additionally, regulatory capital ratios alone do not account for concentration risk, market risk, or risks associated with nontraditional activities on the balance sheet. Examiner judgment is integral in assessing both the level of risk and management's ability to adequately manage such risk.

Risk Exposure Represented By Off-Balance Sheet Activities

The risk exposure from off-balance sheet activities will vary between institutions, but must be considered in the capital evaluation. The volume and nature of business transacted in a fiduciary capacity can be significant in the assessment of capital needs. Contingencies where the bank is acting in a fiduciary or nontraditional banking capacity can expose the bank to surcharges and therefore, operations, controls, and potential exposures must be carefully appraised. Similarly, lawsuits involving the bank as defendant or any other contingent liability, such as off-balance sheet lending, may indicate a need for a greater level of capital protection. Refer to the Contingent Liabilities and Off-Balance Sheet Activities sections for additional discussion.

The Quality and Strength of Earnings, and the Reasonableness of 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 even exceptional earnings performance and result in a weakened capital position, while an excessively low dividend return lowers 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. Refer to the Earnings section for additional discussion on the subject.

Prospects and Plans for Growth, as well as Past Experience in Managing 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 would be a good starting point for this review. The examiner may want to compare asset growth to capital formation during recent periods. The examiner may also want to review the current budget and strategic plan to review growth plans. Through this analysis, the examiner will be able to assess management's ability to both forecast and manage growth.

Access to Capital Markets and Other Sources of Capital, Including Support Provided by a Parent Holding Company

Management's access to capital sources, including 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 strength of a holding company will factor into capital requirements. 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 ratio analysis of the bank to assess management's access to capital sources.

RATING THE CAPITAL FACTOR

Adequacy of the capital base is one of the elements that must be evaluated to arrive at a composite rating in accordance with the Uniform Financial Institutions Rating System. This determination is a judgmental process and necessitates that the examiner take into account all of the subjective and objective variables, concepts, and

guidelines that have been discussed throughout this Section. The rating scheme itself is based on a scale of "1" through "5." Banks with capital ratings of "1" or "2" are considered to presently have adequate capital and are expected to continue to maintain adequate capital in future periods. Although both have adequate capital, "1" rated banks will generally have capital ratios that exceed ratios in "2" rated banks and/or their qualitative and quantitative factors will be such that a lower capital level is acceptable. A "3" rating should be assigned when the relationship of the capital structure to the various qualitative and quantitative factors comprising the analysis is adverse, or is expected to become adverse in the relatively near future (12 to 24 months) even after giving weight to management as a mitigating factor. Banks rated "4" or "5" are clearly inadequately capitalized, the latter representing a situation of such gravity as to threaten viability and solvency.

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.