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RESCINDED

March 15, 2011

Replaced by OCC Bulletin 2012-16.

MEMORANDUM FOR: **CHIEF EXECUTIVE OFFICERS**

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SUBJECT: Capital Management

The financial crisis exposed many material weaknesses in the banking system, including excessive risk concentrations and inadequate capital relative to risks. Some savings associations that were well-capitalized by regulatory standards at the onset of the crisis failed, and others struggled as their capital was not adequate to absorb the losses they incurred. While regulators are working on a number of regulatory initiatives to address these weaknesses, savings associations themselves should have a rigorous process for assessing their own capital adequacy, especially as we move into a new business and regulatory environment.

Capital planning is critical for savings associations of all sizes and complexity. Capital planning should generally begin with a meaningful assessment of capital adequacy relative to an institution's own unique risk profile and business plan. Capital planning should be at least an annual process, coinciding with the annual business plan/budget process. An institution's specific circumstances may warrant a more frequent capital planning assessment. Stress tests or "what if" scenario analysis should also be part of that assessment.

All savings associations should conduct an assessment of their capital adequacy. Larger and more complex savings associations should assess their material risks and the quality of their capital in greater depth and detail. They should determine whether their holding company, if they have such a structure, provides a reliable source of strength. Smaller institutions should perform stress testing at least annually. Larger and more complex institutions should conduct stress tests more frequently.

A capital planning process should result in the establishment of internal capital targets appropriate for the savings association's risk profile and business plan. It should also result in the development of contingency plans for addressing stress scenarios to which the savings association may be particularly vulnerable.

In assessing capital adequacy, OTS examiners will consider compliance with regulatory capital requirements, the quality of capital, holding company strength, the savings association's capital planning process, and the extent to which that process is forward-looking and risk-focused. Examiners will likewise review the adequacy and reasonableness of internally established capital targets, and the savings association's plans for meeting and maintaining those targets.

Internal Capital Analysis

Savings associations of all sizes should have a robust process for setting internal capital targets that are commensurate with their individual risk profiles and strategic plans, and adequate to withstand periods of economic stress. In setting internal capital targets, savings associations should consider regulatory capital requirements as minimums in light of the following considerations:

- Risk-based regulatory capital requirements do not take into account certain risks, both specific to individual savings associations and more generally to the economy at large, including concentration risk, interest rate risk, liquidity risk, and business cycle risk.
- The economic value of capital often falls in times of stress. A savings association should have sufficient capital to weather both normal business fluctuations as well as stressed economic conditions.
- In times of stress, particularly during unfavorable market conditions, associations often find it difficult and costly to replace depleted capital.

A savings association should express their internal capital targets as ratios based on the regulatory capital requirements: tier 1 leverage, tier 1/risk-based, and total risk-based capital ratios. In addition, it may base internal capital targets on GAAP common equity, tangible equity, or other reasonable measures. A savings association may establish more than one internal capital target, such as one based on total risk-based capital, and another on tier 1 leverage capital.

A savings association should base its internal capital targets on a sound capital adequacy assessment process that includes:

- A process for identifying, measuring, and reporting all material risks.
- A process that relates capital to the level of overall risk.
- A process that takes into account a savings association's business plans.
- A process that sets capital adequacy goals with respect to risk and strategic planning.
- A process that assesses the potential impact of stress scenarios, including an economic downturn or a failure to meet projections, as well as specific stress scenarios for that institution, its individual risk level, and its local economy.
- A process that has Board involvement and oversight of the entire process.

Such assessment should specifically consider those material risks that minimum regulatory capital requirements do not fully capture, including, for example:

- Concentration risks;
- Above average credit risks of certain portfolios (e.g., subprime portfolios);
- Interest rate risk;
- Pipeline risk for mortgage banking activities;
- Operational risk (e.g., internal control lapses, mortgage servicing problems);
- Other risks (e.g., reputational risk, legal risk, compliance risk, business risk).

Although for most savings associations a formal internal capital adequacy assessment process is not mandatory[1] OTS expects all savings associations to have a capital planning process. The larger the institution's asset size and the more complex its risk profile, the more sophisticated the capital planning process should be.

Stress Testing

Savings associations should use stress testing as a tool in their capital adequacy assessment process. Stress testing refers to various techniques used to gauge potential vulnerability to exceptional but plausible adverse events. Stress testing should identify the amount of additional capital an institution may need under various stress scenarios. However, stress tests, no matter how exhaustive, need not consider every possible adverse event or every possible negative assumption. Rather, they are a tool management should use to reasonably assess (and in some cases, quantify) an institution's vulnerabilities under various stress scenarios. The institution can then take steps to reduce or mitigate those risks, or develop contingency plans for those risks.

In stress testing, an institution alters assumptions about one or more financial, structural, or economic variables to determine the potential effect on the institution. Both informal analysis and sophisticated financial models and advanced methodologies are used. The particular method employed is less important than asking relevant and critical "what if" questions and incorporating the resulting answers into the risk management and capital planning process. Often, management is aware of the top four or five risks that it faces as an enterprise, but not always. Stress testing can reveal previously unknown material risks. As a risk management tool, all savings associations can derive benefit from stress testing, regardless of the sophistication of their methods.[2]

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[1] Institutions operating under the Basel II advanced approaches (generally these are subsidiaries of very large financial institutions) are required to have an internal capital adequacy assessment process. Refer to Appendix C to 12 C.F.R. Part 567, Section 22(a). Also refer to Supervisory Guidance: Supervisory Review Process of Capital Adequacy (Pillar 2) related to the Implementation of the Basel II Advanced Capital Framework published in the Federal Register/Vol. 73, No. 148/Thursday, July 31, 2008/Rules and Regulations.

[2] Note that all banking organizations with total consolidated assets of $10 billion or more will be required under the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act to conduct annual stress tests in accordance with regulations to be issued by each primary Federal financial regulatory agency.

Smaller, non-complex institutions might use some of the following "what if" scenarios to assess the potential impact on earnings and capital. This list is illustrative, as risks are often specific to the operation and business plan of the institution.

- A decline in local or regional house prices or an increase in the unemployment rate in the local area.
- A decline in commercial real estate prices or rents, or an increase in vacancy rates.
- Over-development or a decreased demand for new homes or other newly developed real estate (e.g. condominium projects) in the institution's lending area.
- A downturn in the national or regional economy and resulting increases in delinquency or charge-off rates.
- A sudden, unexpected increase in market interest rates.
- The closing of a local business and resulting unemployment in the local economy, including estimates of loan defaults and losses.
- Increase in delinquencies or defaults on adjustable rate loans from a sudden, unexpected increase in interest rates.
- Changes in an institution's mortgage origination pipeline with increases or decreases in interest rates.
- Increases in servicing costs on mortgage loans, due to unexpected levels of defaults and foreclosures, or changes in foreclosure costs.
- A local natural disaster such as flooding, including resulting loan defaults and possible changes in property values, or damage to agriculture in the area.
- Slower or faster prepayments as compared to projections.
- Core deposit outflow faster than projected.
- Losses on REO higher than projected.

Management should use the information derived from the stress tests to develop action plans appropriate to the stress scenarios identified. In many cases, holding an increased level of capital against the risk may be sufficient. Other action plans might include restrictions on capital distributions. A savings association should establish a dividend policy that clearly articulates the institution's objectives and approaches for maintaining a strong capital position throughout the economic cycle. The policy should restrict dividends and other discretionary capital distributions when the institution does not meet internal capital requirements. If stress testing and capital planning indicates that the savings association needs more capital, it should develop an appropriate plan to meet those requirements. The savings association may then decide, for example, to reduce its risk level, raise more capital, change its dividend policies, or a combination of all three.

OTS Examinations

The existence of a robust capital planning process that includes stress testing and establishment of appropriate internal capital targets will generally reflect positively on the savings association. It will also help highlight for the savings association's management and board, as well as for OTS examiners, the potential vulnerabilities of the institution and should lead to a better understanding of the level of capital appropriate for that institution's individual risk profile under stress conditions.

As part of the review process, examiners will discuss with management the savings association's capital planning process. Among other things, these discussions will cover:

- Does the savings association have a capital planning process and does it incorporate stress testing?
- Does the savings association set internal capital targets? How did it establish these targets?
- Did it use scenario analysis? If so, what are the scenarios, what is the process of developing the scenarios, and is the range of scenarios reasonable for that savings association? For example, does the institution incorporate adverse scenarios appropriate for that its local market and products?
- Does the capital planning process involve senior managers as well as the members of the board of directors? Does the board approve the internal capital targets?
- What information has the savings association obtained through the stress testing process?
- How has management acted on that information? Has management identified credible actions that it would take when faced with a certain stress event?
- Has the savings association determined what actions it would undertake to continue operations through a period of stress without breaching the regulatory capital requirements?

By addressing these questions, OTS examiners will be in a better position to support the adequacy and reasonableness of a savings association's internally established targets, and to identify and understand the plans to meet and maintain those targets.