

Capital Adequacy Program

EXAMINATION OBJECTIVES

To determine the adequacy of capital relative to the institution's risk profile, financial condition, and strategic plans.

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

To evaluate the composition and quality of the capital base.

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

To determine if capital related policies and procedures are adequate and are being followed.

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

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, or whenever capital is insufficient for the level of risk.

EXAMINATION PROCEDURES

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LEVEL I

1. Obtain and review the information on capital provided in the UTPR, off-site monitoring reports, latest examination reports, 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.

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

- Prior examination report comments and exceptions.

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- Internal and external audit exceptions.
 - Any enforcement/supervisory actions and directives.
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3. Review the Matters Requiring Board Attention and Corrective Actions from the three or four previous ROEs to ensure that the board and management have taken appropriate corrective action where necessary and persistent problems have not recurred.
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4. Review the savings association'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 own business plan or board imposed capital targets?
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5. Review the composition and quality of the savings association's capital base. Consider the following items:
- The percent of Tier 1 capital composed of common voting shares. Common shares are the highest quality of capital as they can absorb losses on a going concern basis by way of the institution reducing dividends, as well as through loss in market value. The amount of noncumulative preferred shares and other Tier 1 qualifying hybrid capital instruments that have some debt like characteristics such as an implied obligation to make regular dividend payments. These instruments are typically less capable of absorbing losses on an ongoing basis, and therefore should compose only a limited portion of the Tier 1 capital base.

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- The amount of noncontrolling interests in a subordinate organization, which is also generally a lower quality form of Tier 1 capital as it is usually only available to absorb losses in the subordinate organization and should therefore compose only a limited portion of Tier 1 capital.
 - Cumulative preferred shares, qualifying subordinated debt, and other debt like hybrid instruments are permitted only in Tier 2 capital. Generally, the greater the percent of Total Capital composed of Tier 1 capital and the lesser amount of Tier 2 capital, then the stronger the capital base.
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6. Review trends in capital levels and ratios. Consider the following:

- The prospects for continuing capital compliance;
 - Whether management has planned for capital adequacy in line with anticipated growth;
 - Whether the risk orientation of the institution is changing;
 - The amount of higher risk asset types that have the potential to generate losses as well as assets with potentially volatile values including intangible assets such as mortgage servicing assets, deferred taxes, and securities with embedded losses. These types of assets may detract from the quality of the capital base;
 - The impact of the institution's dividend policy and related practices on capital. Hybrid capital instruments at the holding company level including trust preferred securities, as well as ordinary cumulative and noncumulative preferred shares may place pressure on the savings association to pay dividends to its holding company so that the holding company will have funds to service the debt on these instruments. These instruments at the holding company level can therefore indirectly detract from the savings associations' capital base.
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7. Evaluate the savings association's own assessment of its capital adequacy relative to its own level of risk. While this assessment may be quite simple for small traditional savings associations, the level of analysis should be commensurate with the size and complexity of the institution, and therefore should be fairly sophisticated for large and complex organizations. Consider the following:
- Has the institution established internal capital targets? Is the institution in compliance with its own established targets?
 - Has the institution has conducted some assessment of its risk profile? Is its risk profile in line with the board established risk tolerance levels? Is the risk profile changing? Is it considered high, medium or low? Is risk well managed or mitigated?
 - Do the internal capital targets take into consideration an assessment of the institution's risk profile, its local economic environment, and its strategic plans?
 - Are the internal capital targets in with the institution's risk profile and strategic direction?
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8. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.
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LEVEL II

9. 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 savings association has not recorded in the income statement.

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- 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 [Examination 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 savings association deducted goodwill and intangible assets from capital and assets according to policy?
 - Are assets subject to limitation appropriately handled?
 - ✓ 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?

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- Has the savings association 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 savings association properly treated assets sold with recourse?
- Is the savings association properly holding dollar-for-dollar capital against most residual interests? (And, is the savings association deducting any credit-enhancing interest-only strips that exceed 25 percent of Tier 1 capital?)

10. Determine a level of capital that is appropriate for the institution's unique risk profile. Where applicable, apply the capital guidance for subprime lending programs. If appropriate, recommend an IMCR, or use of the OTS reservation of authority to achieve higher risk weights for other high risk assets or portfolios, or other exposures.

- Review the institution's own assessment of its capital adequacy given its unique level of risk. Ascertain if the institution has included in its assessment the major risks to which it is exposed: credit risk, interest rate risk, liquidity risk and operational risk.
- Consider the risk orientation and diversification of loan and investment portfolios. Do portfolios present excessive risk? Is the institution's risk orientation changing? If the institution has subprime portfolios or other exposures with elevated levels of risk, a higher risk-based capital requirement for those portfolios is appropriate.

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- 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. For analysis of capital adequacy, off-balance sheet activities may need to be analyzed as if on-balance sheet.
- 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? Does the institution maintain capital reserves sufficient to meet a well capitalized status during an economic downturn?
- Confer with the examiners assigned to [Examination Program 260](#), Classification of Assets, and [Examination 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 institution 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 savings association 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.

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- 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?
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11. Assess management's capital planning process.

- Consider the institution's own assessment of capital in light of conclusions for item no. 10 above. Is the institution's own capital adequacy assessment adequate?
 - 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.
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12. 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 or whether the capital deficiency rises to the level requiring formal action. Discuss your recommendation with the EIC and OTS regional management. See Appendix A, [Examination Handbook 080](#), 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.

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- 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 13 below).
 - The pass-through insurance restrictions (Number 14 below).
 - The broker deposit restrictions (Number 15 below).
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13. If the institution is less than adequately capitalized (as reflected in its TFR, a final report of examination, or disclosed in a notice from OTS – see 12 CFR § 565.3), you should review for compliance with the mandatory and discretionary supervisory actions. You can refer to 12 CFR § 565.6 for a description of the mandatory and discretionary actions.

14. If the 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 savings association 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 savings association 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 employee benefit plan depositor (administrator or manager) makes a request for information.
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15. Check for compliance with brokered deposit restrictions. Only well-capitalized institutions may accept brokered deposits without restriction. If the institution is not well-capitalized, you may refer to [Examination Handbook Section 560](#), Deposits and Borrowed Funds, for the applicable restrictions and prohibitions on brokered deposits.

16. 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

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