

RESCINDED

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Handbook: Examination
Subject: Capital

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Section: 120

Capital Adequacy

Summary: This Regulatory Bulletin issues revised Examination Handbook Section 120, Capital Adequacy. This bulletin rescinds RB 32-31 dated November 20, 2003.

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Regulatory Bulletin 37-62

SUMMARY OF CHANGES

OTS is issuing an updated Examination Handbook Section 120, Capital Adequacy. Revisions to this handbook section are extensive; therefore, we did not include change bars. We list a summary of changes below.

120 Capital Adequacy

This handbook section update reflects revisions to guidance in the following areas:

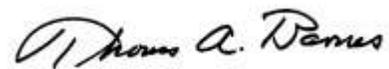
- Expands the discussion on assessing compliance with minimum regulatory capital requirements as well as assessing overall capital adequacy in relation to a saving association's risk profile and strategic plans.
- Updates the discussion of the Basel International Accord and its impact on federal banking regulations.
- Expands the discussion on determining compliance with regulatory capital requirements.
- Significantly expands the discussion on Assessing Overall Capital Adequacy to include: a review of an institutions own capital adequacy assessment process; factors that affect capital, including material risks; an assessment of the quality of capital; and, an assessment of capital adequacy relative to an institution's unique risk profile.
- Revises the section on includable and nonincludable subsidiaries.
- Adds a discussion on assessing the quality of capital.
- Updates accounting references.

In addition, we incorporated the contents of former Appendix A: Capital Components and Risk-Based Capital, and former Appendix B: Supplementary Information and Issues, with updates into two new appendices: Appendix A, which focuses on the Components of Tier 1, Tier 2, and Total

Capital (the numerator); and Appendix B, which focuses on the Calculation of Risk Weighted Assets (the denominator). Updates include:

- Updated discussion of regulatory policy related to the treatment of non-controlling (minority) interests in regulatory capital.
- Clarification of the treatment of intangible assets acquired in a taxable versus a nontaxable transaction.
- Updated discussion of regulatory policy related to the treatment of employer's accounting for defined benefit pension and other post-retirement plans for regulatory capital purposes.
- Updated discussion of the regulatory treatment of liabilities under fair value accounting.
- Added discussion on the regulatory capital treatment of TARP and CPP payments.
- Updated discussion of the importance of common stockholders Equity as the predominant form of Tier 1 capital, and expanded the discussion on the composition of common stockholders' equity and noncumulative perpetual preferred stock.
- Updated the discussion regarding the treatment of other than-temporary impairment on available-for-sale securities.
- Inserted an example showing how to calculate the deduction of servicing assets.
- Updated a discussion of regulatory policy with regard to accounting changes affecting the treatment of on- and off-balance sheet assets.
- Clarified the zero percent risk-weight for covered assets, Temporary Liquidity Guarantee Program (TLGP) assets, and FDIC pre-paid insurance assessments.
- Added FDIC loss-sharing arrangements to the twenty-percent risk-weight category.
- Added a discussion about underwriting and qualifying residential mortgage loans for the fifty-percent risk-weight category.
- Added references to CEO Letter No. 344, Early Default Clauses.

We retained Appendix C, PCA Restrictions, with no changes. We also added a new Appendix D that addresses frequently asked questions and answers regarding risk weight treatment of various types of one-to-four residential mortgage loans.



—Thomas A. Barnes

**Senior Deputy Director
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Capital Adequacy

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

Federal banking law requires banking organizations to achieve and maintain adequate capital. The law authorizes federal banking agencies to set minimum capital levels to ensure that banking agencies maintain adequate capital. The law also gives federal banking agencies broad discretion with respect to capital regulation by authorizing them to also use many other methods that they deem appropriate to ensure capital adequacy. If federal savings associations fail to maintain adequate capital, federal law authorizes the OTS to take prompt corrective or other enforcement action (12 USC 1464(s)).

L I N K S

-  [Program](#)

-  [Appendix A](#)

-  [Appendix B](#)

-  [Appendix C](#)

-  [Appendix D](#)

A savings association’s capital is adequate when it meets its mandated regulatory requirements, **and** is commensurate with the savings association’s risk profile and strategic business goals. The capital level should be sufficient to support current business activities, future growth, and periods of economic stress. While minimum regulatory capital requirements provide a consistent starting point for determining capital adequacy, most savings associations should, and in fact do, exceed well-capitalized standards. (See Prompt Corrective Action (PCA) Categories below.)

There is a direct relationship between the amount of capital an association needs and the risk profile of the association. Savings associations are expected to hold capital commensurate with the size, complexity, and risk of their business and business goals. Minimum regulatory capital requirements focus primarily on credit risk and assume that a savings association primarily engages in relatively lower risk activities. Higher risk activities require more capital, especially if the activities are conducted at significant concentration levels. Moreover, the minimum risk-based capital requirements do not take into account other risks or factors that can affect a savings association’s financial condition. These factors include operational risks, interest rate exposure, liquidity, funding and market risks, the level and quality of earnings, loan and investment strategies, the adequacy of the allowance for loan and lease losses (ALLL), and quality of risk management – all of which can impact an institution’s risk profile and capital adequacy. In sum, the final supervisory judgment on capital adequacy may differ significantly from an evaluation of compliance with the *minimum* risk-based capital requirements.

In assessing the capital adequacy of a savings association, you must ensure that the savings association is in compliance with the OTS minimum regulatory capital requirements as set forth in 12 CFR Parts 565 and 567 or other capital requirements imposed by the OTS consistent with its enforcement and other regulatory authority. You must then ensure that the savings association’s capital levels are

consistent with the strategic business goals of the savings association. And finally, and most importantly, you must ensure that the savings association is holding capital adequate for its risk profile.

SECTION OVERVIEW

This Handbook Section provides guidance in four main areas:

- Assessing Compliance with Minimum Regulatory Capital Requirements.
- Assessing Overall Capital Adequacy.
- Rating the Capital Factor.
- Addressing Capital Deficiencies.

Appendices to this Handbook Section provide additional guidance:

- Capital Components (Tier 1 and Tier 2 Capital) ([Appendix A](#)).
- Risk-Weighted Assets and Risk-based Capital (Basel I) ([Appendix B](#)).
- Prompt Corrective Action (PCA) Restrictions ([Appendix C](#)).
- Questions and Answers on Risk Weighting 1-to-4 Family Residential Mortgage Loans ([Appendix D](#)).

ASSESSING COMPLIANCE WITH REGULATORY CAPITAL REQUIREMENTS

OTS capital rules are substantially similar to those of the other banking regulators. In addition, the federal banking agencies must work together to develop and refine uniform rules implementing common statutory or supervisory policies, including capital requirements. Many of the agencies' uniform capital rules are based on the framework set forth in the "International Convergence of Capital Measurement and Capital Standards" (Basel I).

Background

In 1989, the banking agencies implemented a risk-based capital framework for the U.S. banking organizations based on the Basel I framework. The general risk-based capital rules remain in effect and are described in detail in [Appendix B](#). The risk-based capital requirement captures primarily credit risk from on-balance-sheet assets and most off-balance-sheet commitments and obligations.

In June 2004, the Basel Committee on Bank Supervision introduced a new capital adequacy framework, known as Basel II that is designed to promote improved risk measurement and management processes and better align minimum risk-based capital with risk. Basel II includes several options for calculating

risk-based capital requirements for credit risk and for operational risk. For credit risk, the Basel II includes three approaches for calculating regulatory capital: the Standardized, the Foundation, and the Advanced Internal Ratings Based (AIRB) approaches. For operational risk, Basel II includes three approaches: Basic Indicator, Standardized, and the Advanced Measurement (AMA) approaches. The federal banking agencies are not currently planning to adopt all of these Basel II approaches for the United States. Instead, the banking agencies have focused on the AIRB and AMA (together referred to as the Advanced Approaches) which have already been adopted, and the agencies are developing a U.S. version of the Standardized Approach.

In December 2007, the federal banking agencies published a final rule implementing the Advanced Internal Ratings Based approach for credit risk and the Advanced Measurement Approach for operational risk. The Basel II Advanced Approaches Rule is mandatory only for certain banking organizations and voluntary for others that may choose to use them. In general, the Basel II Advanced Approaches Rule is mandatory for banking organizations that have consolidated total assets of \$250 billion or more, consolidated on-balance sheet foreign exposure of \$10 billion or more, or are a subsidiary or parent of an Advance Approaches organization. Certain savings associations that are subsidiaries of larger banking organizations are subject to the Advanced Approaches on a mandatory basis. The Basel II Advanced Approaches can be found at 12 CFR Part 567, Appendix C. The Advanced Approaches are NOT covered in this handbook section.

Regulatory Capital Requirements

All savings associations are subject to two overlapping sets of minimum regulatory capital requirements established by federal statutes. They are subject to the tangible, core/leverage, and risk-based capital requirements set forth in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), as well as the Prompt Corrective Action capital categories set forth in the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA).

Tangible, Core, and Risk-based Capital Requirements (FIRREA)

The FIRREA-based requirements for tangible, leverage, and risk-based capital are defined in 12 CFR Part 567. Savings associations must satisfy all three of the following minimum capital requirements:

<u>Capital Ratio</u>	<u>Minimum Capital Requirement</u>
Tangible Capital Ratio	Tangible capital of at least 1.5% of adjusted total assets*
Leverage Ratio	Tier 1 capital of at least 4% of adjusted total assets (3% for savings associations with a composite CAMELS rating of 1)
Risk-Based Capital Ratio	Total Risk-Based Capital of at least 8% of total risk-weighted assets

** While all three capital requirements exist as a matter of law, the tangible capital requirement has effectively been eclipsed by the more stringent PCA requirements (see below). Therefore, Thrift Financial Report (TFR) instructions do not include a calculation for tangible capital. Tangible capital is defined in 12 CFR § 567.9.*

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

The composition and calculation of Tier 1 and Tier 2 capital is fully discussed in [Appendix A](#). The risk-based capital calculation and the calculation of total risk-weighted assets is fully discussed in [Appendix B](#).

Schedule CCR of the TFR also includes detailed computational instructions for calculating Tier 1, Tier 2, total risk-based capital, and total risk-weighted assets.

Adjusted total assets are defined in 12 CFR § 567.1. Adjusted total assets are calculated on Schedule CCR of the TFR, which adjusts Total Assets from Schedule SC of the TFR for investment in subsidiaries, gains and losses on available-for-sale (AFS) securities, certain hedges, and certain other adjustments. (See Schedule CCR and corresponding TFR instructions.)

Prompt Corrective Action (PCA) Categories (FDICIA)

The FDICIA-based capital standards are set forth in 12 CFR Part 565.

The PCA minimum capital requirements are as follows:

	<u>Leverage Ratio</u> (tier 1 capital to adjusted total assets)		<u>Tier 1 Risk-Based Capital Ratio</u> (tier 1 capital to total risk-weighted assets)		<u>Total Risk-Based Capital Ratio</u> (total risk based capital to total risk-weighted assets)
Well Capitalized	5% or greater	<i>and</i>	6% or greater	<i>and</i>	10% or greater
Adequately Capitalized	4% or greater (3% for 1-rated)	<i>and</i>	4% or greater	<i>and</i>	8% or greater
Undercapitalized	Less than 4% (except for 1-rated)	<i>or</i>	Less than 4%	<i>or</i>	Less than 8%
Significantly Undercapitalized	Less than 3%	<i>or</i>	Less than 3%	<i>or</i>	Less than 6%
Critically Undercapitalized	Has a ratio of tangible equity capital* to total assets that is equal to or less than 2%				

* The definition of tangible equity capital under PCA differs from the definition of tangible capital under FIRREA. You may find the definition of tangible equity capital in 12 CFR § 565.2(f). Essentially, tangible equity capital equals: **Core capital** (Tier 1) + cumulative perpetual preferred stock – intangible assets (defined in 12 CFR § 567.1, except for mortgage servicing assets that are otherwise includable under 12 CFR § 567.12) and nonmortgage servicing assets that have not been previously deducted in calculating core capital. For purposes of the tangible equity capital ratio, total assets is defined at 12 CFR 565.2 as adjusted total assets (defined in 12 CFR § 567.1) less intangible assets (defined in 12 CFR § 567.1).

Savings associations are expected to remain at least adequately capitalized at all times and should strive for well capitalized standards and above, since failing to do so may subject an institution to various operating restrictions, such as those on brokered deposits. During periods of economic stability, a savings association should hold capital in excess of minimum requirements, and maintain a capital buffer sufficient to continue to maintain a well-capitalized status during economic downturns or other periods when losses occur.

Other Regulatory Capital Requirements

In addition to the minimum regulatory capital requirements, a savings association may be subject to other regulatory capital requirements. If OTS makes a supervisory determination that a savings association's capital is deficient in relation to its risk profile, a savings association may be subject to higher capital requirements imposed by OTS via **Reservation of Authority**, the imposition of an **IMCR**, or via **Formal Enforcement Action** to address capital deficiencies. (See discussions below on "Assessing Overall Capital Adequacy" and "Addressing Capital Deficiencies".) Also, see the TFR instructions for Schedule CCR that describe where a savings association should report other regulatory capital requirements related to a Reservation of Authority, an IMCR, or a Formal Enforcement Action.

Capital For Subprime Lending Programs

In accordance with [CEO Memo 137](#), *Expanded Guidance for Subprime Lending Programs*, issued February 2, 2001, and the *Interagency Guidance on Non-traditional Mortgage Products*, Volume 70, No. 249 Federal Register 77249, issued December 25, 2005, examiners must evaluate the capital adequacy of subprime lenders on a case-by-case basis, and determine the appropriate level of capital needed to support subprime lending activities. Generally subprime portfolios should be supported by capital equal to **one and one-half to three times** greater than what is appropriate for prime assets of a similar type as a starting point. This is not meant to imply that additional capital is always required. Some subprime loans may be only marginally more risky than prime loans and, thus, may warrant increased supervisory scrutiny and monitoring, *but not necessarily additional capital*. Conversely, examiners may determine that savings associations that originate or purchase high-risk subprime loan pools, such as unsecured or poorly documented loans, or loans to very high-risk borrowers, may need significantly higher levels of capital depending on the level and volatility of risk. A savings association's ALLL should also be adequate to address its subprime program. More information about subprime lending and risk analysis for capital adequacy is available in guidance issued by the four federal banking agencies and available on the OTS website. It applies to subprime lending programs that exceed 25 percent of a savings association's Tier 1 capital.

Although the subprime guidance applies specifically to subprime programs as defined in that guidance, it should be noted that OTS may assign other portfolios or assets higher risk weights where appropriate. This would be done under the reservation of authority or by use of an IMCR.

Regulatory Capital Requirements for Investments in Subsidiaries¹

OTS capital regulations define a subsidiary as an entity in which the parent savings association has a majority ownership interest and, for purposes of GAAP, consolidates the entity's assets. Such an entity could be either a service corporation or an operating subsidiary. [Examination Handbook Section 730](#) and 12 CFR Part 559 discuss savings association investments in subsidiaries, including service corporations and operating subsidiaries, and the differences between these types of subsidiaries.

For purposes of OTS capital rules (Part 567) and Schedule CCR, a subsidiary is either includable or nonincludable. **A savings association must deconsolidate and deduct from Tier 1 capital any subsidiary that is a nonincludable subsidiary.**

An includable subsidiary means a subsidiary of a savings association that is:

- Engaged solely in activities permissible for a national bank;
- Engaged in activities not permissible for a national bank, but only if acting solely as agent for its customers;
- Engaged solely in mortgage banking activities;
- Itself an insured depository institutions or a holding company whose sole investment is an insured depository institution (acquired before May 1, 1989);
- A subsidiary of a federal savings association existing as such on August 9, 1989, and was either previously chartered by a state savings bank prior to October 15, 1982, or acquired its principal assets from a state savings banks prior to this date.

Note that a savings association's **operating subsidiary** is always considered an includable subsidiary for regulatory capital purposes, unless the operating subsidiary is itself a savings association that is engaged in activities impermissible for national banks. (See 57 Federal Register 48944 (October 29, 1992).)

Includable subsidiaries are consolidated with the parent savings association for capital purposes. Investment, including both debt and equity investment, in nonincludable subsidiaries is deducted from both assets and capital (12 CFR § 567.5(a)(1)(iv)).

Documentation Requirements

Savings associations must have adequate systems in place to compute their capital requirements and capital levels. Supporting documentation should establish how a savings association tracks and reports

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

its capital components, how it risk weights its assets, and how it calculates each of its capital levels. Where a savings association has inadequate documentation to support its assignment of a risk weight to a given item, examiners may assign an appropriate risk weight to that item. You should verify that savings associations are correctly reporting the information requested in Schedule CCR of the TFR that is used in computing the capital requirements. In addition, you should determine whether a savings association is in compliance with:

- Minimum regulatory capital requirements.
- Other capital requirements established by a PCA capital restoration plan, conditions to approval of an application(s), an IMCR, enforcement action, other applicable agreement or plan, or through use of the OTS reservation of authority.
- Capital levels established by a business plan or the Board of Directors.

Prompt Corrective Action

A savings association that becomes *undercapitalized, significantly undercapitalized, or critically undercapitalized*, as defined for purposes of PCA, must file a capital restoration plan and, among other things, is subject to certain mandatory and discretionary supervisory actions pursuant to 12 CFR 565—Prompt Corrective Action. (See Appendix C and 12 CFR Part 565.) See also [Examination Handbook Section 080](#) on Enforcement Actions.

ASSESSING OVERALL CAPITAL ADEQUACY

Capital helps protect savings associations from insolvency, thereby promoting safety and soundness in the overall U.S. banking system, and serves as a buffer in an economic downturn. Minimum risk-based capital requirements establish a threshold below which a sound savings association's risk-based capital must not fall. Risk-based capital ratios permit some comparative analysis of capital adequacy across banks and savings associations because they are based on certain common assumptions. However, examiners must perform a more comprehensive review of capital adequacy that considers the risks that are specific to each individual institution, including those not incorporated in the risk based capital requirements. In short, supervisors must ensure that a savings association's overall capital does not fall below the level required to support its entire risk profile. OTS generally expects savings associations to hold capital above their minimum risk-based capital levels, commensurate with their risk profiles, to account for all material risks. In determining the extent to which savings associations should hold capital in excess of risk-based capital minimums, whether under a formal action or an informal agreement, you should consider: compliance with the minimum regulatory capital requirements; the quality and results of a savings association's own process for determining whether its capital is adequate; and its risk management processes, control structure, and other relevant information relating to the savings association's risk profile and capital level. (See discussion below on "Factors Impacting Capital Adequacy".)

Internal Capital Adequacy Assessment

Savings associations should be able to identify and manage material risks to which the association is exposed. Savings associations should also be able to conduct an internal assessment of capital adequacy considering the material risks to which the association is exposed, the capital needs relative to those risks, and the strategic business and capital goals of the association. The sophistication of this analysis will depend on the size and complexity of the association's activities. OTS generally expects institutions with large, sophisticated, and complex business operations to employ a rigorous process for identifying and measuring material risks and for determining appropriate capital relative to those risks. Those internal capital adequacy assessment processes should be capable of: identifying and measuring material risks; setting and assessing internal capital adequacy goals that relate directly to risk; and ensuring the integrity of internal capital adequacy assessments. All institutions should set internal capital targets and should be able to demonstrate that those capital targets are well-founded and consistent with the savings association's overall risk profile and current operating environment. In assessing capital adequacy, management should be mindful of the particular stage of the business cycle in which they are operating, and should consider (preferably through some form of forward-looking stress testing) possible events or changes in market conditions that could adversely impact the savings association.

Factors Impacting Capital Adequacy

In evaluating an association's capital adequacy, you should consider a number of factors that can impact the risk profile and thus the capital adequacy of a savings association. You should refer to the relevant Examination Handbook sections for further discussion on these specific topics and should rely on examination findings and other pertinent information in assessing the risk and capital impact of the following factors:

Quality of Risk Management and Internal Control Processes

While capital is not a substitute for inadequate control or inadequate risk management processes, there is a relationship between the amount of capital held by a savings association and the strength and effectiveness of the savings association's risk management and internal control processes. In addition, to proactively addressing these weaknesses, you should consider whether savings associations with less than satisfactory control or risk management processes need more capital or whether there are other sufficient options to address these risks.

Asset Quality

Asset quality is a key factor in evaluating capital adequacy. When assessing capital adequacy, you should evaluate the nature of and the risks associated with each lending and investment program. For example, is the lending program nontraditional (e.g., high-LTV option ARMS) with higher risk loans? Are the underwriting standards appropriate for the type of lending? Is the association heavily concentrated in a certain product or market? You should consider the extent to which individual assets or portfolios of assets exhibit serious weaknesses or loss of value. Key indicators of overall asset quality are the dollar value of assets subject to adverse classification and the severity of those classifications relative to capital. You should consider delinquency and foreclosure trends, the level of nonaccrual or

nonperforming loans, and market depreciation of securities. Savings associations with higher risk lending should maintain sufficient ALLL to offset expected losses and a higher capital base to absorb unanticipated losses. (Refer to [Asset Quality, Section 200](#), of the Examination Handbook and related guidance.)

Off-Balance Sheet Activities and Exposures

A savings association may engage in off-balance sheet activities such as outstanding commitments, guarantees, derivatives, or recourse obligations that are not reflected on the savings association's balance sheet. In such cases, you must determine whether the savings association is exposed to economic risks or potential legal liabilities that are not fully captured by generally accepted accounting principles (GAAP) or regulatory capital rules. Note that while risk-based assets include many off-balance sheet risk exposures, the Tier 1 leverage capital requirement does not address off-balance sheet risk.

Earnings and Dividends

Consider earnings performance and dividend practices. You should consider the quality, stability, and trend of earnings. Good earnings performance enables a savings association to fund its growth, build and maintain a strong capital position, absorb unexpected losses, and remain competitive in the marketplace. Dividend practices and policies can impact capital. For example, excessive dividends can negate even exceptional earnings performance and result in a weakened capital position. In addition, hybrid capital instruments at the holding company level, including trust preferred securities and cumulative and noncumulative preferred shares, may place pressure on the savings association to pay dividends to its holding company so that the holding company has funds to service debt on these instruments. Such practices at the holding company can indirectly and negatively impact the savings association's capital. Generally, management should first apply earnings to the elimination of losses and the establishment of necessary reserves and prudent capital levels; and then, after full consideration of those needs, management may disburse dividends in a reasonable amount.

Interest Rate Risk

Savings associations with excessive interest rate risk exposure may experience a significant decline in earnings and capital levels as a result of unfavorable changes in interest rates. Therefore, savings associations with relatively high interest rate risk may require higher capital levels to offset that risk to the extent that that risk is not adequately managed.

Liquidity and Funds Management

Savings associations that are experiencing financial problems and are in a constricted liquidity situation may have no alternative but to dispose of assets at a loss in order to honor funds outflows; and such losses must be absorbed by the capital accounts. Generally, the lower a savings association's level of liquidity or the more limited and volatile its funding sources, or the absence of contingency funding sources, the more seriously you should consider higher capital requirements. Be aware that liquidity

needs may be greater for some business plans, such as mortgage banking operations and trading activities.

Deposit Structure

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

Contingent Liabilities

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

Peer Comparison

You should also assess capital adequacy by comparing a savings association with similar (peer) institutions, although you should not rely on this information exclusively.

New Products and Activities

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

Local Characteristics

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

Risk Diversification

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

Relationships with Affiliates

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

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

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

Subordinate Organizations

Subordinate organizations can significantly affect the operations and overall financial condition of their parent savings association. Therefore, it is important to determine if subordinate organizations pose risk to the capital adequacy of the parent. Where a regulator other than OTS regulates the subordinate organization, it is important to consider whether capital from the subordinate organization would actually be available to the parent savings association in a time of stress. Furthermore, it is important to consider whether the parent savings association has obligated itself, either formally or informally, to fund obligations of its subsidiary.

You should pay particular attention to functionally regulated subsidiaries² as well as most subsidiary depository institutions that have a primary regulator other than OTS. In analyzing the capital adequacy of a savings association that owns these subordinate organizations, you should consider the capital needed to meet the requirements of the primary regulator and whether that capital is actually available to the savings association. Or, whether the excess capital in the subsidiary (that is, capital in excess of that required by the subsidiary's primary regulator) is available to the entities above it in the organizational hierarchy. In these situations, you should review the examination reports of the subsidiary's primary regulator (and engage in discussions with the subsidiary's primary regulator) in order to determine whether the subsidiary's excess capital is transferable and available to support the parent. Depending upon the outcome of this analysis, you should decide whether to permit inclusion of the subsidiary's excess capital in your consideration of the capital adequacy of a savings association.

² Functionally regulated subsidiaries include: registered broker-dealers, registered investment advisors, registered investment companies, insurance companies, or entities subject to regulation by the Commodity Futures Trading Commission.

Quality of Management

The ability, experience, depth, integrity, and record of management are important in your assessment of a savings association's capital adequacy. In fact, it is difficult to conceive of a capital structure capable of withstanding the deterioration that eventually results from inept or dishonest management. Sound management practices include the formulation and implementation of robust, rigorous, and adequate policies and procedures relative to loans, investments, interest rate risk, operations, internal controls, audits, and other functional areas. Deficiencies in these policies or their implementation can have an adverse impact on the savings association's capital position. See [Examination Handbook Section 340](#) on Internal Controls and [Section 355](#) on Internal Audit for more general information.

Future Plans

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

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

Management's plans and projections should be realistic in terms of the economic outlook, previous performance, and industry averages. Management should apply stress testing to their projections using a methodology commensurate with the complexity of their organizations activities. An analysis of the ratio of equity growth to asset growth can be helpful in your analysis of capital trends. When this ratio is less than one, it signifies that assets are expanding faster than capital growth, hence a declining equity position and increasing financial leverage.

Composition and Quality of Capital

In your assessment of capital adequacy, it is also important to consider both the composition and quality of a savings association's capital. For regulatory capital purposes, a savings association's total capital consists of two components: Tier 1 (or core) capital and Tier 2 (or supplementary) capital. Tier 2 capital is limited to 100 percent of Tier 1 capital. Tier 1 capital components generally consist of common stockholder's equity, including capital stock, surplus, and retained earnings; qualifying non-cumulative perpetual preferred stock; and allowable noncontrolling (or minority) interests in the equity accounts of consolidated subsidiaries. Tier 2 capital components include perpetual preferred stock that does not qualify for Tier 1 capital; certain other hybrid instruments; mandatory convertible securities; long-term preferred stock; and limited amounts of subordinated debt and intermediate preferred stock. [Appendix A](#) discusses in detail each of the components that comprise Tier 1 and Tier 2 capital.

OTS expects that the predominant form of Tier 1 capital be voting common stockholder's equity (common stock plus retained earnings). Common stockholder's equity best serves the purpose and function of capital: the capacity to absorb losses, the availability to absorb losses (permanence), the ability to conserve a savings association's resources in times of stress, and the ability to influence a savings association's risk taking. A savings association should not rely excessively on nonvoting elements in capital that do not provide similar capital support.

For example, noncontrolling interests in consolidated subsidiaries may be includable in Tier 1 capital; however, they are only includable to the extent that: (1) the subsidiary capital instrument issued to the investors has the terms and features that would allow the instrument to qualify as a tier 1 capital instrument if issued directly by the parent savings association, and (2) the noncontrolling interest absorbs losses in the subsidiary commensurate with the subsidiary's capital needs, and does not represent an essentially risk-free or low-risk investment for the holders of the subsidiary capital instrument. (See discussion in [Appendix A](#).)

Banking organizations in the United States rely to some extent on hybrid capital instruments and other innovative instruments for capital funding. Sources of hybrid capital funding are evolving. The quality of capital provided by hybrids varies widely depending on the type of hybrid instrument. Hybrid capital instruments have both debt and equity features. These sources of funding, especially if double leveraged,³ can increase a savings association's risk profile by generating substantial pressure to maintain earnings to support dividend payments. An institution's over-reliance on double leverage will trigger increased supervisory scrutiny.

Hybrid instruments offer the advantages of a lower cost of capital, tax deductibility, regulatory and rating agency equity credit recognition, and diversification in funding source. However, the overuse of hybrid instruments could lead to increased levels of risk that warrant management's close attention. Risks may include increased leverage, a thinner capital base for the consolidated organization (including both the savings association and its holding company), increased interest rate risk, and increased

³ For a source of capital, savings associations sometimes rely on debt the holding company issues. Double leverage exists when a holding company invests funds it obtains from debt proceeds into the savings association as equity. Increasing the capital base allows the savings association to increase its borrowings as well, thereby compounding the original holding company debt resulting in higher consolidated leverage.

funding and liquidity risks. During the savings association and holding company examinations, as well as through ongoing supervisory monitoring, OTS will review capital levels and the ability to service debt both individually and on a consolidated basis. While hybrid capital instruments can help banking organizations manage their capital structure, OTS expects parent-infused Tier 1 capital to derive predominantly from voting common stock and retained earnings. In addition, OTS considers the following features as guiding principles when evaluating whether to allow inclusion of certain hybrid instruments in capital: loss absorption ability, permanence of the instrument, ability to suspend dividend payments, and certainty in cost of funding.

Other major items which reduce the quality of capital include the add back to regulatory capital for unrealized losses on AFS debt securities, as well as concentrations in assets that are intangible or otherwise have values that can be volatile. Examples include deferred taxes and excessive concentrations in servicing assets.

ADDRESSING CAPITAL DEFICIENCIES

If, notwithstanding minimal capital adequacy, a supervisory determination is made that a savings association's capital is deficient as described above, and the savings association has not yet taken sufficient steps to address the deficiency, you should reflect this concern in your overall rating of the capital component during an examination and request corrective action. In addition, to address capital deficiencies, OTS may:

- Use its **reservation of authority** to determine, on a case-by-case analysis based on the substance of a transaction, an appropriate risk weight for any asset or credit-equivalent amount, or off-balance sheet credit conversion factor if OTS finds that the risk weights assigned under 12 CFR 567.6 do not appropriately reflect the risks imposed on the savings association;
- Impose a higher IMCR in cases where the problem or risk is more systemic;
- Initiate **formal enforcement action** based on the severity of the problems and the inability or unwillingness of management to initiate corrective action.

For additional discussion on OTS authority to impose higher capital requirements, see [Examination Handbook Section 080](#) on Enforcement Actions.

RATING THE CAPITAL COMPONENT

Based on your assessment of the savings association's risk profile, your supervisory judgment of a savings association's capital adequacy may differ significantly from conclusions that might be drawn solely from the determination of compliance with the minimum regulatory capital requirements. This conclusion might be based on an assessment of the risk associated with certain assets or asset class, or may be based on an overall assessment of an institution's risk profile, financial condition, and loss exposure. This determination is a judgmental process that requires you to consider all of the objective and subjective variables, concepts, and guidelines discussed above. You should evaluate capital relative to a savings association's risk profile, rather than simply to a minimum regulatory requirement. These

are the standards set by the Uniform Financial Institutions Rating System. We include examples to provide you with a better understanding of a particular rating.

- A rating of “1” indicates a strong capital level relative to the savings association’s risk profile. For example, a “1” rating typically indicates a high degree of confidence that unexpected losses pertaining to credit risk, interest rate risk, and operational risk, among other risks are not expected to adversely affect the institution’s ability to meet regulatory well capitalized standards as well as maintain a strong buffer of additional capital to carry the institution through economic downturns or periods of losses.
- A rating of “2” indicates a satisfactory capital level relative to the savings association’s risk profile. For example, a 2-rated institution is typically well capitalized; has sufficient capital relative to its risk profile; and a sufficient buffer to maintain capital through most economic downturns.
- A rating of “3” indicates a less than-satisfactory level of capital that does not fully support the savings association’s risk profile. For example, there is generally some uncertainty as to the institution’s ability to withstand a degree of unexpected losses and maintain solvency and regulatory capital compliance. Thus, the rating typically indicates a need for improvement, even if the savings association’s capital level exceeds minimum regulatory and statutory requirements.
- A rating of “4” indicates a deficient level of capital. In light of the savings association’s risk profile, viability of the savings association may be threatened. The savings association may need assistance from shareholders or other external sources of financial support.
- A rating of “5” indicates a critically deficient level of capital that threatens the savings association’s viability. The savings association needs immediate assistance from shareholders or other external sources of financial support.

REFERENCES

United States Code (12 USC)

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

Code of Federal Regulations (12 CFR)

§ 560.101	Real Estate Lending Standards
§ 563.74	Mutual Capital Certificates

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

OTS Issuances

Regulatory and Savings association Bulletins

RB 3b	Policy Statement on Growth of Savings Associations
RB 18	Enforcement Series
RB 33a	FDIC “Pass-Through” Deposit Insurance Coverage Disclosure Rule
TB 23a	Sales of Securities
TB 56	Regulatory Reporting of Net Deferred Tax Assets
TB 72a	Interagency Guidance on High Loan-to-Value Residential Real Estate Lending
TB 73a	Investing in Complex Securities

CEO Memos

No. 137	Expanded Guidance for Subprime Lending Programs
No. 141	Joint Agency Advisory on Brokered and Rate-Sensitive Deposits
No. 160	Regulatory Capital Treatment for Accrued Interest Receivable in Credit Card Securitizations
No. 161	Unsafe and Unsound Use of Covenants Tied to Supervisory Actions in Securitization Documents
No. 162	Implicit Recourse in Asset Securitizations
No. 163	Questions and Answers on the Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations
No. 169	Accounting Treatment of Accrued Interest Receivable Related to Credit Card Securitizations
No. 192	ALLL Update on Accounting for Loan and Lease Losses

No. 217	Asset-Backed Commercial Paper (ABCP) Program Guidance
No. 220	Interagency Advisory on Accounting and Reporting for Commitments to Originate and Sell Mortgage Loans
No. 223	Guidance to Clarify the Asset-Backed Commercial Paper Final Rule.
No. 257	Statement on Subprime Mortgage Lending
No. 304	ALLL-Observed Thrift Practices Including Sound Practices
No. 307	Risk-weighting Down Graded Securities
No. 310	Guidance on California Registered Warrants
No. 311	Risk Management and Liability Concentrations
No. 315	Regulatory and Accounting Issues Related to Modifications and TDR of 1-4 Residential Mortgage Loans
No. 320	Accounting Considerations Related to OTT Impairment of Securities
No. 329	Accounting for Credit Losses and Impairments
No. 337	Risk Weighting of Claims on and Guarantees of the FDIC
No. 344	Risk Weighting of Early Default Provisions
No. 350	Interagency Supervisory Guidance on Bargain Purchases and FDIC- and NCUA-Assisted Acquisitions

Additional Interagency Guidance

Interim Regulatory Reporting and Capital Guidance on FAS 133, “Accounting for Derivative Instruments and Hedging Activities.” (December 29, 1998).

Interim and Regulatory Capital Reporting Guidance on FAS 158, “Employers’ Accounting For Defined Benefit Pension and Other Postretirement Plans.”(Interagency Joint Release, December 15, 2006).

Interagency Guidance on Non-traditional Mortgage Products, Volume 70, No. 249 Federal Register 77249 (December 25, 2005).

Final Rule on “Risk-based Capital and Capital Adequacy Guidelines, Capital Maintenance, Capital-Residential Mortgage Loans Modified pursuant to the Making Home Affordable Program, Volume 74, No. 223 Federal Register 60137 (November 20, 2009).

Final Rule on “Risk-based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Regulatory Capital; Impact of Modifications to Generally Accepted Accounting Principles; Consolidation of Asset-backed Commercial Paper Programs; and other related issues (Volume 75, No. 18 Federal Register 4636 (January 28, 2010)).

Statements of Financial Accounting Standards (SFAS)

SFAS No. 65, “Accounting for Certain Mortgage Banking Activities,” as amended by SFAS No. 140, “Accounting for the Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,” and SFAS No. 156, “Accounting for Servicing of Financial Assets” as codified in ASC Topic 948, “Financial Services—Mortgage Banking” and ASC Topic 860, “Transfers and Servicing.”

SFAS No. 109, “Accounting for Income Taxes (SFAS 109)” as codified in ASC Topic 740, “Accounting for Income Taxes.”

SFAS No. 114, “Accounting by Creditors for Impairment of a Loan (SFAS 114)” as codified in ASC Topic 310, “Receivables.”

SFAS No. 115, “Accounting for Certain Investments in Debt and Equity Securities (SFAS 115)” as codified in ASC Topic 320, “Investments-Debt and Equity Securities.”

FASB Staff Position (FSP) FAS No. 115-2 and No. 124-2, “Recognition and Presentation of Other-than Temporary Impairments” as codified in ASC Topic 320, “Investments—Debt and Equity Securities.”

SFAS No. 133, “Accounting for Derivative Instruments and Hedging Activities (SFAS 133),” codified in ASC Topic 815, “Derivatives and Hedging.”

SFAS No. 158, “Employer’s Accounting For Defined Benefit Pension and Other Postretirement Plans (SFAS 158)” as codified in ASC Topic 715, “Compensation-Retirement Benefits.”

SFAS No. 160, “Non-controlling Interests in Consolidated Financial Statements (SFAS 160)” as codified in ASC Topic 810, “Consolidation.”

SFAS No. 166, “Accounting for Transfers of Financial Assets – An Amendment of FASB Statement No. 140 (SFAS 166)” as codified in ASC Topic 860, “Transfers and Servicing.”

SFAS No. 167, “Amendments to FASB Interpretation No. 46(R)” as codified in ASC Topic 810, “Consolidation.”

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

3. 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?
-

4. 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.
- 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

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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.
-

5. 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's capital base.
-

6. 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?

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- 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?
-

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

LEVEL II

8. 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.
 - 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.

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- 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?
 - 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

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credit-enhancing interest-only strips that exceed 25 percent of Tier 1 capital?)

9. 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.
 - 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.

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- 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.
- 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?

10. Assess management's capital planning process.

- Consider the institution's own assessment of capital in light of conclusions for item no. 9 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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11. 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.
 - 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 12 below).
 - The pass-through insurance restrictions (Number 13 below).
 - The broker deposit restrictions (Number 14 below).
-
12. 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.
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13. 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.
-
14. 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.
-
15. 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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COMPOSITION OF CAPITAL

This appendix provides an overview of how to calculate Tier 1, Tier 2, and Total Risk-Based capital, and provides a description of the various components that comprise Tier 1, Tier 2, and Total Risk Based capital. Refer to the capital regulation at 12 CFR § 567 and schedule CCR of the Thrift Financial Report (TFR) for additional details and other items not included in this appendix. You will find relevant definitions in 12 CFR § 567.1. We have organized this appendix as follows:

- Calculating Risk-Based Capital.
- Components of Risk-Based Capital.

CALCULATING RISK-BASED CAPITAL

Total Risk-Based capital is essentially the sum of Tier 1 and Tier 2 capital less adjustments for certain equity investments, low-level recourse exposures, and residual interests. The calculation of Tier 1 capital begins with the savings association's generally accepted accounting principles (GAAP) capital, and then adjustments are made for various items that are included in GAAP capital but are not included in regulatory capital. The items below are further discussed under Components of Capital in this appendix.

Tier 1 (Core) Capital

Tier 1 (core) capital is calculated in the following manner:

- Equity capital (as reported on the savings association's TFR). This includes common stock, retained earnings, perpetual preferred stock, additional paid-in capital (APIC), and accumulated other comprehensive income (AOCI). Items included in AOCI are reported net of deferred taxes.
- *Qualifying* noncontrolling interests in the accounts of consolidated subsidiaries (minority interests).¹

Less

- Equity instruments not qualifying for Tier 1 capital (for example, cumulative perpetual preferred stock).
- Investments in and advances to nonincludable subsidiaries.
- Goodwill (that may be deducted net of any associated deferred tax liabilities). (See 12 CFR § 567.12.)

¹ Statement of Financial Accounting Standard (SFAS) 160, "Noncontrolling Interests in Consolidated Financial Statements," establishes the accounting and reporting standards for noncontrolling interests in a subsidiary and for the deconsolidation of a subsidiary. It also changed the reference from "minority" interest to "noncontrolling" interest.

- Intangible assets (other than servicing assets and purchased credit card relationships (PCCRs)) acquired in a taxable transaction (12 CFR § 567.12).
- Intangible assets (other than servicing assets and PCCRs) acquired in a nontaxable transaction (that may be deducted net of any associated deferred tax liabilities) (12 CFR § 567.12).
- Servicing assets and PCCRs in excess of specified limitations set forth at 12 CFR § 567.12.
- Disallowed deferred tax assets as set forth at 12 CFR § 567.12.
- Credit-enhancing interest-only strips (CEIOs) in excess of 25 percent of Tier 1 capital as set forth at 12 CFR § 567.5 and 12 CFR § 567.12.
- Accumulated unrealized gains on certain available-for-sale (AFS) debt and equity securities and qualifying cash-flow hedges net of tax (as reported in AOCI).
- Accumulated surpluses (gains) reported under Statement of Financial Standard (SFAS) No. 158, *Employer's Accounting For Defined Benefit Pension and Other Postretirement Plans* (SFAS 158). See also December 15, 2006 Joint Press Release. Until the agencies determine otherwise through a rulemaking, banking organizations including savings associations should exclude from regulatory capital any amounts recorded in AOCI resulting from the adoption and application of SFAS 158. Therefore, any unrealized gains related to pensions under SFAS 158 reported in AOCI for GAAP purposes should be reversed out (or neutralized) net of tax for regulatory capital reporting purposes on TFR schedule CCR.
- Initial and subsequent gains recorded due to a decline of an institution's "own" creditworthiness under either mandatory or optional fair value accounting for liabilities. Exclude from Tier 1 capital the cumulative change in the fair value of all financial liabilities (accounted for under a fair value option that is otherwise included in retained earnings) attributable to changes in an organization's own creditworthiness. Savings associations should report in this item, the amount of this cumulative change, net of applicable taxes. In addition, for regulatory capital purposes, this excluded portion of the change in fair value should be reported so the adjustment is taken into account in determining the core capital subtotal that is used to determine the regulatory capital limits on such items as servicing assets, deferred tax assets, and CEIOs.

Plus

- Securities issued to and purchased by the U.S. Department of the Treasury pursuant to the Troubled Asset Relief Program (TARP) and Capital Purchase Program (CPP).
- Specified nonwithdrawable and pledged deposit accounts held in mutual savings associations.
- Accumulated unrealized losses on certain AFS debt securities and on qualifying cash-flow hedges as reported in AOCI, net of applicable deferred taxes.

- Accumulated deficits (losses) on pensions reported under SFAS 158. Losses reported for GAAP purposes are added back (or, neutralized) for regulatory capital reporting purposes, net of applicable deferred taxes. Note that in any future rulemakings, this level of capital relief for losses may not continue; associations should plan accordingly.
- Initial and subsequent losses due to an increase in an association's "own" creditworthiness resulting from the fair value option. Note that in any future rulemakings, this treatment for losses may not continue; associations should plan accordingly.

Tier 2 (Supplementary) Capital

Note: Tier 2 capital may not exceed Tier 1 capital (i.e., Tier 2 capital may be included up to 100 percent of Tier 1 capital).

Tier 2 (supplementary) capital includes the following up to 100 percent of the Tier 1 capital limitation:

- Permanent capital instruments such as:
 - Mutual capital certificates and nonwithdrawable accounts not counted for Tier 1 capital.
 - Cumulative perpetual preferred stock.
- Perpetual subordinated debt and mandatory convertible subordinated debt issued in compliance with 12 CFR § 563.81.
- Maturing capital instruments (for example, nonperpetual preferred stock, subordinated debt and mandatorily convertible subordinated debt).
- Allowance for loan and lease losses (ALLL) up to 1.25 percent of total risk-weighted assets.
- Up to 45 percent of unrealized gains, net of unrealized losses, on AFS equity securities with readily determinable fair values.

Total (Risk-based) Capital

An association's total (risk-based) capital includes:²

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

² Unlike the other banking agencies, the OTS has not adopted the Market Risk Rule, which provides for a Tier 3 capital requirement for those institutions subject to the rule. Until OTS adopts the Market Risk Rule, savings associations do not include any instrument as Tier 3 capital.

Less

- Reciprocal holdings of the capital instruments of another depository institution.
- Equity investments as defined in 12 CFR § 567.1, which excludes among other things equity investments permissible for a national bank (for a list of activities permissible for a national bank, see OCC publication entitled “Activities Permissible for a National Bank, 2007”).
- Low-level recourse exposures and residual interests that the association chooses to deduct using the simplified/direct deduction method (excluding those CEIOs already deducted from Tier 1 capital above).

COMPONENTS OF RISK-BASED CAPITAL**Tier 1 (Core) Capital Components**

OTS, along with the other banking agencies, affirms that common stockholder’s equity is the key form and should be the predominant form of Tier 1 capital. Moreover, consistent with The Basel Committee on Banking Supervision’s³ position on “Instruments eligible for inclusion in Tier 1”,⁴ the banking agencies agree that the following requirements should be met by all other forms of Tier 1 capital instruments:

- Must be issued and fully paid.
- Must be noncumulative.
- Must be able to absorb losses with the bank on a going-concern basis.
- Must be junior to depositors, general creditors, and subordinated debt of the bank.
- Must be permanent.
- Must not be secured or covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis bank creditors.
- Must be callable at the initiative of the issuer only after a minimum of five years with supervisory approval and under the condition that it will be replaced with capital of same or

³ The Basel Committee on Banking Supervision provides a forum for regular cooperation on banking supervisory matters. Its objective is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide. It seeks to do so by exchanging information on national supervisory issues, approaches and techniques, with a view to promoting common understanding. At times, the Committee uses this common understanding to develop guidelines and supervisory standards in areas where they are considered desirable. In this regard, the Committee is best known for its international standards on capital adequacy; the Core Principles for Effective Banking Supervision; and the Concordat on cross-border banking supervision.

⁴ See Basel Committee on Banking Supervision Press Release dated October 27, 1998.

better quality unless the supervisor determines that the bank has capital that is more than adequate for its risks.

- Must include no or limited dividend step ups after a minimum of 10 years after issue date.

Savings associations should avoid overreliance on noncommon equity instruments, such as preferred stock, noncontrolling interests, and other nonvoting equity elements, within Tier 1 capital.

Common Stockholder's Equity

Common stockholder's equity is included in GAAP capital and consists of voting common stock, APIC, and retained earnings. Common stockholder's equity is the most desirable capital element from a supervisory perspective, and should be the predominant element within Tier 1 capital. Common stockholder's equity provides a savings association with the maximum amount of financial flexibility necessary to weather financial difficulties because of its availability and capacity to absorb losses, its ability to conserve resources in times of stress (the issuer is able to waive any payments, i.e., dividends, to investors without any future obligations), and the ability of investors through voting rights to provide market discipline over a savings association's management. Common stock with mandatorily redeemable provisions is not includable in Tier 1 capital. In addition, stock issuances where the dividends that are not paid in one period are reset based on current market conditions or the savings association's current credit rating are not includable as both common and preferred in Tier 1 capital.

Noncumulative Perpetual Preferred Stock

Noncumulative perpetual preferred stock can qualify for inclusion in Tier 1 capital. The stock has no maturity date and cannot be redeemed at the option of the holder. Preferred stock typically entitles a holder to a fixed dividend, which is received before any common stockholders may receive dividends. Noncumulative simply means that dividends are not carried over to subsequent dividend periods.

The general rule, however, is that noncumulative perpetual preferred stock qualifies for inclusion in Tier 1 capital only if it can absorb losses while the issuer of the stock operates as a going concern. Clauses, covenants, and restrictions inserted in preferred stock issuances that make the issuance more debt-like may also make it unacceptable for Tier 1 capital. As with common stock, preferred stock issuances where the dividends are reset based on current market conditions or the association's current credit rating are not includable in Tier 1 capital. A noncash dividend payment that is made when a cash dividend payment cannot be paid is subject to supervisory approval in order to count the preferred stock toward Tier 1 capital.

Preferred stock issued by a savings association or a subsidiary that is, in effect, collateralized by assets of the savings association or one of its subsidiaries is not included in capital.

Preferred Securities Issued Pursuant to the Capital Purchase Program

Equity interests (e.g., senior preferred securities) sold to the U.S. Department of the Treasury under its Capital Purchase Program implemented under the Emergency Economic Stabilization Act of 2008 are includable in Tier 1 capital.

Noncontrolling Interests in Equity Accounts of Fully Consolidated Includable Subsidiaries (Minority Interests)⁵

Noncontrolling interests are created when a depository institution owns a controlling interest, but not 100 percent of a subsidiary, and the remaining interest is owned by third parties, referred to as noncontrolling shareholders. While noncontrolling interests are includable in GAAP equity, only *qualifying* noncontrolling interests are includable in Tier 1 capital. A key consideration in making this determination is the extent of the contribution, if any, of a noncontrolling interest to a savings association's capital adequacy and ability to absorb losses. Additionally, the noncontrolling interest transaction should satisfy, at a minimum, the following criteria:

- The subsidiary capital instrument issued to the investors must have the terms and features that would allow the instrument to qualify as a Tier 1 capital instrument if issued directly by the parent banking organization. Common stock and noncumulative perpetual preferred stock issued by a banking organization have the potential to be treated as Tier 1 capital on a consolidated basis through a noncontrolling interest in a consolidated subsidiary. For example, a capital instrument held by the noncontrolling interest owners of the subsidiary would not be includable in Tier 1 capital of its parent banking organization if the instrument: (1) includes any terms or conditions that could require the instrument to be repaid on a specified future date, or at the option of the holders of the instrument; (2) is secured or effectively secured; (3) pays noncancellable or cumulative distributions; or (4) contains other provisions that limit the ability of the noncontrolling interest to effectively absorb losses. A subsidiary capital instrument should also allow for the cancellation of dividends when the parent savings association is experiencing financial stress.
- The noncontrolling interest should absorb losses in the subsidiary commensurate with the subsidiary's capital needs and it should not represent an essentially risk-free or low-risk investment for the holders of the subsidiary capital instrument. It is essential that a noncontrolling interest provide meaningful capital support to the subsidiary, and in turn its consolidated parent. A noncontrolling interest in a subsidiary would be viewed by the agencies as a risk-free or low-risk investment where the subsidiary has been formed to hold only high-quality assets of the savings association, or where the subsidiary has been essentially over-collateralized in relation to the noncontrolling interest owners' claim on the subsidiary's assets. The subsidiary capital instrument should not be disproportionate to the capital needs of the subsidiary in which the investment will absorb losses.

Noncontrolling interests generally do not provide capital support to absorb losses arising elsewhere in the consolidated organization, including losses on assets in the subsidiary's parent savings association or affiliates within the consolidated banking organization. This issue has been addressed in certain instruments accepted by the agencies as eligible for Tier 1 capital through the inclusion of an exchange feature (see the discussion below on real estate investment trusts below). This feature requires an exchange or conversion of the subsidiary instrument into common or noncumulative perpetual

⁵Savings associations should follow all relevant accounting standards for consolidation.

preferred stock of the parent savings association, or savings association holding company (with a required contribution of the subsidiary instrument to the association) upon the deterioration of the financial condition of the subsidiary or parent savings association organization. However, the exchange feature alone does not result in an instrument qualifying for Tier 1 eligibility. The OTS will review all the terms and features of a subsidiary instrument on a case-by-case basis to determine eligibility for inclusion in Tier 1 capital of the parent banking organization.

Real Estate Investment Trust (REIT) Preferred Shares and Other Noncontrolling Interests

Companies with a primary business of investing in real estate or mortgages secured by real estate can elect to be categorized as a REIT, under the income tax code. The election enables the REIT to avoid corporate level taxation as long as certain criteria are met.

REITs have been treated as wholly owned special purpose entities (SPE). The SPE, as the REIT, issues noncumulative perpetual preferred securities into the market, and uses the proceeds from the issuance to purchase mortgage-related assets from the savings association, its sole common shareholder.

Generally, the REIT is fully consolidated with the savings association for regulatory reporting purposes. In the consolidated financial statements, the association reports the REIT preferred stock that was issued to third parties as a noncontrolling interest in includable consolidated subsidiaries, and the noncontrolling interest is included in Tier 1 capital.

However, the asset-backed nature of REIT preferred stock raises supervisory concerns when a savings association issues it through a subsidiary. If the association faces difficulty, all assets of the consolidated entity must be immediately available for the association's use. As a result, OTS limits includable noncontrolling interests in REIT preferred stock to 25 percent of Tier 1 capital. Moreover, OTS requires savings association subsidiaries to include certain restrictive covenants in REIT preferred stock offerings. Among the criteria that must be met in order for REIT preferred stock to be included in Tier 1 capital:

- The terms of the stock issuance must meet all the same terms and conditions as Tier 1 eligible stock issued directly by the parent (e.g., be permanent (or perpetual) and noncumulative as to dividends).
- Stock can only be redeemed with the approval of the OTS.
- The stock must be convertible into common equity of the parent savings association in the event of a conversion event (e.g., the savings association becomes undercapitalized or is placed into receivership).
- Shareholders must sign an agreement acknowledging that transfers of shares to a nonqualifying shareholder is prohibited.

- The terms of the REIT and shareholder agreements must clearly specify that upon a conversion event, all assets of the REIT become assets of the savings association. Shareholders should sign an acknowledgment of that point.

A REIT preferred interest that does not meet these terms is deemed a “secured equity investment.” A noncontrolling REIT interest that functions as “secured equity” is not eligible for inclusion in Tier 1.

If the SPE issues common stock rather than preferred stock to third parties, OTS would consider the noncontrolling interest in the common stock of the REIT subject to the same restrictions and the aggregate 25 percent of Tier 1 capital that currently applies to REIT preferred stock. REIT common stock would not necessarily provide the same level of capital support that common stock issued by a savings association itself would provide. It also raises other safety and soundness concerns in that it would be unable to provide capital support if the savings association incurred losses.

Pledged Deposits and Nonwithdrawable Accounts

Savings associations organized as mutual savings associations do not issue capital stock and have no stockholders. Instead, mutual savings associations must build capital almost exclusively through retained earnings. Thus, it was common for founding members of mutual savings associations to pledge savings deposit accounts (referred to as nonwithdrawable accounts or pledged deposits) for the period of time required for the new mutual to build-up capital through profitable operations and retention of earnings. OTS regulation, 12 CFR § 567.5(a)(1)(iv) allows *nonwithdrawable accounts and pledged deposits* of mutual savings associations (excluding any treasury shares held by the savings association) meeting certain criteria to count toward Tier 1 capital. The criteria in 12 CFR § 567.5(a)(1)(iv) requires that the accounts or deposits have no fixed maturity date, cannot be withdrawn at the option of the accountholder, and do not earn interest that carries over to subsequent periods. If the criteria listed in 12 CFR § 567.5(a)(1)(iv) are not met, 12 CFR § 567.5(b)(1)(iii) allows these instruments to count toward Tier 2 capital as long as they meet other criteria set out in 12 CFR § 561.42 for savings accounts.

ADDITIONS TO TIER 1 CAPITAL

Accumulated Gains and (Losses) on Certain AFS Securities

For Tier 1 capital purposes, savings associations must reverse (or neutralize) all unrealized gains related to AFS debt and AFS equity securities, and also reverse (or neutralize) unrealized losses on AFS debt securities, net of applicable taxes. Only unrealized losses from AFS equity securities reported in AOCI for GAAP purposes remain to reduce Tier 1 capital, and are not reversed or neutralized for regulatory capital reporting purposes. See Tier 2 (supplementary) capital for reporting unrealized gains on AFS equity securities.

On April 9, 2009, the FASB released FASB Staff Position (FSP) FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments* (FSP FAS 115-2). FSP FAS 115-2 amends U.S. GAAP for AFS and held-to-maturity (HTM) *debt* securities. It does not amend existing recognition and measurement guidance related to other-than-temporary impairment (OTTI) of *equity* securities. It also improves the presentation and disclosure of OTTI for debt and equity securities in the financial statements.

FSP FAS 115-2 Debt Securities

Under GAAP, when the fair value of an AFS or HTM security is less than its amortized cost basis, it is considered impaired. The impairment is either temporary or OTTI. Under FSP FAS 115-2, an OTTI of either an AFS or HTM debt security, in certain circumstances, is separated into (1) the credit loss amount recognized in earnings and (2) the amount related to all other factors (noncredit loss) recognized in other comprehensive income, net of applicable taxes. For regulatory capital purposes, amounts reported as AFS or HTM in AOCI will be subject to neutralization, net of applicable taxes.

Under FSP FAS 115-2:

- If (1) an institution intends to sell the debt security, or (2) it is “more likely than not” that it will be required to sell the security before recovery of the security’s amortized cost basis (less any current-period credit loss), OTTI equal to the entire difference between the security’s amortized cost basis and its fair value is recognized in earnings.
- If, however, (1) an institution does not intend to sell the debt security, and (2) it is not “more likely than not” that the institution will be required to sell the security before recovery of the security’s amortized cost basis (less any current-period credit loss), and (3) it does not expect to recover the entire amortized cost basis, the OTTI is separated and recognized as follows:
 - The credit loss amount shall be recognized in earnings.
 - The noncredit loss shall be recognized in other comprehensive income (OCI), net of applicable taxes.

The difference between the present value of the cash flows expected to be collected and the amortized cost basis is referred to as the credit loss. One way of estimating the credit loss amount is to use the methodology described in paragraphs 12-16 of SFAS No. 114, *Accounting by Creditors for Impairment of a Loan* (SFAS 114). Under a SFAS 114 methodology, an institution discounts the cash flows management expects to collect at the effective interest rate implicit in the debt security at the date of acquisition. If the discounted amount is less than the debt security’s amortized cost basis, the difference represents the credit loss amount to be recognized through earnings.

The regulatory capital treatment of losses on debt securities has *not* changed. Note that the new accounting guidance may result in a different amount of noncredit losses on AFS and HTM debt securities being recognized in OCI instead of earnings. These noncredit losses in AOCI will then be added back as part of unrealized losses in determining Tier 1 capital on TFR Schedule CCR.

Accumulated Gains and (Losses) on Cash Flow Hedges

SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* (SFAS 133), requires that changes in the fair value of properly designated and qualifying derivatives used as a cash flow hedge initially also be reported in AOCI, and reclassified into earnings in the same future period that the hedged transaction affects earnings. (Refer to SFAS 133, Appendix A, Section 2, for further information.) Generally, under SFAS 133, the savings association would exclude from net income the “effective” portion of the change in fair value of a derivative designated as a cash flow hedge and record it instead

in AOCI. For regulatory reporting purposes, accumulated net gains or losses on cash flow hedges included in AOCI are reversed (or neutralized), net of applicable deferred taxes. In other words, gains are reversed and losses are added-back to Tier 1 capital, net of tax.

DEDUCTIONS FROM TIER 1 CAPITAL

Equity Instruments Not Qualifying for Tier 1

This includes Cumulative Perpetual Preferred Stock (and related surplus) (collectively, cumulative perpetual preferred stock). Cumulative perpetual preferred stock may be includable in Tier 2 capital but not Tier 1 capital. Cumulative perpetual preferred stock means perpetual preferred stock and related surplus where the issuer has the option to waive payments of dividends; however, dividends waived or deferred accumulate to future periods and represent a claim on the issuer.

Additionally, stock with a feature where the dividend is reset periodically based on current market conditions and the savings association's current credit rating, including but not limited to, auction rate, money market, or remarketable preferred stock, are assigned to Tier 2 capital, regardless of cumulative or noncumulative characteristics under 12 CFR § 567.5(a)(1).

Nonincludable Subsidiaries

Under OTS capital rules, a subsidiary is defined as an entity in which the parent savings association has a majority ownership interest and the assets of which are consolidated with those of the savings association for GAAP purposes (12 CFR § 567.1). For purposes of OTS capital rules, a subsidiary is either an includable subsidiary or a nonincludable subsidiary. An includable subsidiary is defined as a subsidiary that:

- Engages solely in activities not impermissible for a national bank (see OCC handbook entitled "Activities Permissible for a National Bank, 2007);
- Engages in activities not permissible for a national bank, but only if acting solely as agent for its customers;
- Engages solely in mortgage banking activities;
- Is an insured depository institution or a holding company whose sole investment is an insured depository institution (acquired before May 1, 1989); or
- Is a subsidiary of a federal savings association existing as such on August 9, 1989, and was either previously chartered by a state savings bank prior to October 15, 1982, or acquired its principal assets from a state savings bank prior to this date.

A nonincludable subsidiary is one that does not meet the definition of an includable subsidiary. A savings association must deconsolidate and deduct from capital the amount of its investment in and advances to any subsidiary that is a nonincludable subsidiary for Tier 1 capital purposes.

Goodwill and Other Intangible Assets

OTS follows GAAP in defining goodwill and intangible assets. Intangible assets include, but are not limited to:

- goodwill
- core deposit premiums
- PCCRs
- servicing assets (mortgage and nonmortgage)
- favorable leaseholds
- covenants to not compete and
- computer software.

Deduct goodwill from a savings association's Tier 1 capital. A savings association may elect to deduct goodwill on a basis that is net of any associated deferred tax liabilities.

Savings associations must also deduct other intangible assets (other than servicing assets and PCCRs) from Tier 1 capital, but may elect to deduct certain of these other intangible assets on a basis net of associated deferred tax liabilities if the association acquired the intangible assets in a nontaxable transaction. Core deposit intangibles, covenants to not compete, and trade names are examples of intangibles that must be deducted from Tier 1 capital. However, if acquired as a result of a nontaxable transaction, the savings association could elect to deduct them net of any associated deferred tax liabilities, if any. As a departure from the general intangible deduction rules, savings associations may choose also to not deduct computer software (purchased or internally developed) as an intangible asset for Tier 1 capital purposes.

Except as noted above, the only intangible assets that are eligible to be included in – that is, not deducted from – a savings association's capital are mortgage servicing assets (MSAs), nonmortgage servicing assets (NMSAs), and PCCRs. However, these intangibles are subject to limitations (see below).

Servicing Assets and Purchased Credit Card Relationships in Excess of Limitations (Disallowed amounts)

Servicing assets result from contracts to service financial assets for which the benefits of servicing (revenues from contractually specified servicing fees, late charges, and other ancillary income sources) are expected to more than adequately compensate the servicer for performing the servicing. Adequate compensation fully covers servicing costs and provides an adequate and reasonable profit margin. Servicing liabilities result from contracts to service financial assets for which the benefits of servicing are not expected to adequately compensate the servicer for performing the servicing. Relevant

accounting standards are SFAS No. 65, *Accounting for Certain Mortgage Banking Activities* (SFAS 65), as amended by SFAS No. 140, *Accounting for the Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (SFAS 140), and SFAS No. 156, *Accounting for Servicing of Financial Assets* (SFAS 156). See [Examination Handbook Section 750](#), Mortgage Banking: Accounting Considerations.

As mentioned, MSAs, NMSAs, and PCCRs are eligible for inclusion in Tier 1 capital. The amount of MSAs, NMSAs, and PCCRs that a savings association may include in capital is limited to the lesser of (1) 90 percent of their fair value,⁶ (2) 100 percent of their book value (amortized cost), (3) or 100 percent of Tier 1 capital (the “three-part test”).⁷ The total amount of NMSAs and PCCRs is subject to a separate aggregate sublimit of 25 percent of Tier 1 capital.

For example, assume a savings association has servicing assets of \$150, its Tier 1 capital is \$80, and fair value and cost are both \$150 such that 90 percent of fair value is \$135. Under the “three-part” test, \$80 is the lesser value, and becomes the amount of (or limit on) servicing assets that the savings association may include in regulatory capital. The limit, or \$80, is subtracted from the recorded servicing assets, or \$150, and the difference, \$70 (\$150 - \$80), is the amount of disallowed servicing assets. This amount of **disallowed servicing assets** is the amount a savings association would deduct if it did not take the “netting” election (as discussed below).

Net of Deferred Tax Liability Calculation for Servicing Assets (Gross Assets Method)

Savings associations may elect to deduct disallowed servicing assets (MSRs and NMSRs) on a basis that is net of associated deferred tax liabilities (“netting” election).

Using the example above, the savings association chooses to offset the disallowed servicing assets deduction of \$70 by a **portion** of the related deferred tax liabilities by making the “netting” election. Assuming a blended effective income tax rate of 40 percent, that portion is calculated as \$28 (\$70 x 40 percent estimated tax rate). Assuming the savings association recorded associated deferred tax liabilities under GAAP,⁸ it nets \$28 against the disallowed servicing assets, or \$70, and reduces the deduction from Tier 1 (core) capital to \$42 (\$70 less \$28). Without the election, the deduction would have been \$70.

⁶ Servicing assets accounted for at fair value will generally have a servicing deduction at least equal to the 90 percent of fair value “haircut.”

⁷ The haircut is determined as the lesser of cost or 90 percent of fair value. This haircut amount is then compared to the overall Tier 1 capital limit. An illustration is provided in this section.

⁸ This example assumes that the savings association reported \$60 as the associated deferred tax liability (\$150 x 40 percent).

Assume Tier 1 Capital is \$80 MSAs (fair value)	\$150	
Allowed portion in Tier 1	(\$ 80)	Calculated as the lesser of: ⁹ (1) 100% of Tier 1 capital = \$ 80 (given); (2) 90% of \$150 fair value = \$135;or (3) Cost = \$150.
Excess MSAs	\$ 70	
Calculation of Applicable Deferred Tax Liability:	(28)	(\$70 x 40% = 28)
Regulatory Capital Deduction	\$42	

If an association has PCCRs, the calculation becomes somewhat more complex because it must calculate both the overall limit as well as the sublimit.

Disallowed Deferred Tax Assets

Taxes paid in prior carry-back years and future reversals of existing taxable temporary differences as determined under GAAP (SFAS No. 109, *Accounting for Income Taxes* (SFAS 109)) are included in Tier 1 capital without limitation. However, the amount of other deferred tax assets reported on the balance sheet may be limited in Tier 1 capital. Generally, deferred tax assets that are dependent upon future taxable income are limited in Tier 1 capital to the lesser of: (i) the amount of such deferred tax assets that the savings association 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 percent of the amount of the savings association’s Tier 1 capital (calculated before any deduction for deferred tax assets).

For purposes of this limitation, all existing temporary differences should be assumed to fully reverse at the calendar quarter end date. The recorded amount of deferred tax assets that are dependent upon future taxable income, net of any valuation allowance for deferred tax assets, in excess of this limitation will be deducted from assets and from equity capital for purposes of determining Tier 1 capital under this part. The amount of deferred tax assets that can be realized from taxes paid in prior carry back years and from the reversal of existing taxable temporary differences generally would not be deducted from assets and from equity capital.

Projected future taxable income should not include net operating loss carry-forwards expected to be used within one year of the quarter-end report date or the amount of existing temporary differences expected to reverse within that year. Projected future taxable income should include the estimated effect of tax planning strategies expected to be implemented to realize carry-forwards that will otherwise expire during that year. Each reporting savings association’s calculations should be made on a separate entity basis.

⁹ This example illustrates the statutory “haircut.” For the haircut, determine the lesser of cost (see footnote 2) or 90 percent of fair value (items 2 and 3). In addition to the haircut, the lesser amount in items (2) and (3) is then compared to the overall Tier 1 capital limit in item (1). In this example, the lesser of all the amounts is \$80 (item 1), or the Tier 1 capital amount before counting servicing assets.

When a deferred tax liability is netted against other assets, such as AFS debt securities, goodwill, servicing assets, other intangible assets, or CEIO strips, the taxable temporary difference that gives rise to this deferred tax liability must be excluded from existing taxable temporary differences when determining the amount of deferred tax assets that are dependent upon future taxable income and calculating the maximum amount of such assets. This means that deferred tax liabilities that are netted against other assets for regulatory capital deduction purposes for those assets cannot also be netted against deferred tax assets when determining the amount of deferred tax assets that are dependent upon future taxable income.

In addition, if an institution nets a deferred tax liability against an associated asset, it must consistently apply this netting approach even where the deferred tax liability becomes as deferred tax asset.

Credit Enhancing Interest-only Strips in Excess of Limitations

CEIOs are high risk residual interests in securitizations, often retained by the originator of securitization transactions. Generally, savings associations are prohibited from purchasing residual interests as they are typically unrated or rated well below investment grade.

As defined in 12 CFR § 567.1, a CEIO strip means an on-balance-sheet asset that in form or in substance: (i) represents the contractual right to receive some or all of the interest due on transferred assets; and (ii) exposes the savings association to credit risk directly or indirectly associated with the transferred assets that exceed its pro rata share of the savings association's claim on the assets whether through subordination provisions or other credit enhancement techniques.

OTS will consider the economic substance of a transaction and reserve the right to identify other cash flows or related interests as a CEIO strip. For those that meet the regulatory definition in 12 CFR § 567.1, a maximum aggregate amount of CEIO strips may be included in Tier 1 capital up to 25 percent of the amount of core capital. For purposes of computing the limit, core capital is computed before the deduction of disallowed servicing assets, disallowed credit card relationships, disallowed deferred tax assets, and disallowed CEIO strips. The limitation applies to both retained and purchased CEIO strips.

Interest-only strips (IOs) issued by government-sponsored entities (e.g., Fannie Mae or Freddie Mac) or other IOs that do not function in a credit enhancing or otherwise subordinate capacity are NOT deducted from core capital. They receive a 100 percent risk weight.

A savings association may elect to deduct disallowed CEIO strips on a basis that is net of any associated deferred tax liability.

TIER 2 COMPONENTS

Tier 2 (Supplemental) Capital Instruments

Tier 2 capital counts toward total capital up to a maximum of 100 percent of a savings association's Tier 1 (core) capital. It is comprised of, within certain limitations: (1) permanent capital instruments that do not count for Tier 1; (2) maturing capital instruments; (3) allowance for loan and lease losses; (4) certain unrealized gains on equity securities.

Permanent Capital Instruments

Permanent capital instruments include (i) equity instruments qualifying for Tier 2 capital such as cumulative perpetual preferred stock and other nonTier 1 capital eligible perpetual preferred stock issued pursuant to OTS regulations; (ii) nonwithdrawable accounts and pledged deposits not included in Tier 1; (iii) perpetual subordinated debt issued pursuant to OTS regulations and memoranda; (iv) mandatory convertible subordinated debt (capital notes) issued pursuant to OTS regulations and memoranda; and (v) certain certificates (mutual capital, net worth, and income capital).

Equity Instruments Qualifying for Tier 2 Capital but not Tier 1 Capital

Cumulative perpetual preferred stock is includable in Tier 2 capital. Cumulative Perpetual Preferred Stock and related surplus (collectively, cumulative perpetual preferred stock) does not have a maturity date, cannot be redeemed at the option of the holder, and has no other provisions that would require future redemption of the issue. Cumulative perpetual preferred stock means perpetual preferred stock and related surplus where the issuer has the option to waive payments of dividends. Dividends so waived accumulate to future periods and represent a claim on the issuer.

Noncontrolling interests in excess of the amount includable in Tier 1 capital may also be included in Tier 2 capital.

Nonwithdrawable Accounts and Pledged deposits not included in Tier 1 Capital

To the extent nonwithdrawable accounts and pledged deposits were not included in Tier 1 capital, they may be included in Tier 2 capital if they meet the eligibility requirements for savings accounts set out in 12 CFR § 561.42. (See discussion under Tier 1 Components.)

Perpetual Subordinated Debt and Mandatory Convertible Subordinated Debt (Capital Notes)

Perpetual subordinated debt and mandatory convertible subordinated debt (capital notes) issued pursuant to regulations and memoranda of OTS, including 12 CFR sections 567.5(b), 563.81, 563.80, and 563g, and approved by the OTS for inclusion in regulatory capital may be includable in Tier 2 capital.

Other Capital Instruments Provided for in OTS regulations

OTS capital rules allow inclusion of net worth certificates (12 CFR § 567.5(b)(1)(iv)),¹⁰ mutual capital certificates (12 CFR § 567.5(b)(1)(ii)),¹¹ and income capital certificates (12 CFR § 567.5(b)(1)(v))¹² in Tier 2 capital. All of these instruments are tied to the industry's financial difficulties in the 1980s.

¹⁰ Net worth certificates, issued under the Garn-St. Germain Depository Institutions Act, provided assistance to savings associations suffering losses and regulatory capital deterioration due to economic conditions. The FDIC purchased a net worth certificate from a qualified institution in exchange for an FDIC issued promissory note. The note was an asset on the institution's books, with the offsetting liability of the net worth certificate counted toward regulatory capital. The FDIC paid interest on the note as cash, while the institution, if it had earnings and achieved a certain level of net worth, paid part of its net income back to the FDIC. As savings associations regained financial health, they redeemed the certificates.

Since the above three types of permanent capital instruments resulted from the 1980s, and most likely no longer exist on any savings associations' regulatory reports, you should contact the regional or Washington office if you discover any institution reporting them.

Maturing Capital Instruments

Intermediate Term Preferred Stock

Intermediate term preferred stock refers to preferred stock issuances with an original maturity of less than 20 years. Intermediate term preferred stock may qualify for Tier 2 capital under certain guidelines. It must have an original weighted average maturity of at least five years. The portion of intermediate term preferred stock and subordinated debt discussed below is limited to 100 percent of Tier 1 capital (12 CFR § 563.81).

Subordinated Debt and Mandatory Convertible Subordinated Debt

Subordinated debt and mandatory convertible subordinated debt (capital notes) issued pursuant to regulations and memoranda of OTS, including 12 CFR sections 567.5(b), 563.81, including 12 CFR sections 567.5(b), 563.81, 563.80 and 563g, and approved by the OTS for inclusion in regulatory capital may be includable in Tier 2 capital.

Pursuant to 12 CFR § 567.5(b), savings associations issuing maturing capital instruments after November 7, 1989, may choose to elect one of two methods (Paragraph A or Paragraph B) to determine the amount of maturing capital instruments includable in Tier 2 capital:

- A. At the beginning of each of the last five years of the life of the maturing capital instrument, the amount that is eligible to be included as Tier 2 capital is reduced by 20 percent of the original amount of that instrument (net of redemption).
- B. Only the aggregate amount of maturing capital instruments that mature in any one year during the seven years immediately prior to an instrument's maturity that does not exceed 20 percent of an institution's capital will qualify as Tier 2 capital.

Example

Paragraph A looks at a particular issuance of subordinated debt, and in a series of step-downs, reduces the amount that can be included in Tier 2 capital. Basically, you take off 20 percent a year consecutively, each of the last five years.

¹¹ The Home Owners' Loan Act (HOLA) authorizes mutual capital certificates, which are long-term debt securities issued by a federal mutual savings association that are subordinated to all other claims on assets, and are not covered by federal deposit insurance. A savings association may count them toward capital to the extent permitted by the OTS Director. (12 USC 1461). Typically, the FDIC purchased the certificates from savings associations as a temporary way to help savings associations meet minimum capital standards.

¹² The Federal Savings and Loan Insurance Corporation (FSLIC) developed income capital certificates (ICC). These instruments also provided assistance to troubled savings association institutions. Under the program, savings associations issued ICCs to the FSLIC in return for cash or the FSLIC's promissory notes. If held by FSLIC, and later by the FDIC, the savings association could count outstanding ICCs toward regulatory capital. As the savings association regained financial health, it retired the ICCs.

Example: The amount of the instrument is \$100. It matures in 12/31/2014. (Assume no redemptions.)

- Up to 12/31/2009: \$100 eligible for inclusion in Tier 2 capital
- Beginning 12/31/2009: \$80 eligible
- Beginning 12/31/2010: \$60 eligible
- Beginning 12/31/2011: \$40 eligible
- Beginning 12/31/2012: \$20 eligible
- Beginning 12/31/2013: \$0 eligible

If the bank had two other issuances of \$100 each, maturing in 2012 and 2016, each would step down based on its own maturity (see table below). The 2012 would have started stepping down in 2007. The 2016 will start stepping down in 2011.

	Issuance 1 (\$100) matures 12/2012	Issuance 2 (\$100) matures 12/2014	Issuance 3 (\$100) matures 12/2016	Total Amount Includable in Tier 2 Capital
12/08 to 12/09	80	100	100	280
12/09 to 12/10	40	80	100	220
12/10 to 12/11	20	60	100	180
12/11 to 12/12	0	40	80	120
12/12 to 12/13		20	60	80
12/13 to 12/14		0	40	40
2015			20	20
2016			0	0

Paragraph B looks at the aggregate amount of subordinated debt and compares it with total capital. We limit the amount that can be included in Tier 2 capital during the last seven years of the instrument’s life. Only the aggregate amount of maturing capital instruments that mature in any one year during the seven years immediately prior to an instrument’s maturity that does not exceed 20% of a saving association’s capital will qualify as supplemental capital. Assume total capital holds steady at \$1,000. Also, assume \$200 of a subordinated debt instrument matures in 2014 and that \$200 does not exceed 20 percent of total capital. Therefore, all \$200 is eligible for inclusion up to the end. No need for the step down as in the Paragraph A example. On the other hand if the instrument were \$300, only \$200 would be eligible at any given time in this period, because \$300 exceeds \$200 (the maximum limit of 20 percent of capital.) If two subordinated debt instruments mature in the same year (e.g. 2015 per the example below) then only \$200 of the aggregate amount maturing in that year would be included in Tier 2 capital.

Example assuming multiple issuances with different maturity dates:

Assumes Capital is \$1000 and Remains Constant					
	Issue 1— amount 200 (matures 12/2014)	Issue 2— amount 300 (matures 12/2015)	Issue 3— amount 100 (matures 12/2012)	Issue 4— amount 100 (matures 12/2015)	Amount includable in Tier 2 Capital
2004	200	300	100	100	700
2005	200	300	100	100	700
2006	200	300	100	100	700
2007	200	300	100	100	700
2008	200	300	100	100	700
2009	200	300	100	100	500
2010	200	300	100	100	500
2011	200	300	100	100	500
2012	200	300	100	100	500
2013	200	300		100	400
2014	200	300		100	400
2015		300		100	200

Qualifying Trust Preferred Securities

Trust preferred securities are undated cumulative preferred securities issued out of an SPE usually in the form of a trust, in which a savings association holding company or bank holding company owns all of the common securities. The trust issues cumulative preferred securities into the market. The trust’s only assets are deeply subordinated debentures of the corporate issuer (the holding company), which the trust purchases with the proceeds from the sale of its common and preferred securities. The corporate issuer makes periodic interest payments on the subordinated debentures to the trust, which uses these payments to pay periodic dividends on the trust preferred securities to the investors. These trusts provide certain tax advantages in that dividends paid on the trust securities are tax deductible.

Generally, a holding company issues trust preferred securities. However, it is possible that these securities could be issued at a savings association level. OTS must approve any issuance of these securities or any form of these securities at the savings association level. The approval must be advance of any issuance, and the issuance would only be includable in Tier 2 capital.

Allowance for Loan and Lease Losses (ALLL)

The regulatory capital rules allow savings associations to add the ALLL to Tier 2 capital up to 1.25 percent of risk-weighted assets. The 1.25 percentage is applied to the subtotal risk-weighted assets. The amount added to Tier 2 capital for the ALLL consists of credit losses associated with on-balance sheet loans and leases, such as the ALLL reported on mortgage loans on the balance sheet. The amount determined as the ALLL may not include the ALLL of unconsolidated subordinate organizations or nonincludable subsidiaries. In addition, the ALLL does not include recourse liability accounts that arise

from recourse obligations for any transfers of loans or other assets that the savings association reported as a sale. These recourse liability accounts are separate and distinct from the ALLL.

For example, if the subtotal risk-weighted assets equal \$500 million, then up to \$6.25 million of the ALLL may be added into Tier 2 capital (1.25 percent times \$500 million). Therefore, if a savings association has recorded \$8 million as the ALLL, then it may add \$6.25 million to Tier 2 capital provided it meets all accounting guidelines for estimating the ALLL.

Excess ALLL arises only if a savings association reports more ALLL on TFR schedule SC than it may add to Tier 2 capital. The excess, if any (not including liabilities for credit losses on off-balance sheet credit exposures), is deducted for risk-weighting purposes.

However, if in the above example, the savings association has only \$5 million recorded as the ALLL and \$3 million recorded as liabilities for credit losses on off-balance sheet credit exposures (commitments, standby letters of credit, and guarantees) that are not related to sales of loans or other assets with recourse, the savings association would include in Tier 2 capital \$5 million of the ALLL related to loans and leases plus \$1.25 million recorded as liabilities for credit losses on off-balance sheet credit exposures, for a total \$6.25 million, which is the overall limit on including the ALLL in Tier 2 capital. Thus, the ALLL potentially includable in Tier 2 capital is the sum of (1) the ALLL on mortgage and nonmortgage loans, and leases, and (2) liabilities for credit losses on off-balance sheet credit exposures such as commitments, standby letters of credit, and guarantees.¹³

For example, if the savings association reports a liability for credit losses on off-balance sheet credit exposures as an “other liability” on schedule SC, and it is comprised of \$50,000 associated with letters of credit and \$20,000 associated with sales of loans with recourse, only the \$50,000 may be includable in the 1.25 percent risk-weighted assets limitation. Sometimes it may be difficult to discern between a recourse liability reserve and a liability for a credit loss on an off-balance sheet credit exposure. Generally, the accounting rules will determine whether a reserve may be considered a liability for credit losses on off-balance sheet credit exposures versus a recourse liability reserve. There have been situations where an arrangement to buy back loans fell within the 120 day rule for recourse, such that, the arrangement was not treated as recourse for purposes of this rule. Therefore, depending on all other considerations, such an amount may be considered for Tier 2 capital treatment as part of the ALLL add-back.

Unrealized Gains on AFS Equity Securities

SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (SFAS 115), requires institutions to report unrealized gains and losses from AFS debt and equity securities in AOCI. For Tier

¹³ SFAS No. 166, *Accounting for Transfers of Financial Assets—An Amendment of FASB Statement No. 140* (SFAS 166) and SFAS No. 167, *Amendments to FASB Interpretation No. 46(R)* (SFAS 167) made substantive changes to how financial institutions account for many items, including securitized assets. Savings associations affected by these new accounting standards will be subject to higher risk-based capital requirements. Because of this, the federal banking agencies issued an interagency rule on January 28, 2010 (75 FR 4636) that allows financial institutions, including savings associations, an optional four quarter transition period to account for the impact on risk-weighted assets and also on ALLL in Tier 2 capital. The optional treatment provides a two quarter exclusion period and a two quarter phase-in period for assets reported on-balance sheet due to these new accounting standards, and therefore, provides some regulatory capital relief. Specific relief is also provided to certain ALLL. This temporary treatment is explained at 12 CFR § 567.0 (c).

1 capital purposes, as discussed above, a savings associations must reverse (or, neutralize) all unrealized gains related to AFS equity securities reported in AOCI from Tier 1 capital.

However, for Tier 2 capital purposes, a savings association may include up to 45 percent of unrealized gains on AFS equity securities with readily determinable fair values. A savings association reports unrealized gains net of unrealized losses (before income taxes).

TOTAL RISK-BASED CAPITAL

Total Risk-Based capital is the sum of Tier 1 and Tier 2 capital less the following:

Equity Investments and Other Assets Required to be Deducted

Assets required to be deducted from total capital include:

- Investments in other depository institutions (reciprocal holdings) that other depository institutions may count in their regulatory capital (such as capital stock, qualifying subordinated debt, etc.).
- Debt and equity investments in subordinated organizations not constituting subsidiaries under 12 CFR § 567.1 and engaged in activities impermissible for national banks.
- All other equity investments as defined in 12 CFR § 567.1, which is defined to exclude equity investments permissible for a national bank).

For purposes of the capital rule, equity investments are defined as investments in *equity securities* and *real property* that would be considered an equity investment under GAAP (see 12 CFR § 567.1).

Under this definition, the term *equity securities* does NOT include: investments in a subsidiary as defined in 12 CFR § 567.1; equity investments permissible for a national bank; ownership interests in pools of assets that are risk-weighted in accordance with 12 CFR § 567.6; and, stock of Federal Home Loan Banks and Federal Reserve Banks.

Under this definition, the term equity investments in *real property* does NOT include interests in real property that are acquired in satisfactions of a debt previously contracted in good faith or acquired in sales under judgments, decrees, or mortgages held by the savings association, provided that the property is not intended to be held for real estate investment purposes and is expected to be disposed of within five years or a longer period as approved by the OTS.

Deduction for Low-Level Exposures

When recourse is legally and contractually limited to an amount less than the on-balance sheet capital requirement, the savings association can choose to deduct using the simplified/direct deduction method (excluding those CEIO strips already deducted from Tier 1 capital).

RISK-BASED CAPITAL: RISK-WEIGHTED ASSETS (GENERAL RULES)¹**General Description**

Under the general risk-based capital requirements (sometimes referred to as Basel I-based rules), a savings association determines its risk-weighted assets by allotting assets among four standard risk-weight categories: 0 percent, 20 percent, 50 percent, and 100 percent.² The risk weight assigned depends upon the nature of the assets, obligors, and collateral. In general, if a particular item can be placed in more than one risk category, a savings association may assign it to the category that has the lower risk weight. However, as discussed in detail below, the following procedures apply:

- Each on-balance sheet asset is assigned to an appropriate risk weight category. Risk-weighted on-balance sheet assets are computed by multiplying the on-balance sheet asset amount by the appropriate risk weight.
- Risk-weighted off-balance sheet assets are determined in a two-step process. First, a savings association must convert the off-balance sheet commitment or exposure to an on-balance sheet credit equivalent amount by using a prescribed conversion factor. The savings association then risk weights the credit equivalent amount in accordance with the rules used for on-balance sheet assets.
- Certain traded and non-traded positions (such as asset or mortgage backed securities, recourse obligations, direct credit substitutes, and qualifying residual interests) may be eligible for the ratings-based approach (RBA) where the risk weight assigned to the exposure or obligation is determined by its credit rating.
- The risk-weighted assets amount for recourse exposures and direct credit substitutes that are not eligible for the RBA is determined by multiplying the full amount of the credit-enhanced asset for which the savings associations directly or indirectly retains or assumes credit risk by 100 percent conversion factor and assigning this credit equivalent amount to a risk weight category used for on-balance sheet assets as appropriate based on the obligor to the underlying transaction.
- Certain residual interests and low-level recourse obligations receive a dollar-for-dollar capital treatment.

¹ The general risk-based capital rules apply to all savings associations except those that have been approved, following a successful parallel run period, to begin using the Basel II Advanced Approaches.

² There is also a 200 percent risk weight-category used in the ratings-based approach. In addition, certain items receive a dollar-for-dollar capital treatment, equivalent to a risk weighting of 1250 percent (the reciprocal of 8 percent). See the Recourse section later in this Appendix.

- Total risk-weighted assets equal the sum of risk-weighted on-balance sheet assets, risk-weighted off-balance sheet amounts, risk-weighted recourse obligations, direct credit substitutes, and certain other positions.³

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

Risk Weight Category	Effective Capital Charge (rw% * 8%)
0%	No capital charge
20%	1.6%
50%	4.0%
100%	8.0%
200%	16.0%
Dollar-for dollar	100.0%

This appendix discusses how risk-weighted assets are determined for on-balance sheet assets; for off-balance sheet exposures; and for recourse obligations, direct credit substitutes, and residual interests. (Refer to 12 CFR Part 567.) Asset types not specifically addressed in the regulation automatically receive a 100 percent risk weight unless OTS determines that a different risk-weight, or a different capital treatment, is appropriate.

Risk Weights: On-Balance Sheet Assets⁴

Every on-balance sheet asset is assigned to a risk-weight category. Risk-weighted on-balance sheet assets are computed by multiplying the on-balance sheet asset amount times the appropriate risk-weight category. Below is a **general** summary of the risk weight categories to which various on-balance sheet

³ OTS has not yet adopted a Market Risk Rule. However, if adopted, in the future, OTS regulated institutions subject to this rule will include market risk equivalent assets in their calculation of RWA.

⁴ Statement of Financial Accounting Standard (SFAS) Nos. 166 and 167 made substantive changes to how financial institutions account for many items, including securitized assets. Savings associations affected by these new accounting standards will be subject to higher risk-based capital requirements. Because of this, the federal banking agencies issued an interagency rule on January 28, 2010 (75 FR 4636) that allows financial institutions, including savings associations, an optional four quarter transition period to account for the impact on risk-weighted assets and also on ALLL in Tier 2 capital. The optional treatment provides a two quarter exclusion period and a two quarter phase-in period for assets reported on-balance sheet due to these new accounting standards, and therefore, provides some regulatory capital relief. Specific relief is also provided to certain ALLL. This temporary treatment is explained at 12 CFR 567.0 (c).

assets are assigned in order to determine an equivalent risk-weighted assets amount (refer to 12 CFR § 567.6 for a full listing of assets subject to the different risk weight categories):

0 Percent Risk-Weight Category

This category is for the lowest risk assets. These assets receive a zero percent risk-weight, which means there is no capital charge against these assets. This category includes:

- Cash, including the amount of currency owned and held, or in transit, in all the savings associations' offices.
- Securities issued by or other direct claims on the United States Government or its agencies (includes most GNMA securities) and unconditionally backed by the full faith and credit of the US government, or the central government of an OECD country (e.g., U.S. Treasury Securities) (OECD country is defined at 12 CFR § 567.1) .
- That portion of assets directly and unconditionally guaranteed by the United States Government or its agencies or the central government of an OECD country.
- Covered assets that were initiated under the Federal Savings and Loan Insurance Corporation (FSLIC) (even if assumed by a successor agency such as the FDIC).
- Deposit reserves at, claims on, and balances from Federal Reserve Banks.
- Temporary Liquidity Guarantee Program (TLGP) nondeposit debt obligations.
- FDIC pre-paid insurance assessments.

20 Percent Risk-Weight Category

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

- Securities issued or guaranteed by, or that portion of assets guaranteed by government sponsored agencies (including most FannieMae and FreddieMac mortgage-related securities, *except for their principal only securities (POs), interest-only securities (IOs), and their equity securities.*
- That portion of assets collateralized by the current market value of U.S. Government securities or securities issued or guaranteed by U.S. government sponsored agencies.
- That portion of assets conditionally guaranteed by the U.S. Government or its agencies.
- Loss-sharing agreements, unless there is some specific arrangement in which you should consult with the Regional office to determine the appropriate risk-based capital treatment.
- General obligations of state and local governments.

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- Claims on Federal Home Loan Banks (FHLB), including the book value of FHLB stock; deposits with a FHLB; securities, bonds and notes issued by the FHLB.
 - Items collateralized by cash held in a segregated deposit account at the savings association (i.e., loans and other obligations collateralized by deposits).
 - Balances due from and all claims on domestic depository institutions.
 - All claims on depository institutions incorporated in an OECD country, and all assets backed by the full faith and credit of depository institutions incorporated in an OECD country.
 - Mortgage- and asset-backed securities rated AAA or AA eligible for the RBA, but excluding stripped securities.⁵
 - Certain claims on, or guaranteed by, qualifying securities firms.

A *qualifying securities firm* in the United States is a broker-dealer registered with the Securities and Exchange Commission (SEC) that complies with the SEC's net capital regulations. A different definition applies to foreign-based firms (12 CFR § 567.1).

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

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

- It is a reverse repurchase/repurchase agreement or securities lending/borrowing transaction executed using standard industry documentation.
- It is collateralized by debt or equity securities that are liquid and readily marketable.
- It is marked to market daily.
- It is subject to a daily margin maintenance requirement under the standard industry documentation.
- It can be liquidated, terminated, or accelerated immediately in bankruptcy or similar proceeding, and the security or collateral agreement will not be stayed or voided under applicable law.

⁵ See discussion on the Ratings Based Approach in this Appendix.

50 Percent Risk-Weight Category

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

- Qualifying mortgage loans:⁶ A qualifying mortgage loan is defined at 12 CFR § 567.1. A qualifying mortgage loan is a loan that is:
 - Fully secured by a first lien on a one-to-four (1-to-4) family residential property.
 - Is underwritten in accordance with prudent underwriting standards including standards relating the ratio of the loan amount to the value of the property (LTV ratio) (refer to the Real Estate Lending Guidelines at 12 CFR § 560.101). The real estate lending standards state the prudently underwritten real estate loans should reflect all relevant credit factors, including the capacity of the borrower to adequately service the debt. Those loans, particularly no documentation loans, some low documentation loans, and stated income loans that do not reflect all relevant credit factors or support the borrower's ability to repay the loan, would not be eligible for the more favorable risk weighting and will receive a 100 percent risk weighting. Further supplemental guidance on prudent underwriting practices, including the assessment of a borrower's ability to repay a loan, is set forth in various agency issuances, including OTS [Examination Handbook Section 212](#); the October 4, 2006, Interagency Guidance on Nontraditional Mortgage Products; the July 10, 2007 Interagency Statement on Subprime Lending; and Interagency Guidelines Establishing Standards for Safety and Soundness (12 CFR Part 570).
 - Maintains an appropriate LTV ratio (calculated at origination) based on the amortization of the loan.⁷ Note that mortgage loans above 90 percent LTV will not typically qualify for 50 percent risk weight unless they have acceptable private mortgage insurance or other appropriate credit enhancement to effectively reduce their LTV to 90 percent or less.⁸
 - Is performing and is not more than 90 days past due.

Note: If a savings association holds the first and junior lien(s) on a property, and no other party holds an intervening lien, you treat the transaction as a single loan secured by a first lien.

- Qualifying multifamily mortgage loans: To qualify for the 50 percent risk weight, multifamily mortgage loans must meet the specific criteria of the regulation that tracks a federal statute. (Refer to the definition in 12 CFR § 567.1.)

⁶ Qualifying mortgage loans include first lien 1-to-4 family residential mortgage loans on houses, condominiums, cooperative units, and manufactured homes titled as real property (see discussion in [Examination Handbook Section 212](#)). Loans on mixed-use properties that are primarily one- to four-family may also be considered qualifying if they meet the regulatory criteria. Qualifying mortgage loans do not include loans on boats, motor homes, and time-share properties, even if they are a primary residence. (See [Appendix D](#) to this handbook entitled "Q & A on 1-4 Family Residential Mortgage Loans").

⁷ If the loan negatively amortizes such that the principal balance of the loan exceeds 90 percent of the value of the loans (at origination), then the loan may no longer qualify for a 50 percent risk weighting.

⁸ Does not include pool PMI.

- Qualifying residential construction loans. To qualify for the 50 percent risk weight, residential construction loans must meet the specific criteria of the regulation (12 CFR § 567.1).
- Privately issued securities (excluding stripped securities) backed by qualifying 1-to-4 family or multifamily mortgage loans – where the underlying loans are eligible for 50 percent risk weight.
- Most state and local revenue bonds.
- Mortgage and asset-backed securities rated “A” eligible for the RBA, but excluding stripped securities.

100 Percent Risk Weight Category

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

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

Ownership in Mutual Funds (and other pooled assets)

The capital rules risk-weight mutual funds based on the investment objectives in the portfolio and the investment limits set forth in the prospectus:

- You may assign the entire investment to the risk-weight category applicable to the highest risk-weighted asset that the fund is permitted to hold in accordance with the investment objectives set forth in its prospectus.
- You may assign different risk weights to the fund on a pro-rata basis, according to the investment limits for the different investment categories in the fund's prospectus.

However, if the mutual fund now includes assets that do not meet the investment limits of the prospectus, including particular securities that have been downgraded to below investment grade, the entire fund must be risk-weighted at 100 percent. Assets received through a redemption-in-kind (RIK) provision should be risk-weighted individually, based on the obligor and the rating. On a case-by-case basis, under 12 CFR § 567.11(c) (Reservation of Authority) provides that the OTS may require or permit a savings association to apply a different risk weight where the assigned risk weight for an asset does not appropriately reflect the risks imposed on the savings association.

Off-Balance Sheet Risk Exposures

You determine risk weights for most off-balance sheet items in a two-step process:

First, you multiply the face amount of the exposure by the appropriate credit conversion factor to get the balance sheet credit equivalent amount. You then assign the on-balance sheet credit equivalent amount to the appropriate risk weight category based on the nature of the obligors, guarantors, and collateral listed above for on-balance sheet assets.

There are five credit conversion factor groups: 0 percent, 10 percent, 20 percent, 50 percent, and 100 percent.

0 Percent Credit Conversion Factor Group

There is no on-balance sheet credit equivalent amount (and thus no risk weighted asset amount) for off-balance sheet assets assigned a zero percent credit conversion factor. This group includes:

- Unused commitments with an original maturity of one year or less.
- Unused commitments with an original maturity of greater than one year:
 - That you may unconditionally cancel at any time, and
 - You have the contractual right to make, and you do make, either:
 - ✓ A separate credit decision based upon the borrower's current financial condition before each draw, or

- ✓ An annual, or more frequent credit review, based upon the borrower's current financial condition to determine whether or not to continue the lending arrangement.
- Unused portions of retail credit card lines of credit that you may unconditionally cancel to the extent allowed by applicable law.
- Unused portion of home equity lines of credit:
 - That you may unconditionally cancel at any time to the extent fully permitted by relevant federal law, and
 - You have the contractual right to make, and you do make, either:
 - ✓ A separate credit decision based upon the borrower's current financial condition before each draw, or
 - ✓ An annual, or more frequent credit review, based upon the borrower's current financial condition to determine whether to continue the lending arrangement.
- A commitment to make a permanent loan, where either the balance sheet or off-balance sheet includes the construction loan. If the commitment to make the permanent loan exceeds the construction loan, treat the excess as a separate commitment and convert it to an on-balance sheet equivalent.

10 Percent Credit Conversion Factor Group

Savings associations may exclude from their risk-weighted asset base asset-backed commercial paper programs that are consolidated onto a sponsoring organization's balance sheet under FASB Interpretation No. 46, Consolidation of Variable Interest Entities, as revised (FIN 46R).⁹

20 Percent Credit Conversion Factor Group

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

50 Percent Credit Conversion Factor Group

This group includes:

- Unused portions of commitments, including home equity lines of credit, with an original maturity exceeding one year or that are unconditionally cancellable (see 0 Percent Credit Conversion Factor above).

⁹ However, a 10 percent conversion factor is imposed on unused eligible liquidity facilities with an original maturity of one year or less that provide liquidity support to ABCP programs. Eligible liquidity facilities with an original maturity exceeding one year remain subject to the current 50 percent credit conversion factor below. Those that fail to meet certain asset quality tests are treated as direct credit substitutes or as recourse obligations.

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- Most LIP commitments with an original maturity over one year.
 - Transaction-related contingencies such as performance bonds and performance-based standby letters of credit related to a particular transaction. For example, arrangements backing subcontractors' and suppliers' performance, labor and materials contracts, and construction bids.
 - Unused eligible ABCP liquidity facilities with an original maturity exceeding one year.
 - Revolving underwriting facilities, note issuance facilities, and other similar arrangements pursuant to which the savings association's customer can issue short-term debt obligations in its own name, but for which the savings association has a legally binding commitment to either: (1) purchase the obligations the customer is unable to sell by a stated date or (2) advance funds to its customer if the obligations cannot be sold.

100 Percent Credit Conversion Factor Group

This group includes:

- Guarantees or financial guarantee-type standby letters of credit.
- Recourse obligations and direct credit substitutes.
- Forward agreements with a certain drawdown. For example, legally binding agreements to purchase assets at a specified future date.
- Risk participations purchased in bankers acceptances.
- Indemnifications of customers whose securities the savings association has lent as agent.

Off-balance Sheet Derivative Contracts: Interest-Rate and Foreign Exchange-Rate Contracts¹⁰

A savings association must determine the credit equivalent amount of its off-balance sheet interest-rate and foreign exchange-rate contracts that are not subject to qualifying bilateral netting contracts. The credit equivalent amount of an interest-rate or exchange-rate contract is the sum of the current credit exposure (that is, the replacement cost of the contract) and the potential future credit exposure of the contract. You calculate this as follows:

$$\text{Credit Equivalent Amount} = \text{Current Exposure Amount} + \text{Potential Future Credit Exposure}^{11}$$

Current Exposure Amount: Replacement value of the contract, that is, the fair value or mark-to-market value of the contract, but not less than zero.

¹⁰ Unlike the other banking agencies, the OTS regulatory capital requirements do not address Commodity and Equity-linked derivative contracts. Credit derivative contracts that are considered recourse obligations or direct credit substitutes are discussed in the next section.

¹¹ Credit Equivalent Amount is measured in U.S. dollars

Potential Future Credit Exposure:¹² The notional principal amount of the contract multiplied by the appropriate credit conversion factor:

Remaining Maturity	Interest Rate Contracts	Foreign Exchange Rate Contracts
One year or less	0.0%	1.0%
Over one year	0.5%	5.0%

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

Exceptions: There are certain exceptions to the above calculation for foreign exchange contracts with an original maturity of less than 14 days, and for interest-rate and exchange-rate contracts traded on an exchange requiring the daily payment of variations in the market value of the contracts (e.g., exchange traded futures contracts and options contracts.) Savings associations may use bilateral netting to compute the net replacement value for multiple contracts with the *same* counterparty under certain conditions specified in the regulation (12 CFR § 567.6(a)(2)(vi)(B)).

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

On November 29, 2001, OTS and the other federal banking agencies issued a capital rule for recourse, direct credit substitutes, and residual interests including those resulting from asset securitizations. This section outlines and highlights some of the more important aspects of the rule.

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

This part contains four sections:

- Capital Treatment for Recourse.
- Capital Treatment for Direct Credit Substitutes.
- Capital Treatment for Residual Interests.

¹² Savings associations, subject to examiner review, should use the effective rather than the apparent or state notional amount. Where notional principal is equivalent to cash flows (e.g., foreign exchange contracts) total notional principal is defined as the net receipts to each party falling due on each value date in each currency.

- The Ratings-based Approach (RBA).

Capital Treatment for Recourse Obligations

What is a Recourse Obligation?

The term recourse refers to a savings association's retention, in form or in substance, of any credit risk directly or indirectly associated with an asset it has sold. A recourse obligation typically arises when a savings association transfers an asset in a sale (a sale according to generally accepted accounting principles (GAAP)) that exceeds a pro rata share of that savings association's claim on the asset. If the savings association has no claim on the assets it has sold, then the retention of any credit risk is recourse. A recourse obligation typically arises when a savings association transfers assets in a sale and retains an explicit obligation to repurchase the asset or to otherwise absorb losses on the asset due to default on the payment of principal or interest or any other deficiency in the performance of the underlying obligor or some other party. Examples of recourse obligations include:

- Assets sold under an agreement to repurchase.
- Credit-enhancing representations and warranties related to sold assets. Early default clauses and similar warranties (including premium refund clauses) that, for a period not to exceed 120 days from the date of transfer, permit the return of qualifying mortgage loans are not considered recourse. See [CEO Memo 344](#), Risk Weighting of Early Default Provisions.
- Retained loan servicing with an agreement under which the savings association is responsible for losses associated with the loans serviced (except for servicer cash advances as defined in 12 CFR § 567.1).
- Retained subordinated interests that absorb more than their pro rata share of losses from the underlying assets.
- Clean-up calls on assets sold (except for clean-up calls that are 10 percent or less of the original pool balance and that are exercisable at the option of the savings association).
- Credit derivatives that absorb more than the savings association's pro rata share of losses on transferred assets.
- Loan strips sold where the maturity of the transferred portion of the loan is shorter than the commitment under which the loan is drawn.
- Liquidity facilities that provide support to asset-backed commercial paper (other than eligible ABCP liquidity facilities).

Recourse can exist explicitly and implicitly. Implicit recourse arises when a savings association repurchases assets, absorbs losses, or otherwise supports assets that it has sold, in instances where it is *not contractually required* to do so. The existence of implicit recourse can trigger the requirement for additional capital commensurate with that additional risk. Moreover, on a case-by-case basis, it can taint

future similar transactions and lead to the assumption of greater risk and higher capital requirements. Refer also to [CEO Memo 162](#).

Capital for Recourse Obligations

One of three approaches is generally used for determining the amount of capital to be held against a recourse obligation: the general approach, the RBA (where applicable), and the low-level exposure approach (where applicable). The RBA is discussed in detail beginning on page 16 below. If the position is not eligible for the RBA, then one of the two following approaches will be used:

General Approach:

Generally, a savings association retains a recourse exposure that is limited in dollar amount or as a percentage of assets transferred, but is designed to absorb the first losses that occur for the entire pool of transferred assets. The recourse exposure thus absorbs *more than its pro rata share of losses*. As a result, under the general capital treatment for recourse exposures the savings association must hold capital against the full amount of the transferred assets as if they were still on the balance sheet. OTS applies this relatively rigorous capital treatment because the recourse exposure receives more than its pro rata share of risk with both a transferred loan and the risk of all of the assets senior to it in a securitization transaction.

Therefore, using the general approach, you obtain the credit equivalent amount by multiplying the *full amount of the transferred assets* for which the savings association directly or indirectly retains or assumes credit risk by a *100 percent conversion factor*. You assign this credit equivalent amount to the risk-weight category appropriate to the obligor in the underlying transaction after considering any associated guarantees or collateral:

Example: Recourse sale of loans

Assume a savings association has sold \$100,000 in qualifying mortgage loans (that is, 50 percent risk weight 1-to-4 family loans) with an agreement to repurchase them for up to 180 days. Until the recourse period expires, total risk-weighted assets must include: $(\$100,000) \times (100 \text{ percent conversion factor}) \times (50 \text{ percent risk weight}) = \$50,000$. Thus, the capital requirement is: $\$50,000 \times 8 \text{ percent} = \$4,000$.

Note: if the sales agreement limits recourse to 120 days or less, no capital is required. See [CEO Memo 344](#), Risk Weighting of Early Default Provisions.

Low Level Recourse Approach

There is an exception to the general approach for low-level exposures where recourse is legally and contractually limited to an amount less than the on-balance sheet capital requirement. OTS limits the capital requirement to the maximum exposure rather than the full ordinary capital requirement.

Example: Low-level Recourse

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

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

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

Direct Credit Substitutes**What is a Direct Credit Substitute?**

The term direct credit substitute means an arrangement in which a savings association assumes, in form or in substance, credit risk associated with an on- or off-balance sheet asset or exposure that was not previously owned by the savings association (third-party asset) and the risk assumed by the savings association exceeds the pro rata share of the savings associations interest in the third-party asset. If the savings association has no claim on the third-party asset, then the savings association's assumption of any credit risk is direct credit substitute. Direct credit substitutes can be on- or off-balance sheet. Examples of direct credit substitutes include:

- Financial standby letters of credit that support financial claims on a third-party that exceed the savings association's pro rata share of the financial claim.
- Guarantees, surety arrangements, credit derivatives, and similar instruments banking financial claims that exceed a savings association's pro rata share in the financial claim.
- Purchased subordinated interests that absorb more than their pro rata share of losses from the underlying assets (e.g., mezzanine securities).

- Credit derivative contracts under which the savings association assumes more than its pro rata share of credit risk on a third-party asset or exposure.
- Loans or lines of credit that provide credit enhancement for the financial obligations of a third party.

Example: Direct credit substitute – Non-subordinated Position

A savings association has provided a financial letter of credit of \$5,000 to support a third party's claim of \$100,000. The savings association has no claim on the third-party assets. The savings association must use the general approach for risk weighting direct credit substitutes and multiply the full amount of the third party assets for which it has assumed credit risk by a 100 percent conversion factor and then assign that amount to the risk weight category of the obligor on whose behalf it issued the letter of credit. Thus, the savings association must convert the \$5,000 to an on-balance sheet asset at a 100 percent conversion factor (\$5,000 x 100 percent). Then, the savings association risk weights the \$5,000 letter of credit at 100 percent, resulting in \$5,000 in risk-weighted assets. The capital requirement for the \$5,000 in risk weighted assets is \$400 (\$5,000 x 8 percent).

Capital for Direct Credit Substitutes

As with recourse obligations, unless a nonsubordinated position is eligible for the RBA, the savings association generally must multiply the *full amount of the transferred assets* for which the association directly or indirectly retains or assumes credit risk by a *100 percent conversion factor*. For a subordinated position that is ineligible for the RBA, the savings association must “gross-up” the risk exposure associated with the direct credit substitute in order to determine the capital requirement. This means, for example, in the case of a subordinated asset backed security that the savings association must hold capital against the total amount of the subordinated security plus all assets senior to it. However, the low-level recourse rule can apply to direct credit substitutes.

Example: Direct credit substitute – gross-up treatment

A savings association has purchased the first dollar loss subordinated interest of \$5,000 in a securitization of \$100,000 in qualifying mortgage loans (1-to-4 family 50 percent risk weight loans). The savings association using the gross-up treatment must gross-up its exposure to include all exposures that are more senior to the security that it owns. Thus, the association must convert the \$100,000 balance of the pool to an on-balance sheet asset at a 100 percent conversion factor (\$100,000 x 100 percent). The association must add its position of \$5,000 to the \$100,000 for a total of \$105,000. Then, it risk weights the \$105,000 at 50 percent, resulting in \$52,500 in risk-weighted assets. The capital requirement for the \$52,500 in risk-weighted assets is \$4,200 (\$52,500 x 8 percent).

Residual Interests

What is a residual interest?

The term residual interest means any on-balance sheet asset that:

- Represents an interest (including a beneficial interest) created by a transfer of financial assets that qualifies as a sale in accordance with GAAP, whether through a securitization or otherwise; and
- Exposes the savings association to credit risk directly or indirectly that exceeds a pro rata share of that savings association's claim on the asset, whether through subordination provisions or other credit enhancement techniques.

Residual interests do not include interests purchased from a third party, except for credit-enhancing interest-only (CEIO) strips. A primary example of a residual is a *retained* subordinated interest in assets formerly owned by the savings association.

Capital treatment for residual interests

The standard capital treatment for most residual interests, except some CEIO strips, is *dollar-for-dollar*. That is, the savings association must hold one dollar in capital for every one dollar in residual interests.

Example: Residual interests

A savings association has retained the first dollar loss subordinated interest of \$5,000 *on the sale of its own loans* of \$100,000 in qualifying mortgage loans (50 percent risk weight 1-to-4 family). The risk-based capital requirement is \$5,000, that is, \$1 of capital for \$1 of residual interests – dollar-for-dollar capital.

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

- A simplified/direct deduction approach where the savings association deducts the amount for computing total risk-based capital.
- A risk-weighted approach where the savings association multiplies the exposure by 12.5 (the reciprocal of 8 percent).

In the risk-weighted approach, the savings association multiplies the \$5,000 capital requirement by 12.5 for a risk-weighted asset of \$62,500. Then, when the savings association multiplies \$62,500 times the 8 percent risk-based capital requirement, the result is a \$5,000 capital charge.

Example: CEIO Strip

A savings association has the first dollar loss subordinated interest (whether retained or purchased) that is a CEIO strip of \$15 in a securitization of subprime auto loans. Tier 1 capital is \$40. The association does not have any other CEIOs. The capital requirement is calculated as follows:

- 25 percent of Tier 1 capital is \$10 ($\40×25 percent). The \$15 CEIO exceeds the \$10 limit by \$5, so the savings association must deduct \$5 in excess CEIO when computing Tier 1 capital.
- New Tier 1 capital is thus \$35 ($\$40 - \$5 = \35).
- The savings association must also hold dollar-for-dollar risk-based capital against the remaining balance of CEIO, or \$10.

THE RATINGS-BASED APPROACH¹³

A savings association may use the RBA to calculate the risk-weighted asset amount for *certain* eligible positions: an asset- or mortgage-backed security, a recourse obligation, a direct credit substitute, or a residual interest, but not a CEIO strip.

To be *eligible* for the RBA, a position must:

- Be a traded position.
- Have a long-term NRSRO rating of one grade below investment grade or better, or a short-term NRSRO rating of investment grade.

A position that is not traded may be eligible for the rating-based approach if:

- The position is an asset- or mortgage-backed security extended in connection with a securitization, a recourse obligation, a direct credit substitute, or a residual interest arising from an asset securitization, and is not a CEIO strip.
- The position has an external rating by more than one NRSRO.
- The minimum rating assigned by each NRSRO that meets all of the following:
 - Long-term: no worse than one category below investment grade.

¹³ The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act) enacted into law on July 21, 2010, requires the removal of references to or requirements of reliance on the use of credit ratings issued by national recognized statistical rating organizations (NRSROs) in all Federal Agency Regulations, including those of the banking agencies. The agencies are required to remove such requirements that refer to or rely upon credit ratings, and to substitute in their place standards of credits worthiness.

- Short term: investment grade.
- Rating must be publicly available.
- Rating must be based on the same criteria as for traded positions.

The following positions are never eligible for the RBA:

- CEIO strips.
- Bonds not in security form.
- Bonds not backed by assets.

A savings association may calculate the risk-weighted asset amount for an **eligible** position under the RBA (as opposed to the general approach for calculation of capital for mortgage-backed and asset-backed securities, recourse obligations, direct credit substitutes, and qualifying residual interests) by multiplying the face amount of the position¹⁴ by the appropriate risk weight determined in accordance with Tables A and B below:

TABLE A

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

¹⁴ For risk-based capital purposes, the “face amount” of an available-for-sale (AFS) and a held-to-maturity (HTM) security is its amortized cost. (If a security has been written down to fair value because of an other-than-temporary impairment, the write-down establishes a new cost basis for the security.) The “face amount” of a trading security is its fair value. The “face amount” of an off-balance sheet item is the notational principal amount of the item.

TABLE B

Short-Term Rating Category	Examples	Risk Weight
Highest investment grade	A-1 or P-1	20%
Second highest investment grade	A-2 or P-2	50%
Lowest investment grade	A-3 or P-3	100%
Below investment grade or unrated		Not eligible

Unrated Senior Positions

If the recourse obligation, direct credit substitute, residual interest, or asset- or mortgage-backed security is not rated by an NRSRO, but is senior or preferred in all features to a rated, traded position, the savings association may risk-weight the face amount of the senior position based on the rating of the traded position. This may occur only if the savings association satisfies the OTS that such treatment is appropriate and if the traded position provides substantive credit support to the unrated position until it matures.

Positions that are not Rated by NRSROs

Under certain circumstances, a savings association may use *internal or program ratings* for certain risk exposures. A savings association may make use of internal rating *after* it has demonstrated to the OTS that its internal credit risk rating system is adequate (as set forth in 12 CFR § 567.6(b)(4)), or may make sure of its program rating after OTS has reviewed the nature of the program and accepts, under specific conditions, a rating assigned to a particular risk exposure that the savings association retains. The rating must correspond credibly and reliably with an NRSRO rating, for example AA.

Downgraded Positions

An eligible position that has been downgraded to more than one grade below investment grade in the case of a long-term rating and below investment grade in the case of a short-term rating is no longer eligible to use the RBA and must use the general approach for calculating capital. Thus, for downgraded securities the following rules apply:

- for **senior securities**, use the risk weight applicable to the underlying obligor or collateral;
- for **recourse obligations and direct credit substitutes (including mezzanine¹⁵ securities)**, apply the “gross-up” treatment—in cases where the savings association owns the entire mezzanine piece, or “proportional gross-up” treatment – in cases where the savings association owns only a portion of the mezzanine piece of the securitization (see [CEO Memo 307](#), “Risk Weighting Down Graded Securities,” June 25, 2009); and
- for **residual interests**, apply the “dollar-for-dollar” treatment.

ALTERNATIVE CAPITAL COMPUTATION FOR SMALL BUSINESS OBLIGATIONS

With respect to the transfer of a small business¹⁶ loan or lease that is a sale under GAAP, a qualified savings association¹⁷ may elect to include only the amount of its recourse in its risk-weighted assets. The total outstanding amount of such recourse retained and included in risk-weighted assets may not exceed 15 percent of the association’s total capital computed under 567.5(c). To qualify for this election, the savings association must establish and maintain a reserve under GAAP sufficient to meet the reasonable estimated liability of the savings association under the recourse obligation.

¹⁵ A mezzanine security refers to a security that is not the most senior class and not the most subordinate class in a structured securitization. However, be aware that some securitization structures, especially collateralized mortgage obligations, have multiple senior tranches that receive different timing of payments, but are nonetheless senior for credit risk purposes.

¹⁶ Small business means a business that meets the criteria for a small business concern established by the Small Business Administration in 13 CFR Part 121 pursuant to 15 USC 632.

¹⁷ Qualified Savings Association means a savings association that is well capitalized without applying this alternative capital treatment; or is adequately capitalized without applying this alternative capital treatment, and has received permission from the OTS to apply this alternative capital treatment.

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Prompt Corrective Action Restrictions 12 CFR §565.6

<i>Capital Category</i>	<i>Restriction</i>
Well and adequately capitalized	Cannot pay dividends or management fees to controlling persons if it would result in undercapitalization.
Undercapitalized	<p><u>Mandatory actions:</u></p> <ul style="list-style-type: none"> • Capital distributions and management fees restricted. • Capital plan required. • Monitoring of condition and capital plan. • Growth restricted. • Prior approval of certain expansion proposals such as acquisitions, branching and new lines of business.
Significantly Undercapitalized	<p><u>Mandatory actions:</u></p> <ul style="list-style-type: none"> • Activities restricted. • Payments on subordinated debt restricted. <p><u>Discretionary actions:</u></p> <ul style="list-style-type: none"> • Require recapitalization: <ul style="list-style-type: none"> — Issue stock. — Require acquisition (if grounds exist for appointing a conservator or receiver). • Restrict interest rates paid. • Impose more stringent asset growth restrictions (or require shrinkage). • Restrict activities. • Improve management by requiring the election of directors or employment of qualified senior executive officers. • Prohibit deposits from correspondent banks. • Require prior approval for capital distributions by a bank holding company. • Require divestiture. • Require other actions the regulator determines appropriate.
Critically Undercapitalized	<p><u>Mandatory actions:</u></p> <ul style="list-style-type: none"> • Activities restricted - Associations may not: <ul style="list-style-type: none"> — Enter into any material transactions other than in the usual course of business. — Extend credit for any highly leveraged transaction. — Amend the association’s charter or bylaws, except to the extent necessary to carry out any other requirement of any law, regulation, or order. — Make any material change in accounting methods. — Engage in any covered transaction. — Pay excessive compensation or bonuses. • Payments on subordinated debt prohibited.

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*Questions and Answers on
Risk Weighting 1-to-4 Family Residential Mortgage Loans*

1. When do 1-to-4 family residential mortgages receive 100% risk weight?

Any 1-to-4 family residential mortgage loan that is not a Qualifying Mortgage Loan receives a 100% risk weight. A Qualifying Mortgage Loan is a loan that:

- (i) *Is fully secured by a first lien on a 1-to-4 family residential property;*
- (ii) *Is underwritten in accordance with prudent underwriting standards, including standards relating the ratio of the loan amount to the value of the property (LTV ratio). See Appendix to 12 CFR § 560.101. A nonqualifying mortgage loan that is paid down to an appropriate LTV ratio (calculated using value at origination) may become a qualifying loan if it meets all other requirements of this definition;*
- (iii) *Maintains an appropriate LTV ratio based on the amortized principal balance of the loan; and*
- (iv) *Is performing and is not more than 90 days past due.*

Thus, loans that are non performing and more than 90 days past due; loans not prudently underwritten in accordance with the Real Estate Lending Standards, such as loans over 90 percent LTV without private mortgage insurance or other additional readily marketable collateral, and loans that do not reflect all relevant credit factors, including the capacity of the borrower to adequately service the debt (see answers 8 and 9 below) would receive a 100 percent risk weight.

2. (a) Does the value for calculating loan-to-value (LTV) continue to be based on the appraisal or evaluation at origination? If an institution has an updated appraisal, may it be used to calculate an updated LTV? (TFR Q&A 126) If a 1-to-4 family residential loan continues to meet all the other qualifying criteria for a 50 percent risk weight but the institution has a valid appraisal indicating a much lower value, MUST the institution use the new appraisal?

Answer for Risk-based Capital: For the Qualifying Mortgage Loan definition that is used to determine whether a loan may be risk weighted at 50 percent, you use value at origination. The applicable value at origination is the lower of the appraised value or sales price. You continue to use value at origination throughout the life of the loan, even if housing prices in the area have changed. However, if the loan is refinanced, has defaulted, or has been otherwise modified generating a new appraisal – then assuming the new appraisal is valid and meets all applicable standards – you use the new appraisal.

Answer for Schedule Loan Data (LD): While an institution must use value at origination for capital risk weighting purposes, there are other valid reasons for an institution to track home values in its lending area or to seek reappraisals of certain properties. For example, the institution might use this information to assess its overall risk exposure and make an assessment of its individual capital adequacy. An institution may also want an assessment of current values to determine its exposure and policies for home equity lines. Follow the TFR instructions and Q&A 126 for Schedule LD.

(b) Does the loan amount for calculating LTV continue to be based on the amount of the loan at origination?

No. A Qualifying Mortgage Loan is one that “maintains an appropriate LTV ratio based on the amortized principal balance of the loan.” Moreover, “a nonqualifying mortgage that is paid down to an appropriate LTV ratio (calculated using value at origination) may become a qualifying loan if it meets all other requirements of this definition” (see definition of Qualifying Mortgage Loan at 12 CFR § 567.1). Conversely, should a loan’s amortized principal balance increase (e.g., as a result of negative amortization on the loan), a qualifying loan may become a nonqualifying loan based on an increase in the LTV ratio (that is, current balance divided by value at origination).

Thus, a loan’s outstanding balance changes due to amortization -- whether ordinary positive amortization that decreases the loan balance, or negative amortization that increases the balance. The current balance is used to determine the LTV ratio and whether the loan meets the Qualifying Mortgage Loan definition.

3. Does the definition of “subprime” continue to rely on the examples in [CEO Memo 257](#) or has the definition evolved to using 620 or less for real estate secured loans and 660 or less for nonreal estate secured loans to define subprime loans (rather than the 660 or below indicated in the CEO memo)? Does the institution still need to define any programmatic subprime loan programs? Do the examples in the guidance continue to be potential characteristics of subprime?

The guidance and definition of subprime have not changed. Borrower credit risk characteristics define whether the borrower is subprime. FICO score alone does not determine whether a borrower is subprime. A number of borrower credit risk characteristics are listed in both the “Interagency Statement on Subprime Lending” ([CEO Memo 257](#)) and the 2001 “Interagency Expanded Guidance for Subprime Lending Programs” (“Expanded Guidance”) ([CEO Memo 137](#)).

- 4. Do loans that are originated as prime and subsequently have subprime characteristics have to follow the subprime lending guidance? Are these loans not “subprime” as defined by the guidance and thus do not have to be treated as such – although there might be credit and capital implications because of performance?**

As explained in the Expanded Guidance, subprime lending does not refer to individual subprime loans originated and managed in the ordinary course of business as exceptions to prime risk selection standards. The Agencies recognize that many prime loan portfolios will contain such accounts. Generally, this guidance will not apply to: prime loans that develop credit problems after acquisition; loans initially extended in subprime programs that are later upgraded as a result of their performance to programs targeted to prime borrowers; and community development loans as defined in the Community Reinvestment Act (CRA) regulations that may have some higher risk characteristics, but are otherwise mitigated by guarantees from government programs, private credit enhancements, or other appropriate risk mitigation techniques.

- 5. Do we currently apply the subprime multiplier (1.5 to 3 times the normal risk-based capital requirement) and capital stress testing only if the population of subprime loans is 25 percent or more of tier 1 capital, or do we apply these to any populations of 1-to-4 subprime loans?**

The Expanded Guidance applies specifically to those institutions that have subprime lending programs with an aggregate credit exposure greater than or equal to 25 percent of Tier 1 capital. Aggregate exposure includes principal outstanding and committed, accrued and unpaid interest, and any retained residual assets relating to securitized subprime loans.

However, the Agencies may also apply these guidelines to certain smaller subprime portfolios, in certain situations such as those experiencing rapid growth or adverse performance trends, those administered by inexperienced management, those impacted by local or national economic conditions, or those where the activity is conducted with inadequate or weak controls, or other similar conditions. Thus, as a supervisory matter, we would expect stress testing and use of the multiplier for portfolios that are 25 percent or more of Tier 1 capital. However, it may behoove the savings association to analyze the potential impact of subprime portfolios on smaller populations, especially as concentrations develop, and even more so if they begin to approach the 25 percent of capital threshold.

- 6. What are we currently using as the subprime multiplier for 1-to-4 family residential loans originated as part of a subprime lending program?**

A subprime portfolio could be risk-weighted as high as 300 percent in the case of high LTV or other nonqualifying 100 percent risk weight loans with the 3 times capital subprime multiplier

applied. For loans that otherwise meet the Qualifying Mortgage Loan definition on an individual loan basis, the 50 percent base risk weight is used before a subprime multiplier is applied.

The Expanded Guidance states that: “Each subprime lender is responsible for quantifying the amount of capital needed to offset the additional risk in subprime lending activities, and for *fully documenting* the methodology and analysis supporting the amount specified. Examiners will evaluate the capital adequacy of subprime lenders on a case-by-case basis, considering, among other factors, the institution’s own documented analysis of the capital needed to support its subprime lending activities. Examiners should expect capital levels to be risk sensitive, that is, allocated capital should reflect the level and variability of loss estimates within reasonably conservative parameters.” Examiners should also consider the impact on the Allowance for Loan and Lease Losses (ALLL).

Given the higher risk inherent in subprime lending programs, examiners should reasonably expect, as a starting point, that an institution would hold capital against such portfolios in an amount that is one and one half to three times greater than what is appropriate for nonsubprime assets of a similar type. Refinements should depend on the factors analyzed above, with particular emphasis on the trends in the level and volatility of loss rates, and the amount, quality, and liquidity of collateral securing the loans. Institutions with riskier subprime programs affected by this guidance should have capital ratios that are well above the averages for their traditional peer groups or other similarly situated institutions that are not engaged in subprime lending.

The subprime multiplier may also be applied to home equity lines of credit that are originated as part of a subprime program.

7. What is the risk weight for low doc loans? Can these still use the traditional 50 percent and 100 percent risk weight for risk-based capital?

For purposes of calculating minimum risk-based capital requirements, only Qualifying Mortgage Loans are eligible for the more favorable 50 percent risk weight. To be eligible, a mortgage loan must meet the criteria set forth in the regulation, including the criteria that it be underwritten in accordance with prudent underwriting standards (see Real Estate Lending Standards in Appendix to 12 CFR § 560.101). The real estate lending standards state that the prudently underwritten real estate loans should reflect all relevant credit factors, including the capacity of the borrower to adequately service the debt. Those loans, particularly no-documentation loans or low-documentation loans, that do not reflect all relevant credit factors or support the borrower’s ability to repay the loan, would not be eligible for the more favorable 50 percent risk weight.

Further supplemental guidance on prudent underwriting practices, including the assessment of a borrower’s ability to repay a loan, is set forth in various agency issuances, including OTS

[Examination Handbook Section 212](#) and its [Appendix F](#) (the October 4, 2006, Interagency Guidance on Nontraditional Mortgage Products); the July 10, 2007 Interagency Statement on Subprime Lending; and Interagency Guidelines Establishing Standards for Safety and Soundness (12 CFR Part 570).

Notwithstanding the minimum risk-based capital requirements for qualifying and nonqualifying mortgage loans, OTS may find that the risk weight assigned to any asset does not appropriately reflect the risk of that asset and may require the savings association to apply another risk weight that OTS deems appropriate (see 12 CFR § 567.11 Reservation of Authority). In addition, the OTS may find that the loans are otherwise unsafe and unsound based on the risks and the underwriting characteristics and take additional supervisory or enforcement action.

8. What is the risk weight for nontraditional mortgage loans?

For purposes of calculating minimum risk-based capital requirements, only Qualifying Mortgage Loans are eligible for the more favorable 50 percent risk weighting. To be eligible, a mortgage loan must meet all the criteria set forth in the regulation (12 CFR § 567.1), including the criteria that the loan be underwritten in accordance with prudent underwriting standards (see Real Estate Lending Standards in Appendix to 12 CFR § 560.101). The real estate lending standards state that prudently underwritten real estate loans should reflect all relevant credit factors, including the capacity of the borrower to adequately service the debt.

Further supplemental guidance about prudent underwriting practices for Nontraditional Mortgage Products is set forth in the October 4, 2006 Interagency Guidance on Nontraditional Mortgage Product Risks. Among other things, the guidance discusses underwriting standards for assessing a borrower's ability to repay the loans. For example, the guidance states that "For all nontraditional mortgage loan products, an institution's analysis of a borrower's repayment capacity should include an evaluation of their ability to repay the debt by final maturity at the fully indexed rate, assuming a fully amortized repayment schedule. In addition, for products that permit negative amortization, the repayment analysis should be based upon the initial loan amount plus any balance increase that may accrue from the negative amortization provisions." (See [Appendix F of Section 212 of the Examination Handbook](#).) OTS expects that loans made after the issuance of [CEO Memo 244](#), Interagency Guidance on Nontraditional Mortgage Product Risks, October 2006 must be underwritten in accordance with that guidance in order to be considered prudently underwritten for purposes of being eligible for the 50 percent risk weight. Loans made prior to the Interagency Guidance may receive a 100 percent risk weight or higher if warranted due to poor underwriting. In addition, higher capital requirements may be imposed using the OTS Reservation of Authority if OTS finds, based on the substance of the transaction, that the assigned risk weight does not appropriately reflect the risks imposed.

9. CEO Memo 244 and the Interagency Nontraditional Loan Guidance indicate that an adjustable loan must be underwritten to the “fully indexed rate”. What does this mean?

Assume a borrower qualifies for a maximum payment of \$1,200 per month based on payment-to-income and debt-to-income ratios. In other words, this is the most the borrower can pay without exceeding the ratio limits. If interest rates are 6 percent on a 30-year fixed rate loan, and assuming that all other underwriting criteria is satisfactory, this implies the borrower can qualify for a \$200,000 fixed-rate loan.

Say then for example, that the savings association has an adjustable rate product that starts out at a rate lower than 6 percent, but adjusts to a fully indexed rate of 7 percent. In that case, the maximum loan that this borrower may qualify for would be \$180,000 (based on 7 percent interest, 30-year term, and this borrower’s maximum \$1,200 payment). If the savings association lends him more than \$180,000 on the adjustable loan, the loan would not qualify for 50 percent risk weight as it has not been prudently underwritten to the fully indexed rate.

10. What is the appropriate conversion factor for the undrawn portion of a home equity line of credit (HELOC)?

Whether the 0 percent or 50 percent conversion factor is appropriate depends upon the terms of the HELOC at the particular savings association. The undrawn portion of a HELOC receives a zero percent risk weight if the unused commitment is unconditionally cancelable at any time at the option of the savings association and the savings association has the contractual right to make, and in fact does make, either:

- A separate credit decision based upon the borrower’s current financial condition before each “drawing” under the lending facility; or
- An annual (or more frequent) credit review based upon the borrower’s current financial condition to determine whether or not the lending facility should be continued.

A commitment is unconditionally cancelable if the savings association can prohibit additional extensions of credit, reduce the credit line, and terminate the commitment to the full extent permitted by applicable laws (e.g., applicable language in Reg Z which allows for cancellation under certain safety and soundness related conditions).

11. Can HELOCs and HELs that otherwise meet the definition of Qualifying Mortgage Loan be risk weighted at 50 percent?

Yes, but only if the same institution owns the first mortgage, the combined LTV does not exceed 90 percent, and there is no intervening lien.

For this purpose, LTV is calculated using the combined outstanding balance of the first mortgage loan plus the drawn and undrawn portions of the second.

The risk-weighted assets amount is calculated using outstanding balance of the first mortgage loan, plus the outstanding balance (the drawn amount) of the second, plus the credit equivalent amount of any outstanding commitment (HELOC).

For example:

Value of Home:	\$100,000
Balance of first mortgage:	\$ 70,000
Undrawn portion of HELOC	\$ 10,000
Drawn balance of HELOC	<u>\$ 5,000</u>
Total amount of HELOC	\$ 15,000

In this case, the first mortgage and HELOC are from the same institution. There is no intervening lien. The HELOC extends more than one year and is *not* unconditionally cancellable.

To calculate maximum LTV: $\$70,000 + \$15,000 = \$85,000$, or 85 percent of \$100,000. The LTV does not exceed 90 percent; therefore the loan can receive 50 percent risk weight, assuming prudent underwriting and that it meets the other requirements for Qualifying Mortgage Loan.

To calculate risk weighted assets and the capital requirement:

Outstanding balance of first plus drawn portion of second:

$\$70,000 + \$5,000 = \$75,000$. Then, $\$75,000 \times 50$ percent risk weight = \$37,500 in risk-weighted assets for the outstanding combined drawn balance. $\$37,500 \times 8$ percent = \$3,000 capital required on the outstanding combined drawn balance.

Undrawn portion of second:

$\$10,000 \times 50$ percent credit conversion factor = \$5,000 in credit equivalent on-balance sheet assets. $\$5,000 \times 50$ percent risk weight = \$2,500 in risk-weighted assets. $\$2,500 \times 8$ percent = \$200 capital required on the undrawn portion.

Total: Thus the total risk-weighted assets for this loan are: $\$37,500 + \$2,500 = \$40,000$. And the total capital requirement is $\$3,000 + \$200 = \$3,200$.

12. What is the appropriate conversion factor for the undrawn portion of a loan that allows negative amortization and an increase in the principal (e.g., option ARM)?

The unfunded portion of a loan with a negative amortization feature is treated the same as other unfunded commitment (see the response to Questions 11 and 13 above).

As stated above, whether the unfunded off-balance sheet commitment is subject to a zero or a 50 percent credit conversion factor depends on whether the unused commitment is unconditionally cancelable at any time at the option of the savings association and whether the savings association has the contractual right to make, and in fact does make, either:

- A separate credit decision based upon the borrower’s current financial condition before each “drawing” under the lending facility; or
- An annual (or more frequent) credit review based upon the borrower’s current financial condition to determine whether or not the lending facility should be continued.

An example with a negatively amortizing loan subject to a 50 percent credit conversion factor:

Assume that an \$85,000 Option ARM loan to purchase a \$100,000 house permits negative amortization for 3 years up to a cap of 110 percent of the original balance. For the example assume there is no private mortgage insurance or other credit enhancement.

Value of Home:	\$ 100,000
Day 1 balance of disbursed 1st mortgage:	\$ 85,000
Maximum permitted negative amortization Over three year’s time:	\$ 8,500

For determining LTV, you treat the negative amortization commitment similarly to the HELOC or HEL commitment described in the answer to Question 13 above:

First calculate the LTV: $\$85,000 + \$8,500 = \$93,500$. LTV is 93.5 percent ($\$93,500/\$100,000$). Therefore, the loan would receive 100 percent risk weight.

To determine the capital requirement, add together the capital requirements for the drawn and undrawn portions:

Drawn portion: $\$85,000 \times 100 \text{ percent r.w.} \times 8 \text{ percent}$:	\$6,800
Commitment to allow negative amortization	
$\$8,500 \times 50\% \text{ conversion factor} \times 100 \text{ percent r.w.} \times 8 \text{ percent}$	<u>340</u>
Total Capital Requirement	\$7,140

13. Can a mortgage loan to a homeowner/borrower for a second principal residence be considered a Qualifying Mortgage Loan for purposes of receiving a 50 percent risk weighting?

Among other things, a Qualifying Mortgage Loan is a loan that is:

- Fully secured by a first lien on a 1-to-4 family residential property and
- Is underwritten in accordance with the prudent underwriting standards, including LTV ratio standards (per the Real Estate Lending Guidelines in 12 CFR § 560.101).

The LTV requirement for a 50 percent risk weight depends on whether the 1-to-4 family residential property is owner-occupied or nonowner-occupied. Non owner-occupied 1-to-4 family residential loans must have an LTV of 85 percent or less to receive a 50 percent risk weight. While the Real Estate Lending Guidelines do not set a specific LTV for *owner-occupied* 1-to-4 family loans, generally loans over 90 percent LTV at origination require appropriate credit enhancement in the form of either mortgage insurance or readily marketable collateral in order to receive the 50 percent risk weight.

The definition of *owner-occupied* in turn requires that the owner of the underlying property occupy at least one unit of the property as a *principal residence*. Generally, a borrower has only one principal residence. When reviewing loans on second homes or vacation homes the rebuttable presumption is that only the first home is the principal residence for this purpose. Thus, the loan on the second home would be considered *non* owner-occupied and would have to have an LTV of 85 percent or lower in order to qualify for 50 percent risk weight.

There may be *some limited exceptions* where a borrower may in fact have two principal residences. For example, a couple who, due to their particular circumstances, both have jobs in different states and each resides in that state; or, a retired couple who live half the year in one location and half the year in another location. In such limited circumstances, it would be the bank's responsibility to have documentation to support that a second home is, for all intents and purposes, a principal residence if the bank wishes to avail itself of the LTV/risk weight benefit associated with owner-occupied 1-to-4 family qualifying mortgage loan.

14. Can a nonowner-occupied 1-to-4 family residential mortgage loan receive 50 percent risk weight?

Yes. But as discussed above, the maximum LTV is 85 percent for nonowner-occupied residential real estate (see definition of "other improved property" in the Real Estate Lending Guidelines at 12 CFR § 560.101). Moreover, the loan must meet the other requirements set forth in 12 CFR Part 567 for a Qualifying Mortgage Loan. For example, to meet the prudently underwritten criteria, cash flow from the rented property combined with other income or

resources of the borrower must be sufficient to adequately service the debt without relying on resale of the property as means of repaying the loan.

15. Can a construction loan to a builder on a 1-to-4 family residence receive a 50 percent risk weight?

Yes, if the loan meets all of the criteria under the definition of Qualifying Residential *Construction* Loan (12 CFR § 567.1). The definition of Qualifying Residential Construction loan is different from the definition of Qualifying Mortgage Loan. Both definitions may be found in section 12 CFR § 567.1.

16. Can a construction/permanent loan, or similar loan for construction of a borrower's own residence, receive 50 percent risk weight?

Yes. Under the definition of Qualifying Mortgage Loan, the applicable LTV is 85 percent during the construction phase, and 90 percent after the house is complete and occupied by the owner. (We do not envision a change in LTV at the end of construction; this is simply to note that if the loan is 85 percent LTV or less, it can receive 50 percent risk weight all along; if a loan is in the 85 percent to 90 percent range, it cannot receive 50 percent risk weight until construction is complete and the home is occupied by the owner.)

17. Can a 1-to-4 family construction loan or acquisition/renovation loan to an individual investor for purposes of resale receive a 50 percent risk weight?

Yes, but only if the loan meets all of the criteria for inclusion as a Qualifying Mortgage Loan. For example, it is unlikely that such loan would qualify as an "owner-occupied" 1-to-4 family home. Thus the appropriate LTV would be 85 percent. In addition, the criteria that the loan be underwritten in accordance with prudent underwriting standards must be met. Among other things, prudently underwritten loans should reflect all relevant credit factors, including the capacity of the borrower to adequately service the debt. If the sole source of repayment of the loan is from the sale of the house and the borrower lacks other resources to make the loan payments if the house does not sell in a timely manner, then the loan would be speculative and would not meet the underwriting standards for a preferential 50% risk weight.

18. Can Private Mortgage Insurance (PMI) be used on a nonowner-occupied loan to get 50 percent risk weight?

No. Pursuant to the Real Estate Lending Standards (12 CFR § 560.101) PMI is taken into consideration in the calculation of LTVs for owner-occupied, 1-to-4 family residential units.

19. Can pool PMI be used for purposes of reducing the LTV on owner-occupied, 1-to-4 family residential loans?

Generally no, because pool PMI does not provide loss coverage on a loan by loan basis for all loans covered by the policy. Bank-paid pool PMI (also referred to as portfolio PMI) generally has a cap on the maximum loss coverage provided for a portfolio of loans. Once enough losses have occurred such that the cap is reached there is no more coverage for the remaining loans in the portfolio.

If, however, the particular policy does not have a cap on maximum coverage, or if the portfolio PMI will otherwise provide adequate protection for every individual loan in the portfolio (thereby giving the same coverage of traditional borrower-paid PMI), then it could be available for the purpose of reducing LTV for the Qualifying Mortgage Loan definition. From what we have seen, this is not ordinarily the case.

20. (a) If a 12-month construction loan allows for an automatic extension, what is the appropriate credit conversion factor?

The appropriate credit conversion factor is 50 percent, as the loan commitment is for more than 12 months.

(b) What is the appropriate conversion factor when construction loans are routinely extended beyond 12 months?

For determining risk-weighted assets, you use a 50 percent credit conversion factor for loan commitments over 12 months, unless the commitment is unconditionally cancellable at any time at the option of the savings association, and the savings association has the contractual right to make, and in fact does make, either: (1) a separate credit decision based upon the borrower's current financial condition before each drawing under the lending facility; or (2) an annual (or more frequent) credit review based upon the borrower's current financial condition to determine whether or not the lending facility should be continued.

As a practical matter, however, construction loans are not likely to be unconditionally cancellable. There may be exceptions of course depending upon the nature of the construction. The bank ought to take a realistic approach when structuring the terms of construction loans. It may make sense to have a 12-month loan term for construction projects which can realistically be completed within 12 months. For construction projects expected to take longer than 12 months, a longer loan term is probably appropriate and should be assumed for risk-based capital purposes. Given this context, there have been instances where an occasional weather delay or other unforeseen event causes a construction project originally planned for less than 12 months to take longer than anticipated, and as a result the original 12-month loan term had to be extended. We would not necessarily advise a supervisory action to require extension of terms on all other similar loans or otherwise hold risk-based capital for the commitment solely because of

an occasional, unanticipated delay – if in fact a 12-month schedule and 12-month loan term was realistic to begin with.

21. In the case of a construction/permanent loan, to determine LTV for risk-weight capital purposes, does OTS require a new appraisal at the time that construction is complete and the borrower is ready to occupy the home?

No. For capital risk-weighting purposes, OTS does not require a reappraisal.