

## XVIII. CAPITAL

Capital adequacy is a key element of assessing safety and soundness. The more capital that a bank has, the better cushion it has against insolvency. But, capital is costly in part because it restricts the amount of profitable activities in which a bank may engage. To assess capital, examiners focus on available capital protection in comparison to capital needs as reflected in the bank's risk profile. Capital levels that do not fully support the volume, type, characteristics, and risks of all of the bank's business lines, including credit card programs, are cause for concern. Risk-based capital guidelines and other capital rules establish minimum capital ratios, but those banks exposed to a high or above average degree of risk are expected to operate significantly above those ratios. Banks engaged in credit card lending activities, particularly subprime programs, are easily exposed to risk levels that may warrant higher capital protection.

Because banks are exposed to varying degrees and types of risk, any comprehensive capital-adequacy determination is made on a case-by-case basis and considers a wide range of both quantitative and qualitative factors. It involves many dimensions of assessments which consider capital requirements as set forth in PCA regulations and other capital-based rules as well as factors that require a combination of analysis and judgment. While capital ratios provide an initial approximation of a bank's ability to withstand adversity, they may not be absolute indicators of the level of the bank's vulnerability and should be considered in the context of qualitative factors.

This chapter highlights the ongoing evolution of the Basel capital accords and discusses customary capital analyses for credit card programs, including qualitative and quantitative factors.

### BASEL CAPITAL ACCORDS

The Basel capital accords are international regulatory agreements that provide a framework for determining the minimum capital that must be held as a cushion against insolvency. The accords require a bank to hold more capital as its asset profile becomes more risky.

#### *Basel II Framework*

In June 2004, the Basel Committee on Banking Supervision released a document entitled *International Convergence of Capital Measurement and Capital Standards: A Revised Framework*, otherwise known as Basel II. Basel II is designed to create incentives for entities to improve their risk measurement and management processes and to better align minimum capital requirements with the risks of the entity's activities. It is geared to large, internationally-active banks, but certain other large and/or complex banks will more than likely be expected to perform similar risk quantification and capital analyses regardless of whether they are subject to Basel II. This is particularly important when more traditional capital adequacy measures may not adequately capture the inherent risk of activities, such as for securitizations.

The Agencies are in the process of establishing and implementing a comprehensive plan to incorporate Basel II's provisions into regulations and supervisory guidance. On October 27, 2004, the Agencies published the proposed supervisory guidance, *Internal Ratings-Based Systems for Retail Credit Risk for Regulatory Capital* (Retail IRB Guidance), with request for comment. At that point, the Agencies had issued, in draft form, three critical pieces of supervisory guidance - Corporate IRB, Retail IRB, and Advanced Measurement Approaches (AMA) (with AMA used for operational risk approaches). The three documents are intended to help the Agencies in drafting a notice of proposed rulemaking (NPR) for revised capital adequacy standards. As currently proposed, certain banks would be required to adopt the IRB and AMA approaches while other banks that meet certain criteria would have the ability to opt-in. Many banks that expect to adopt Basel II have already commenced planning their implementation

efforts, based on the aggregate proposed guidance. Aspects of the Retail IRB Guidance, which would apply to credit cards, are highlighted next.

### *IRB Systems for Retail Credit Risk*

The Retail IRB Guidance is only a proposal as of this writing. Nevertheless, it does reflect the current views of the Agencies, some of which may ultimately become part of the NPR and some of which are highlighted here. Examiners must consistently remain abreast of proposals (including changes thereto) and forthcoming final rulings regarding Basel II implementation.

The proposed Retail IRB Guidance identifies three retail risk categories, one of which is Qualifying Revolving Exposures (QRE). QREs would be exposures whose outstanding amount fluctuates, determined largely by the borrower's decisions to borrow and repay, up to a pre-established limit. To qualify, the exposure would have to be revolving, unsecured, and unconditionally cancelable by the bank. It would also have to reflect a maximum exposure of \$100,000 or less. QREs would include most credit cards to individuals (but not those issued on behalf of a business). Other credit cards would be measured elsewhere in the framework.

The Retail IRB Guidance describes proposed components and characteristics of a qualifying IRB framework. In summary, IRB banks would be expected to construct and maintain a retail credit system comprised of four interdependent components: segmentation, quantification, data maintenance, and control and oversight mechanisms.

- *Segmentation* - For segmentation, banks would assign risk parameters to pools of exposures with similar risk characteristics (or risk segments), rather than to individual exposures. In this phase management would need to determine whether the assignment of retail exposures to segments effectively separates exposures by characteristics that remain significant drivers of risk over time.
- *Quantification* - For quantification, management would statistically estimate three risk parameters for each retail segment: PD – Probability of Default; LGD – Loss Given Default; and EAD – Exposure at Default. For this phase, management would have to determine whether the risk parameter estimates are accurate and representative of the risk in the existing portfolio.
- *Data Maintenance* – Data structures and practices adopted would be unique to each bank. Nevertheless, the data systems would need to be of sufficient depth, scope, and reliability to implement and evaluate the IRB retail credit risk system. They would need to be able to:
  - Develop a risk segmentation system and assign retail exposures to segments.
  - Develop a quantification process and assign risk parameter estimates to segments.
  - Validate the IRB risk segmentation system criteria and architecture.
  - Validate the IRB risk parameter estimates.
  - Produce internal and public reports.
  - Support the overall retail credit risk management process.
- *Control and Oversight Mechanisms* – Banks would have flexibility in establishing appropriate control and oversight mechanisms. However, the mechanisms would have to include controls over lending activities, independent review, transparency, accountability, use of risk parameter estimates for internal risk management purposes, internal and external audit, and board and senior management oversight.

Regulators would evaluate compliance with the four components as well as how well the various components complement and reinforce one another to achieve the overall objective of accurately determining required regulatory capital.

Although banks would be able to designate some retail exposures as nonmaterial (and not subject to the IRB approach), the aggregate amount of nonmaterial retail exposures and their credit risk would have to be small as percentages of total retail exposures and total amount of retail exposure credit risk. Subject to supervisory review, minimum capital requirements for a nonmaterial retail portfolio would be based on the risk-based capital standards for non-IRB banks, which are also evolving.

### *Revisions to Basel I*

The Agencies believe that it is important to update their risk-based capital standards to enhance the risk-sensitivity of the capital charges, to reflect changes in accounting standards and financial markets, and to address competitive equity questions (such as those that may be raised by implementation of Basel II). As such, the Agencies are considering a number of revisions to their Basel-I based regulations, including:

- Increasing the number of risk-weighting categories.
- Expanding the use of external credit ratings.
- Requiring that certain loans 90 days or more past due or in a nonaccrual status be assigned to a higher risk-weight category.
- Increasing risk sensitivity of capital requirements for retail exposures.
- Assessing a risk-based capital charge to reflect the risks in securitizations backed by revolving retail exposures with early amortization provisions.

Examiners need to be cognizant of the risk-based capital standards, including any changes thereto as a result of these or other future proposals. The Agencies are not currently proposing revisions to the existing leverage capital requirements.

## ASSETS

Asset quality problems emanating from the credit card portfolio can quickly deplete capital. To evaluate capital, consideration is given not only to the nature, trend, and volume of problem credit card assets and the adequacy of credit card loan loss allowances, but also to the unique features of credit card portfolios. The portfolio's typically large quantity of geographically-diverse, revolving accounts with relatively low outstanding balances makes the asset structure of credit card banks very different from other commercial banks and tends to limit the amount of risk on an account-by-account basis. However, actions such as lowering underwriting standards or using improper account management techniques tend to raise the level of credit risk in the aggregate portfolio. As such, the evaluation of capital should consider items such as management's target market, changes in underwriting or servicing standards, and account management practices.

Management's ability to adequately plan for and manage asset growth is also important with respect to assessing capital adequacy. The examiner normally reviews past performance and future prospects as well as compares asset growth to capital formation during recent periods. In addition to discussions with management, the bank's budgets and strategic plans are typically items reviewed to identify growth plans.

Asset risk-weightings under the risk-based capital rules account for the relative credit risk of different instruments. However, the guidelines do not appropriately account for weak or valueless assets held by a bank. Lower quality assets have a greater potential for loss and should be reflected in a stronger capital base. Subprime credit card loans, an example of a typically lower quality asset, are discussed next.

## SUBPRIME CREDIT CARD LOANS

Banks often refer to the subprime market by other names such as the nonprime, nonconforming, or high coupon market. Regardless of the name used, subprime lending is generally characterized as a lending program or strategy that targets borrowers who pose a significantly higher risk of default than traditional retail banking customers. Examiners should direct their attention to situations in which the bank cannot or does not provide a sufficient level of capital support in relation to the volume and nature of the additional risks assumed. Banks with subprime credit card programs frequently have more exposure to certain risks in comparison to other banks. For example, greater credit, legal, and reputation risks are often evident. Banks that engage in subprime credit card lending without adequate procedures to estimate and document the level of capital necessary to support their activities should be criticized.

The minimum risk-based and leverage capital ratios established by existing regulations generally apply to portfolios that exhibit substantially lower risk profiles than those which exist in subprime credit card programs and, thus, may not be sufficient to reflect the risks associated with subprime programs. The additional capital that may be necessary varies according to the volume and type of activities and the adequacy of the bank's risk management program. Thus, evaluation of capital adequacy for each subprime lender is conducted on a case-by-case basis. The evaluations may show that certain subprime pools do warrant increased supervisory scrutiny and monitoring but not necessarily additional capital. On the other hand, they often show that higher-risk subprime pools, such as those that contain unsecured loans or high LTV loans, need significantly higher capital protection.

Given the risk inherent in subprime lending programs, the *Expanded Guidance for Evaluating Subprime Lending Programs* (Expanded Subprime Guidance) cites a reasonable starting point as holding capital against such portfolios in an amount that is 1.5 to 3 times greater than what is appropriate for non-subprime assets of a similar type. Refinements (either up or down) depend on various factors, with particular emphasis on the trends in the level and volatility of loss rates, and the amount, quality, and liquidity of collateral protection. There is no definitive guidance in assigning additional risk-weightings to the subprime portfolios or identifying an appropriate level of capital. In that respect, segmentation is a valuable and frequently used tool for determining reasonable capital requirements and helps to map certain portfolio characteristics to appropriate risk-weightings. There have been instances in which risk-weightings towards the higher end of the starting point range (and once in a while even higher) for certain portfolio segments have been warranted and assigned.

Ultimately, banks with subprime programs should have capital ratios that are well above the averages for their traditional peer groups or other similarly situated banks that are not engaged in subprime lending or other similar, high-risk activities. Those subprime lenders that are in a growth mode or that have not been in the business for a sustained period may likely require even higher levels of capital due to less predictability of the business.

The March 1999 *Interagency Guidance on Subprime Lending* (Subprime Guidance) clearly states that management is responsible for determining how much additional capital is needed to offset the additional risk posed by undertaking subprime lending activities, and the Expanded Subprime Guidance emphasizes that management is expected to fully document the methodology used.

The examiner's evaluation of capital adequacy considers, among other factors, the bank's capital allocation methodology. Concerns normally arise when the sophistication of the bank's analysis is not consistent with the size, concentration level, and relative risk of the subprime lending activities and/or when it fails to consider:

- Portfolio growth rates.
- Trends in the level and volatility of expected losses.

- The level of subprime loan losses incurred over one or more economic downturns, if such data is available.
- The impact of planned underwriting or marketing changes on the credit characteristics of the portfolio, including the relative levels of risk of default, loss in the event of default, and the level of classified assets.
- Any deterioration in the average credit quality over time due to adverse selection or retention.
- The amount, quality, and liquidity of collateral securing the individual loans.
- Any asset, income, or funding source concentrations.
- The degree of concentration of subprime credits.
- The extent of residual assets or other potentially volatile components. Securitization is discussed in a separate heading later in this chapter.
- The degree of legal and/or reputation risk undertaken.
- The amount of capital necessary to support the bank's other risks and activities.

The supervisory approach expects capital levels to be risk sensitive (that is, allocated capital should reflect the level and variability of loss estimates within reasonably conservative parameters) and expects that a direct link between the estimated loss rates used to determine the allowances and the unexpected loss estimates used to determine capital is established.

Examiners also check to see if results of stress-tests are properly considered and documented in the bank's capital adequacy analysis. The Expanded Subprime Guidance discusses the types of modeling and stress-testing that may be appropriate depending on the size, concentration level, and relative risk of the program. Concerns arise if management does not project the performance of subprime loan pools under various stress scenarios, including an estimation of the portfolio's susceptibility to deteriorating economic, market, and business conditions, or if management does not incorporate shock-testing basic assumptions, such as delinquency rates, loss rates, and recovery rates on collateral. Scrutiny could also be greater when testing does not consider other potentially adverse scenarios, such as changing payment rates, utilization rates, and credit score distributions. Whether stress tests are performed manually, or through automated modeling techniques, examiners generally expect them to reflect:

- A clearly documented and rational process that is easily understood by management.
- Reliable inputs that relate directly to the subject portfolios.
- Well-documented and conservative assumptions.
- A comprehensive validation process for any models used.

## EARNINGS AND DIVIDENDS

Poor or deteriorating earnings performance and/or poor earnings retention can hinder internal capital formation. As such, the current level, historical trend, and sustainability of earnings are significant factors in evaluating capital. For some banks, the ability to securitize a significant portion of the loan portfolio has contributed to a significant amount of non-interest income. The evaluation of capital should consider management's ability to maintain competitive in the market while generating a sufficient interest margin and restraining credit losses. It should also assess management's ability to control overhead expenses and should evaluate securitization activities. Excessive dividends can negate even exceptional earnings performance and result in a weakened capital position. Excessively low dividends can also hurt some banks because low returns weaken the attractiveness of stock to investors, thereby potentially hindering the bank's ability to raise additional equity if needed.

## FUNDS MANAGEMENT

The supervisory approach used normally considers funds management when determining whether capital is adequate. Lower levels of liquidity and higher levels of interest rate risk tend to

demand higher capital levels than would otherwise be expected. As discussed in the Liquidity chapter, examiners consider consumers' behavioral patterns (including payment and purchasing patterns), the bank's access to the financial markets, and the strength of the parent company when assessing liquidity. Access to capital sources, including holding company support, is a vital factor in analyzing capital. The relationship with the parent company should be evaluated in much the same manner as it would be for any other bank. For example, the approach will normally consider the levels of financial support the parent can provide, debt of the parent, and dividends up-streamed to the parent.

As also discussed in the Liquidity chapter, many banks rely on funding sources such as brokered deposits or securitizations. Securitizations can enhance both credit availability and profitability but can also involve risks that might not be fully recognized by management or adequately incorporated into risk management systems. According to the Subprime Guidance, banks actively involved in the securitization of subprime loans should develop a CFP that includes measures for raising additional capital.

## SECURITIZATION

Regulators expect banks to fully support securitization activities with adequate capital. Higher capital requirements may be necessary depending on the structure and the composition of retained interests. Capital treatment for securitization components is complex and is only briefly touched on here. As such, examiners should refer to the Regulatory Capital chapter of the Risk Management Credit Card Securitization Manual and other guidance referenced under each subsection to follow.

### *Capital Treatment of Recourse Arrangements, Direct Credit Substitutes, and Residual Interests*

On November 29, 2001, the federal banking agencies published a final rule revising the regulatory capital treatment of **recourse** arrangements and **direct credit substitutes**, including residual interests and credit-enhancing interest-only strips (CE IO strips). Examiners should reference these materials for full guidance:

- Part 325 of the FDIC Rules and Regulations.
- Report of Condition and Income instructions.
- FIL-99-2001, *Final Rule to Amend the Regulatory Capital Treatment of Recourse Arrangements, Direct Credit Substitutes, Residual Interests in Asset Securitizations, and Asset-Backed and Mortgage-Backed Securities*.
- FIL-54-2002, *Interagency Questions and Answers on the Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations*.
- Regulatory Capital chapter of the Risk Management Credit Card Securitization Manual.

The regulatory capital rule, as amended in November 2001, includes these broad standards:

- It varies the capital requirements for positions in securitizations according to relative risk exposure, using credit ratings from rating agencies.
- It permits the limited use of a qualifying internal risk-rating system for certain unrated direct credit substitutes.
- It permits the limited use of a rating agency's review of the credit risk of positions in structured programs and qualifying software for certain unrated direct credit substitutes and recourse exposures (but not residual interests).
- It requires banks to deduct CE IO strips, whether retained or purchased, that are in excess of 25 percent of Tier 1 capital from Tier 1 capital and from assets (concentration limit).

- It requires a bank to maintain risk-based capital in an amount equal to the face amount of a residual interest that does not qualify for the ratings-based approach (including CE IO strips that have not been deducted from Tier 1 capital). This is referred to as dollar-for-dollar capital.
- It permits each agency to modify a stated risk-weight, credit conversion factor, or credit equivalent amount, if warranted, on a case-by-case basis.

Examiners should apply this rule to the substance, rather than the form, of the securitization.

#### *Low-Level Exposure Rule:*

The capital rule imposes a concentration limit on CE IO strips and a dollar-for-dollar capital charge on residual interests. In no event will this combined capital charge exceed the face amount of a bank's residual interests (low-level exposure rule). The instructions for schedule RC-R - Regulatory Capital of the Report of Condition explain the two methods used to calculate risk-based capital requirements: the direct reduction method and the gross-up method.

#### *Implicit Recourse*

If the selling bank provides credit support beyond contractual obligations to receivables considered sold under GAAP, it may be providing implicit recourse and as such, would generally be required to hold capital against the entire outstanding amount of receivables sold for risk-based capital purposes. Examiners should refer to FIL-52-2002, *Interagency Guidance on Implicit Recourse in Asset Securitizations*. Implicit recourse takes on many forms, generally including these post-sale actions:

- Selling assets to the securitization trust at a discount from the price specified in the securitization documents.
- Purchasing assets from the securitization trust at an amount greater than fair value.
- Exchanging performing assets for nonperforming assets.
- Funding credit enhancements beyond contractual requirements.

If any of these situations were evident at the time of the initial transaction, the transaction would not qualify as a sale under GAAP. Thus, if the bank provides such support after the initial sale, it stands to reason that the underlying receivables should not be treated as sold for regulatory capital purposes, and that the bank should hold capital against these assets as if they were still on the bank's balance sheet.

#### *Accrued Interest Receivable (AIR)*

In general, the AIR asset represents a subordinated retained interest in cash flows that are initially allocated to the investors' portion of the securitization and is subject to higher capital requirements. Examiners should refer to FIL-48-2002, *Interagency Advisory on the Regulatory Capital Treatment of Accrued Interest Receivable Related to Credit Card Securitizations*. The guidance discusses reasons why the AIR is considered a subordinated interest, the main reason being that if and when the bank collects any portion of the AIR, the cash collected must be included in the cash flow that runs through the securitization vehicle and thus serves as a credit enhancement to protect third-party investors from credit losses. The AIR meets the definition of a recourse exposure, and as such, the bank must hold risk-based capital against the full, risk-weighted amount of the assets transferred with recourse, subject to the low-level recourse rule. It also meets the definition of a residual interest, which requires dollar-for-dollar capital even if that amount exceeds the full equivalent risk-based capital charge on the transferred assets.

## CONTINGENT LIABILITIES

Lawsuits are one form of contingent liability that should be considered in the capital analysis, namely when the lawsuit's outcome may impact the bank's financial condition. Examiners must fully understand the essential points upon which the lawsuit is based, the total dollar amount of the plaintiff's claim, the basis of the bank's defense, the status of any negotiations toward a compromise settlement, and the opinion of bank management and/or counsel relative to the probability of a successful defense. Determination of Potential or Estimated Losses in connection with lawsuits is often difficult, and there may be occasions where damages sought are of such magnitude that, if the bank is unsuccessful in its defense, it could be rendered insolvent. In addition to stemming from a direct action (or inaction) by a bank, lawsuits may stem from outsourcing or other third-party arrangements.

Contingent liabilities also typically include a high level of unused loan commitments. These commitments sometimes exceed on-balance sheet assets as well as Tier 1 Leverage Capital by several multiples. Although many commitments can be terminated at any time, the examiner should evaluate management's policies and practices to cancel these commitments in relation to the level of capital.

### *Reserving for Rebate Programs*

Many banks offer rebate programs. Rebates come in many forms such as frequent flier miles, automobile discounts, and cash rebates. In many instances, the contingent liability attributable to the rebate rests with the bank and is based on a rebate formula involving sales volume (in dollars) or a similar measurement. The agreement usually determines the bank's cost, marketing requirements, and potential liabilities of the program. Examiners should assess whether management, before entering into an agreement, specifically considers the contingent liability when establishing pricing for the relationship. Generally, banks have based the amount of the rebate on the historical percentages of consumers carrying interest-bearing balances, and some banks use a teaser rate in conjunction with the program. Thus, incorrect assumptions or projections about the amount of finance charges or fees expose the bank to potential losses. The examiner is tasked with judging the reasonableness of management's reserve method and level for future contingent liabilities. Analysis of the rebate reserve should be similar to analysis of the ALLL. It should consider how long the program has been in existence, whether significant methodology modifications have occurred, what type of product the partner is promoting, and what kind of rebate limitations exist. Examiners also evaluate management practices for periodically reviewing and revising its rebate reserve policies. In general, examiners should expect policies to address:

- How often the analysis is to be prepared.
- How monthly accruals will be handled.
- The attestation of management on the adequacy of the reserve.
- Approvals for changes in reserve levels.
- The accounting for redemptions.
- How over- or under-reserves will be handled.
- Procedures governing internal controls.

## QUALITY OF MANAGEMENT

The absence of strong supervision will likely ultimately lead to a deterioration of bank capital. As such, the experience, ability, integrity, depth, and succession of management are critical components in the evaluation of capital. Consideration should be given to management's overall strategic direction which includes risk and account management procedures, policies, data processing facilities, internal and external reporting, and internal controls.



## RISK DIVERSIFICATION

Generally, a greater degree of defined asset and liability concentrations increases the need for capital. Both examiners and management should consider whether any on- or off-balance sheet concentrations exist. Concentrations in higher-risk assets may warrant higher holdings of capital.

## OPERATING PROCEDURES AND CONTROLS

Inefficient or lax operations are costly and can substantially impact a bank's capital position. Short-comings in systems, procedures, and controls expose a bank to loss through fraud, defalcation, or employee error. Banks with credit card programs can be especially prone to such exposures because the complex systems, procedures, and controls necessary to effectively operate the program also pose many opportunities for manipulation or other faulty actions. Banks subject to Basel II are required to have processes in place to measure operational risk.

## CAPITAL MODELS

The use of **economic capital** and other risk modeling techniques continues to evolve and expand to more industry participants, including some banks adopting Basel II (although economic capital models are not explicitly required). Many banks have adopted advanced modeling techniques intended to improve the ability to quantify and manage risks. The techniques frequently incorporate the internal allocation of economic capital considered necessary to support risks associated with all lines of business or portfolios, such as those associated with credit card lending. The models can provide valuable information that bankers and examiners can use to assess capital adequacy. Existing regulatory capital charges capture only credit, market, and operational risk and do not fully address certain aspects of these risks, such as credit concentration risk. Economic capital models, however, address nearly all risks. Total economic capital requirements as measured by the models typically are higher than the regulatory minimum capital charge.

The supervisory approach used to evaluate a bank's economic capital process varies based on the complexity of the bank and the extent of use by management. In any case, examiners should be aware that while such models are inherently imprecise to some degree or another, there are weaknesses that can make the models overly imprecise. Those include data limitations, erroneous assumptions, insufficient quantification of risks, and potential misuse or misunderstanding of model outputs. Examiners should consider both the adequacy of economic capital processes and the results of such processes in their supervisory evaluation of the bank. They may refer to the Scoring and Modeling chapter because some concepts for scoring models can be applied to economic capital models.

## QUANTITATIVE MEASUREMENTS

In addition to qualitative factors, quantitative factors assist the examiner in determining and supporting capital adequacy and most commonly include the Tier 1 leverage, risk-based capital, and Substandard and Doubtful Items to Total Capital plus Ineligible ALLL ratios. The following ratios may also be helpful:

- *Equity Growth to Asset Growth* – This ratio measures the amount of capital support in relation to asset growth and can be an early indicator of capital problems. A ratio of less than one indicates that assets are expanding at a rate greater than capital.
- *Non-Current Credit Card Receivables to Equity Capital and Allowances* – This ratio measures the percentage of credit card loans 90+ days delinquent and nonaccrual loans placed against equity capital and the loan loss allowance. This ratio should be evaluated based on its current level as well as its historical trend.

For a bank that securitizes a significant portion of credit card receivables, capital adequacy should be evaluated in relation to estimated managed assets in addition to the standard quantitative measures. Examiners may want to consider the following ratios:

- *Total Equity Capital to Estimated Managed Assets* – This ratio measures the total amount of equity capital, including preferred stock, as a percentage of estimated managed assets.
- *Tangible Capital to Estimated Managed Assets* – This ratio measures the amount of equity capital less all intangible assets as a percentage of estimated managed assets.
- *Tier 1 Leverage Capital to Estimated Managed Assets* – This ratio measures regulatory Tier 1 Leverage Capital as a percentage of estimated managed assets.

A detailed discussion on credit card securitization activities is housed in the Risk Management Credit Card Securitization Manual.

## SUMMARY OF EXAMINATION GOALS - CAPITAL

Examiners must determine whether the bank's capital level adequately supports the bank's activities and risk profile. An assessment of the adequacy of the capital level generally involves:

- Referencing prior ROE and UBPR data to perform level and trend analysis.
- Reviewing the quality of management and the content of its strategic plans.
- Assessing the reasons and sources of any instances of recapitalization.
- Taking into account the Basel-implementing regulations and other supervisory guidance that exists at the time of review (examination date).
- Reviewing management's reports on capital adequacy.
- Determining whether the capital allocation methodology is well-documented and reasonable.
- Determining whether the capital adequacy analysis incorporates appropriate stress-testing.
- Reviewing the nature, volume, and migration of problem credit card assets.
- Incorporating the review of earnings performance, including whether or not it enables the bank to fund its growth and remain competitive.
- Analyzing the bank's dividend practices and plans.
- Investigating pending litigation against the bank and any other contingent liabilities.
- When applicable, documenting and referencing each bank's subprime capital evaluation.
- Considering quantitative measurements.
- Reviewing board reporting to ensure it is sufficient to:
  - Allow for the evaluation risk exposures.
  - Determine that the bank holds sufficient levels of capital relative to identified risk.
  - Incorporate capital needs into the strategic planning process.
- Reflecting on estimated managed assets when the bank is involved in securitization activity.
- Determining if the bank is involved in a rebate program. If it is, examiners generally:
  - Review governing agreements to determine what contingent liabilities exist at the bank level.
  - Review management's accounting policy governing the allowance method.
  - Assess who is involved in the rebate operation, how information is communicated, and how payments are transacted. This assessment is especially needed when the bank uses outside vendors to provide a

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- variety of these services.
  - Determine if the bank reserves for rebate programs and whether the reserves are adequate.
  - Assessing any capital restoration plans.

The following items might signal current or future elevated risk and warrant follow-up:

- The absence of adequate capital policies.
- Aggressive growth strategies, especially if in higher-risk products.
- Asset growth outpacing capital growth.
- High dividend levels.
- Inadequate audit coverage.
- Flawed capital models.
- Growth in nonperforming credit card assets.
- New, high-risk, or atypical products.
- Failure to appropriately establish rebate reserves for rebate programs.

These lists are not exhaustive. Examiners should exercise discretion when determining procedures to apply. If they identify significant concerns, they should expand procedures accordingly.