EM-11.1

Category: **Capital**
Topic: **Capital Adequacy**
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Overview

Capital adequacy is an institution's ability to absorb losses, meet asset growth needs, and ensure long-term financial viability. Capital adequacy depends on the quantity and quality of capital, and the ability to capitalize growth and protect against risks and threats that could cause dissipation of capital. The quantity and quality of capital focus on the levels and trends in key capital measures and the composition and stability of capital. Capitalization of growth focuses on the ability to increase capital at a rate sufficient to maintain adequate capital during periods of asset growth. Risks to capital focus on the amount of capital needed to protect against adversity, absorb unexpected losses, and continue meeting the financing needs of the institution's customers. These factors interrelate and should all be considered when evaluating capital adequacy.

Examination Procedures and Guidance

General

1. Quantity & Quality:

Evaluate past and projected trends in capital amounts and capital-related ratios and statistics. Also, evaluate the quality of each capital component.

Guidance:

The quantity and quality of capital are critical factors in determining if the institution is adequately capitalized. The quantity of capital focuses on the levels and trends in key capital measures, whereas the quality of capital addresses the permanence of each capital component and its availability to absorb losses. The Farm Credit Administration (FCA) capital regulations contain minimum regulatory requirements for the quantity and quality of capital, but these requirements must not be viewed as optimum levels or the minimum levels needed to ensure the institution's long-term financial viability.

Evaluative questions and items to consider when examining the quantity and quality of capital include:

- ***Quantity of Capital:*** **What are the current levels, trends, and causes of trends in the amount of capital, leverage ratios, and risk-based capital ratios? Do key capital measures compare favorably with regulatory requirements, Financial Institution Rating System (FIRS) benchmarks, the board's capital standards and goals, the institution's internal assessment of capital needs, and peer groups?** FCA Regulation 628.10(b) establishes

minimum capital requirements. Additionally, FCA Regulation 628.11 establishes capital conservation and leverage buffers that require institutions to hold capital above those minimum requirements to avoid restrictions on capital distributions and certain discretionary bonus payments. However, operating with a cushion above these requirements is essential to maintain adequate capitalization during adverse conditions, withstand unexpected losses, and ensure long-term financial viability. The FIRS benchmarks provide general guidelines on capital adequacy, but the amount of cushion needed depends on the institution's unique business model, financial condition, risk profile, access to capital sources, and growth necessary to meet the needs of customers. The capital cushion should be sufficient to ensure the institution's ongoing financial stability and viability during the most acute stress events and business cycles. Comparisons of capital measures to peer groups are useful but should consider differences in business models, asset characteristics, risk profiles, and the institution's unique capital needs.

- ***Quantity of Projected Capital:*** **Are key capital measures and capital composition projected to be adequate? Are the projections reliable?** The primary considerations when evaluating projected capital are whether projections are reliable and if capital will be adequate in relation to the institution's needs and capital goals. If material changes in capitalization are projected, determine the cause(s) and impact of the change. Consider past success in achieving projections, support for assumptions underlying the projections, and the extent to which projections incorporate capitalization strategies and potential changes in the operating environment.

- ***Quality of Capital:*** **Are the primary components of capital stable and readily available to absorb losses?** The quality of capital considers each component's stability and availability to absorb losses. The highest quality capital component is first to be impaired from operating losses, last to be liquidated in the event of institution failure, most stable (i.e., most permanent or perpetual), and the component over which the board has the greatest control. From a regulatory perspective, common equity tier 1 (CET1) capital, as defined in FCA Regulation 628.20(b), is the highest quality capital. Therefore, if almost all capital is counted as CET1, capital quality should be high. Conversely, a component of capital that does not qualify as regulatory capital is likely lower quality and cannot be relied on to absorb losses. From a priority-of-claims perspective, the quality of each capital component is generally ranked as follows: (1) unallocated retained earnings, (2) allocated equities (surplus or stock), (3) purchased capital stock, and (4) preferred stock. Unallocated retained earnings is the highest quality, most stable, and most readily available form of capital to absorb losses, and the capital component over which the board has the greatest control. The quality of other capital components can also be high, but varies and is unique to each institution's bylaws and capital management practices. For example, allocated equities (surplus or stock) that are not subject to retirement are more stable than those retired through a planned revolvement cycle. In addition, noncumulative perpetual preferred stock is more stable than preferred stock that is cumulative and has a defined maturity. The quality of a capital component is also determined by the length of time the institution has committed to hold it (i.e., its permanence). Generally, capital instruments with longer holding periods are higher quality. The *Capital Distribution Programs* procedure guidance in the *Capital Management* Examination Manual topic contains additional guidance on capital quality and examining how it is managed.

2. Capitalization of Growth:

Evaluate ability to capitalize asset growth.

Guidance:

To capitalize growth and prevent declines in capital ratios, capital should increase at a rate that is equal to or greater than the asset growth rate. Various strategies can be employed to capitalize growth. For example, the institution can retain earnings, issue capital stock, adjust patronage programs, sell assets, or transition to assets with lower risk weightings. While several alternatives exist, retention of earnings is the most sustainable strategy over the longer term and results in the highest quality of capital.

Asset growth can vary significantly over the course of business cycles. During slow growth periods, the ability to capitalize growth through retained earnings may be easily manageable. However, during high growth periods, capitalizing growth can be challenging and may require adjustments to capital and business strategies. Such strategies should ensure the institution remains adequately capitalized. The examination of this area should begin with a comparison of the institution's growth trends to its sustainable growth rate, and then consider the impact of growth on capitalization.

Evaluative questions and items to consider when examining the capitalization of growth include:

- ***Growth Trends:*** **What are the past and projected growth rates for total assets and total risk-weighted assets? Are the projections reliable?** The evaluation of projected growth should consider past success in achieving projections and the support for assumptions underlying the projections. This is particularly important if the institution has a history of significantly exceeding its asset growth projections.

- ***Sustainable Growth Rate (SGR):*** **How do trends in asset growth compare to the SGR? Are the SGR and earnings retention rates significantly affected by capital distributions (i.e., cash dividends, cash patronage distributions, and allocated equity retirements)?**

    - The SGR measures an institution's ability to capitalize asset growth from retained earnings. SGR is the maximum rate that an institution can grow given its earnings retention rate without issuing additional capital stock, increasing financial leverage, or reducing regulatory capital ratios. The SGR is equal to the return on equity (ROE) multiplied by the earnings retention rate. For example, if the ROE is 10 percent, and 70 percent of earnings are retained after cash dividends and patronage distributions, then the SGR will equal 7 percent (i.e., .10 x .70). Evaluations of the SGR should consider the impact of dividend payments, patronage payments, allocated equity retirements, and ROE trends. The Uniform Performance Report in the Consolidated Reporting System reports the incremental impact of these factors on the SGR, although additional work is typically needed to understand institution programs and practices that affect the SGR.

    - To prevent declines in key capital ratios and measures, the SGR must equal or exceed asset growth. If asset growth is continually greater than the SGR, it indicates that earnings retention is insufficient to capitalize growth. Therefore, capital ratios will decline unless alternatives are implemented to capitalize growth. Examples of alternatives include issuing capital stock, selling assets, and transitioning to assets with lower risk weightings. The SGR can be compared to growth in assets or risk-

weighted assets. Comparisons to growth in total assets are appropriate when evaluating the potential impact of growth on financial leverage, such as the capital to assets ratio and the tier 1 leverage ratio. Comparisons to growth in risk-weighted assets are appropriate when evaluating the potential impact of growth on regulatory risk-based capital ratios, such as the CET1, tier 1, and total regulatory capital ratios.

- ***Impact of Growth on Capitalization:*** **Is past and projected asset growth challenging the institution in maintaining adequate capitalization? If the institution cannot capitalize growth fully from retained earnings, has management implemented sound alternative strategies for capitalizing growth that are sustainable?** When evaluating the capitalization of growth, consideration should be given to current capital levels and any strategies that have been implemented. A well-capitalized institution likely has more time available to address growth issues compared to an institution that is approaching under-capitalization. In addition, strategies for capitalizing growth should be viable and sustainable over the long term. For example, a plan to reduce capital distributions and increase the earnings retention rate could potentially be a viable long-term strategy for increasing the SGR and capitalizing growth. Conversely, a plan to issue preferred stock might be relatively limited as a strategy for capitalizing growth over the longer term if it significantly affects the institution's ability to capitalize normal growth from retained earnings. Preferred stock causes a decline in the SGR (via dividends that increase capital distributions). In addition, preferred stock will not increase all capital ratios (e.g., it cannot be used as a strategy to increase CET1 capital).

3. Risks to Capital:

Evaluate threats and risks to capital.

Guidance:

Institutions need to maintain capital commensurate with the level and nature of all risk exposures. In Farm Credit System institutions, credit risk in the loan and investment portfolios is commonly the most significant threat to capital. However, risks in other areas (e.g., interest rate, operations, strategic, and off-balance sheet risks) should also be considered.

Institutions with lower risk exposures may be able to operate in a safe and sound manner with relatively lower capitalization. However, even these institutions require a capital cushion to cover unidentified risks and ensure stability and viability during adverse times. No institution should operate with marginal capital levels. Such institutions would be prone to financial failure because it is impossible to predict all risks that will emerge or to withstand the effects of business decisions or assumptions that prove to be incorrect. If the institution has a sound internal process for assessing capital needs, this assessment should be considered in determining if capital is adequate for its unique risk exposures.

Evaluative questions and items to consider when examining risks to capital include:

- ***Credit Risks:*** **Does the quality or composition of assets present a significant threat to capital? Do management processes ensure adequate identification of and controls over credit risks in the loan and investment portfolios?** Credit risk is typically the most significant threat to capital. Loan and investment portfolios with high credit risk can potentially erode capital. Key considerations include:

- Level and trend in criticized, adverse, and nonaccrual asset volume in relation to capital. Deterioration in asset quality can result in nonearning assets that reduce net interest income and increase provisions for losses or impairment charges, thereby impacting capital.

- Credit concentrations and correlations among portfolio segments. Concentrations and correlations among portfolio segments can result in widespread deterioration and volatility in asset quality. Such widespread credit deterioration can stress even the strongest capital position. Conversely, a highly-diversified portfolio can help insulate the institution against business cycles.

- Adequacy of the allowance for loan losses. The allowance is an important consideration because it protects capital against estimated losses in the portfolio. Any shortfalls in the allowance will increase risks to capital.

- Loan and investment portfolio management processes. Management processes, particularly underwriting practices and credit administration, are critical to managing credit risks and ensuring stable and sufficient capital.

- ***Other Risks:*** **Does the institution's exposure to other risks pose a significant threat to capital?** While credit risk in loans is typically the primary threat to capital, other risks (e.g., interest rate, operations, or strategic risks) can also pose a significant threat. Refer to the *Earnings Adequacy* Examination Manual section for additional examples and details. If realized, these risks will impact earnings first, but they can also pose a threat to capital if significant.

- ***Off-Balance Sheet Risks:*** **Do off-balance sheet risks and contingent liabilities pose a significant threat to capital?** Examples of these include litigation, unfunded commitments on adverse or nonaccrual loans, letters of credit, guarantees by the institution, and requirements to repurchase loans previously sold (triggered by violations of representations and warranties). Each of these off-balance sheet liabilities may result in losses if the institution is required to fund and bring them onto the balance sheet. If significant, such losses can pose a threat to capital.

- ***Earnings:*** **To what extent do earnings serve as a first line of defense against risk exposures?** The adequacy of earnings should be considered when evaluating risks to capital. Earnings serve as the first line of defense against the various business risks. If earnings are low, then earnings may not provide much buffer against risks and could result in operating losses and capital dissipation even during normal business cycles. Strong earnings provide more of a buffer against risk fluctuations. While earnings adequacy should be considered, even the strongest earnings can disappear quickly if widespread credit deterioration occurs.

- ***Stress Test Results:*** **Do results of the institution's stress tests and economic capital measures indicate capital is reasonably insulated against potential risks?** Results of stress tests can provide valuable information on risk exposures and the amount of capital needed to ensure the institution's ongoing financial viability. Stress tests can be performed on credit risk, off-balance sheet risk, interest rate risk, and other significant sources of risk. The usefulness and interpretation of stress test results should consider the reliability, plausibility, severity, and conceptual soundness of the stress test scenarios along with whether the

scenarios appropriately focus on the institution's primary risk exposures. If the results show the institution will fall below required capital levels during plausible stress scenarios, the institution should build additional capital commensurate with its risks even if that requires capitalization above the levels otherwise considered well-capitalized. Results of any economic capital measures should also be considered. If measurement of economic capital is reliable, it can provide an estimate of the capital needed to protect the institution against its unique risks as a going concern.