Bank: **Date of Exam:**

Charter #: **Prepared By:**

#5 – CAPITAL ACCOUNTS AND DIVIDENDS
(Risk Focused)

ASSIGNMENT OVERVIEW

Adequate capital is essential to: absorb losses not covered by earnings; support asset growth; provide protection to depositors; and ensure public confidence in the banking system. The examiner's role is to evaluate the adequacy of capital in light of the bank's current condition and operations, considering growth trends, new activities, and other strategic initiatives. Both qualitative and quantitative factors are used in the evaluation of capital, since a high level of capital does not necessarily guarantee adequacy. It is also important to assess the capital structure and ownership of the organization to determine the extent of potential future support from existing shareholders.

For more information, refer to the "Capital Adequacy" section in the FDIC Risk Management Manual of Examination Policies; FDIC's Expanded Community Bank Guide to the New Capital Rule for FDIC-Supervised Banks; FDIC's Interagency Community Bank Guide to the New Capital Rule. DOBIE Reference Material document for this procedure. Federal regulations can be viewed in the electronic code of federal regulations (CFR).

INSTRUCTIONS

Examiners must follow the requirements in the Examiner Bulletin addressing Guidelines for Procedures and Work Paper Documentation for Commercial Examinations.

All examiners performing these procedures must be listed above in the "Prepared By" section. All of the CORE ANALYSIS PHASE should be completed. Comments and findings for each step should be made in the comment box below each question. If there is non-compliance with a regulation or policy, a comment must be made. Reference work paper documentation in the Comment section. Documentation is to be sufficient to allow an audit trail of the examiner's thought process and all significant findings.

Based on any significant/critical findings in the CORE ANALYSIS PHASE or as directed by the EIC, the applicable SUPPLEMENTAL ASSESSMENT PHASE (SAP) should also be performed. Responses should be entered in the SAP. Summarize conclusions in the corresponding CORE ANALYSIS comment section.

Information on the Summary of Findings page must tie back to the findings noted within the procedure. The SEIC/EIC will determine which information in the Summary of Findings will be included in the Report of Examination.

The EIC/AEIC should review this procedure when completed. Acknowledgement that this procedure has been reviewed by the EIC/AEIC will be indicated on the SCOPE FORM.

EXAMINERS ARE RESPONSIBLE FOR EXERCISING SOUND JUDGMENT AND UTILIZING REASONABLE INVESTIGATIVE AND ANALYTICAL SKILLS TO ARRIVE AT AN ACCURATE ASSESSMENT OF THE RISK PROFILE OF THIS SEGMENT OF THE INSTITUTION'S OPERATIONS. PERFORMING ALTERNATE PROCEDURES NOT LISTED WITH THESE GUIDELINES MAY BE NECESSARY TO COMPLETE THIS RISK ANALYSIS.

CORE ANALYSIS PHASE

#5 Capital Accounts and Dividends

1. Prior Criticisms

1a. Determine if deficiencies were noted in the last examination and most recent internal/external audit. If yes, determine if the deficiencies have been addressed and/or corrected by management. Detail how deficiencies were corrected. *Include a copy of audit exceptions and/or prior examination criticisms and management response in work papers or indicate the page number in the prior report of examination where the deficiencies are noted, or summarize exceptions/criticisms below, if applicable.*

Comment:

2. Optional Community Bank Leverage Ratio Framework

2. Determine if the bank has plans to or has opted into the Community Bank Leverage Ratio (CBLR) framework which became effective on January 1, 2020. Qualifying banking organizations can opt into the CBLR framework beginning with their March 31, 2020 regulatory reporting forms. If opting in to the CBLR framework: (1) Determine if the bank meets the eligibility requirements; and (2) Review the bank's capital ratios to determine compliance.

Banks electing to use the CBLR Framework will not be required to calculate risk-based capital ratios, including complying with the HVCRE requirements or higher risk weights for mortgage servicing assets, deferred tax assets, or investments in unconsolidated financial institutions. Reporting requirements will be simplified under the CBLR framework.

Refer to APPENDIX I for additional information.

Comment:

3. Reconcilement

3a. Balance and reconcile the capital accounts (all categories of Tier 1 and 2) to the general ledger and verify that any capital schedules are accurately reported in the call report.

Review the bank's calculation of Common Equity Tier 1 Capital, Additional Tier 1, and Tier 2 Capital under the revised capital rules. (The calculations are found on Call Report Schedule RC-R Part I.)

Determine if the calculations appear correct under the revised capital rules, 12 CFR Part 324 (FDIC) and 12 CFR Part 217 (FRB), or whether the bank needs to make any revisions.

- Determine whether the bank has chosen to opt-out of the inclusion of accumulated other comprehensive income.

#5 Capital Accounts and Dividends

- Review applicable deductions and adjustments for each tier of capital, including phase-in and phase-out provisions (refer to 324.22 (FDIC) and 217.22 (FRB) for capital adjustments and deduction rules and 324.300 (FDIC) and 217.300 (FRB) for transition provisions).

- Consider whether the bank has non-qualifying capital instruments or non-qualifying minority interests subject to phase-out (refer to 324.20 (FDIC) and 217.20 (FRB) for criteria for capital instruments for each tier of capital, 324.21 (FDIC) and 217.21 (FRB) for minority interest rules, and 324.300 (FDIC) and 217.300 (FRB) for transition provisions).

Ensure any transfers and reductions are in accordance with Section 32.103 of the Texas Finance Code, 12 CFR 303.241 (FDIC), and 12 CFR 208.5 (FRB). If applicable, review the transactions. *Include copy of reconcilements in 5-C of work papers.*

Compliance with (answer applicable one):

(Non-Member) 12 CFR Part 324: Choose an item.
(FRB Member) 12 CFR Part 217: Choose an item.

Compliance with TFC §32.103: Choose an item.

Compliance with (answer applicable one):

(Non-Member) 12 CFR 303.241: Choose an item.
(FRB Member) 12 CFR 208.5: Choose an item. Choose an item.

A response of "No" requires a comment on compliance.

Comments:

3b. Review the bank's calculation of risk-weighted assets reported on Schedule RC-R, Part II. For bank's reporting on FFIEC form 051, review the most current risk weighted asset date report (6/30 or 12/31).

Review the bank's supporting documentation as appropriate. Determine if the calculations are **accurate** (FDIC: Part 324.32 and FRB: Part 217.32) or overly conservative which may impact off-site monitoring. Discuss if the bank needs to make any revisions.

See *Table 3: Risk Weights* found in APPENDIX VIII**.**

Refer to APPENDIX II for other categories of exposures, including HVCRE.

Comment:

3c. Determine compliance with deferred tax assets reporting restrictions, specifically, 12 CFR Part 324.22.

Compliance with 12 CFR Part 324.22: Choose an item.

#5 Capital Accounts and Dividends
A response of "No" requires a comment on compliance.
Comment:
3d. Determine if the bank's capital structure includes subordinated debt instruments, mandatory convertible debt, intangibles, minority investments in subsidiaries, or treasury stock. Refer to the FDIC Examination Manual and call report glossary to determine appropriate accounting treatment, and any impact on overall capital adequacy. Determine compliance with Section 34.102 of the Texas Finance Code (TFC)..
Compliance with TFC §34.102: Choose an item. *A response of "No" requires a comment on compliance.*
Comment:
4. Capital Stock
4a. Review stockholders' list for any changes in ownership since the last state examination. • Note directorate control, both individually and in aggregate. • Identify any shareholder with 5% or more ownership/control. • If there have been any changes in ownership/control since the last state exam that require regulatory approval, determine compliance with Section 33.001 of the TFC. Review Correspondence and determine that proper approvals were obtained. *Include copy of shareholders list in 5-B of work papers. Include copy of correspondence with Banking Commissioner if there has been a change in ownership/control requiring prior approval.*
Compliance with TFC §33.001: Choose an item. *A response of "No" requires a comment on compliance.*
Comment:
4b. Balance the stock books to the current shareholder list. Describe the internal controls over the bank's stock certificates and dividends and include a comment on frequency of audits. Determine if internal controls and audit are adequate. Refer to APPENDIX III for guidance. When review is completed initial and date the back of the last certificate.
Comment:
4c. If the bank has 2,000 shareholders or more and is a **non-member bank**, determine that it has registered with the Securities and Exchanges Commission as required by 12 CFR 335 – Securities of Nonmember Banks.

#5 Capital Accounts and Dividends

Compliance with 12 CFR 335: Choose an item.

A response of "No" requires a comment on compliance.

Comment:

5. Capital Levels

Additional guidance can be found in:

APPENDIX IV Factors which can Impact the Adequacy of the Capital Accounts; and

APPENDIX VIII Tables: Table 1 Transition Schedule for New Ratios & Capital Definitions and Table 2 Capital Components and Table 3 Risk Weights

5a. Determine if there is a board approved capital plan/policy. What thresholds or triggers exist? Determine compliance with this policy.

Comment:

5b. Determine whether management's policies and practices promote capital preservation.

Consider the following:

- The strategic plan and its underlying assumptions, projected asset growth, dividend plans, asset quality, income, liquidity, funds management, deposit structure, parent company relationship, contingent liabilities, expansion plans, competition, economic conditions, etc.
- The availability of additional capital sources, such as funding provided by insiders, external sources, or additional debt at the parent level. If additional stock is sold, who are potential purchasers (i.e. current shareholders, directors, prominent customers, others in the community)?

Comment:

5c. Determine if the existing capital level is adequate for the bank's earnings performance and risk profile. Refer to APPENDIX V for guidance. Address any factors which could threaten the adequacy of the bank's capital levels.

Comment:

5d. Confer with examiners performing procedures in other areas to identify the types of concentrations present in the bank's balance sheet, i.e., correspondent bank relationships, loans, funding concentrations.

If the bank has concentrations, determine whether:

- The level of concentrations increases the risks to capital, and
- Management adequately monitors and manages concentrations of risk.

#5 Capital Accounts and Dividends

If needed, complete the Concentrations page.

Concentrations are defined as obligations, direct and indirect, according to the following guidelines:

1) Asset concentrations of 25% or more of Total Capital (loan related) or Tier 1 Capital (non-loan related) by:
   a. individual borrower,
   b. small interrelated group of individuals,
   c. single repayment source with normal credit risk, or
   d. individual project;
2) Concentrations of 100% or more of Total Capital (loan related) or Tier 1 Capital (non-loan related) by:
   a. industry,
   b. product line (Product lines are common programs used by an institution that target specialty lending within a broad loan category, such as leveraged financing, accounts receivable, home equity, row crops, farm equipment, and subprime.),
   c. type of collateral, or
   d. short term obligations of one financial institution or affiliated group (For the purposes of concentration identification, short-term obligations represent Federal Funds Sold with a maturity of one day or less or Federal Funds Sold under a continuing contract, and resale agreements that have an original maturity of one business day (or is under a continuing contract) and are in immediately available funds in domestic offices.).

Comment:

5e. Review the bank's capital ratios under the revised PCA standards found in APPENDIX VI. Determine the PCA capital category for the bank. If the PCA category is less than "Well Capitalized" complete the **SAP**.

Refer to:

12 CFR 324 Subpart H – Prompt Corrective Action (PCA) (FDIC supervised banks)

12 CFR Chapter II Part 208 Subpart D §208.43, Regulation H, FRB member banks).

SAP Completed? YES ☐ **NO** ☐

If Yes, summarize conclusions in Comment section.

Comment:

6. Dividends

6a. Evaluate dividend practices and plans and determine if they are consistent with the maintenance of adequate capital levels or are required for debt service. Comment on the effects to capital.

#5 Capital Accounts and Dividends
For state-member banks, verify compliance with 12 CFR 208.5. (Refer to FIL-40-2014 regarding dividend requests from S-Corp banks.
Compliance with 12 CFR 208.5: Choose an item. *A response of "NO" requires a comment.*
Comment:
6b. Review the bank's capital conservation buffer, and the appropriateness of any distributions and discretionary bonus payments. Refer to APPENDIX VII for information regarding the capital conservation buffer. Verify compliance with 12 CFR 324.11 Subpart B (FDIC supervised banks) and 12 CFR Chapter II Part 208, Subpart A Section 208.5, Regulation H (FRB member banks). Comment if deficient.
Compliance with (Answer applicable one): (Non-Member) 12 CFR 324.11: Choose an item. (FRB Member) 12 CFR 208.5: Choose an item. *A response of "No" requires a comment on compliance.*
Comment:
6c. If dividends were paid, determine if they were properly approved by the Board of Directors as required by Texas Business Organizations Code *§*21.302.
Compliance with Business Organizations Code §21.302: **Choose an item.** *A response of "No" requires a comment on compliance.*
Comment:
7. Final Analysis
7. Prepare a Capital comment and assign a rating for the bank. Refer to Supervisory Memorandum 1001 for definitions of ratings. Complete the **Summary of Findings** page.

SUMMARY OF FINDINGS

#5 - CAPITAL ACCOUNTS AND DIVIDENDS

Describe all strengths evident from the evaluation.

Describe all weaknesses evident from evaluation, including violations of law/regulation/rules; noncompliance with Departmental policies/guidelines; internal policy deficiencies/ noncompliance; internal control weaknesses; MIS problems; and deficiencies in management supervision.

Determine why weaknesses exist and comment on management's response and plan of action. Identify bank personnel making the response.

SUMMARY RISK RATING ASSIGNED: Select Rating

Definitions:
1-Strong; 2-Satisfactory; 3-Less than satisfactory; 4-Deficient; 5-Critically deficient; NR-Not Rated

Ratings Matrix.xlsm

Provide copy of this page to EIC/AEIC. Receipt and review of this form by the EIC/AEIC will be evidenced by his/her initials in the appropriate column for this procedure on the SCOPE FORM.

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SUPPLEMENTAL ASSESSMENT PHASE

SAP

Document findings in the SAP. Summarize weaknesses in the corresponding CORE ANALYSIS section.

Capital Levels (Q4e)

PCA CATEGORY "LESS THAN WELL CAPITALIZED"

If the bank is less than "Well Capitalized" perform the following and document responses below:

1. Determine compliance to operational limitations in 12 CFR 324.404– Capital Restoration Plans. (12 CFR 208.44 state FRB member banks)
2. Determine compliance to operational limitations in 12 CFR 324.405– Mandatory and Discretionary Supervisory Actions Under Section 38. (12 CFR 208.45 state member banks).
3. Determine compliance to operational limitations in 12 CFR 337.6 – Brokered Deposits in Undercapitalized Insured Depository Institutions.
4. Determine compliance to operational limitations in FDICIA 12 USC 183 lo (d)(1) and (2) – Capital Distributions Restricted and Management Fees Restricted.

Compliance with (answer applicable one):

(Non-member, FDIC supervised) 12 CFR 324.404 **:** Choose an item.

(FRB member) 12 CFR 208.44: Choose an item.

Compliance with (answer applicable one):

(Non-member, FDIC supervised) 12 CFR 324.405: Choose an item.

(FRB member) 12 CFR 208.45: Choose an item.

Compliance with:

12 CFR 337.6: Choose an item.

FDICIA 12 USC 183: Choose an item.

Any response of "No" for Compliance requires a comment.

Comments:

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APPENDIX I

Community Bank Leverage Ratio Framework
Effective January 1, 2020

Qualifying Community Banking Organization	• Leverage Ratio greater than 9 percent • Less than $10 billion in average total consolidated assets • Off-balance-sheet exposures of 25 percent or less of total consolidated assets • Trading assets plus trading liabilities of 5 percent or less of total consolidated assets • Not an advanced approaches banking organization
Calculation of the Leverage Ratio	$\frac{\text{Tier 1 capital}}{\text{Average total consolidated assets}}$
Leverage Ratio Requirement	Greater than 9 percent
Grace Period	A two-quarter grace period (which begins as of the end of the calendar quarter in which the electing banking organization ceases to satisfy any of the qualifying criteria) to either meet the qualifying criteria again or to comply with the generally applicable capital rule. • Grace period applies when a banking organization's leverage ratio is 9 percent or less but greater than 8 percent. • A banking organization that fails to maintain a leverage ratio greater than 8 percent would not be permitted to use the grace period and must comply with the generally applicable capital rule and file the appropriate regulatory reports. • Grace period does not apply in the case of a merger or acquisition.

Resources:
Community Bank Leverage Ratio Framework – Community Bank Compliance Guide (October 2019) released by the Board of Governors of Federal Reserve System, the FDIC, and the OCC.

Banker Webinar: CBLR Framework Final Rule presented by the FDIC, FRB, and OCC (Conference Slides or Conference Video.

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APPENDIX II

Risk Weights – Other Categories of Exposure

Consider the following:

a. Off-balance sheet exposures (FDIC: Part 324.33 and FRB: part 217.33),

b. OTC Derivative contracts (FDIC: Part 324.34 and FRB: Part 217.34),

c. Cleared transactions (FDIC: Part 324.35 and FRB: Part 217.35),

d. Guarantees and credit derivatives (FDIC: Part 324.35 and FRB: Part 217.35),

e. Collateralized transactions (FDIC: Part 324.37 and FRB: Part 217.37)

f. Securitizations (FDIC: Part 324.41-45 and FRB: Part 217.41-45),

g. Equity exposures (FDIC: Part 324.51-52 and FRB: Part 217.51-52),

h. Equity exposures to investment funds (FDIC: Part 324.53 and FRB Part 217.53), and Other aspects of the revised capital rules as applicable; and

i. High Volatility Commercial Real Estate (HVCRE) loans.

High Volatility Commercial Real Estate (HVCRE)

Effective January 1, 2015, the new regulatory capital rules require HVCRE loans to be reported on a separate item in the Call Report and are assigned a risk weighting of 150%.

HVCRE does not include:

1. 1-4 Family Residential Projects
2. Loans for Agricultural Purposes
3. Community Development Loans; and
4. Certain Acquisition, Development, and Construction (ADC) Loans
    a. ADC Loans that meet the following are not HVCRE:
        - LTV is below supervisory limits; **AND**
        - Borrower has contributed 15% or more of “as completed” AV in cash or unencumbered readily marketable assets; **AND**
        - Borrower contributed capital is contractually committed until completion.

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APPENDIX III

Capital Stock – Internal Controls and Audit of Stock

Determine if internal controls and audit of the bank stock books are adequate by considering the following:

1. Have transfers and changes in ownership been properly recorded in stock books?
2. Is there any evidence of:
    a. Missing stock certificates
    b. Improper cancellation of surrendered certificates; or
    c. Improper receipt of issued certificates.
3. Are stock books maintained under dual control?
4. Is there a separation of duties – handling certificates, recording transactions, dividend checks?
5. Are stock books reconciled annually?
6. Annual audit scope reviews internal controls?

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APPENDIX IV

Capital Adequacy - The Impact of Various Factors on the Account

The capital adequacy of an institution is rated based upon, but not limited to, an assessment of the following evaluation factors:

- **The Level and Quality of Capital and the Overall Financial Condition of the Institution**
  Asset quality problems can quickly deplete capital. Poor earnings performance can hinder internal capital formation. Examiner judgment is required to review capital adequacy in relation to the institution's overall condition. Additionally, all capital is not created equally. For instance, voting common equity is a preferred capital source compared to hybrid capital instruments given the debt-like features inherent in the latter.

- **The Ability of Management to Address Emerging Needs for Additional Capital**
  Management's ability to address emerging needs for additional capital depends on many factors. A few of these factors include earnings performance and growth prospects, the financial capacity of the directorate, and the strength of a holding company. A combination of ratio analysis and examiner judgment is required to address this evaluation factor.

- **The Nature, Trend, and Volume of Problem Assets, and the Adequacy of the ALLL and Other Valuation Reserves**
  The nature, trend, and volume of problem assets (including off-balance sheet activity) and the ALLL adequacy are vital factors in determining capital adequacy. The examiner should reference prior Reports of Examination and Uniform Bank Performance Report ratios to perform a level and trend analysis. The review of the nature of problem assets will require a careful analysis of examination findings. The examiner may find the optional Analysis of Loans Subject to Adverse Classification page of the Report helpful in performing this analysis. In reviewing the ALLL adequacy, the examiner will review the bank's ALLL methodology in accordance with outstanding regulatory and accounting pronouncements.

- **Balance Sheet Composition, Including the Nature and Amount of Intangible Assets, Market Risk, Concentration Risk, and Risks Associated with Nontraditional Activities**
  The quality, type, and diversification of on- and off-balance sheet items are important with respect to the review of capital adequacy. Examiners should ensure that management identifies, measures, monitors, and controls the balance sheet risks and that the economic substance of the risks are recognized and appropriately managed. Risk-weighted capital ratios will help the examiner to a degree, but judgment is required to adequately address capital adequacy. Specifically, a portfolio of 100 percent risk-weighted commercial loans at two different institutions may have different risk characteristics depending on the risk tolerance of the management teams. Additionally, regulatory capital ratios alone do not account for concentration risk, market risk, or risks associated with nontraditional activities on the balance sheet. Examiner judgment is integral in assessing both the level of risk and management's ability to adequately manage such risk.

- **Risk Exposure Represented By Off-Balance Sheet Activities**
  The risk exposure from off-balance sheet activities will vary between institutions, but must be considered in the capital evaluation. The volume and nature of business transacted in a fiduciary capacity can be significant in the assessment of capital needs. Contingencies where the bank is acting in a fiduciary or nontraditional banking capacity can expose the bank to surcharges and therefore, operations, controls, and potential exposures must be carefully appraised. Similarly, lawsuits involving the bank as defendant or any other contingent liability, such as off-balance sheet lending, may indicate a need for a greater level of capital protection. Refer to the Contingent Liabilities and Off-Balance Sheet Activities sections for additional discussion.

- **The Quality and Strength of Earnings, and the Reasonableness of Dividends**
  A bank's current and historical earnings record is one of the key elements to consider when assessing capital adequacy. Good earnings performance enables a bank to fund asset growth and remain competitive in the marketplace while at the same time retaining sufficient equity to maintain a strong capital position. The institution's dividend policy is also of importance. Excessive dividends can negate even exceptional earnings performance and result in a weakened capital position, while an excessively low dividend return lowers the attractiveness of the stock to investors, which can be a detriment should the bank need to raise additional equity. Generally, earnings should first be applied to the elimination of losses and the establishment of necessary reserves and prudent capital levels. Thereafter, dividends can be disbursed in reasonable amounts. Refer to the Earnings section for additional discussion on the subject.

- **Prospects and Plans for Growth, as well as Past Experience in Managing Growth**
  Management's ability to adequately plan for and manage growth is important with respect to assessing capital adequacy. A review of past performance and future prospects would be a good starting point for

this review. The examiner may want to compare asset growth to capital formation during recent periods. The examiner may also want to review the current budget and strategic plan to review growth plans. Through this analysis, the examiner will be able to assess management's ability to both forecast and manage growth.

- **Access to Capital Markets and Other Sources of Capital, Including Support Provided by a Parent Holding Company**
  Management's access to capital sources, including holding company support is a vital factor in analyzing capital. If management has ample access to capital on reasonable terms, the institution may be able to operate with less capital than an institution without such access. Also, the strength of a holding company will factor into capital requirements. If a holding company previously borrowed funds to purchase newly is sue d stock of a subsidiary bank (a process referred to as double leverage), the holding company may be less able to provide additional capital. The examiner would need to extend beyond ratio analysis of the bank to assess management's access to capital sources.

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APPENDIX V

Capital Level Given the Bank's Earnings and Risk Profile

Considering the following in determining the adequacy of the bank's capital level:

Earnings performance and trends

Determine if earnings performance enables the bank to fund its growth, remain competitive in the marketplace, and support the overall risk profile. Consider the level and trend of equity capital to total assets as well as asset and equity growth rates.

- Level of the provision for loan and lease losses and the adequacy of the allowance for loan and lease losses. (Consult with examiner(s) evaluating the adequacy of the ALLL.)
- Reliance on core earnings or income from non-recurring events.
- Dividends in relation to current earnings. (Considered excessive?)
- Negative retained earnings.

Risk Profile:

- The adequacy of capital-management policies and related controls;
- The level and trend of adversely classified assets;
- The adequacy of the allowance for loan and lease losses;
- The volume and trends of charged off loans and recoveries;
- The balance sheet structure and liquidity needs (consider prior growth and projected growth);

- The level and type of concentrations;
- The vulnerability of assets and liabilities to stress events; (Note: For institutions under $10 billion in total assets, interagency guidance dictates that stress testing be conducted for subprime lending programs, liquidity, interest rate risk, and certain CRE concentrations.)
- The volume of unrealized gains or losses on available-for-sale securities; (Note: Examiners should closely review this area if an institution has not opted-out of the accumulated other comprehensive income (AOCI) treatment for certain securities gains and losses.)
- The degree of interest rate risk exposure assumed by the bank;
- The reasonableness of booked future tax benefits;
- The accounting treatment and valuation of intangible assets;
- The extent of contingent liabilities associated with trust or other activities;
- Dividend/repayment requirements for government capital programs (e.g. TARP or SBLF);
- Future tax liability for Subchapter S Corporations;
- The extent of any other liabilities not shown on the bank's books, including contingent liabilities;
- The letters from the bank's attorney as to the existence of pending litigation against the bank and its subsidiaries and the potential and estimated loss exposure (This information should be disclosed on the Officer's Questionnaire);
- The volume and risk characteristics of new business initiatives, and higher risk investment or lending strategies (e.g., subprime lending, electronic banking), as well as involvement in nontraditional activities such as nondeposit products, insurance sales, discount brokerage services;
- The extent to which higher-risk loans or investments may require additional capital under the revised regulatory capital rules' risk-weights (for example, high-volatility commercial real estate loans (HVCRE), equity exposures, or certain structured or securitized investments);
- Compliance with state and federal capital level requirements;
- The value of any subordinated debt or intermediate-term preferred stock that is not included as Tier 2 capital because it exceeds 50 percent of Tier 1 capital; and
- The level of operational and reputational risk.

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APPENDIX VI

PROMPT CORRECTIVE ACTION
(AS OF JANUARY 1, 2015)

PCA CAPITAL CATEGORY	Total Risk-Based Capital Ratio	Tier 1 Risk-Based Capital Ratio	CET1 Risk-Based Capital Ratio	Tier 1 Leverage Ratio	Capital Order or Directive
Well Capitalized	≥ 10%	≥ 8%	≥ 6.5%	≥ 5%	NO
Adequately Capitalized	≥ 8%	≥ 6%	≥ 4.5%	≥ 4%(1)	
Undercapitalized	< 8%	< 6%	< 4.5%	< 4%(2)	
Significantly Undercapitalized	< 6%	< 4%	< 3%	< 3%	

PCA CAPITAL CATEGORY	RATIO	Capital Order or Directive
Critically Undercapitalized	Tangible Equity /Total Assets ≤ 2%	

(1) Beginning January 1, 2018. for an advanced approaches bank (as defined in 12 CFR §208.41), the supplementary leverage ratio is ≥ 3%

(2) Beginning January 1, 2018. for an advanced approaches bank (as defined in 12 CFR §208.41), the supplementary leverage ratio is < 3%

Tangible Equity Ratio
The tangible equity ratio is defined as tier 1 capital *plus* outstanding perpetual preferred stock (including related surplus) not included in tier 1 capital *divided by* total assets

For a Comparison of the Components of the Rule prior to January 1, 2015 with the Current Rule See Table 3 in APPENDIX VIII.

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APPENDIX VII

Capital Conservation Buffer

The capital conservation buffer is designed to strengthen an institution's financial resilience during economic cycles. Beginning January 1, 2016, financial institutions will be required to maintain a capital conservation buffer as shown in the table below in order to avoid restrictions on capital distributions and other payments.

Year	CET1 Capital Conservation Buffer
2016	0.625%
2017	1.25%
2018	1.875%
2019	2.50%

If a bank's capital conservation buffer falls below the amount listed in the table above, its maximum payout amount for capital distributions and discretionary payments declines to a set percentage of eligible retained income based on the size of the bank's buffer. The following table reflects the maximum payout ratio for the fully phased in capital conservation buffer beginning January 1, 2019. For the maximum payout ratios during the transition period (January 1, 2016 through December 1, 2018), refer to Section 32.400(a)(2).

Capital Conservation Buffer (% of RWA)	Maximum Payout Ratio (% of Eligible Retained Income)
Greater than 2.5%	No payout limitation
Less than or equal to 2.5% and greater than 1.875%	60%
Less than or equal to 1.875% and greater than 1.25%	40%
Less than or equal to 1.25% and greater than 0.625%	20%
Less than or equal to 0.625%	0%

The types of payments subject to the restrictions include dividends, share buybacks, discretionary payments on tier 1 instruments, and discretionary bonus payments. It is important to note that the FDIC maintains the authority to impose further restrictions and require capital to be commensurate with the bank's risk profile.

A bank cannot make capital distributions or certain discretionary bonus payments during the current calendar quarter if its eligible retained income is negative and its capital conservation buffer was less than 2.50 percent as of the end of the previous quarter. Eligible retained income is a bank's net income as reported in its Call Reports for the four calendar quarters preceding the current quarter, net of any capital distributions, and certain discretionary bonus payments that were made during those four quarters.

To calculate the capital conservation buffer for a given quarter, each minimum risk-based capital requirement in Part 324 is subtracted from the institution's corresponding capital ratios. The following ratios would be subtracted from the institution's corresponding ratio to derive the buffer amount:

- Common equity tier 1 risk-based capital ratio minus 4.5 percent;
- Tier 1 risk-based capital ratio minus 6 percent; and
- Total risk-based capital ratio minus 8 percent.

The lowest of the three measures would represent the institution's capital conservation buffer and is used to determine its maximum payout for the current quarter. To the extent a bank's capital conservation buffer is 2.50 percent or less of risk-weighted assets, the bank's maximum payout amount for capital distributions and discretionary payments would decline.

The FDIC may permit an FDIC-supervised institution that is otherwise limited from making distributions and discretionary bonus payments to make a distribution or discretionary bonus payment upon an institution's request, if the FDIC determines that the distribution or discretionary bonus payment would not be contrary to the purposes of this section, or to the safety and soundness of the FDIC-supervised institution.

Source: FDIC Risk Management Manual of Examination Policies

Return to Core Analysis - Dividends

APPENDIX VIII

Revised regulatory capital rules (Title 12 CFR Part 217 for the FRB and Title 12 CFR Part 32 for the FDIC) for most insured depository institutions, other than large institutions that are subject to advanced approaches, generally became effective on January 1, 2015. These new requirements mandate significant changes to regulatory capital components, risk-weight calculations, minimum regulatory capital ratios, and Prompt Corrective Action thresholds. The revised rules also require institutions to hold a capital-conservation buffer in order to avoid limitations on capital distributions and discretionary bonus payments.

Source: **Interagency Community Bank Guide, July 2013**

Timeline and Transition Period

Community banks will begin transitioning to the new rule on January 1, 2015**.** The new minimum capital requirements are effective on January 1, 2015, whereas the capital conservation buffer and the deductions from common equity tier 1 capital phase in over time. Similarly, non- qualifying capital instruments phase out over time, except as described above. The timeline is summarized in Table 1.

Table 1: Transition Schedule for New Ratios and Capital Definitions

Year (as of January 1)	**2015**	**2016**	**2017**	**2018**	**2019**
Minimum common equity tier 1 capital ratio	4.5%	4.5%	4.5%	4.5%	4.5%
Common equity tier 1 capital conservation buffer	N/A	0.625%	1.25%	1.875%	2.5%
Minimum common equity tier 1 capital ratio plus capital conservation buffer	4.5%	5.125%	5.75%	6.375%	7.0%
Phase-in of most deductions from common equity tier 1 (including 10 percent & 15 percent common equity tier 1 threshold deduction items that are over the limits)[1]	40%	60%	80%	100%	100%
Minimum tier 1 capital ratio	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum tier 1 capital ratio plus capital conservation buffer	N/A	6.625%	7.25%	7.875%	8.5%
Minimum total capital ratio	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum total capital ratio plus conservation buffer	N/A	8.625%	9.25%	9.875%	10.5%

N/A means not applicable.

Most existing capital instruments issued by community banks will continue to count as regulatory capital. Community banks that have concerns about whether existing capital instruments meet the new eligibility criteria should consult with their primary Federal supervisor.

[1]Deductions from common equity tier 1 capital include goodwill and other intangibles, DTAs that arise from net operating loss and tax credit carryforwards (above certain levels), gains-on-sale in connection with a securitization, any defined benefit pension fund net asset (for banking organizations that are not insured depository institutions), investments in a banking organization's own capital instruments, MS investments in the capital of unconsolidated financial institutions (above certain levels).

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Summary Tables

Table 2 covers minimum capital ratios, capital buffers, PCA, and a regulatory capital components comparison. Table 3 provides risk weights by asset category.

Table 2: Capital Components

	Capital Rule	Section
Minimum regulatory capital ratios		
Common equity tier 1 capital / RWA	4.5%	
Tier 1 capital / RWA	6%	Subpart B, §.10
Total capital / RWA	8%	Subpart B, §.10
Leverage ratio	4%	Subpart B, §.10
Capital buffers		
Capital conservation buffer	Capital conservation buffer equivalent to 2.5% of risk-weighted assets; composed of common equity tier 1 capital	Subpart B, §.11
Prompt corrective action levels: Common equity tier 1 capital ratio		
Well capitalized	≥ 6.5%	See footnote[2]
Adequately capitalized	≥ 4.5%	See footnote[2]
Undercapitalized	< 4.5%	See footnote[2]
Significantly undercapitalized	< 3%	See footnote[2]
Prompt corrective action levels: Tier 1 capital ratio		
Well capitalized	≥ 8%	See footnote[2]
Adequately capitalized	≥ 6%	See footnote[2]
Undercapitalized	< 6%	See footnote[2]
Significantly undercapitalized	< 4%	See footnote[2]
Prompt corrective action levels: Total capital ratio		
Well capitalized	≥ 10%	See footnote[2]
Adequately capitalized	≥ 8%	See footnote[2]

	Capital Rule	Section
Undercapitalized	< 8%	See footnote[2]
Significantly undercapitalized	< 6%	See footnote[2]

[2] PCA regulations are found in the following locations: 12 CFR Part 6 for banking organizations supervised by the OCC; Subpart D of Regulation H (12 CFR Part 208), §.208.41 for banking organizations supervised by the Federal Reserve; and 12 CFR Part 324, subpart H for banking organizations supervised by the FDIC.

	Capital Rule	Section
Prompt corrective action levels: Leverage ratio		
Well capitalized	≥ 5%	See footnote[2]
Adequately capitalized	≥ 4%	See footnote[2]
Undercapitalized	< 4%	See footnote[2]
Significantly undercapitalized	< 3%	See footnote[2]
Prompt corrective action levels: Critically undercapitalized category		
Critically undercapitalized	Tangible equity to total assets ≤ 2%	See footnote[2]
Regulatory capital components (definition/instruments)		
Common equity tier 1 capital	Common stock (plus related surplus) and retained earnings plus limited amounts of minority interest in the form of common stock, less the majority of the regulatory deductions.	Subpart C, §.20(b)and §.22
Tier 1 capital	Common stock (plus related surplus) and retained earnings plus; Non-cumulative preferred stock and related surplus;, however, instruments must meet new eligibility criteria; Cumulative preferred stock and related surplus, trust-preferred securities (for BHCs); not permitted going forward, but grandfathered securities are permitted; Limited amounts of minority interest in the form of additional tier 1 capital instruments; Less certain deductions.	Subpart C, §.20(c)and §.22

	Capital Rule	Section
Tier 2 capital	Certain capital instruments (e.g., subordinated debt) and limited amounts of the allowance for loan and lease losses (ALLL) - Generally unchanged for most banking organizations with respect to subordinated debt and the ALLL. However, there are new eligibility criteria that tier 2 capital instruments, including subordinated debt, must meet. Less applicable deductions.	Subpart C, §.20(d)and §.22
Regulatory deductions and adjustments treatment		
Regulatory deductions	Deductions from common equity tier 1 capital include goodwill and other intangibles, DTAs that arise from net operating loss and tax credit carryforwards (above certain levels), gains-on-sale in connection with a securitization, any defined benefit pension fund net asset (for banking organizations that are not insured depository institutions), investments in a banking organization's own capital instruments, MSAs (above certain levels) and investments in the capital of unconsolidated financial institutions (above certain levels). MSAs, DTAs arising from temporary differences that the banking organization could not realize through net operating loss carrybacks, and certain investments in financial institutions, are each limited to 10 percent of common equity tier 1 and in combination are limited to 15 percent of common equity tier 1.	Subpart C,§.22
Regulatory adjustments	For banking organizations that make a one-time, irrevocable AOCI opt-out election, adjustments include the neutralization of unrealized gains and losses on AFS debt securities for regulatory capital purposes.[3]	Subpart C,§.22

[3] Institutions will not be able to reverse their choice in order to benefit from recognizing gains, or to protect against recognizing losses, in AOCI due to changes in the interest rate environment. For example, an institution that has elected to take the AOCI opt-out and neutralize the unrealized gains and losses on AFS debt securities from flowing through to regulatory capital cannot reverse the election in a declining interest rate environment in order to recognize unrealized gains.

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Table 3: Risk Weights

Category	Capital Rule	Section
Cash	0%	Subpart D, §.32(l)(1)
Direct and unconditional claims on the U.S. government, its agencies, and the Federal Reserve	0%.	Subpart D, §.32(a)(1)(i)
Claims on certain supranational entities and multilateral development banks	0%	Subpart D, §.32(b)
Cash items in the process of collection	20%	Subpart D, §.32
Conditional claims on the U.S. government	20%	Subpart D, §.32(a)(1)(ii)
Claims on government- sponsored enterprises (GSEs)	20% on exposures other than equity exposures and preferred stock. 100% on GSE preferred stock.	Subpart D, §.32(c)
Claims on U.S. depository institutions and National Credit Union Administration-insured credit unions	20% Unchanged unless the instrument is an equity exposure or required to be deducted.	Subpart D, §.32(d)(1)
Claims on U.S. public sector entities (PSEs)	20% for general obligations. 50% for revenue obligations.	Subpart D, §.32(e)(1)
Industrial development bonds	100%	Subpart D, §.32
Claims on qualifying securities firms	100% See corporate exposures below.	Subpart D, §.32(f)
One- to four-family loans	50% if first lien, prudently underwritten, owner occupied or rented, not 90 days or more past due or carried in nonaccrual status, is not restructured or modified. 100% otherwise.	Subpart D, §.32(g)
One- to four-family loans modified under Home Affordable Modification Program	50% and 100% The banking organization must use the same risk weight assigned to the loan prior to the modification so long as the loan continues to meet other applicable prudential criteria.	Subpart D, §.32(g)(3)

Category	Capital Rule	Section
Loans to builders secured by one- to four-family properties presold under firm contracts	50% if the loan meets all criteria in the regulation. 100% if the contract is cancelled. 100% for loans not meeting the criteria..	Subpart D, §.32(h)
Loans on multifamily properties	Substantively unchanged. Clarified and updated the manner in which the rule defines these exposures.	Subpart D, §.32(i)
Corporate exposures and consumer loans	100% unless the exposure is an investment in an instrument included in the regulatory capital of another financial institution.	Subpart D, §.32(f)
Commercial real estate (CRE)	100%. 150% for high volatility commercial real estate (HVCRE), which is a subset of CRE, and defined as a credit facility that, prior to conversion to permanent financing, finances or has financed the acquisition, development, or construction of real property, ***unless*** the facility finances: (1) one- to four-family residential properties; (2) certain community development projects; (3) the purchase or development of agricultural land; or (4) commercial real estate projects that meet the criteria in the rule, including criteria regarding the loan-to-value ratio and capital contributions to the project.	Subpart D, §.32(j)
Past-due exposures	150% for the portion that is not guaranteed or secured (does not apply to sovereign exposures). One- to four-family loans that are past due 90 days or more are assigned a 100% risk weight..	Subpart D, §.32(k)

Category	Capital Rule	Section
Assets not assigned to a risk weight category, including fixed assets, premises, and other real estate owned	100%.	Subpart D, §.32(l)(5)
Mortgage-backed securities (MBS), asset-backed securities (ABS), and structured securities	Two general approaches—gross-up approach and simple supervisory formula approach. May also choose to risk weight a securitization exposure at 1,250%.	Subpart D, §.42, §.43, and §.44
Equity exposures	Range of risk weights between 0 and 600% depending on the entity and whether the equity is publicly traded.	Subpart D, §.51 and§.52
Equity exposures to investment funds	There is a 20% risk weight floor on investment fund holdings.. Risk weight is the same as the highest risk weight investment the fund is permitted to hold. (now called the Simple Modified Look-Through Approach) A banking organization may assign risk weight on a pro rata basis based on the investment limits in the fund's prospectus (now called the Alternative Modified Look-Through Approach) A third treatment (called the Full Look-Through Approach) has been introduced and it risk weights each asset of the fund (as if owned directly) and multiplies by the banking organization's proportional ownership in the fund.	Subpart D, §.53
Claims on foreign governments and their central banks, foreign banking organizations, and foreign public sector entities	Risk weight depends on Country Risk Classification (CRC) applicable to the sovereign and whether the sovereign has defaulted within the previous five years.	Subpart D, §.32(a)(2) to(6), (d)(2)and (e)(2) to (6)

Category	Capital Rule	Section
Conversion factors for off-balance sheet items	0% for the unused portion of a commitment that is unconditionally cancellable by the banking organization; 20% for the unused portion of a commitment with an original maturity of one year or less that is not unconditionally cancellable; 20% for self-liquidating, trade-related contingent items; 50% for the unused portion of a commitment with an original maturity of more than one year that is not unconditionally cancellable; 50% for transaction-related contingent items (performance bonds, bid bonds, warranties, and standby letters of credit); 100% for guarantees, repurchase agreements, securities lending and borrowing transactions, financial standby letters of credit, and forward agreements and certain credit- enhancing representations and warranties that are not securitization exposures.	Subpart D,§.33
Derivative contracts	Conversion to an on-balance sheet amount based on current exposure plus potential future exposure and a set of conversion factors. No risk weight cap.	Subpart D,§.34

Category	Capital Rule	Section
Guarantees	Recognizes guarantees from eligible guarantors: sovereign entities, certain international organizations, such as the Bank for International Settlements, Federal Home Loan Banks, Farmer Mac, a multilateral development bank, a depository institution, a bank holding company, a savings and loan holding company, a foreign banking organization, a qualifying central counterparty banking organization, or certain entities that have investment grade debt. Substitution approach that allows the banking organization to substitute the risk weight of the protection provider for the risk weight ordinarily assigned to the exposure	Subpart D,§.36
Collateralized transactions	The new rule provides two approaches for recognizing a broader range of financial collateral: Substitute risk weight of collateral for risk weight of exposure, sometimes with a 20 percent risk weight floor. (now called the Simple Approach) Includes a new treatment (called the Collateral Haircut Approach) that is available only for eligible margin loans, repo-style transactions, and collateralized derivative contracts.	Subpart D,§.37
MSAs, certain DTAs arising from temporary differences, and certain significant investments in the common stock of unconsolidated financial institutions	Items that are not deducted are subject to a 250 percent risk weight.	Subpart D, §.32(l) and§.52

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