CAPITAL ADEQUACY

Core Analysis Decision Factors

Examiners should evaluate the Core Analysis in this section to determine if an Expanded Analysis is necessary. Click on the hyperlinks found within each of the Core Analysis Decision Factors to reference the applicable Core Analysis Procedures.

Do Core Analysis and Decision Factors indicate that risks are adequately identified, measured, monitored, and controlled?

C.1. **Is the capital level sufficient in relation to the risk profile of the bank?** ***Refer to Core Analysis Procedure #19.***

C.2. **Is earnings retention sufficient to provide for future growth, capital maintenance, and potential losses?** ***Refer to Core Analysis Procedure #18.***

C.3. **Are the bank's operating policies, procedures, and risk limits regarding capital preservation adequate?** ***Refer to Core Analysis Procedure #6.***

C.4. **Are information, communication, and regulatory reporting systems adequate and accurate?** ***Refer to Core Analysis Procedures #13-15.***

C.5. **Are the audit or independent review functions adequate?** ***Refer to Core Analysis Procedures #11-12.***

C.6. **Are internal controls adequate?** ***Refer to Core Analysis Procedures #8-10.***

C.7. **Do the Board and senior management effectively supervise this area?** ***Refer to Core Analysis Procedures #20-23.***

CAPITAL ADEQUACY

Core Analysis Procedures

Examiners are to consider the following procedures but are not expected to perform every procedure at every bank. Examiners should complete only the procedures relevant for the bank's activities, business model, risk profile, and complexity. If needed, based on other identified risks, examiners can complete additional procedures. References to laws, regulations, supervisory guidance, and other resources are not all-inclusive.

Note: **Revised regulatory capital rules* for most insured depository institutions, other than large institutions that are subject to *advanced approaches*, generally became effective on January 1, 2015. The 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.**

As the revised rules are phased in (and through full implementation in 2022), financial institutions should be meeting or preparing to meet the new capital requirements. Such steps may include:

- **Evaluating the permissibility of Tier 1 and Tier 2 capital instruments,**
- **Modifying information systems and related procedures to ensure the accurate risk-weighting of assets and other exposures, and**
- **Assessing prospective capital positions and dividend plans relative to minimum regulatory capital ratios and the capital-conservation buffer.**

Examiners should work with bankers to ensure they are appropriately prepared for full implementation of the revised regulatory capital rules. Accordingly, examiners should assess the bank's compliance with applicable (phased-in) capital requirements and the bank's plans and efforts to comply with revised (fully phased-in) regulatory capital requirements. Such assessments may include reviewing the institution's:

- **Understanding of the revised regulatory capital rules and definitions,**
- **Regulatory capital calculations,**
- **Risk-weighted assets calculations,**
- **Capital ratios in relation to the revised Prompt Corrective Action (PCA) standards, and**
- **Capital levels, capital distributions, and discretionary bonus payments in relation to any capital conservation buffer requirements.**

Note: This module is to be used at institutions that do not use the advanced approach.

**** The rules are codified at Title 12 of the Code of Federal Regulations (CFR) for the FRB in Part 217 and codified at Title 12 of the CFR for the FDIC in Part 324.***

Preliminary Review

1. **Review prior examination reports, prior examination work papers, pre-examination memorandum, and file correspondence for an overview of any previously identified capital deficiencies and identification of any government-sponsored capital programs, such as Troubled Asset Relief Program (TARP) and Small Business Lending Fund (SBLF).**

2. Assess management's preparation for phased-in requirements of the capital rules.

3. Review internal and external audits for capital concerns. Review remedial action taken by management to correct prior audit and examination findings.

4. Analyze capital levels and trends in the Uniform Bank Performance Report. Consider loan losses, provisions to the allowance for loan and lease losses (ALLL), problem asset levels, loan growth, material concentration levels, and any operating losses.

5. Determine whether there have been any changes to the corporate or capital structure since the previous examination, such as Sub Chapter S reorganization or new capital offerings.

Policies and Procedures

6. Determine whether policies and practices promote capital preservation and address future capital needs. 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.;**
- **Findings from interviews with management regarding the strategic planning process (including any potential issues due to a change in PCA designation);**
- **Internal risk-monitoring policies and procedures;**
- **The availability of additional capital sources (such as funding provided by insiders, external sources, or additional debt at the parent level); and**
- **The permissibility of current or planned components of capital to qualify as Common Equity Tier 1 Capital or Additional Tier 1 Capital.**

(Note: Coordinate with examiners completing the Management and Internal Control Evaluation Modules)

7. Review historical and planned dividend payout ratios and other planned capital reductions. For planned capital stock retirements, ensure management requested prior regulatory approval.[1] Also, determine whether management evaluated the impact of the capital conservation buffer.

[1] An FDIC-supervised institution must obtain prior FDIC approval for any dividend payment involving a reduction or retirement of capital stock in accordance with Section 324.20 (FDIC); FRB, 12 CFR 303.241.

Internal Controls

8. Determine whether entries to capital accounts are appropriate and properly authorized.

9. Assess controls over off-balance sheet items (Schedule RC-L) and their overall impact to sufficiency of capital levels and needs.

10. Review board and management's procedures to prevent, detect, and respond to policy exceptions that may affect capital.

Audit or Independent Review

11. Determine whether the audit function verifies the accuracy of the capital accounts and regulatory reports; assesses the appropriateness, accuracy, and timeliness of reports produced for the board and executive management; and evaluates the reasonableness of capital planning.

12. Determine whether audits or independent reviews include an assessment of compliance with policies, procedures, and regulatory requirements related to capital issues.

Information and Communication Systems

13. Determine whether board and management reports provide sufficient, timely, and accurate information.

14. Review the accuracy of the bank's calculation of Common Equity Tier 1 Capital, Additional Tier 1, and Tier 2 Capital. Reviewing the bank's calculations may involve some of the following procedures:

- **Review Call Report Schedule RC-R and supporting documentation.**
- **Determine whether the bank has chosen to opt-out of the inclusion of accumulated other comprehensive income (AOCI).**
- **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).**

15. Review the accuracy of the bank's calculation of risk-weighted assets reported on Schedule RC-R, Part II. Review the bank's supporting documentation as appropriate. Reviewing the bank's calculations may involve some of the following procedures:

- **Determine whether risk weights for most assets conform with applicable requirements (FDIC: Part 324.32, FRB: Part 217.32).**
- **As applicable, review risk weights for other categories of exposures, such as:**
  - **Off-balance sheet exposures (FDIC: Part 324.33 and FRB: part 217.33),**
  - **Over-the-counter derivative contracts (FDIC: Part 324.34 and FRB: Part 217.34),**
  - **Cleared transactions (FDIC: Part 324.35 and FRB: Part 217.35),**
  - **Guarantees and credit derivatives (FDIC: Part 324.35 and FRB: Part 217.35),**
  - **Collateralized transactions (FDIC: Part 324.37 and FRB: Part 217.37)**
  - **Securitizations (FDIC: Part 324.41-45 and FRB: Part 217.41-45),**
  - **Equity exposures (FDIC: Part 324.51-52 and FRB: Part 217.51-52),**
  - **Equity exposures to investment funds (FDIC: Part 324.53 and FRB Part 217.53), and**
  - **Other aspects of the revised capital rules.**

16. Review the bank's capital ratios under the revised PCA standards. If the bank is less than well capitalized under the revised standards (or appears that it could become less than well capitalized due to the phase-in of deductions or other aspects of the new capital rules) consider whether the bank has a reasonable strategy to meet the fully phased-in requirements over the transition period.

17. Review the bank's capital conservation buffer and the appropriateness of any distributions and discretionary bonus payments.

Earnings Considerations

18. Determine whether earnings performance enables the bank to fund growth, compete in the marketplace, and support the overall risk profile. Consider the level and trend of equity capital in relation to asset levels, quality, and growth rates.

- **Assess the impact of current and projected provisions to the ALLL on capital retention and growth.**
- **Review whether the bank is relying on core earnings or non-recurring income.**
- **Determine whether dividends are excessive compared to current earnings. (Consider applicable state and federal laws and regulations.)**

Risk Profile Considerations

19. Determine whether the existing capital level is adequate for the bank's risk profile when considering the following items:

- **The adequacy of capital-management policies and controls;**
- **The level, type, and trend of adversely classified assets;**
- **The adequacy of the ALLL;**
- **The volume and trends of charged-off loans and recoveries;**
- **The balance sheet structure and liquidity needs;**
- **The level, type, and trend of concentrations;**
- **The vulnerability of assets and liabilities to adverse events;** ***(Note: While not required for most institutions, stress testing or sensitivity analysis is considered a prudent practice to assist in the identification, measurement, and mitigation of risks.)***
- **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 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 trusts or other activities;**
- **Dividend/repayment requirements for government capital programs (e.g. TARP or SBLF);**
- **The extent of any other liabilities not shown on the bank's books, including contingent liabilities;**
- **The existence of pending litigation against the bank (and its subsidiaries) and the potential and estimated loss exposure;** ***(Note: This information should be disclosed on the responses to the Officer's Questionnaire or First Day Letter.)***
- **The volume and risk characteristics of new business initiatives and higher risk investment or lending strategies (e.g., subprime lending or mobile banking), or involvement in nontraditional activities such as non-deposit products, insurance sales, or 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, equity exposures, or certain structured or securitized investments);**
- **Compliance with state and federal laws and regulations regarding capital levels; and**
- **The level of operational and reputational risk.**

Managerial Effectiveness

20. Assess the adequacy of management's actions to correct criticisms related to capital in previous examination reports and recent internal or external audits.

21. Evaluate management's effectiveness at preparing for and reacting to changes in economic, industry, and regulatory environments.

22. Determine whether management effectively identifies and manages: • **The institution's overall risk profile,** • **Factors that may change the institution's risk profile, and** • **How a change in the risk profile will affect the sufficiency of capital levels.**
23. Determine whether management adequately prepared for full implementation of the revised regulatory capital rules by: • **Evaluating its prospective capital position pursuant to the new rule;** • **Adopting ways to measure capital (including capital components and deductions, risk-weighted assets, and minimum capital ratios); and** • **Ensuring that the board is aware of these changes.**
End of Core Analysis. If needed, Continue to the Expanded and Impact Analyses.