

<b>CAPITAL ADEQUACY</b>
<b>Core Analysis Decision Factors</b>

*Examiners should evaluate the Core Analysis in this section to determine whether 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 institution's risk profile? 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 institution's operating policies, procedures, and risk limits regarding capital preservation adequate? Refer to Core Analysis [Procedures #6-7](#).**

**C.4. Are information, communication, and regulatory reporting systems adequate and accurate? Refer to Core Analysis [Procedures #13-17](#).**

**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 #20-22](#).**

## 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.*

**The U.S. Basel III regulatory capital rules\* became effective on January 1, 2014, for large institutions that are subject to *advanced approaches* and on January 1, 2015, for all other insured depository institutions. Effective January 1, 2020, (April 1, 2020, for institutions that elect not to early adopt) regulatory capital calculations for non-advanced approaches institutions will change, with the maximums for threshold-based deductions increasing to 25 percent from 10 percent. The combined 15 percent limit on such capital also goes away. In addition, the distinction between significant and non-significant investments in the unconsolidated capital of a financial institution is removed for non-advanced approaches institutions.**

**Also effective January 1, 2020, banking organizations under \$10 billion in average total consolidated assets that meet certain criteria are eligible to adopt the community bank leverage ratio (CBLR) framework. Under this framework, institutions that adopt CBLR are required to calculate the leverage ratio only and are not required to calculate the risk-based capital ratios and capital conservation buffer. Such institutions are required to maintain a leverage ratio above 9 percent and are generally deemed well-capitalized for purposes of Prompt Corrective Action (PCA) if the leverage ratio remains above 9 percent.<sup>1</sup>**

*\* The rules are codified at 12 CFR 217 for the FRB and 12 CFR 324 for the FDIC.*

#### Preliminary Review

1. Review prior examination reports, prior examination work papers, the examination planning memorandum, and file correspondence for an overview of any previously identified capital concerns.<sup>2</sup>

2. Review internal and external audits for capital concerns.

3. Review action taken by management to correct prior audit and examination findings.

<sup>1</sup> In accordance with Section 4012 of the Coronavirus Aid, Relief, and Economic Security Act, the banking agencies issued interim final rules (IFR) to reduce the CBLR ratio to 8 percent for 2020, 8.5 percent for 2021, and 9 percent thereafter. For further information refer to the IFR attached to the April 6, 2020 interagency press release titled [Agencies Announce Changes to the Community Bank Leverage Ratio](#).

<sup>2</sup> Also note any government-sponsored capital programs, such as Troubled Asset Relief Program (TARP) and Small Business Lending Fund (SBLF).

<p><b>4. Analyze capital levels and trends in the Uniform Bank Performance Report. Consider credit losses on financial assets, provisions to the appropriate credit loss reserve,<sup>3</sup> problem asset levels, loan growth, material concentration levels, and any operating losses.</b></p>
<p><b>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.</b></p>
<p><b>Policies and Procedures</b></p>
<p><b>6. Determine whether policies and practices promote capital preservation and address future capital needs.<sup>4</sup> Consider the following:</b></p> <ul style="list-style-type: none"> <li>• 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.;</li> <li>• Findings from interviews with management regarding the strategic planning process (including any potential issues due to a change in PCA designation);</li> <li>• Internal risk-monitoring policies and procedures;</li> <li>• The availability of additional capital sources (such as funding provided by insiders, external sources, or additional debt at the parent level); and</li> <li>• The permissibility of current or planned components of capital to qualify as Common Equity Tier 1 Capital or Additional Tier 1 Capital (institutions electing to use the CBLR framework do not calculate or report Tier 2 Capital).</li> </ul>
<p><b>7. Review historical and planned dividend payout ratios and other planned capital reductions. For planned capital stock retirements, ensure management requested prior regulatory approval.<sup>5</sup> Also, determine whether management assessed the impact of the capital conservation buffer.<sup>6</sup></b></p>
<p><b>Internal Controls</b></p>
<p><b>8. Determine whether entries to capital accounts are appropriate and properly authorized.</b></p>

<sup>3</sup> Either the Allowance for Loan and Lease Losses (ALLL), or the Allowance for Credit Losses (ACL) for institutions that adopted ASU 2016-13.

<sup>4</sup> Coordinate with examiners completing the Management and Internal Control Evaluation Modules.

<sup>5</sup> FDIC: Refer to 12 CFR 324.20 and 12 CFR 303.241; FRB: Refer to section 11 of the Federal Reserve Act (12 U.S.C. 329) and section 208.5 of Regulation H (12 CFR 208.5).

<sup>6</sup> Institutions under the CBLR framework do not calculate or report the buffer.

<p><b>9. Assess controls over off-balance sheet items (Schedule RC-L) and the overall impact of off-balance sheet items on capital levels and needs.</b></p>
<p><b>10. Review procedures to prevent, detect, and respond to policy exceptions that may affect capital.</b></p>
<p><b>Audit or Independent Review</b></p>
<p><b>11. Determine whether audit verifies the accuracy of the capital accounts and regulatory reports; assesses the appropriateness, accuracy, and timeliness of reports produced for the board and management; and evaluates the reasonableness of capital planning.</b></p>
<p><b>12. Determine whether audits or independent reviews assess compliance with the institution's policies and procedures and regulatory requirements related to capital issues.</b></p>
<p><b>Information and Communication Systems</b></p>
<p><b>13. Determine whether board and management reports provide sufficient, timely, and accurate information.</b></p>
<p><b>14. Review the accuracy of the institution's calculation of Common Equity Tier 1 Capital, Additional Tier 1 Capital, and Tier 2 Capital (institutions under the CBLR framework do not calculate or report Tier 2 Capital). Reviewing the institution's calculations may involve some of the following procedures:</b></p> <ul style="list-style-type: none"> <li>• Review Call Report Schedule RC-R and supporting documentation.</li> <li>• Determine whether management opted out of including accumulated other comprehensive income (AOCI).</li> <li>• Review applicable deductions and adjustments for each tier of capital.</li> <li>• Consider whether the institution has non-qualifying capital instruments subject to phase-out (refer to 12 CFR 324.20 (FDIC) and 12 CFR 217.20 (FRB) for criteria for capital instruments for each tier of capital, and 12 CFR 324.300 (FDIC) and 12 CFR 217.300 (FRB) for transition provisions).</li> </ul>
<p><b>15. Review the accuracy of the institution's risk-weighting calculations reported on Schedule RC-R, Part II for institutions reporting under the risk-based capital framework. Review the institution's supporting documentation as appropriate.</b></p>

<b>16. Review the institution's capital ratios under the PCA standards.</b>
<b>17. Review the institution's capital conservation buffer, if applicable, and the appropriateness of any distributions and discretionary bonus payments.</b>
<b>Earnings Considerations</b>
<p><b>18. Determine whether earnings performance enables the institution 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.</b></p> <ul style="list-style-type: none"> <li>• Assess the impact of current and projected provisions to the appropriate credit loss reserve (either ALLL or ACL) on capital retention and growth.</li> <li>• Review whether the institution relies on core earnings or non-recurring income.</li> <li>• Determine whether dividends are excessive compared to current earnings. Consider applicable state and federal laws and regulations.</li> </ul>
<b>Risk Profile Considerations</b>
<p><b>19. Determine whether the existing capital level is adequate for the institution's risk profile when considering the following items:</b></p> <ul style="list-style-type: none"> <li>• The adequacy of capital-management policies and controls;</li> <li>• The level, type, and trend of adversely classified assets;</li> <li>• The appropriateness of the credit loss reserve (either ALLL or ACL);</li> <li>• The volume and trends of charged-off loans and recoveries;</li> <li>• The balance sheet structure and liquidity needs;</li> <li>• The level, type, and trend of concentrations;</li> <li>• The vulnerability of assets and liabilities to adverse events;<sup>7</sup></li> <li>• The volume of unrealized gains or losses on available-for-sale debt securities;<sup>8</sup></li> <li>• The degree of interest rate risk exposure;</li> <li>• The reasonableness of booked, future tax benefits;</li> <li>• The accounting treatment and valuation of intangible assets;</li> <li>• The extent of contingent liabilities associated with trusts or other activities;</li> <li>• Dividend or repayment requirements for government capital programs (e.g. SBLF);</li> <li>• The extent of any other liabilities not shown on the institution's books, including contingent liabilities;</li> </ul>

<sup>7</sup> Stress testing or sensitivity analysis is not required for most institutions but can be a prudent practice to assist in the identification, measurement, and mitigation of risks.

<sup>8</sup> Examiners should closely review this area if an institution has not opted-out of the AOCI treatment for certain securities gains and losses.

<ul style="list-style-type: none"> <li>• The existence of pending litigation against the institution (and its subsidiaries) and the potential and estimated loss exposure;<sup>9</sup></li> <li>• 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;</li> <li>• The extent to which higher risk loans or investments may require additional capital under the revised regulatory capital rules' risk-weights (e.g., high-volatility commercial real estate loans, equity exposures, or certain structured or securitized investments);</li> <li>• Compliance with state and federal laws and regulations regarding capital levels; and</li> <li>• The level of operational risk.</li> </ul>
<b>Managerial Effectiveness</b>
<b>20. Assess management's actions to correct criticisms related to capital in previous examination reports and recent internal or external audits.</b>
<b>21. Evaluate management's effectiveness at preparing for and reacting to changes in economic, industry, and regulatory environments.</b>
<b>22. Determine whether management effectively identifies and manages:</b> <ul style="list-style-type: none"> <li>• The institution's overall risk profile;</li> <li>• Factors that may change the institution's risk profile;</li> <li>• The effect of changes in the risk profile on capital levels; and</li> <li>• The effect of changes to capital rules, and, if applicable assess management's preparations for these changes.</li> </ul>
<b>End of Core Analysis. If needed, Continue to the Expanded and Impact Analyses.</b>

<sup>9</sup> This information should be disclosed on the responses to the Officer's Questionnaire or First Day Letter.