

# Capital Adequacy

Examiners should evaluate the above-captioned function against the following control and performance standards. The Standards represent control and performance objectives that should be implemented to help ensure the bank operates in a safe and sound manner, and that the entity's objectives are carried out. Associated Risks represent potential threats to the bank if the standards are not achieved and maintained. The Standards are intended to assist examiners in analyzing important functions that may warrant additional review. All of the following Standards may NOT need to be considered at every bank. Conversely, these do NOT represent all of the control and performance standards needed for every bank. Examiners should continue to use their judgement when assessing risk.

Standards	Associated Risks
<b>MANAGEMENT AND CONTROL</b>	
Operating policies, including the strategic plan, budget and dividend policy, promote capital preservation, and an appropriate return on assets and equity.	Weak controls may increase the bank's exposure to errors and omissions.  Inadequate controls increase the potential for fraud and abuse.
Management has established adequate internal controls for its capital and treasury activities.	Weak controls may increase the bank's exposure to errors and omissions.  Inadequate controls increase the potential for fraud and abuse.
Internal reviews and audits discuss deficiencies in capital and treasury activities, and reports are provided directly to senior management and the board.	Identification, communication, and correction of deficiencies may be inadequate.
Adequate information and communication systems have been established which produces accurate information.	Inaccurate management information reports may result in poor or uninformed decisions.
Management has the proven ability and experience to maintain an adequate capital base.	Excessive risk taking may result in capital depletion.
<b>PERFORMANCE</b>	
The level of capital allows for continued operations if operating losses or other adverse financial results are experienced.	Bank may become insolvent as a result of increased credit, market, or operational risk.
Earnings retention sufficiently augments capital to provide for future growth, capital maintenance, and potential losses.	Insufficient capital levels limit the bank's ability to grow and remain competitive in the marketplace.
Management's dividend policy is reasonable.	Payment of the excessive dividends could impair capital protection.
Capital is adequate to support anticipated asset growth.	Capital ratios may decline to an unacceptable level if asset growth is excessive.
Capital levels are sufficient to provide for adequate protection from the risks associated with concentrations, Special Mention, adversely classified assets, and other contingencies.	Potential losses from higher risk assets may result in a weakened capital position.  Capital ratios may decline to an unacceptable level if certain types of contingent liabilities are realized.
Securities depreciation is insignificant.	Market declines in debt and equity securities place increased strain on capital.
Capital is sufficient relative to the bank's liquidity needs.	Management may not be able to borrow necessary funds to meet liquidity needs if capital levels are low.

Standards	Associated Risks
	Low capital levels make it difficult to obtain funds at a reasonable cost.
Capital is sufficient relative to interest rate risk.	Excessive interest rate risk exposure may cause a significant decline in earnings capacity thereby impairing the ability to maintain or augment capital.  A loss in public confidence increases reputation and liquidity risk, which may cause a liquidity crisis.
The level of capital is in compliance with applicable laws and regulations.	Noncompliance with required minimums increases the bank's legal risk and may require additional regulatory action.
The bank holding company does not use extensive double leverage.	The bank may not have sufficient means to support cash dividend requirements of the parent company.

## Capital Adequacy

### Core Analysis Decision Factors

Examiners should evaluate Core Analysis in this section for significance and to determine if an Expanded Analysis is necessary. Negative responses to Core Analysis Decision Factors may not require proceeding to the Expanded Analysis. Conversely, positive responses to Core Analysis Decision factors do not preclude examiners from proceeding to the Expanded Analysis if deemed appropriate.

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

**Core Answer: General Comment:(If any)**

#### **Core Analysis Decision Factors**

C.1. Are the bank's operating policies, procedures, and risk limits regarding capital preservation adequate?

C.2. Are internal controls adequate?

C.3. Are the audit or independent review of this area adequate?

C.4. Are information and communication systems adequate and accurate?

C.5. Is earnings retention sufficient to provide for future growth, capital maintenance, and potential losses?

C.6. Is the capital level sufficient in relation to the risk profile of the bank?

C.7. Does the Board and senior management effectively supervise this area?

## Capital Adequacy

### Expanded Analysis Decision Factors

This section evaluates the significance and materiality of deficiencies or other specific concerns identified in the Core and Expanded Analyses.

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

**Expanded Answer: General Comment:(If any)**

#### **Expanded Analysis Decision Factors**

E.1. Has management taken sufficient action to address capital deficiencies?

E.2. Are capital deficiencies immaterial to the bank's condition? (If capital ratios are below regulatory minimums, proceed to Impact Analysis.)

## Capital Adequacy

Consider the following procedures at each examination. Examiners are encouraged to exclude items deemed unnecessary. This procedural analysis does not represent every possible action to be taken during an examination. The references are not intended to be all-inclusive and additional guidance may exist. Many of these procedures will address more than one of the Standards and Associated Risks. For the examination process to be successful, examiners must maintain open communication with bank management and discuss relevant concerns as they arise.

### IMPORTANT

**Several of these procedures will be completed during the review of other functional areas. Avoid duplication by coordinating procedures at the beginning of the examination. Duplicate procedures are presented here for analytical purposes since the examiner should consider conclusions derived from the review of other functional areas.**

### 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.
- 2 Review internal and external audits for capital concerns.
- 3 Review remedial action taken by management to correct audit and examination findings.
- 4 Analyze the Uniform Bank Performance Report for current and historical capital levels and trends.
- 5 Determine if there have been any changes to the corporate structure since the previous examination, e.g., Chapter S reorganization.
- 6 Review the bank's dividend policy and historical and planned dividend payout ratios.
- 7 Assess any other potential risks to capital, e.g., a growing trend in nonperforming loans, rapid growth, etc.

### POLICIES AND PROCEDURES

- 8 Determine whether management's policies and practices promote capital preservation considering the following issues:
  - 8 A The strategic plan and its underlying assumptions giving consideration to projected asset growth, dividend plans, asset quality, income, liquidity, funds management, deposit structure, parent company relationship, contingent liabilities, expansion plans, competition, economic conditions, etc. (Coordinate with Management and Internal Control Evaluation.)
  - 8 B Interviews with bank management regarding the strategic planning process.
  - 8 C Management's risk monitoring procedures.

### INTERNAL CONTROLS

- 9 Determine if entries to capital accounts are appropriate.
  - 9 A Review changes in equity accounts and investigate unusual entries.
- 10 Determine if entries to capital accounts are properly authorized.

- 11 Determine if controls exist over off-balance sheet items. Consult with those examiners completing the loan portfolio, securities, and interest rate risk modules.
- 12 Review board and management's procedures to prevent, detect, and respond to policy exceptions.

## **AUDIT / INDEPENDENT REVIEW**

- 13 Determine if the audit function verifies the accuracy of the capital accounts and regulatory reporting, the accuracy and timeliness of management reports, and the reasonableness of capital budgeting.
- 14 Determine if the audit or independent review program provides sufficient coverage relative to the institution's size and risk profile. The program should:
  - 14 A Recommend corrective action when warranted.
  - 14 B Verify the implementation of corrective action commitments.
  - 14 C Determine compliance with policies, procedures, and regulatory requirements related to capital issues.
  - 14 D Determine if managerial reports provide sufficient information relative to the size and risk profile of the organization and evaluate the accuracy and timeliness of reports produced for the board and executive management.

## **INFORMATION AND COMMUNICATION SYSTEMS**

- 15 Determine if board and management reports provide sufficient information. Evaluate the accuracy and timeliness of these reports.
- 16 Validate the accuracy of the Consolidated Reports of Condition and Income related to capital entries.

## **EARNINGS CONSIDERATIONS**

- 17 Determine if earnings performance enables the bank to fund its growth and remain competitive in the marketplace. Consider the level and trend of equity capital to total assets as well as asset and equity growth rates.
  - 17 A Review the level of the provision for loan and lease losses and the adequacy of the allowance for loan and lease losses.
  - 17 B Review whether the bank is relying on core earnings or income from non-recurring events.
  - 17 C Determine if dividends are excessive compared to current earnings. (FRB consider regulatory requirements such as Section 5199 of the U. S. C. and Section 5204 of the Revised Statutes).

## **RISK PROFILE CONSIDERATIONS**

- 18 Determine if the existing capital level is adequate for the bank's risk profile when considering the following items:

- 18 A The level and trend of adversely classified assets.
- 18 B The adequacy of the allowance for loan and lease losses.
- 18 C The volume of charged off loans and recoveries.
- 18 D The balance sheet structure and liquidity needs.
- 18 E 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.
- 18 F The volume of unrealized gains or losses on available-for-sale securities.
- 18 G The amount of interest rate risk experienced by the bank.
- 18 H The reasonableness of booked future tax benefits.
- 18 I The accounting treatment and valuation of intangible assets.
- 18 J The extent of contingent liabilities associated with trust activities.
- 18 K 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.
- 18 L The extent of any other liabilities not shown on the bank's books, including contingent liabilities.
- 18 M The level and type of concentrations.
- 18 N The volume and risk characteristics of new business initiatives, and atypical or higher risk investment or lending strategies, e.g., subprime lending, electronic banking, etc.
- 18 O Compliance with state and federal capital level requirements.
- 18 P Designated as less than Well Capitalized for PCA purposes.

## **MANAGERIAL EFFECTIVENESS**

- 19 Determine if senior management is aware of established regulatory capital guidelines.
- 20 Assess the adequacy of management's actions to correct criticisms related to capital in previous examination reports as well as recent internal and external audits.
- 21 Evaluate management's effectiveness at reacting to changes in economic, industry, and regulatory environments.
- 22 Determine if management has developed an effective internal control program.
- 23 Where necessary, assess management's ability to raise additional capital and the reasonableness of capital restoration plans.

## Capital Adequacy

Generally, procedures used in the Expanded Analysis should target concerns identified in the Core Analysis and Decision Factors. Expanded procedures associated with Core Analysis and Decision Factors of no concern need not be used. The flexible guidelines specified for the Core Analysis also apply here.

### CAPITAL MAINTENANCE AND PRESERVATION

- 1 If there is significant uncertainty whether the bank's future performance will be satisfactory, estimate future capital levels using information collected during the examination and discussions with management.
- 2 If compliance with risk-based capital minimums is marginal, complete the following calculations:
  - 2 A Risk-weighted assets.
  - 2 B Risk-weighted capital ratios.
- 3 Review any existing capital restoration plans.
- 4 If the bank was recently recapitalized, review the volume of insider loans for a corresponding increase. (Note: This situation may indicate internal funding of the recapitalization which is prohibited by most state laws.)

### DIVIDENDS

- 5 Determine if there is undue pressure to pay increased dividends.
  - 5 A Review bank holding company equity profile to determine if excessive double leverage exists.
  - 5 B Determine if the financial condition of affiliate banks has resulted in increased pressure to pay excessive dividends.
  - 5 C Determine if stockholder debt requirements have resulted in increased pressure to pay dividends.

### CONTINGENT LIABILITIES

- 6 If high levels of off-balance sheet activities exist, review supporting documentation and determine if management properly monitors these potential exposures. (Note: Monitoring of concentrations should include contingent liabilities.)
- 7 Review insurance for possible coverage of potential contingent liability losses.
- 8 Review actual complaints (legal documentation) that management is litigating (focus primarily on cases involving insiders or significant dollar amounts).

### CONTROLS

- 9 Prepare a detailed capital account reconciliation and scrutinize entries for appropriateness.
- 10 Review the bank's procedures regarding stock certificates to determine the following controls are in place:



10 A Unissued stock certificates are under dual control.

10 B Redeemed stock certificates are properly controlled and canceled.

## REPORTING

11 Consider the implication of ESOPs and associated accounting procedures. Refer to the Consolidated Reports of Condition Instructions. (FDIC: Refer to Advisory Opinions including 81-15, 84-22, 90-18, 91-33, and 93-75, FDIC Rules and Regulations Part 333, and various EITF Abstracts - - available from Accounting Specialists -- for additional information.)

## Capital Adequacy

Impact Analysis reviews the impact that deficiencies identified in the Core and Expanded Analysis and Decision Factors have on the bank's overall condition. Impact Analysis also directs the examiner to consider possible supervisory options.

- 1 Determine the effect of current capital levels on the future viability of the bank.
  - 1 A Assess management's ability to reverse deteriorating trends and augment capital through earnings.
  - 1 B Assess the ability of the bank to raise capital from existing shareholders, issue new capital instruments, or access alternative sources of capital.
  - 1 C If the capital level and trend raise going-concern issues, estimate time to reach insolvency as well as time to reach the two percent Tier 1 capital threshold under PCA.
- 2 Determine the need for administrative and enforcement actions, formulate specific recommendations, and advise the appropriate supervisors on the nature of the concerns. (FDIC: Field Office Supervisor, Regional Office.)
- 3 Discuss potential regulatory responses with management and the board.
  - 3 A Formal and informal enforcement actions such as cease and desist orders, MOUs, and capital directives.
  - 3 B Banks with less than the minimum leverage capital requirement must submit a capital restoration plan.
  - 3 C Banks with less than a 2% Tier 1 leverage capital ratio must enter into and comply with a written agreement to increase capital to acceptable levels.
  - 3 D Under PCA guidelines, banks that are undercapitalized, significantly undercapitalized, or critically undercapitalized must file and implement an approved written capital plan and may be subject to other restrictions.