

Capital Regulatory Compliance

Institution:

SCD:

This workpaper addresses regulatory requirements for capital bylaws and resolutions; preferred stock and subordinated debt included in regulatory capital; and capital buffers only. Other capital-related regulations are included in separate examination workpapers or are examined with other areas (e.g., capital distributions, capital ratio calculations, business planning, shareholder reporting, and borrower rights).

Capital Bylaws & Resolutions

Question	Response	Comment
<p>1. Do bylaws or an annual board resolution stipulate the institution will:</p> <p><i>Note: To include otherwise eligible purchased and allocated equities in tier 1 and tier 2 capital, the institution must affirm its intent to adhere to these regulatory requirements in either bylaws or a resolution that is reaffirmed by the board annually in the capital plan. If the institution does not comply with these bylaws or resolution requirements, then only URE, paid-in capital, and the statutory minimum stock requirement equities can be included in regulatory capital.</i></p>		
<p>a. Obtain FCA prior approval (under 628.20(f)) before retiring, redeeming, revolving, or calling any equities included in common equity tier 1 (CET1), additional tier 1 (AT1), or tier 2 capital? 615.5200(d)(1)</p> <p><i>Note 1: There are 3 types of FCA prior approval: deemed prior approval (institutions meeting “safe harbor” requirements do not need to submit a request to FCA); 30-day approval (submit request to FCA); and advance approval (submit request to FCA).</i></p> <p><i>Note 2: Equities outstanding less than 7 years (CET1) or 5 years (tier 2) may be retired under the safe harbor if they are mandated to be redeemed or retired by a court order, are held by the estate of a deceased former borrower, or are required to be canceled under 615.5290 in connection with a restructuring under part 617. 628.20(f)(1) and (6).</i></p> <p><i>Note 3: Prior approval is not required for retiring term instruments included in regulatory capital (e.g., limited life preferred stock, subordinated debt) at their maturity date; although such instruments must be</i></p>		

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<i>gradually phased out of tier 2 capital as they approach maturity.</i>		
<p>b. Have a minimum redemption or revolvement period of at least 7 years for equities included in CET1 capital? 615.5200(d)(2)</p> <p><i>Note: The statutory minimum stock requirement (i.e., the lesser of \$1,000 or 2 percent of the loan) is not subject to a minimum holding period. 628.20(b)(1)(xiv)(B)</i></p>		
c. Have a minimum no-call or redemption period of at least 5 years for equities included in AT1 capital? 615.5200(d)(2)		
d. Have a minimum no-call, redemption, or revolvement period of at least 5 years for equities included in tier 2 capital? 615.5200(d)(2)		
<p>e. Obtain FCA prior approval before:</p> <ul style="list-style-type: none"> • Redesignating URE equivalents as equities that the institution may exercise its discretion to redeem other than upon dissolution or liquidation? • Removing equities or other instruments from CET1 capital, AT1 capital, or tier 2 capital other than through repurchase, cancellation, redemption, or revolvement? • Redesignating equities included in one component of regulatory capital (CET1 capital, AT1 capital, or tier 2 capital) for inclusion in another component of regulatory capital? 615.5200(d)(3) 		
f. Not revolve URE equivalents except upon dissolution or liquidation and shall not offset URE equivalents against a loan in default except as required under final court order or as required by 615.5290 in connection with a restructuring? 615.5200(d)(4)		
2. <i>For banks and associations</i> , were the capitalization bylaws adopted by the board and approved by the shareholders? 615.5220(a)		
3. <i>For banks and associations</i> , do bylaws address each class of equity and how each is issued, transferred, converted, and retired? 615.5220(a)(1)		

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<p>4. <u>For banks and associations</u>, do bylaws address, for each equity class, a description of:</p> <ul style="list-style-type: none"> • The class(es) of persons to whom such stock may be issued? • Voting rights? • Dividend rights and preferences? • Priority upon liquidation, including any rights to the residual estate? 615.5220(a)(2) 		
<p>5. <u>For banks and associations</u>, do bylaws address the number of shares and par value of equities authorized to be issued for each class of equities? 615.5220(a)(3)</p> <p><i>Note: Bylaws are not required to address limits on number of shares or par value for the following equities:</i></p> <ul style="list-style-type: none"> • <i>Equities that are required to be purchased as a condition of obtaining a loan, lease, or related service.</i> • <i>Non-voting stock resulting from the conversion of voting stock due to repayment of a loan.</i> • <i>Non-voting equities that are issued to an association's funding bank in conjunction with any agreement for a transfer of capital between the association and the bank.</i> • <i>Equities resulting from the distribution of earnings.</i> 		
<p>6. <u>For Farm Credit Banks, agricultural credit banks (ACBs) (with respect to loans other than to cooperatives), and associations</u>, do bylaws establish the percentage [of loan amount] or dollar amount of equity that serves as the “required investment” for obtaining a loan (which cannot be less than 2 percent of the loan amount or \$1,000, whichever is less)? 615.5220(a)(4)</p> <p><i>Note: This “required investment” can be expressed as a range within which the board may periodically determine the requirement.</i></p>		
<p>7. <u>For ACBs (with respect to cooperative loans)</u>, do bylaws establish the percentage [of loan amount] or dollar amount of equity (or guarantee fund investment) that serves as a “target investment” in the bank for patronage-sourced business (which shall be not less than 2 percent of the loan amount or \$1,000, whichever is less)? 615.5220(a)(5)</p> <p><i>Note: This “targeted investment” can be expressed as a range within which the board may periodically determine the requirement.</i></p>		

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<p>8. <u>For banks and associations</u>, do bylaws define the way all classes of equities will be retired, including a provision that all equities (except for any remaining protected equities) are retireable at the sole discretion of the board, provided that all minimum regulatory capital standards and board-established capital requirements are met? 615.5220(a)(6)</p>		
<p>9. <u>For banks and associations</u>, do bylaws address the way earnings will be allocated and distributed, including the basis on which patronage will be paid, and is it consistent with cooperative principles? 615.5220(a)(7)</p> <p><i>Note: The relevant cooperative principles are described in FCA Regulation 615.5230(c). This regulation requires that patronage distributions be on an equitable and nondiscriminatory basis. If separate earnings pools are established for payment of patronage, they must be rational and equitable, and must ensure each patron receives a fair share of earnings and bears a fair share of the institution's expenses. This regulation requires that dividends paid on common stock and participation certificates be on a per-share basis without preference as to rate or priority of payment within the same class or between different classes of common stock or participation certificates (except that any class of common stock or participation certificates that results from a conversion of allocated surplus may be subordinated to other classes of common stock and participation certificates for dividend payments). This regulation further requires that all classes of common stock and participation certificates (except those resulting from a conversion of allocated surplus) be accorded the same rights and priority with respect to impairment or institution liquidation.</i></p>		
<p>10. <u>For banks</u>, do bylaws define the way capitalization requirements of the bank will be allocated and periodically equalized among its owners? 615.5220(a)(8)</p>		
<p>11. <u>For service corporations (including the Leasing Corporation)</u>, did the board adopt capitalization bylaws, subject to voting shareholder approval, that address:</p> <ul style="list-style-type: none"> • The requirements in 615.5220(a)(1), (2), and (3), to the extent applicable? • The way equities will be retired? • The way earnings will be distributed? <p>615.5220(b)</p>		

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Preferred Stock & Subordinated Debt Included in Regulatory Capital

This section addresses regulatory requirements related to preferred stock and subordinated debt. Specifically, this section addresses qualifying criteria for including these instruments in regulatory capital, issuance and retirement requirements, policy requirements, and limits on total third-party capital. The Office of Regulatory Policy (ORP) and Office of General Counsel (OGC) regularly review many of these areas as part of FCA's clearance of offering circulars. Thus, if any problems are identified, the examiner should consult with ORP and OGC, as well as with the capital markets specialist examiners.

Question	Response	Comment
12. Regarding the issuance of preferred stock and subordinated debt included in regulatory capital:		
a. Was the issuance of preferred stock approved by a majority of the shares voting for each class of equities adversely affected by the preference, voting as a class, regardless of whether such classes are otherwise authorized to vote? 615.5230(c)(1)		
b. Did the institution obtain FCA review and clearance for the offering disclosure statement prior to issuance? 615.5255(a) , (b), (e), and (f) <i>Note 1: 615.5255(c) and (d) require disclosure content that is not addressed in this workpaper because this is an area normally addressed by ORP as part of the clearance process.</i> <i>Note 2: Refer to 615.5255(j), which identifies certain purchasers where the requirements of 615.5255 do not apply.</i>		
c. Did the institution ensure the issuance complied with all applicable federal and state securities laws (e.g., via legal review)? 615.5255(k)		
d. Did insiders (officers, directors, employees, agents) refrain from disclosing inaccurate or misleading information in connection with the sale of equities, or omit information needed to prevent disclosures from being misleading? 615.5255(h)		
e. <i>For banks and associations</i> , was a method established to disclose and make information on <u>insider</u> preferred stock transactions readily available to the public? 615.5255(i) <i>Note: At a minimum, each institution offering preferred stock must make this information available upon request.</i>		

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Question	Response	Comment
f. <i>For associations</i> , was the preferred stock offering made available to each of the association's members on the same basis? 615.5245(b)		
g. <i>For associations</i> , did they refrain from extending credit to fund the purchase of the association's preferred stock? 615.5245(c)		
13. Did preferred stock and subordinated debt included in AT1 capital and tier 2 capital comply with the qualifying criteria listed in FCA Regulations 628.20(c)(1) and (d)(1) , respectively?		
14. Regarding retirement of noncumulative perpetual preferred stock included in AT1 capital, and retirement of term preferred stock and subordinated debt included in tier 2 capital:		
a. Did the institution wait at least 5 years from issuance to exercise a call option? 628.20(c)(1)(v) and (d)(1)(v) <i>Note: The instrument may be called earlier than 5 years upon the occurrence of a regulatory or tax event as defined in 628.20(c)(1)(v) and 628.20(d)(1)(v).</i>		
b. Did the institution obtain prior approval from FCA prior to calling, redeeming, or repurchasing preferred stock or subordinated debt included in regulatory capital? 628.20(c)(1)(v)(A) , (c)(1)(vi) , (d)(1)(v)(A) , and (d)(1)(x) <i>Note: Prior approval is not required for term instruments retired at the maturity date pursuant to 628.20(f)(1).</i>		
c. Prior to calling noncumulative perpetual preferred stock, or immediately thereafter, did the institution either replace the instrument with an equal amount of equity meeting criteria for inclusion in tier 1 capital (i.e., CET1 or AT1 capital) or demonstrate to the satisfaction of FCA that, following redemption, the institution would continue to hold capital commensurate with its risk? 628.20(c)(1)(v)(C)		
d. Prior to calling term preferred stock or subordinated debt, or immediately thereafter, did the institution either replace the instrument		

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<p>with an equal amount of equity meeting criteria for inclusion in tier 1 or tier 2 capital or demonstrate to the satisfaction of FCA that, following redemption, the institution would continue to hold capital commensurate with its risk? 628.20(d)(1)(v)(C)</p>		
<p>15. If the institution issued preferred stock, did it establish a written board policy that addresses the following, at a minimum:</p> <p><i>Note: Examiners should consider testing preferred stock retirement transactions to validate the institution is complying with its policy requirements.</i></p>		
<p>a. Delegations of authority for retirement and the conditions of delegation, which must meet the specific requirements outlined in 615.5270(c) and include minimum levels for regulatory capital standards as applicable and commensurate with the volatility of the preferred stock? 615.5270(d)(1)</p>		
<p>b. Limitations on the amount of preferred stock that may be retired during a single quarter or shorter period? 615.5270(d)(2)</p>		
<p>c. Provisions ensuring all stockholder requests for retirement are treated fairly and equitably? 615.5270(d)(3)</p>		
<p>d. Restrictions prohibiting institution insiders (e.g., officers, directors, employees, or agents) from retiring preferred stock in advance of the release of material non-public information concerning the institution to other stockholders? 615.5270(d)(4)</p>		
<p>e. When insiders may retire their preferred stock? 615.5270(d)(5)</p>		
<p>f. <i>For associations</i>, conditions or limits on the amount of preferred stock that any one holder, or small number of holders, may acquire? 615.5245(a)</p>		
<p>16. Did the board review its preferred stock policy at least annually to ensure it remains appropriate? 615.5270(e)</p>		
<p>17. Did the institution accurately measure its limit on the amount of third-party capital that can be included in TRC (tier 1 and tier 2 capital)? 628.23(a) and (b)</p>		

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Question	Response	Comment
<p><i>Note: The limit is measured as the greater of (a) or (b):</i></p> <p>a. <i>The then-existing limit, if any (i.e., the previous limit; in other words, if a decline in CET1 or TRC capital causes third-party capital currently included in regulatory capital to exceed limits, then the institution would still be able to include its previous level of third-party capital in regulatory capital ratios).</i></p> <p>b. <i>The lesser of (i) or (ii), where all amounts are based on the average of the previous 4 quarters:</i></p> <p style="padding-left: 20px;">i. <i>CET1.</i></p> <p style="padding-left: 20px;">ii. <i>40% of TRC, where the maximum amount of third-party capital that can be included in TRC is calculated as:</i></p> <p style="padding-left: 40px;"><i>(TRC – Third-Party Capital currently included in TRC) x 2/3</i></p> <p><i>Example: If TRC currently equals \$100 and includes \$10 in third-party capital, then third-party capital equals 10% of TRC which complies with the 40% limit. The institution could issue and include a maximum \$60 of third-party capital in TRC and remain in compliance with the 40% limit [(100 - 10) x 2/3 = 60]. In other words, if the institution issues a total of \$60 in third-party capital, TRC would total \$150 [(100 - 10) + 60], and third-party capital would equal 40% of TRC [60 / 150].</i></p>		

Capital Buffers

This section addresses limits on capital distributions and certain discretionary bonus payments when an institution's capital ratios fall below the 2.5 percent capital conservation buffer or 1.0 percent leverage buffer. This section should be completed when the TRC, tier 1, CET1, or tier 1 leverage ratio falls below 10.5 percent, 8.5 percent, 7.0 percent, or 5.0 percent, respectively. This section is divided into two parts: the first part is a worksheet to help identify buffer and payout amounts, and the second part is the evaluation of regulatory compliance. Workpaper WP 11.2-3 addresses additional regulatory requirements for capital distributions.

Worksheet

The following worksheet may be used to calculate and verify the maximum capital distributions and discretionary bonus payments allowed when capital ratios fall below the capital conservation or leverage buffer. The examiner should obtain the institution's worksheets and other documentation supporting its calculations.

Item	Amount	Comment
18. Eligible Retained Income (ERI) (sum of preceding 4 quarters – e.g., completion of this as of 9/30 would be based on the 4 quarters ended 6/30) 628.11(a)(2)(i)		
a. Net Income		
b. Less: Capital distributions not reflected in 18a (net of any tax impacts not already included in net income)		

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Item	Amount	Comment
c. Eligible Retained Income (item 18a minus 18b)		
19. Capital Conservation Buffer Calculation (preceding quarter-end – e.g., completion of this as of 9/30 would use ratios as of 6/30) 628.11(a)(3)(i)(A) thru (C) <i>Note: If the result for row a., b., or c. is less than zero, then enter "0" in the respective row.</i>		
a. TRC Ratio minus 8.0%		
b. T1 Ratio minus 6.0%		
c. CET1 Ratio minus 4.5%		
d. Capital Conservation Buffer (lesser of items 19a, 19b, and 19c)		
20. Leverage Buffer Calculation (preceding quarter-end) 628.11(a)(3)(i)(D)		
a. T1 Leverage Ratio minus 4.0%		
21. Maximum Payout Ratio 628.11(a)(2)(ii) and (v)		
a. From Table 1 in 628.11, which maximum payout ratio corresponds to the capital conservation buffer listed in item 19d?		
b. From Table 2 in 628.11, which maximum payout ratio corresponds to the leverage buffer listed in item 20a?		
c. Maximum Payout Ratio (lesser of items 21a and 21b)		
22. Maximum Payout Amount for Current Quarter (e.g., quarter ended 9/30 using the example above) 628.11(a)(2)(iii) and (vi)		
a. ERI x Maximum Payout Ratio (item 18c multiplied by 21c) <i>Note: If ERI is negative and one or more capital ratios fall below a capital buffer, the maximum payout amount is zero pursuant to 628.11(a)(4)(iii).</i>		
23. Actual Payout Amounts for Current Quarter (e.g., quarter ended 9/30 using the example above) <i>Note: The examiner should request this information from the institution, along with underlying support for this information.</i>		
a. Capital distributions 628.11(a)(2)(vii) <i>Note: Capital distributions should reconcile in part to Call Report Schedule RI-D, recognizing additional adjustments may be required by 628.11(a)(2)(vii) that are not included in that schedule.</i>		

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Item	Amount	Comment
b. Discretionary bonus payments 628.11(a)(2)(viii) and (ix)		
c. Total actual payout amount (item 23a plus 23b)		

Evaluation

The following questions should be addressed to evaluate regulatory compliance when completing the capital buffer worksheet and validating the institution's measures.

Question	Response	Comment
24. Determine if the institution accurately measured compliance with capital buffer requirements:		
a. Did the institution accurately measure its Eligible Retained Income (item 18c)? 628.11(a)(2)(i)		
b. Did the institution accurately measure its maximum payout ratio and payout amount (items 21c and 22a)? 628.11(a)(2)(ii), (iii), (v), and (vi)		
c. Did the institution accurately measure and capture all forms of its capital distributions (item 23a)? 628.11(a)(2)(vii) <i>Note: FCA Regulation 628.11(a)(2)(vii) lists the various forms of capital distributions.</i>		
d. Did the institution accurately measure its discretionary bonus payments (item 23b)? 628.11(a)(2)(viii) <i>Note: FCA Regulation 628.11(a)(2)(viii) and (ix) defines discretionary bonuses as payments to senior officers (chief executive officer, chief operations officer, chief financial officer, chief credit officer, general counsel, persons in similar positions, any other persons responsible for a major policy-making function), where (1) the institution retains discretion on the amount and whether to make the payment, (2) the amount paid is determined by the institution without prior promise to or agreement with the senior officer, and (3) the senior officer has no express or implied contractual right to the bonus payment.</i>		
25. Did total capital distributions and discretionary bonus payments comply with capital buffer limits? 628.11(a)(4) <i>Note: If item 22a > 23c, the answer is "Yes." If item 22a < 23c, the answer is "No" indicating the institution exceeded capital distribution and discretionary bonus limits.</i>		

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Question	Response	Comment
<p>26. Did the institution refrain from creating an obligation to pay capital distributions or discretionary bonus payments if such obligations would cause total payouts to exceed the maximum payout amount? 628.11(a)(4)(i)</p> <p><i>Note: Consideration should be given to whether the answer to row 25 is "No" or is likely to be answered "No" in future quarters due to capital distributions and bonus payments.</i></p>		
<p>27. If capital distributions and discretionary bonus payments exceeded the maximum payout amount, did the institution obtain FCA prior approval? 628.11(a)(4)(iv)</p>		

Other Comments:

This workpaper is not intended to create any rights, substantive or procedural, enforceable at law or in any administrative proceeding. While the workpaper was carefully reviewed for applicability and accuracy, changes may occur in the wording or interpretation of laws and regulations. If a situation arises where the workpaper becomes inconsistent with applicable laws or regulations, the requirement of the laws or regulations will prevail. Examination scope may vary between institutions. On a particular examination activity, the workpaper may not pertain to all factual situations or interpretations, additional concerns or issues may be addressed that are not covered in the workpaper, and some portions of the workpaper may not be used.