

Safety and Soundness

**Capital
Adequacy
(C)**

**Asset
Quality
(A)**

**Management
(M)**

**Earnings
(E)**

**Liquidity
(L)**

**Sensitivity to
Market Risk
(S)**

**Other
Activities
(O)**

Capital and Dividends

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Introduction

The Office of the Comptroller of the Currency's (OCC) *Comptroller's Handbook*, "Capital and Dividends," is prepared for use by OCC examiners in connection with their examination and supervision of national banks and federal savings associations (collectively, banks).¹ Each bank is different and may present specific issues. Accordingly, examiners should apply the guidance in this booklet consistent with each bank's individual circumstances. When it is necessary to distinguish between them, national banks and federal savings associations (FSA) will be referred to separately.

The Economic Growth, Regulatory Relief, and Consumer Protection Act (Pub. L. 115–174) (Act) was signed into law on May 24, 2018. The Act requires the OCC, the Federal Deposit Insurance Corporation (FDIC), and the Board of Governors of the Federal Reserve System (Federal Reserve) (collectively, the agencies) to establish a simplified leverage ratio capital framework for qualifying community banks. The Act also provides that, effective upon enactment, the agencies may only require a bank to assign a heightened risk weight to a high-volatility commercial real estate (HVCRE) exposure if such exposure is an HVCRE acquisition, development, or construction (HVCRE ADC) loan as defined in section 214 of the Act. As of the publication date of this "Capital and Dividends" booklet, the agencies are working jointly to amend their regulations to incorporate the Act's changes. The agencies issued the "Interagency Statement Regarding the Impact of the Economic Growth, Regulatory Relief, and Consumer Protection Act" on July 6, 2018, setting out the positions they will take while making regulatory changes.² For more information, examiners should refer to OCC News Release 2018-69, "Agencies Issue Statement Regarding the Impact of the Economic Growth, Regulatory Relief, and Consumer Protection Act," and consult the supervisory office.

This booklet provides guidance for examiners to assess a bank's capital adequacy and compliance with capital and dividend requirements. This booklet also presents the regulatory capital framework and discusses the rules that define regulatory capital and establish the minimum standards. Expanded examination procedures provide detailed guidance for examining capital and dividends in circumstances warranting extra attention beyond the core assessment.³ In addition, this booklet provides an internal control questionnaire and verification procedures.

¹ The term "bank" also includes trust banks and federal branches and agencies, since the licensing and regulatory capital rules are generally applicable. There may be circumstances, however, regarding trust banks and federal branches and agencies in which the OCC has developed specific regulations. With regard to these entities, refer to the "Federal Branches and Agencies Supervision" booklet of the *Comptroller's Handbook*; for trust banks, refer also to OCC Bulletin 2007-21, "Supervision of National Trust Banks, Revised Guidance: Capital and Liquidity."

² Refer to OCC News Release 2018-69 for the interagency statement. Appendix C in this booklet sets out the position the agencies will take with respect to HVCRE.

³ For the capital core assessment factors and procedures, refer to the "Community Bank Supervision" and "Large Bank Supervision" booklets of the *Comptroller's Handbook*.

Adequate capital levels enable banks to meet the credit needs of their communities and promote the stability of individual banks and the federal banking system. Federal laws and regulations also require banks to meet minimum regulatory capital standards. These requirements generally serve as a restraint on excessive risk-taking and expansion activities, promote safety and soundness in the banking system, and protect the Deposit Insurance Fund.

The OCC expects a bank to hold capital commensurate with the nature and extent of the risks to which the bank is exposed and for the bank's management to have the ability to identify, measure, monitor, and implement adequate controls over the bank's risks. The core assessment of a bank's capital adequacy and the assignment of the capital component rating include an analysis of many different risks and factors, individually and in the aggregate, that affect a bank's capital.⁴ Examiners' assessments of capital adequacy consider the totality of a bank's circumstances beyond meeting minimum regulatory capital ratios (i.e., the OCC's conclusions on a bank's capital adequacy may differ significantly from conclusions that might be drawn solely from an evaluation of compliance with minimum regulatory capital requirements).

Capital covers a wide range of topics, including capital adequacy, changes in equity capital, prompt corrective action (PCA),⁵ minimum regulatory capital requirements, and dividend-paying capacity. The OCC, along with the other federal banking agencies, continue to review and develop the regulatory capital rules. References to other rules or related booklets, such as the *Comptroller's Licensing Manual* booklets, are also subject to change. As such, this "Capital and Dividends" booklet may not always reflect the most recent changes in rules and regulations or publications of new guidance. Because this booklet summarizes the rules at a given point in time, reviewing the underlying rules, regulations, and references is necessary.

Capital as Equity

The difference between a bank's assets and liabilities is its equity (or capital accounts), as determined under generally accepted accounting principles (GAAP).⁶ Equity represents the book value of a company. Banks report equity on a quarterly basis in the Consolidated Reports of Condition and Income (call report) on schedules RI-A ("Changes in Bank Equity Capital") and RC ("Balance Sheet"). Increases or decreases in these capital accounts may

⁴ Refer to the "Bank Supervision Process" booklet of the *Comptroller's Handbook* for a discussion of the CAMELS rating system, including the capital component rating. A bank's composite rating under the Uniform Financial Institutions Rating System, or CAMELS, integrates ratings from six component areas: capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risk. Evaluations of the component areas take into consideration the bank's size and sophistication, the nature and complexity of its activities, and its risk profile. For the capital core assessment factors and procedures, refer to the "Community Bank Supervision" and "Large Bank Supervision" booklets of the *Comptroller's Handbook*.

⁵ Refer to 12 CFR 6 and 12 USC 1818o.

⁶ References to GAAP mean U.S. GAAP, unless otherwise noted.

trigger additional requirements under the OCC's licensing rules.⁷ An equity section on a bank's balance sheet may be made up of the following.

Common stock: A common stock instrument of a bank represents the basic rights of ownership, such as the right to vote for the directors of the bank, to share in profits (e.g., through dividends), the right to inspect corporate books and records, and to vote on significant changes in corporate policy. Common stockholders exercise their basic rights in proportion to the shares they own and are generally entitled to one vote per share in all matters.⁸ They have the right to share in the distribution of cash or other assets, after payment to creditors, in the event of a bank's liquidation. Thus, common stockholders are structurally subordinated to creditors in the event of liquidation. Typically, a bank issues only one class of common stock. A bank's common stock must meet the relevant eligibility criteria in 12 CFR 3.20(b)(1)(i)–(xiii) to count as common equity tier 1 (CET1) capital, a component of regulatory capital.

Preferred stock: Preferred stock is a special class of stock that carries certain preferences, such as a prior claim on dividends over common stockholders. Preferred stock typically does not convey voting rights, or may convey only limited voting rights, to the holders. Like common stockholders, preferred stockholders have basic ownership rights and do not have priority over creditors in the event of liquidation. Whether preferred stock can be included in regulatory capital depends on whether it meets the relevant eligibility criteria in 12 CFR 3.20(c) or (d) to be included in additional tier 1 (AT1) or tier 2 capital.

Additional paid-in capital: Additional paid-in capital represents payments received from investors that exceed the par value of the bank's outstanding stock instruments (i.e., the stock's issue price minus par value for all shares outstanding). The market value of a stock instrument generally does not coincide with the par value because market price reflects many factors, such as overall economic conditions, the financial health of the issuing bank, the liquidity of the stock, competition, dividend policies, growth potential, and market saturation. Banks account for additional paid-in capital in accordance with GAAP and typically record capital stock on their books at a stated par value,⁹ although this practice may vary based on where the bank is incorporated.

Additional paid-in capital may also include capital contributions in the form of cash, cash equivalents, marketable assets, or other assets (noncash contributions) that were not received as part of a stock issuance. Additional paid-in capital is part of a bank's permanent capital. Banks may include additional paid-in capital in regulatory capital under 12 CFR 3.

⁷ Refer to the "Capital and Dividends" booklet of the *Comptroller's Licensing Manual*, for a discussion of the requirements for increasing or decreasing the various capital accounts. There are no requirements for increasing or decreasing retained earnings to record net income or loss from a bank's operations.

⁸ Refer to 12 USC 61 for national banks and 12 CFR 5.22(e) for FSAs.

⁹ In some states, an issuance may be made that has no par value. A bank considering such an issuance should consult with the OCC in advance.

Treasury stock and unearned employee stock ownership plan (ESOP) shares: These items are considered contra-equity components that reduce equity capital. Treasury stock is deducted from regulatory capital. Similarly, common stock contributed to an ESOP but unearned by employees is deducted from equity capital. Once the shares are earned by ESOP participants, however, they may count as CET1 regulatory capital.

Retained earnings: Retained earnings, or undivided profits, represent accumulated net income less dividends, and reflect a bank's profitability over time. Retained earnings are fully included as CET1 capital.

Accumulated other comprehensive income (AOCI): GAAP explicitly excludes certain gains and losses from earnings and requires them to be reported as other comprehensive income (OCI). AOCI represents OCI for the current and all prior periods.¹⁰ Gains or losses recognized in AOCI include

- net unrealized gains or losses on available-for-sale (AFS) securities.
- accumulated net gains or losses on cash flow hedges.
- cumulative foreign currency translation adjustments.
- minimum pension liability adjustments.

While AOCI is included as part of a bank's equity under GAAP, the capital rule allows non-advanced approaches¹¹ banks to make a one-time election to choose, on an ongoing basis, to offset certain components of AOCI when making regulatory capital calculations. Banks in existence as of March 31, 2015, made the AOCI opt-out election on the bank's March 31, 2015, call report. Banks that come into existence after March 31, 2015, must make the AOCI opt-out election on the bank's first call report.¹² Banks that make such an election can reduce the volatility in their regulatory capital calculations by adding back certain components of AOCI (if negative) or subtracting them (if positive).

Types of Banks and Ownership

National banks are organized as stock institutions. An FSA may be organized either in stock form or as a mutual savings association.

¹⁰ Under GAAP, AOCI is presented on the balance sheet as a component of equity and is reported separately from retained earnings and additional paid-in capital. AOCI represents an accumulation of certain items that are included in OCI but excluded from net income. Refer to the Statement of Financial Accounting Concepts No. 5, "Recognition and Measurement in Financial Statements of Business Enterprises," and Accounting Standards Codification (ASC) No. 220, "Comprehensive Income." Refer also to the instructions for reporting AOCI in the call report. For a discussion of AOCI and regulatory capital, refer to appendix A of this booklet.

¹¹ 12 CFR 3.100(b)(1) describes banks subject to the advanced approaches risk-based capital rules (advanced approaches banks).

¹² Refer to the Instructions for Preparation of Consolidated Reports of Condition and Income (or call report instructions) for more information regarding the AOCI opt-out election.

Stock organizations: When banks are organized with stock, they are considered “stock organizations.” The board of directors authorizes the number of shares a bank can sell, and the authorization must comply with applicable federal securities laws and regulations, including anti-fraud provisions and OCC regulations.¹³ One or more individuals or any business entity (e.g., a partnership, trust, or corporation) may own bank stock. A stock organization may list its shares on an organized exchange or trade them over the counter. A privately held bank typically maintains lists of interested buyers in and sellers of its stock and should have policies and processes to determine the price of the bank’s stock.

Stock organizations may raise capital by selling common or preferred stock. Their ability to sell stock is an important safety and soundness consideration. For example, the market value (or price) of a bank’s stock in relationship to its earnings and book value are important factors in assessing the bank’s health and its general ability to raise capital.

For federal income tax purposes, banks that are stock organizations are formed either as a standard corporation (C-corporation) or as a subchapter S corporation (S-corporation). A C-corporation is recognized as a separate tax-paying entity. Its profits are taxed when earned, and any distributions (i.e., dividends) to shareholders are taxed at the shareholder level when distributed. The alternative is to file as an S-corporation, which receives pass-through tax treatment for federal income taxes.

S-corporations: A stock organization, whether newly established or initially formed as a C-corporation, may elect, at any time, to organize as an S-corporation. An S-corporation allocates its earnings on a proportional basis to its shareholders based on their percentage of ownership. Each shareholder reports his or her allocation of the S-corporation’s earnings on his or her tax return, regardless of how much of the earnings the bank distributes to the shareholders. Shareholders typically expect an S-corporation to make cash dividend distributions sufficient to cover their tax liability on the allocated earnings.

A bank electing to be an S-corporation must meet certain Internal Revenue Service (IRS) requirements. For example, the S-corporation is limited to 100 eligible shareholders and one class of stock. All shareholders must consent to the subchapter S election. In addition, certain entities or individuals, such as partnerships, corporations, and certain nonresident shareholders who are not U.S. citizens, are not eligible to own the stock. Eligible shareholders are generally individuals, trusts, and estates.

Banks can lose their S-corporation status voluntarily (by actively revoking the status) or involuntarily (by violating IRS requirements), which would cause the S-corporation to revert to filing taxes as a C-corporation. Although there is no penalty or direct tax when subchapter S status is lost, it may have adverse effects on capital if the bank has to reestablish deferred tax accounts upon reverting to a C-corporation. S-corporation banks typically have agreements to prevent shareholders from selling their stock or otherwise transferring their stock to ineligible investors. To ensure that the bank does not violate IRS requirements, the

¹³ Refer to the “Capital and Dividends” booklet of the *Comptroller’s Licensing Manual*.

management of an S-corporation bank should monitor stock sales and transfers, including any associated arrangements and agreements, as part of its corporate governance process.¹⁴

The S-corporation stock and shareholder restrictions pose challenges to a bank's efforts to raise capital. Generally, if an S-corporation needs to raise capital, it can sell additional authorized (but not yet issued) amounts of the same class of stock to existing stockholders. This is one approach to avoid violating the number of shareholders and class of stock limitations. If existing stockholders are unable or unwilling to provide sufficient additional capital, an S-corporation may seek a limited number of additional eligible investors while staying within the 100-shareholder limitation. Other alternatives for raising capital, such as exceeding the shareholder number limitation or issuing a second class of stock, would cause an involuntary termination of the S-corporation election. If an S-corporation cannot successfully increase its capital by selling stock to either current or new eligible shareholders, it may need to voluntarily revoke its S-corporation status, which would allow it to pursue investors who do not comply with IRS requirements (i.e., ineligible investors), issue a second class of stock, or exceed the 100-shareholder limitation.

Mutual savings associations:¹⁵ Mutual savings associations are non-stock depository institutions. Savings associations organized under federal banking laws are federal mutual savings associations and are regulated by the OCC.¹⁶ Mutual savings associations do not issue capital stock and have no stockholders. Instead, all holders of a mutual savings association's savings, demand, and other authorized accounts in the savings association are members of the association. Mutual savings association members have the right to vote on significant policies, amend the charter and bylaws, nominate and elect directors, remove directors for cause, request special meetings, communicate with other members, inspect the corporate books and records, and share pro rata in the assets of the savings association following a liquidation.

Mutual savings associations build capital almost exclusively through retained earnings and may receive pledged deposits or issue mutual capital certificates,¹⁷ although these forms of capital are rare and are subject to OCC approval.

¹⁴ The board of an S-corporation bank should consider consulting with legal and tax professionals when setting up an S-corporation or engaging in certain other activities, such as selling shares of stock.

¹⁵ Refer to OCC Bulletin 2014-35, "Mutual Federal Savings Associations: Characteristics and Supervisory Considerations."

¹⁶ Mutual savings associations that are not federal mutual savings associations are organized under state law and regulated by the FDIC—or by the Federal Reserve if the state-chartered savings bank is a member of the Federal Reserve System.

¹⁷ Refer to section 5(b)(4) of the Home Owners' Loan Act (HOLA) (12 USC 1464(b)(4)) and the implementing regulation at 12 CFR 163.74 that authorizes mutual capital certificates. Mutual capital certificates may be included in tier 1 capital only if they satisfy the eligibility criteria for regulatory capital, as applicable, in 12 CFR 3.20. The regulatory capital rule in table 9 at 12 CFR 3.300(c) phases out any cumulative capital instruments from a mutual banking organization's tier 1 capital.

A mutual savings association may reorganize into a mutual holding company structure to raise capital.

Mutual holding companies: In 1987, Congress authorized mutual savings associations and savings banks to reorganize themselves in a holding company structure, in which case, the holding company is the mutual entity.¹⁸ The purpose of this new structure was to afford all mutual savings associations insured by the Federal Savings and Loan Insurance Corporation or the FDIC the opportunity to raise capital in an amount less than that required in a full mutual-to-stock conversion, while retaining at least a partial mutual form of organization. A mutual holding company reorganization permits a mutual savings association to raise incremental amounts of capital, provided that the mutual holding company retains a majority interest in the subsidiary savings association.

A mutual holding company may engage in capital-raising activities. A mutual holding company's subsidiary savings association may issue up to 49.9 percent of its stock to persons other than the mutual holding company.

Alternatively, a mutual holding company may create a new subsidiary stock holding company that would exist between the mutual holding company and its savings association in a three-tier corporate structure. The subsidiary stock holding company, like a stock savings association subsidiary, must issue at least a majority of its shares to the mutual holding company and could issue up to 49.9 percent of its shares to the public. The stock holding company must own 100 percent of the shares of the savings association subsidiary.

Changes to Permanent Capital

Permanent capital is defined as common stock, preferred stock, and additional paid-in capital. The OCC may require prior approval or notice for changes to permanent capital, including issuing or redeeming common or preferred stock or receiving capital contributions from a holding company. Refer to the "Capital and Dividends" booklet of the *Comptroller's Licensing Manual* for more information.

Change in Control

Control is defined as the power, directly or indirectly, to direct the bank's management or policies or to vote 25 percent or more of a class of the bank's voting securities. The OCC may consider significant control by shareholders when reviewing a bank's activities for safety and soundness, and the OCC may monitor significant ownership changes. Generally, parties that wish to acquire control of a bank through the purchase, assignment, transfer,

¹⁸ The Federal Reserve Board regulates mutual holding companies. Although mutual FSAs are not "owned," their members (i.e., those who are depositors) may be referred to as "owners." Technically, mutual members do not own the entities in the same way that shareholders own a stock FSA.

pledge, or other disposition of voting stock must receive prior approval from the appropriate OCC licensing office and submit relevant information as applicable.¹⁹

A bank that manages its own stock activities internally (and appoints an internal party to act as the bank's transfer agent) should maintain adequate documentation of current shareholder information, including the number of shares owned, date acquired, certificate number(s) held, and the amount and type of dividend paid to each stockholder. When a bank uses an internal party to act as the transfer agent, it should have sufficient controls and risk management established over the transfer agent's activities.²⁰ Most banks outsource all or part of managing stock activities to a third-party registered transfer agent. In addition to banks' responsibility to provide oversight of any third-party services²¹ and engage in appropriate risk management over third parties, including transfer agents, banks also are responsible for ensuring that they maintain and make available complete and accurate shareholder records that include names and residences of all shareholders and the number of shares held by each shareholder.²²

Dividend Practices and Requirements

Dividends are distributions of a company's earnings to shareholders. For FSAs, the term "distribution" also includes payments to members of a mutual savings association. To declare a dividend, the board must take formal action to designate the medium of payment, dividend rate, shareholder record date, and date of payment. The bank must record dividends as a liability when they are declared.

Dividends are typically in the form of a cash payment but may also be in the form of stock or other assets. Stock dividends are distributions of additional shares to stockholders in proportion to the number of shares they own. Whether paid in cash, stock, or other assets, the dividend payment comes from a bank's retained earnings. A stock distribution is reported by transferring an amount equal to the fair value of the additional shares from retained earnings to a category of permanent capital (e.g., common stock). The amount transferred from retained earnings may not be less than the par or stated value of the additional shares. When dividends are used to distribute real or personal property, this transaction is referred to as "noncash dividends" (also sometimes called a "dividend-in-kind").

¹⁹ Refer to 12 USC 1817(j), 12 CFR 5.50, and the "Change in Bank Control" booklet of the *Comptroller's Licensing Manual*.

²⁰ Refer to the "Asset Management Operations and Controls" booklet of the *Comptroller's Handbook*. Also, refer to section 12 of the Securities Exchange Act of 1934 for more information on transfer agents and requirements for registration and to the Federal Financial Institutions Examination Council's (FFIEC) Reporting Form TA-1, "Transfer Agent Registration and Amendment Form," and Form TA-1 instructions.

²¹ Refer to OCC Bulletin 2013-29, "Third-Party Relationships: Risk Management Guidance," and OCC Bulletin 2017-21, "Third-Party Relationships: Frequently Asked Questions to Supplement OCC Bulletin 2013-29."

²² Refer to 12 USC 62 (national banks) and 12 CFR 5.22 (stock FSAs).

Banks should have policies that clearly articulate the bank's objectives and approaches for dividends. These policies should include provisions that restrict dividends and other capital distributions when the bank does not, or may not, meet required capital levels or internal capital targets. Policies should include criteria to determine whether capital distributions are consistent with the bank's earnings, overall budget projections, and strategic and capital plans. Before declaring dividends, a bank's board should consider the bank's regulatory capital level (including capital buffers) and future capital needs and determine whether a sufficient amount of capital would remain after the payment.

Paying excessive dividends in light of a bank's earnings can weaken a bank's capital position and represents an unsafe or unsound practice. There may be instances when a proposed dividend does not reduce capital below the minimum required level in the short term but is still imprudent. For example, this could occur if the bank is experiencing high and increasing levels of problem assets or has planned significant growth.

Depending on the amount of the dividend in relation to a bank's retained earnings and type of dividend, the OCC may require the bank to file a notice or application before declaring a dividend. Refer to the "Capital and Dividends" booklet of the *Comptroller's Licensing Manual* for the procedures for notice or application to the OCC for dividends and distributions by national banks and FSAs.

Regulatory Capital Framework

The regulatory capital framework is designed to ensure that a bank's capital is of a sufficient quality and quantity to support the bank's operations and risk profile, and to protect the Deposit Insurance Fund. The two primary components of the regulatory capital framework are 12 CFR 3, "Capital Adequacy Standards," and 12 CFR 6, "Prompt Corrective Action."²³

The OCC and the other federal banking agencies actively participate in the Basel Committee on Banking Supervision (BCBS), an international standard setter for the prudential regulation of banks. BCBS standards are not binding in the United States. After the BCBS finalizes a standard, the U.S. federal banking agencies determine whether the standard would be appropriate for U.S. banking organizations and, if so, implement that standard only after a notice and comment period. The OCC collaborates on an interagency basis to continually monitor regulatory capital rules and may from time to time modify those rules. Figure 1 in this booklet illustrates a general view of the U.S. regulatory capital framework and highlights the basic requirements. As shown in figure 1, the framework consists of two types of banking organizations: advanced approaches and non-advanced approaches. The majority of banks are non-advanced approaches banks.

²³ Also refer to appendix B of this booklet.

Non-Advanced Approaches Banks

The term “non-advanced approaches banks” generally refers to banks that are part of organizations with less than \$250 billion in total consolidated assets and less than \$10 billion in total foreign exposure. Non-advanced approaches banks are typically midsize and community banks. These banks are subject to a set of requirements including

- the definition of capital at 12 CFR 3, subpart C.
- minimum regulatory capital standards at 12 CFR 3, subpart B.
- the standardized approach for risk weighting assets at 12 CFR 3, subpart D.
- the capital conservation buffer (CCB)²⁴ at 12 CFR 3.11.

In some instances, non-advanced approaches banks may be subject to the market risk framework at 12 CFR 3, subpart F.

Certain disclosures in subpart D are required for all banks with over \$50 billion in assets. Refer to the discussion in this booklet’s “Disclosure Requirements” section.

Advanced Approaches Banks

Unless notified in writing by the OCC, a bank is an advanced approaches bank if it²⁵

- has consolidated total assets, as reported on its most recent year-end call report, equal to \$250 billion or more.
- has consolidated total on-balance-sheet foreign exposure on its most recent year-end FFIEC “Country Exposure Report–FFIEC 009” equal to \$10 billion or more.
- is a subsidiary of a bank or bank holding company (BHC) that uses the advanced approaches to calculate its total risk-weighted assets (RWA).
- elects to use 12 CFR 3, subpart E, to calculate its total RWA.

Advanced Approaches Banks

Specific requirements for advanced approaches banks are noted in text boxes like this one throughout this booklet.

²⁴ The CCB applies to all banks and is discussed in this booklet under the section “Regulatory Capital Buffers.” The CCB limits capital distributions and discretionary bonus payments for banks that do not hold a specified amount of CET1 capital in addition to the amount of regulatory capital necessary to meet the minimum risk-based capital requirements. Advanced approaches banks may be required to include, as part of their CCB, a countercyclical capital buffer (CCyB) amount in certain circumstances.

²⁵ Refer to 12 CFR 3.100(b)(1).

To use the advanced approaches to calculate binding capital requirements, a bank must complete a “parallel run”²⁶ period and receive approval from the OCC in accordance with 12 CFR 3, subpart E.

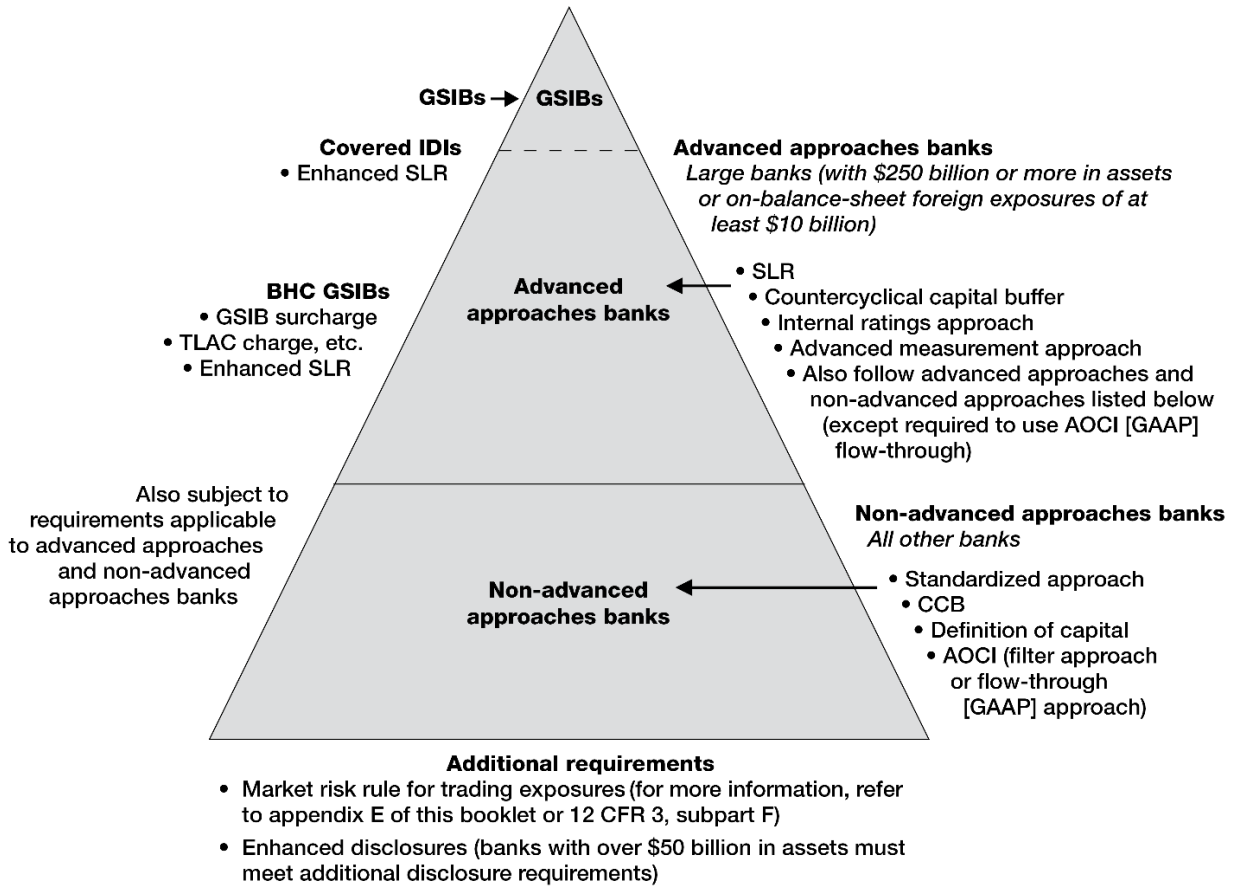
In addition to the advanced approaches rules set forth at 12 CFR 3, subpart E, advanced approaches banks must comply with the same requirements as non-advanced approaches banks, plus additional requirements as shown in figure 1, including the supplementary leverage ratio (SLR) set forth at 12 CFR 3.10(c)(4) and the CCyB at 12 CFR 3.11. Additionally, advanced approaches banks are not permitted to elect to offset the impact of any components of AOCI in their capital calculations.

Global Systemically Important Banks

The largest and most systemically important U.S. advanced approaches banking organizations—referred to as global systemically important banks (GSIB)—are subject to additional requirements. GSIBs generally consist of (1) BHCs identified as global systemically important BHCs by the Federal Reserve using a five-category test designed to assess systemic importance (size, interconnectedness, cross-jurisdictional activity, substitutability, and complexity) and (2) insured depository institutions (IDI) that are subsidiaries of BHCs with more than \$700 billion in total assets or more than \$10 trillion in assets under custody (covered IDI). Bank holding company GSIBs (BHC GSIB) are subject to risk-based capital surcharges and total loss absorbing capital (TLAC) requirements set forth by the Federal Reserve, and must satisfy an enhanced SLR (eSLR) threshold or be subject to restrictions on issuing dividends and making capital distributions. A covered IDI must satisfy the eSLR threshold of 6 percent to be considered “well capitalized” for the purpose of the PCA framework.

²⁶ For more information on the “parallel run,” see appendix F in this booklet.

Figure 1: General Overview of Regulatory Capital Framework



Note: Appendix B of this booklet shows regulatory capital requirements by bank type in table format.

Components of Regulatory Capital

Under 12 CFR 3, the basic components of regulatory capital for all banks are CET1 capital, AT1 capital, and tier 2 capital

These basic components comprise tier 1 (CET1 capital plus AT1 capital) and total capital (tier 1 capital plus tier 2 capital) and are the sum of specific capital account elements modified by applicable regulatory adjustments and deductions in 12 CFR 3.22. The elements for each component are subject to certain criteria, limitations, or other rules for inclusion in regulatory capital. For example, CET1 capital is the sum of the CET1 capital elements (i.e., 12 CFR 3.20(b)(1) through (5)) minus regulatory adjustments and deductions in 12 CFR 3.22. The CET1 capital element at 12 CFR 3.20(b)(1) relating to common stock instruments must meet all the criteria of 12 CFR 3.20(b)(1)(i) through (xiii). Table 1 illustrates each capital component (CET1 capital, AT1 capital, and tier 2 capital) and the elements of each component. Refer to appendix A of this booklet for a detailed explanation of the components and their elements.

Table 1: Regulatory Capital Components

CET1 capital	AT1 capital	Tier 2 capital
<ul style="list-style-type: none"> Common stock instruments (plus any related surplus)^a issued by the bank, net of Treasury stock, including additional paid-in capital Retained earnings AOCI^b 	<ul style="list-style-type: none"> AT1 capital instruments (such as perpetual, noncumulative preferred stock) and related surplus 	<ul style="list-style-type: none"> Tier 2 capital instruments (such as subordinated debt notes) and related surplus Allowance for loan and lease losses (ALLL) (1.25% of standardized total RWA) Up to 45% of unrealized gains on equity securities reported in AOCI (AOCI opt-in banks only)^c
<ul style="list-style-type: none"> CET1 minority interest Includes certain issuances to an ESOP 	<ul style="list-style-type: none"> Tier 1 minority interest (not included in CET1 minority interest) Other instruments including certain issuances to an ESOP 	<ul style="list-style-type: none"> Tier 2 minority interest Other instruments

^a Includes any capital instruments issued by mutual FSAs.

^b Non-advanced approaches banks may elect an AOCI opt-out treatment under the regulatory capital rules. Advanced approaches banks do not have this option and must follow GAAP when calculating regulatory capital. Non-advanced approaches banks that do not choose to opt out must also follow GAAP for regulatory capital purposes. The AOCI opt-out election is discussed in appendix A of this booklet.

^c For fiscal years beginning after December 15, 2017, for public business entities, equity securities will no longer be classified as either trading or AFS; instead, they will generally be measured at fair value, with changes in fair value recognized through net income. Refer to Accounting Standards Update (ASU) 2016-01. Therefore, advanced approaches banks and non-advanced approaches banks that are public business entities make no adjustments to AOCI for these gains or losses. The ASU is effective in later years for all other banks.

12 CFR 3.22 establishes required adjustments and deductions from each component of capital as shown in table 2. Some deductions may not apply to non-advanced approaches banks. Refer to appendix A of this booklet for a detailed explanation of the adjustments and deductions.

Table 2: Adjustments and Deductions Applicable to CET1 Capital, AT1 Capital, and Tier 2 Capital, Pursuant to 12 CFR 3.22(a), (c)–(f)

Adjustments and deductions (✓ means applicable)	CET1 capital	AT1 capital	Tier 2 capital	Regulation
Goodwill net of associated deferred tax liabilities (DTL)	✓			12 CFR 3.22(a)(1)
Intangible assets	✓			12 CFR 3.22(a)(2)
Certain deferred tax assets (DTA)	✓			12 CFR 3.22(a)(3) 12 CFR 3.22(e) for netting DTLs against assets subject to deduction
Gain-on-sale association in connection with a securitization	✓			12 CFR 3.22(a)(4)
Expected credit loss that exceeds eligible credit reserves (advanced approaches banks only)	✓			12 CFR 3.22(a)(6)
Financial subsidiaries (national banks only)	✓			12 CFR 3.22(a)(7)

Adjustments and deductions (✓ means applicable)	CET1 capital	AT1 capital	Tier 2 capital	Regulation
Subsidiaries engaged in activities not permissible for national banks (FSAs only)	✓			12 CFR 3.22(a)(8)(i)
Cash flow hedges (advanced approaches banks and non-advanced approaches banks not making the AOCI election only)	✓			12 CFR 3.22(b)(1)(ii)
Own credit risk gains and losses (applies to all banks). • Advanced approaches banks also must deduct the credit spread premium over the risk free rate for derivatives that are liabilities.	✓			12 CFR 3.22(b)(1)(iii)
Investments in the bank's own capital instruments	✓	✓	✓	12 CFR 3.22(c)(1)(i) for CET1 capital 12 CFR 3.22(c)(1)(ii) for AT1 capital 12 CFR 3.22(c)(1)(iii) for tier 2 capital
Items subject to the corresponding deduction approach:				12 CFR 3.22(c)(2) ^a
• Reciprocal cross holdings	✓	✓	✓	12 CFR 3.22(c)(3)
• Nonsignificant investments in the capital of unconsolidated financial institutions (UFI)	✓	✓	✓	12 CFR 3.22(c)(4)
• Significant investments in the capital of UFIs	✓	✓	✓	12 CFR 3.22(c)(5)
Items subject to the 10 and 15 percent CET1 capital deduction thresholds:				12 CFR 3.22(d)
• Certain DTAs arising from temporary differences	✓			12 CFR 3.22(d)(1)(i) for application to DTAs arising from temporary differences 12 CFR 3.22(d)(2) for application of the 15 percent deduction 12 CFR 3.22(e) for netting DTLs against assets subject to deduction
• Mortgage servicing assets (MSA) net of associated DTLs	✓			12 CFR 3.22(d)(1)(ii) for application to MSAs 12 CFR 3.22(d)(2) for application of the 15 percent deduction
• Significant investments in the capital of UFIs in the form of common stock	✓			12 CFR 3.22(d)(1)(iii) for application to significant investments in the common stock of UFIs

Adjustments and deductions (✓ means applicable)	CET1 capital	AT1 capital	Tier 2 capital	Regulation
				12 CFR 3.22(d)(2) for application of the 15 percent deduction
Shortfall deductions	✓	✓		12 CFR 3.22(f)

^a Note that covered funds otherwise subject to the Volcker rule at 12 CFR 44 may also be subject to deduction under the corresponding deduction approach as a nonsignificant investment in the capital of a UFI. The regulatory capital rule deduction takes precedence for purposes of any deduction required under the Volcker rule such that any remaining amount of covered funds required to be deducted, but not deducted pursuant to the regulatory capital rule at 12 CFR 3.22, are deducted pursuant to the Volcker rule from tier 1 capital. For additional information, refer to OCC Bulletin 2015-43, "Volcker Rule: Interagency Guidance on Capital Deduction Methodology." Also, refer to 12 CFR 3.22(f) for the deduction required under the corresponding deduction approach when there is an insufficient amount of a specific regulatory capital component available for the deduction. For applicability to CET1 capital, refer to 12 CFR 3.22(c)(2)(i)(A) and (c)(2)(ii)(A). For applicability to AT1 capital, refer to 12 CFR 3.22(c)(2)(i)(B), 12 CFR 3.22(c)(2)(ii)(B), and 12 CFR 3.22(c)(2)(iii)(A). For applicability to tier 2 capital, refer to 12 CFR 3.22(c)(2)(ii)(C) and 12 CFR 3.22(c)(2)(iii)(B).

Minimum Capital Ratios and Capital Buffers (12 CFR 3)

12 CFR 3 establishes the minimum regulatory capital requirements for all banks. This regulation includes the following elements:

- Minimum capital ratio requirements (discussed below).
- A CCB that must be met to avoid restrictions on capital distributions and discretionary bonuses. The CCB consists of two parts:
 - The CCB applicable to all banks.
 - The CCyB, which augments the CCB requirement for advanced approaches banks in certain circumstances.
- Definitions of the components of capital and eligibility requirements for capital instruments to count toward regulatory capital.
- The methodology for determining RWA under the standardized and advanced approaches and, for banks with significant trading activity, the methodology for measuring their exposure to market risk.
- The standards and procedures for the OCC to establish individual minimum capital ratios (IMCR) for a bank when the OCC, at its discretion, deems higher minimum capital requirements are appropriate given a particular bank's circumstances.
- Actions the OCC may take against a bank that fails to have or maintain the minimum required capital ratios.²⁷
- The standards and procedures for the OCC to issue a Capital Directive when a bank fails to have or maintain capital ratios above its minimum requirements.²⁸

²⁷ The minimum required capital ratios are the minimums established in 12 CFR 3.10(a), by an IMCR, by written agreement under 12 USC 1818(b), or as a condition of approval of an application, as applicable.

²⁸ Ibid.

All banks²⁹ must maintain the following minimum capital ratios pursuant to 12 CFR 3.10(a):³⁰

- CET1 capital ratio of 4.5 percent (CET1 capital divided by total RWA).
- Tier 1 capital³¹ ratio of 6 percent (tier 1 capital divided by total RWA).
- Total capital ratio of 8 percent (total capital divided by total RWA).
- Leverage ratio of 4 percent (tier 1 capital divided by [average total consolidated assets as reported on the bank’s call report less certain deductions]).

Advanced Approaches Banks

Supplementary leverage ratio: Advanced approaches banks must meet or exceed an SLR that comprises tier 1 capital to “total leverage exposure” of at least 3 percent.

$$\text{SLR} = \frac{\text{Tier 1 capital}}{\text{Total leverage exposure}}$$

Advanced approaches banks began reporting their SLR in 2015. The minimum SLR requirement became effective as of January 1, 2018, and requires advanced approaches banks to meet or exceed the 3 percent SLR requirement to be considered adequately capitalized for PCA purposes.³²

Additionally, pursuant to 12 CFR 3, subpart H, the OCC may impose on a bank an IMCR that is higher than otherwise required under 12 CFR 3.10 if the OCC, in its discretion, deems it appropriate in light of the particular circumstances of the bank. The OCC may also require higher minimum capital ratios in a written agreement issued pursuant to 12 USC 1818(b) or as a condition for approving a bank’s application. If a bank fails to achieve or maintain capital at or above the minimum ratios required by 12 CFR 3.10; 12 CFR 3, subpart H; in a written agreement issued pursuant to 12 USC 1818(b); or as a condition for approval of a bank’s application, as applicable, the OCC may issue a Capital Directive pursuant to 12 CFR 3, subpart J.

²⁹ Advanced approaches banks must calculate each ratio using both the standardized and advanced approaches methods for RWA and take the lower of the two for each ratio for purposes of determining compliance with the minimum capital requirements.

³⁰ Under section 5(t)(2)(B) of HOLA (12 USC 1464(t)) and 12 CFR 3.10(a)(6), FSAs are required to maintain another minimum requirement called tangible capital in an amount not less than 1.5 percent of total assets. In 12 CFR 3, the OCC defined “tangible capital” to mirror the definition of tangible equity at 12 CFR 6.4. Because the tangible equity ratio is a higher standard for the critically undercapitalized rating, the minimum requirement of the tangible capital ratio is no longer determinative.

³¹ Tier 1 capital equals CET1 capital plus AT1 capital. Total capital equals tier 1 capital plus tier 2 capital.

³² Refer to 12 CFR 3.10(c)(4) and 12 CFR 6.4(c)(2)(iv)(B). Advanced approaches banks that are covered IDIs must meet a 6 percent eSLR threshold to be considered well-capitalized for PCA purposes. See the discussion of the eSLR in the “Prompt Corrective Action” section of this booklet.

A Capital Directive is designed to establish and enforce capital levels for a given bank and to take certain other actions relating to capital.³³ Before issuing a Capital Directive, the OCC notifies the bank in writing of its intention to do so, using a “Notice of Intent to Issue a Directive.” A Capital Directive may require a bank to achieve its minimum capital requirement by a specified date, submit and adhere to an acceptable capital plan, or take other actions to achieve the required capital ratios.³⁴

Regulatory Capital Buffers

In addition to the required minimum capital ratios, a bank must hold additional capital as a “buffer” to its minimum regulatory capital requirements or face restrictions on its ability to make capital distributions and pay discretionary bonuses.³⁵ The capital buffer consists of two parts: (1) the CCB, which applies to all banks, and (2) the CCyB, which is an add-on to the CCB applicable only under certain economic conditions and only to advanced approaches banks.

Advanced Approaches Banks

Advanced approaches banks that have successfully completed parallel run must follow 12 CFR 3.10(c)(1)-(3) to determine their minimum regulatory capital ratios. For example, 12 CFR 3.10(c)(1) provides that a bank’s CET1 capital ratio is the lower of the ratio of the bank’s CET1 capital to standardized total RWA and the ratio of the bank’s CET1 capital to advanced approaches total RWA calculated under subpart E. The minimum requirements for tier 1 capital and total capital under 12 CFR 3.10(c)(2) and (3), respectively, apply the same process. The resulting ratios are compared when determining the CCB in accordance with 12 CFR 3.11(a)(3) (including the CCyB, if applicable). Refer to the following CCB discussion.

Capital Conservation Buffer

To avoid any restrictions on capital distributions and discretionary bonus payments, a bank must hold a CCB greater than 2.5 percent. The CCB equals the lowest of the following:

- The bank’s CET1 ratio minus the bank’s minimum CET1 capital ratio requirement under 12 CFR 3.10.
- The bank’s tier 1 capital ratio minus the bank’s minimum tier 1 capital ratio requirement under 12 CFR 3.10.
- The bank’s total capital ratio minus the bank’s minimum total capital ratio requirement under 12 CFR 3.10.

³³ The OCC may also issue a PCA directive pursuant to 12 CFR 6 based on a bank’s PCA capital category. Refer also to 12 USC 1831*o*. The OCC may consider a PCA directive for banks that are in the undercapitalized, significantly undercapitalized, or critically undercapitalized categories as defined in 12 CFR 6.4. Refer to table 7 of this booklet in the “Prompt Corrective Action” section.

³⁴ Refer to PPM 5310-3, “Bank Enforcement Actions and Related Matters,” and 12 CFR 3, subpart J, for more information on Capital Directives.

³⁵ Refer to 12 CFR 3.11. Also refer to 12 CFR 3.2 for definitions of “distribution” and “discretionary bonus payment.”

The maximum amount of distributions and discretionary bonus payments that a bank may pay when its CCB is less than or equal to 2.5 percent may be restricted. Banks began phasing in the CCB requirements on January 1, 2016. The CCB becomes fully effective on January 1, 2019. Table 3 summarizes the CCB restrictions.

Restrictions are based on the amount of the CCB before any distribution or discretionary bonus payment. For example, a bank with a CCB greater than 2.5 percent would not be subject to any restrictions under the buffer framework on distributions or discretionary bonus payments, even if a proposed distribution or payment would result in a CCB of less than or equal to 2.5 percent in the current calendar quarter (i.e., after the payment). Distributions or discretionary bonus payments in a subsequent calendar quarter would be restricted until the bank increased its buffer above 2.5 percent.

Table 3: Summary of Capital Conservation Buffer Restrictions

CCB (as a percentage of RWA)	Maximum payout (as a percentage of eligible retained income)
Greater than 2.5%	No payout limitation applies
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%	OCC approval required for payouts of any amount

The distribution restrictions set by the CCB are described as a percentage of a bank's "eligible retained income." Eligible retained income is defined as a bank's net income for the four calendar quarters preceding the current calendar quarter, net of any distributions and associated tax effects not already reflected in net income.³⁶ If a bank's eligible retained income is negative and its CCB ratio was equal to or less than 2.5 percent at the end of the previous quarter, the bank may not make a capital distribution or discretionary bonus payment during the current calendar quarter without prior OCC approval.

The CCB generally operates independently from the PCA framework. The following example illustrates when a bank meets PCA "well-capitalized" standards but is subject to limitations on capital distributions and discretionary bonuses under the CCB:

³⁶ The capital distribution restrictions tied to the CCB are based on "eligible retained income," as defined at 12 CFR 3.11(a)(2)(i). These capital distribution restrictions are distinct from the longstanding dividend restrictions set forth at 12 USC 56 (national banks); 12 USC 60b (national banks); 12 CFR 5, subpart E (national banks); and 12 CFR 5.55 (FSAs), which are based on "retained net income," as separately defined in 12 CFR 5.

Example

Assume the following:

- The bank's capital ratios are
 - Tier 1 leverage ratio of 6%
 - CET1 capital ratio of 6.5%
 - Tier 1 capital ratio of 9%
 - Total capital ratio of 11%
- The bank is not subject to any other requirements, such as minimum ratios in a written agreement, that would preclude it from being “well-capitalized” under PCA.

For PCA purposes, the bank is “well-capitalized.” The following shows the CCB calculation based on the assumptions in the previous example:

Calculations in 12 CFR 3.11	Calculation
Actual CET1 ratio minus the minimum CET1 capital ratio requirement under 12 CFR 3.10.	$6.5 - 4.5 = 2$
Actual tier 1 capital ratio minus the bank's minimum tier 1 capital ratio requirement under 12 CFR 3.10.	$9 - 6 = 3$
Actual total capital ratio minus the bank's minimum total capital ratio requirement under 12 CFR 3.10.	$11 - 8 = 3$

The bank's CCB is 2 percent because, as defined in 12 CFR 3.11, it is the lowest of the three calculations in the example above. Although the bank meets the PCA “well-capitalized” thresholds, the bank's CET1 capital does not exceed the 2.5 percent buffer (as shown in table 3) necessary to fully avoid the CCB's restrictions on capital distributions or discretionary bonuses. In this case, the bank's ability to pay capital distributions and discretionary bonuses is restricted to 60 percent of the bank's eligible retained income.

Table 4 illustrates the interaction among the CCB, PCA, and the minimum regulatory capital requirements. To avoid the CCB's restrictions, a bank must maintain a total capital ratio, a tier 1 ratio, and a CET1 ratio greater than 10.5 percent, 8.5 percent, and 7 percent, respectively. Each of these ratios also exceeds the amount required for the PCA “well-capitalized” category.³⁷

³⁷ The CCB was designed to give banks the flexibility to use the buffer while still being well-capitalized under PCA. Banks that maintain their risk-based capital ratios at least 50 basis points above the well-capitalized PCA levels are not subject to the CCB, as applicable. As losses may accrue or a bank's RWA grow such that the bank's capital ratios are below the CCB but above the well-capitalized thresholds, the incremental limitations on distributions and discretionary bonuses are unlikely to affect planned capital distributions or discretionary bonus payments, but such limitations may provide a check on rapid expansion or other activities that would weaken the bank's capital position.

Table 4: Interaction Among CCB, PCA, and Minimum Requirements

	Threshold ratios			
	Total capital ratio	Tier 1 capital ratio	CET1 capital ratio	Leverage ratio
Minimum capital ratio under 12 CFR 3	≥ 8%	≥ 6%	≥ 4.5%	≥ 4%
Minimum capital ratio + CCB (2.5%)	> 10.5%	> 8.5%	> 7%	Not applicable
Well-capitalized under PCA ^a	≥ 10%	≥ 8%	≥ 6.5%	≥ 5%
Adequately capitalized under PCA	≥ 8%	≥ 6%	≥ 4.5%	≥ 4%

^a A bank must also not be subject to any formal written agreement, order, Capital Directive, or PCA Directive issued by the OCC requiring the bank to meet and maintain a specific capital level to be considered “well-capitalized” under PCA. Refer to 12 CFR 6.4(c)(1)(v).

Advanced Approaches Banks

The CCyB augments the CCB by adding an amount, between 0 percent and 2.5 percent, during specific agency-determined periods. Advanced approaches banks must hold this amount in addition to the CCB to avoid limitations on distributions and discretionary bonus payments. The CCyB amount, if established, is linked to the condition of the overall U.S. financial system rather than to characteristics of any individual bank. The specific amount of the CCyB that each advanced approaches bank must hold, however, is scaled to the individual bank’s private sector exposures.³⁸ The purpose of the CCyB, as it applies to advanced approaches banks, is to protect the banking system and reduce systemic vulnerabilities during periods of excessive credit growth in the following three ways:

- Increase the resilience of the banking system to declines in asset prices and consequent losses that may occur when credit conditions weaken following an expansionary period.
- Reduce systemic vulnerabilities and protect the banking system by mitigating excessive credit growth and increases in asset prices that are not supported by fundamental factors.
- Limit excessive credit extension by increasing the amount of capital required for further credit extensions.

A decision by the OCC to adjust the CCyB would be based on a range of macroeconomic, financial, and supervisory information indicating an increase in systemic risk. Such information could include

- the ratio of credit to gross domestic product.
- a variety of asset prices.
- other factors indicative of relative credit and liquidity expansion or contraction.
- funding spreads.
- credit condition surveys.
- indices based on credit default swap spreads.
- options implied volatility.
- measures of systemic risk.³⁹

³⁸ To calculate the CCyB for an advanced approaches bank, if applicable, refer to 12 CFR 3.11(b). For example, if the bank were to hold no private sector exposures, the adjusted CCyB amount that it would need to hold would be zero. An advanced approaches bank is subject to the CCyB regardless of whether it has completed the parallel run process and received notification from the OCC pursuant to 12 CFR 3.121(d). When the OCC has not activated the CCyB, it is equal to zero.

³⁹ Although any adjustments to the CCyB are expected to be made jointly by the federal banking agencies, a joint determination is not required. Refer to 12 CFR 3.11(b)(2)(ii).

Although the OCC may determine that an earlier effective date is appropriate, increases in the CCyB generally are announced 12 months before they become effective to give banks time to increase their capital levels. Additionally, any increase in the CCyB expires automatically 12 months after becoming effective unless the OCC affirmatively renews it. There is no limit on the potential number of renewals.

The CCyB includes an adjustment for a reciprocal buffer for banks' private sector credit exposures in countries that have activated their national CCyBs. If a foreign jurisdiction activates its CCyB, the federal banking agencies can impose a reciprocal buffer to increase capital for advanced approaches banks that have private sector credit exposures in that jurisdiction. The preamble to the final regulatory capital rule includes an example of the CCyB applicable to advanced approaches banks.

Risk-Weighted Assets

A bank must assign risk weights to its assets in accordance with 12 CFR 3. RWA make up the denominator of the risk-based capital ratios. A bank determines its RWA by allocating assets among, generally, five standard risk-weight categories: 0 percent, 20 percent, 50 percent, 100 percent, and 150 percent.⁴⁰ Applying the most common risk-weight categories, the effective risk-based capital charges are shown in table 5.

Table 5: Risk Weights and Associated Risk-Based Capital Charges

Risk weight category	Effective capital charge (risk weight x 8%) ^a
0%	No risk-based capital charge
20%	1.6%
50%	4.0%
100%	8.0%
150%	12.0%

^a For illustrative purposes only, table 5 assumes the PCA category of adequately capitalized total capital to show the effect of this risk-weighting approach. In addition, these percentages do not consider CCB requirements.

Standardized Approach for Risk-Weighted Assets

All banks calculate standardized total RWA in accordance with the standardized approach in 12 CFR 3, subpart D.⁴¹ Advanced approaches banks must also calculate advanced approaches RWA in accordance with 12 CFR 3, subpart E.⁴²

The standardized approach requires a bank to calculate a total RWA amount for its on- and off-balance-sheet exposures. For on-balance-sheet assets, a bank assigns assets to broad risk-weight categories, according to the counterparty or, if relevant, the guarantor or the collateral

⁴⁰ Refer to call report schedule RC-R, part II, and appendix C of this booklet for other risk weights that may be applicable to certain exposures.

⁴¹ As applicable, a non-advanced approaches bank may also be subject to the market risk rule in which it would calculate RWA according to subparts D and F.

⁴² Refer to appendix F of this booklet for a discussion of the advanced approaches methodologies to calculate RWA.

pursuant to 12 CFR 3.31(a)(2). The exposure amount for an on-balance-sheet asset is generally the bank's carrying value for the exposure as determined under GAAP. Examples of on-balance-sheet assets include sovereign exposures, exposures to government-sponsored enterprises (GSE), exposures to public-sector entities, cash, corporate bonds, commercial and residential mortgages, and other assets. The applicable risk weights are set forth at 12 CFR 3.32.

For risk weighting off-balance-sheet exposures, the bank must use a two-step process that multiplies the amount of the off-balance-sheet exposure by a credit conversion factor (CCF) to determine a credit equivalent amount, and assigns the credit equivalent amount to the relevant risk-weight category. The CCF for an off-balance-sheet exposure can vary depending on the type of exposure.⁴³ Examples of off-balance-sheet exposures⁴⁴ include commitments, contingent items, guarantees,⁴⁵ certain repurchase (repo)-style transactions,⁴⁶ financial standby letters of credit, forward agreements, warranties, and exposures to over-the-counter (OTC) derivative contracts.⁴⁷

Standardized total RWA are calculated using the formula in table 6.

Table 6: Formula to Calculate Total Risk-Weighted Assets

<p>RWA for general credit risk, cleared transactions, default fund contributions, unsettled transactions, securitization exposures, and equity exposures</p> <p>plus</p> <p>Market risk equivalent assets, if applicable</p> <p>minus</p> <p>The amount of the bank's ALLL that is not included in tier 2 capital and any amount of allocated transfer risk reserves</p>
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Refer to appendix C of this booklet for a detailed chart of specific risk weights (table 9) and CCFs (table 10) for general credit risk, equity exposures, and unsettled transactions. Refer to appendix C, table 11 for the standardized approach for credit risk mitigants such as guarantees and collateralized transactions.

⁴³ Refer to 12 CFR 3.33 and the call report instructions for reporting off-balance-sheet exposures.

⁴⁴ Refer to 12 CFR 3.33(b) for applicable CCFs to determine the exposure amounts. Other off-balance-sheet exposures requiring CCFs are performance bonds, bid bonds, performance standby letters of credit, certain credit-enhancing representations and warranties, and securities lending transactions.

⁴⁵ Refer to 12 CFR 3.36 for determining the applicable risk weight using a substitution approach.

⁴⁶ At 12 CFR 3.2, the definition of a repo-style transaction means a repurchase or reverse repurchase transaction, or a securities borrowing or securities lending transaction, including a transaction in which the bank acts as agent for a customer and indemnifies the customer against losses, in accordance with certain requirements.

⁴⁷ Refer to table 1 at 12 CFR 3.34 for the rules to calculate the exposure amount.

Disclosure Requirements

At the top-tier entity level, non-advanced approaches banks with total consolidated assets of \$50 billion or more, as reported on the bank's most recent year-end call report, are subject to public disclosure requirements related to regulatory capital pursuant to 12 CFR 3.61 through 3.63. Because the disclosures apply only to the top-tier entity in a banking organization, a bank is not required to make these disclosures if its holding company makes the required disclosures on a consolidated basis. Disclosures must include general information about the bank, its capital structure, capital adequacy, the CCB, credit risk, counterparty credit-risk-related exposures, credit risk mitigation, securitization, certain equities, and interest rate risk for non-trading activities. An advanced approaches bank that has not received approval to exit parallel run is also required to make these disclosures.

Advanced Approaches Banks

Advanced approaches banks that have completed the parallel run successfully⁴⁸ are subject to the disclosure requirements in 12 CFR 3.172 and 3.173 (instead of the requirements in 12 CFR 3.61 through 3.63), which include disclosures regarding the bank's CCyB and operational risk. Similar to the requirements applicable to a non-advanced approaches bank, an advanced approaches bank is subject to only a limited set of public disclosure requirements if its holding company is subject to disclosure requirements.

Disclosures must be made publicly available, such as on a bank's public website or in a public financial report. The OCC may grant an exemption from some of the public disclosure requirements, consistent with the applicable provisions of the Freedom of Information Act, for specific commercial or financial information if the bank requests an exemption.⁴⁹ If the OCC granted such an exemption, the bank would be required to disclose general information about the subject matter and explain why it did not make the specific items of information publicly available. Typically, a bank should have a formal disclosure policy approved by its board.

Prompt Corrective Action (12 CFR 6)

12 CFR 6 establishes a framework for supervisory actions for IDIs, which include insured national banks, insured FSAs, and insured federal branches of foreign banks. Under 12 CFR 6, an IDI falls into one of the following categories: "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized," or "critically undercapitalized."

As shown in table 7, the PCA framework generally defines an IDI's capital category based

⁴⁸ For the qualifications of an advanced approaches bank to exit parallel run, refer to 12 CFR 3.121 and 3.122.

⁴⁹ Refer to 5 USC 552.

on its risk-based capital (CET1 capital, tier 1 capital, and total capital) and leverage ratios.⁵⁰ For a bank to meet the definition of “well capitalized,” in addition to meeting the ratio thresholds, it must not be subject to any formal written agreement or order issued pursuant to 12 USC 1818(b), Capital Directive, or PCA Directive that requires the bank to meet and maintain a specific capital level.⁵¹ Even banks in compliance with such formal written agreements, orders, or directives are not considered “well capitalized” until the agreements, orders, or directives are terminated or revised to eliminate the capital requirement. In the case of the “critically undercapitalized” category, the PCA framework refers to an IDI’s tangible equity ratio (discussed in more detail in this section of this booklet).⁵²

Advanced Approaches Banks

An advanced approaches bank must also satisfy the requirements of the SLR—as discussed in the “Minimum Capital Ratios and Capital Buffers (12 CFR 3)” section of this booklet—to be considered “adequately capitalized” for PCA purposes.

Tangible equity: A bank becomes “critically undercapitalized” for PCA purposes if it has a ratio of tangible equity to quarterly average total assets⁵³ that is equal to or less than 2 percent. 12 CFR 6 defines tangible equity as the amount of tier 1 capital (as calculated under 12 CFR 3, subpart B) plus the amount of outstanding cumulative perpetual preferred stock (including related surplus).

Enhanced SLR: The largest, most systemically important advanced approaches banks must satisfy an eSLR threshold to be considered “well capitalized” under the PCA framework.⁵⁴

Enhanced supplementary leverage ratio: A covered IDI is a subsidiary of a BHC that has (1) more than \$700 billion in consolidated total assets or (2) \$10 trillion in assets under custody. Under the PCA framework, a covered IDI must have an SLR of at least 6 percent (the eSLR) as well as meet the PCA “well-capitalized” thresholds for the leverage and risk-based capital ratios to be considered “well capitalized.” BHCs that meet the Federal Reserve’s definition of a covered BHC must have an SLR of 5 percent to be free from restrictions on capital distributions and certain discretionary bonuses.

⁵⁰ Refer to 12 USC 1831*o* and 12 CFR 6.4.

⁵¹ Refer to 12 CFR 6.4(c)(1)(v).

⁵² Refer to 12 USC 1831*o*(c)(3) and 12 CFR 6.4.

⁵³ Unless otherwise directed by the OCC, FSAs must follow 12 CFR 6.2 for the definition of total assets and use average total assets for the tangible equity ratio rather than adjusted total assets. For more information on tangible equity, refer to the definition of tangible equity at 12 CFR 6.2 and the ratio requirements for “critically undercapitalized” at 12 CFR 6.4(b)(5). The OCC reserves the right to require a bank to use actual, rather than total average, assets. Refer to 12 CFR 6.2, footnote 34.

⁵⁴ Refer to OCC Bulletin 2014-18, “Regulatory Capital—Enhanced Supplementary Leverage Ratio: Final Rule,” and 79 Fed. Reg. 24528.

Table 7: Capital Ratios for PCA Categories

PCA category	Total capital ratio	Tier 1 capital ratio	CET1 capital ratio	Leverage ratios	
				Leverage ratio	SLR (advanced approaches banks only)
Well capitalized	≥ 10%	≥ 8%	≥ 6.5%	≥ 5%	≥ 6% (eSLR) ^b
Adequately capitalized ^a	≥ 8%	≥ 6%	≥ 4.5%	≥ 4%	≥ 3%
Undercapitalized	< 8%	< 6%	< 4.5%	< 4%	< 3%
Significantly undercapitalized	< 6%	< 4%	< 3%	< 3%	
Critically undercapitalized	Tangible equity ≤ 2%				

^a The minimum requirements in 12 CFR 3 align with the definition of “adequately capitalized” in 12 CFR 6.4.

^b 12 CFR 6.4(c)(1)(iv)(B). The 6 percent eSLR threshold applies only to covered IDIs that are part of banking organizations with total consolidated assets of \$700 billion or more, or total assets under custody of \$10 trillion or more.

Generally, certain activities, such as controlling a financial subsidiary,⁵⁵ as well as certain expedited filing procedures set forth in 12 CFR 5, are available only for banks that are considered “well capitalized.”⁵⁶ Banks that are less than “adequately capitalized” are subject to enhanced monitoring by the OCC and face a number of restrictions on their activities, such as their ability to make certain distributions and their ability to grow or expand without prior OCC approval.⁵⁷ Banks that are less than “adequately capitalized” also must submit a capital restoration plan to the OCC and adhere to the plan thereafter.⁵⁸

Supervisory actions under PCA may affect not only the bank but also its officers, affiliates, or any company that controls the bank (such as the holding company). The OCC may also take various discretionary actions to strengthen the bank, such as reclassifying a bank to a lower capital category, requiring the sale of voting shares, placing restrictions on growth and activities, requiring an election of new directors, or dismissing directors or officers.⁵⁹

Relationship Between PCA and 12 CFR 3

A bank’s PCA capital category is not considered a determination of capital adequacy under 12 CFR 3. The OCC reviews capital adequacy in terms of the risks to the bank and how the board monitors and ensures that management implements adequate controls over these risks.

⁵⁵ Refer to 12 CFR 5.39(q)(1).

⁵⁶ Refer to 12 CFR 5.3(g) for additional eligibility criteria for expedited filing procedures.

⁵⁷ Refer to 12 CFR 6.6(a)(2).

⁵⁸ Refer to 12 CFR 6.6(a)(2)(iii).

⁵⁹ Refer to OCC Banking Circular 268, “Prompt Corrective Action,” for more information regarding mandatory and discretionary actions under PCA. Banking Circular 268 applies to national banks but is also an appropriate guide for FSAs and federal mutual savings associations.

Notwithstanding the minimum requirements, the OCC expects bank management to maintain capital commensurate with the level and nature of all risks to which the bank is exposed. Therefore, the OCC may determine that a bank that is “well capitalized” for the purposes of PCA nevertheless has taken on outsized risks and thus has inadequate capital for the purposes of 12 CFR 3.

Capital Adequacy

Adequate capital promotes a bank’s stability, its ability to honor its obligations, and its ability to withstand periods of economic stress. Examiners determine a bank’s capital adequacy based on the totality of a bank’s circumstances. The conclusion regarding capital adequacy may differ from an evaluation focused solely on a bank’s compliance with minimum risk-based capital standards. Banks typically operate with capital positions above regulatory minimum requirements to align capital with their risk profiles. Accordingly, most banks meet or exceed “well-capitalized” standards under PCA. The capital adequacy of an institution is rated based on, but not limited to, an assessment of the following evaluation factors:⁶⁰

- The level and quality of capital and the bank’s overall financial condition.
- Management’s ability to address emerging needs for additional capital.
- The nature, trend, and volume of problem assets and the adequacy of ALLL and other valuation reserves.
- Balance sheet composition, including the nature and amount of intangible assets, market risk, concentration risk, and risks associated with nontraditional activities.
- Risk exposure represented by off-balance-sheet activities.
- The quality and strength of earnings and the reasonableness of dividends.
- Prospects and plans for growth, as well as past experience in managing growth.
- Access to capital markets and other sources of capital, including support provided by a parent holding company.

Refer to the “Supervisory Review of Capital Planning and Adequacy” section of this booklet for more information about assessing capital adequacy.

Strategic and Capital Planning

Strategic Planning

A strategic plan defines the bank’s long-term goals and its strategy for achieving those goals.⁶¹ Strategic planning should be linked to the bank’s capital planning process, and the strategic plan should be consistent with the bank’s capital plan. The strategic plan should also

⁶⁰ Refer to appendix A of the “Bank Supervision Process” booklet of the *Comptroller’s Handbook* for a discussion of the factors for the “capital” component rating. Also refer to the “Community Bank Supervision” and “Large Bank Supervision” booklets of the *Comptroller’s Handbook* for the core assessments for capital.

⁶¹ Refer to the strategic planning section in the “Corporate and Risk Governance” booklet of the *Comptroller’s Handbook* for more information regarding strategic planning.

be consistent with the bank's risk appetite and liquidity requirements. Strategic plans typically cover a three- to five-year period but may cover a longer period. A bank may incorporate its capital plan, which typically has a one- to three-year horizon, into its longer-term strategic plan. Management and the board should have a process to monitor the bank's progress toward achieving the bank's strategic goals. Continuous monitoring of the strategic plan should alert management if risks increase from strategic objectives and allow management to make adjustments to protect capital levels.

Capital Planning

Capital planning is a dynamic and ongoing process that, to be effective, should be forward-looking in incorporating changes in a bank's strategic focus, risk tolerance levels, business plans, operating environment, or other factors that materially affect capital adequacy. Capital planning helps the bank's board and senior management

- identify risks, improve their understanding of the bank's overall risks, set risk tolerance levels, and assess strategic choices in longer-term planning.
- identify vulnerabilities such as concentrations and assess the impact on capital.
- integrate business strategy, risk management, and capital and liquidity planning decisions, including due diligence for a merger or acquisition.
- have a forward-looking perspective on the bank's capital needs, including capital needs that may arise from rapid changes in the economic and financial environment.

The most effective capital planning considers short- and longer-term capital needs and is coordinated with a bank's overall strategy and planning cycles, usually with a forecast horizon of at least one to three years. During the capital planning process, banks should factor in potential events that could occur outside of the normal capital planning cycle; for example, an economic downturn could have a major impact on future capital needs.

The capital planning process should be tailored to the overall risk, complexity, and corporate structure of the bank. The bank's range of business activities, overall risks, and operating environment have a significant impact on the level of detail needed in a bank's capital planning. A more complex bank with higher overall risk is expected to have a more detailed planning process than a bank with less complex operations and lower risks. The corporate structure is also a factor. For example, mutual savings associations build capital almost exclusively through retained earnings, so they have very limited means to increase capital quickly. As such, capital planning is critical for a federal mutual savings association. While the exact content, extent, and depth of the capital planning process may vary, an effective capital planning process should include the following components.

Identifying and Evaluating Risks

The first component of capital planning is to identify and evaluate all material risks. Risks that can be quantified with reasonable confidence should be measured to determine how those risks affect the bank's overall capital adequacy. Banks should consider qualitative factors that incorporate management's experience and judgment in evaluating all risks. A

qualitative assessment is especially critical in understanding and evaluating risks that cannot be reasonably quantified.

Some of the risks to which a bank may be exposed include credit, operational, interest rate, liquidity, price, and compliance risks. Other risks, such as reputation risk and strategic risk, may be material for some banks. Risks may arise from significant subsidiaries and operating units. Every bank should have a process that allows it to identify its material risks on an ongoing basis so that it can plan appropriately for those risks.

Banks should not allow current financial performance to mask or compensate for weaknesses that exist in risk management practices and processes. There is often a lag between the creation of risks and when those risks begin to affect a bank's financial performance. By the time the bank faces deteriorating credit quality, increased loan charge-offs, strained funding, increased processing errors, or other financial performance measures, the underlying causes are already well established and difficult to reverse quickly. Furthermore, once weaknesses materialize, it may be difficult, or more expensive, to raise capital. Capital alone does not mitigate excessive risk-taking or unsafe and unsound practices that deviate from sound governance, internal controls, risk management principles, or OCC supervisory guidance. Banks should be alert to deterioration in risk management processes and rising indicators of future risk, such as

- high levels of concentrations that are not paired with strong risk mitigants, including holding additional capital. Banks with high levels of concentrations should have tools or processes to mitigate the heightened risk associated with those concentrations. In some cases, concentration levels may be deemed excessive regardless of capital levels.
- funding asset growth with high-risk or volatile liabilities or other risk-layering strategies.
- increasing investments in new financial instruments without establishing an understanding of the risks, exposures, and structural complexities and assessing whether the investment is suitable for the bank.
- rapid rates of growth that are not accompanied by appropriate changes to staffing levels, systems, and controls.
- entering new lines of business without a well-defined strategy, appropriate risk controls, or the capital appropriate to support the new lines of business.
- liberalization of underwriting standards, weak underwriting, or increasing credit or collateral exceptions.
- higher delinquencies or high levels or increasing trends of adversely classified or criticized assets, loan charge-offs, repossessed assets, or impaired securities.

Setting and Assessing Capital Adequacy Goals That Relate to Risk

The second component of effective capital planning is to determine the amount of capital appropriate for the bank's material risks and strategic direction. A well-run bank should regularly assess capital adequacy to ensure that capital levels remain adequate not just at a point in time, but over time, and should recognize short- and longer-term capital needs. Because overall risks and choices of risk tolerance may differ across banks, the appropriate amount of capital may differ. Banks with higher risk exposure, plans for acquisition or

growth, or less access to capital should operate with higher levels of capital. A bank may deem certain identified risks to be too high regardless of capital levels, as capital alone does not compensate for excessive risk-taking. Some examples of activities that may warrant higher capital levels are

- highly complex or specialized services with high-volume transaction processing (higher operational risk).
- significant concentrations in higher-risk activities, such as subprime lending programs, construction and development lending, or syndicated/leveraged lending (higher credit risk).
- concentrations that have a high degree of correlation with cyclical changes or economic events; for example, construction and development lending (higher credit risk).
- borrowing sources concentrated among a few providers or providers with common investment objectives or economic influences, such as significant reliance on wholesale funds (higher liquidity risk).
- Longer-term repricing mismatches that are significant, complex, or difficult to hedge (higher interest rate risk).
- high volume of consumer complaints or a significant number of violations or weaknesses in consumer, Bank Secrecy Act, or anti-money laundering compliance programs that expose the bank to potential consumer reimbursements, regulatory fines and penalties, significant reputation risk, or litigation risk (higher compliance risk).

In assessing its capital level, a bank should evaluate not only its exposures to risks, including operational, fiduciary, and other off-balance-sheet activities, but also the potential impact of risks arising from third-party relationships, contingent exposures, the business cycle, and changes in the financial and economic environment. Incorporating the results of stress testing into capital planning can be an effective means of quantifying the potential impact of identified risks, particularly for complex banks and those with higher risk profiles. Banks may use a variety of methodologies to translate risks into capital needs; regardless of the methodology chosen, the bank should ask the appropriate “what if” questions and incorporate the answers into the risk management process. The overall goal is to quantify loss potential and the impact on earnings and capital adequacy. Other important factors a bank should consider in the capital planning process include

- concentration levels and limits;
- quality of risk management, internal control, and audit processes;
- quality, sustainability, and level of earnings;
- quality, composition, and sources of capital;
- quality of assets and credit administration practices;
- allowance adequacy;
- balance-sheet structure, liquidity needs, and interest rate risk;

- the bank’s strategic objectives, including whether the bank effectively assesses and controls risks when executing new products and services (critical for de novo banks);⁶²
- historical and planned growth;
- mergers and acquisitions;
- special situations that could cause capital impairment or future losses;
- form of ownership and access to capital;
- dividend practices;
- a holding company’s ability to serve as a source of strength and to contribute capital to the bank;
- a holding company’s reliance on dividend payments from the bank to service debt or other obligations;
- effect of affiliates;⁶³ and
- supervisory requirements for corrective action or associated with enforcement actions.

Banks should express their internal capital targets as ratios based on regulatory definitions and capital requirements. In addition, banks may express their capital targets based on measures important to key stakeholders. Banks’ capital targets may be expressed as ranges rather than point estimates.

Maintaining Strategy to Ensure Capital Adequacy and Contingency Planning

The third component of capital planning is having a strategy to maintain capital adequacy and build capital, if needed. Through discussions with senior management, the board or its designee should evaluate internal and external sources of capital in defining a strategy to build capital when appropriate. One strategy may be strengthening capital through earnings retention. Another option may be an infusion from principal shareholders or a parent holding company, or, in the case of a mutual institution, a partial or full conversion to stock. A bank may also be able to raise capital from external sources. During strong economic times, financially sound banks or banks that are subsidiaries of strong BHCs can generally find purchasers for their equity and debt issuances. In evaluating external sources of capital, banks should consider their history of public or private offerings, current equity market conditions, and the cost of equity.

A bank’s capital planning process should consider contingency or backup plans. Contingency planning should be commensurate with a bank’s overall risk and complexity. Effective contingency planning includes identification of credible mechanisms and strategies for capital preservation and enhancement during an economic downturn or other times of stress. Effective boards hold management accountable for identifying and taking corrective actions if shortcomings or weaknesses in the capital planning process become apparent or if the level of capital falls below identified needs.

⁶² Refer to OCC Bulletin 2017-43, “New, Modified, or Expanded Bank Products and Services: Risk Management Guidance,” for more information.

⁶³ Refer to the discussion about transactions with affiliates in the “Related Organizations” booklet of the *Comptroller’s Handbook*.

Actions may include increasing capital using one of these strategies, subject to any applicable regulatory approvals: adjusting the balance sheet to reduce risk exposures (for example, asset sales), improving internal governance processes, strengthening risk management systems, or reinforcing internal controls. Banks may also consider restricting capital distributions. It is particularly important for a bank's board to ensure the dividend level is prudent relative to the bank's financial position. Decisions on the dividend level should not be based on overly optimistic earnings scenarios or pressure from a holding company or other controlling party. Comprehensive capital distribution/dividend policies should clearly articulate a bank's objectives and approaches for maintaining a strong capital position, including restricting dividends and other discretionary capital distributions when the bank does not, or may not, meet required capital levels or internal targets.

Ensuring Integrity in the Internal Capital Planning Process and Capital Adequacy Assessments

The fourth component of capital planning is ensuring the integrity, objectivity, and consistency of the process through adequate governance. A bank's success depends on strong and independent oversight by its board in all areas, including capital planning. The board should articulate to management its risk appetite level, for example, by setting approved limits. A bank's internal audit function also plays a key role in reviewing the controls and governance surrounding the capital planning process. Capital adequacy is influenced by the quality, experience, and depth of bank management. Sound management entails implementing and monitoring policies and procedures, internal controls, and audit coverage. Documenting the capital planning process and board-approved expectations and goals is important to maintaining the integrity of the capital planning process and the appropriateness of capital level determinations.

The board should review the capital planning process and capital goals at least annually to ensure that a sufficient level of capital exists at all times to fully support the bank's overall risks and anticipated needs. When management provides the board with regular reports and updates, the board should clearly understand the bank's financial resiliency. Reports should typically highlight any changes in the bank's overall risk profile or risk components, proposed risk management enhancements to better manage any new or increasing risks, and, if applicable, stress-testing results that affect the need for capital. Banks use a range of techniques, approaches, and models for a variety of purposes in capital planning (for example, loss estimation, scenario analysis, sensitivity analysis, or reverse stress testing). As models play an increasing role in decision-making processes, it is critical that bank management reduce the likelihood of erroneous model output or incorrect interpretation of model results. Model risk management begins with robust model development, implementation, and use, followed by a sound model validation process and effective governance.

An effective capital planning process and capital goals should be documented and should include

- roles and responsibilities of key parties in the process, including the board, senior management, internal audit, and lines of business management.
- processes for monitoring risk tolerance levels, capital adequacy, and overall capital planning on an ongoing basis, including procedures for board and management reporting and instituting change as conditions warrant.
- key planning assumptions and methodologies used, as well as limitations and uncertainties in the capital planning process.
- risk exposures and concentrations that could impair or influence the bank's level of capital.
- measures to take in response to changes (for example, in strategic direction or economic conditions) or deficiencies in the capital planning process, or when capital falls below internal targets.
- the results of any stress testing performed and any actions planned or taken in response to those results.

Capital planning should evolve with changes in the bank's overall risks and activities, as well as with advances in risk measurement and management practices.

Stress Testing

Stress testing can be a prudent way for a bank to identify its key vulnerabilities to market forces and assess how to effectively manage those risks should they emerge. In accordance with section 165(i) of the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010,⁶⁴ banks with total consolidated assets of \$10 billion or more (i.e., covered banks) must conduct an annual stress test.⁶⁵ The OCC expects the annual Dodd–Frank stress tests to support ongoing improvement in a covered bank's broader stress testing practices⁶⁶ with respect to its internal assessment of capital adequacy and overall capital planning.⁶⁷

Community Bank Stress Testing

Community banks, regardless of size, should have the capacity to analyze key vulnerabilities and the potential impact of certain adverse outcomes on their capital adequacy. Community

⁶⁴ Refer to Pub. L. 111-203, 124 Stat. 1376. Also refer to 12 USC 5365(i)(2).

⁶⁵ Refer to OCC Bulletin 2012-41, "Stress Testing: Final Rule for Dodd–Frank Act Section 165(i)." The Dodd–Frank Act defines "covered" institutions as banks with total consolidated assets over \$10 billion. Refer also to 12 CFR 46.

⁶⁶ Larger banks should conduct more complex stress testing and incorporate not only firm-specific but also systemic stress events and circumstances into their stress tests.

⁶⁷ Refer to OCC Bulletin 2014-5, "Dodd-Frank Stress Testing: Supervisory Guidance for Banking Organizations With Total Consolidated Assets of More Than \$10 Billion but Less Than \$50 Billion." Refer also to OCC Bulletin 2018-4, "Annual Stress Test: Final Rule–Technical and Conforming Changes."

banks that have incorporated stress testing concepts and analyses into their credit risk management and strategic and capital planning processes have demonstrated the ability to minimize the impact of negative market developments more effectively than those that did not use stress testing. Community bank management can use stress testing to appropriately plan for and maintain adequate capital levels.

The OCC does not endorse a particular stress testing method for community banks. Given the smaller scale and lesser complexity of most community banks, assessing portfolio risk and capital vulnerability can be relatively simple. Depending on the bank's portfolio risk and complexity, a single spreadsheet that analyzes key risks and considers potential adverse outcomes affecting capital levels may suffice. For example, some form of stress testing or sensitivity analysis of loan portfolios on at least an annual basis is important to sound risk management for community banks. In addition, because changes in interest rates present another potential area of community bank vulnerability, many well-managed community banks routinely conduct interest rate risk sensitivity analysis to understand and manage the risk from those changes.

If the results of a stress test indicate that capital ratios could fall below the level needed to adequately support the bank's overall risk profile, the bank's board and management should take appropriate steps to protect the bank from such an occurrence. This may include establishing a plan that requires closer monitoring of market information, adjusting strategic and capital plans to mitigate risk, changing risk appetite and risk tolerance levels, limiting or stopping loan growth or adjusting the portfolio mix, adjusting underwriting standards, raising more capital, and selling or hedging loans to reduce the potential impact from such stress events.

Refer to OCC Bulletin 2012-33, "Community Bank Stress Testing: Supervisory Guidance," for more information about community bank stress testing, including an example of a basic loan portfolio stress test.

Risks Associated With Capital and Dividends

From a supervisory perspective, risk is the potential that events will have an adverse effect on a bank's current or projected financial condition⁶⁸ and resilience.⁶⁹ The OCC has defined eight categories of risk for bank supervision purposes: credit, interest rate, liquidity, price, operational, compliance, strategic, and reputation. These categories are not mutually exclusive. Any product or service may expose a bank to multiple risks. Risks may be interdependent and may be positively or negatively correlated. Examiners should be aware of and assess this interdependence. Examiners also should be alert to concentrations that can significantly elevate risk. Concentrations can accumulate within and across products, business lines, geographic areas, countries, and legal entities. Refer to the "Bank Supervision

⁶⁸ Financial condition includes impacts from diminished capital and liquidity. Capital in this context includes potential impacts from losses, reduced earnings, and market value of equity.

⁶⁹ Resilience recognizes the bank's ability to withstand periods of stress.

Process” booklet of the *Comptroller’s Handbook* for an expanded discussion of banking risks and their definitions.

Examiners should assess the potential effect on a bank’s capital.⁷⁰ Additionally, a bank’s capital and dividend practices can affect certain risks (i.e., operational, strategic, reputation, compliance) as explained in the sections below.

Credit Risk

Credit risk is the risk to current or projected financial condition and resilience arising from an obligor’s failure to meet the terms of any contract with the bank or otherwise perform as agreed. Credit risk is found in all activities in which settlement or repayment depends on counterparty, issuer, borrower, or guarantor performance. Credit risk exists any time bank funds are extended, committed, invested, or otherwise exposed through actual or implied contractual agreements, whether reflected on or off the balance sheet.

Credit risk can affect capital adequacy in many ways. For example, a high quantity of credit risk, deficient credit risk management practices, poorly managed portfolios, or liberal risk selection may erode a bank’s capital through increased provision expense and reduced earnings.

Concentration risk is another risk to capital that can arise from a bank’s lending and other activities. The collective performance of concentrations or pools of exposures has the potential to affect capital adequacy even if the individual transactions within a pool are soundly underwritten. When exposures in a pool are sensitive to the same economic, financial, or business developments, that sensitivity, if triggered, may cause the sum of the transactions to perform as if it were a single, large exposure. The greater the concentration in any activity, the higher the likelihood the bank will need to hold more capital and adopt robust strategic and capital planning processes. Holding high capital levels alone may not offset the risk to capital adequacy from excessive concentrations.

Interest Rate Risk

Interest rate risk is the risk to current or projected financial condition and resilience arising from movements in interest rates. Interest rate risk results from differences between the timing of rate changes and the timing of cash flows (repricing risk), changing rate relationships among different yield curves affecting bank activities (basis risk), changing rate relationships across the spectrum of maturities (yield curve risk), and interest-related options embedded in bank products (options risk). Critical to properly assessing interest rate risk are the ability to identify, measure, monitor, and control the strength and stability of a bank’s earnings stream, the level of income needed to generate and maintain normal business operations, and the level of current and potential depreciation in the bank’s underlying economic value in relation to interest rate movements.

⁷⁰ Refer to the “Bank Supervision Process” booklet of the *Comptroller’s Handbook* for an expanded discussion of banking risks and their definitions.

Unfavorable changes in interest rates may affect earnings and, consequently, capital. Banks' capital-at-risk limits should reflect the size and complexity of underlying positions. For banks with few holdings of complex instruments and low risk profiles, simple limits on permissible holdings or allowable repricing mismatches in intermediate- and long-term instruments may be adequate. At more complex banks, more extensive limit structures may be necessary. Banks that have significant intermediate- and long-term mismatches or complex options positions should establish limits to restrict possible losses of economic value or capital.

Refer to the "Interest Rate Risk" booklet of the *Comptroller's Handbook* for more information regarding repricing, basis, yield curve, and options risks.

Liquidity Risk

Liquidity risk is the risk to current or projected financial condition and resilience arising from an inability to meet obligations when they come due. Liquidity risk includes the inability to access funding sources or manage fluctuations in funding levels. Liquidity risk also results from a bank's failure to recognize or address changes in market conditions that affect its ability to liquidate assets quickly and with minimal loss in value. If liquidity and funding sources are insufficient, a bank may need to hold higher capital. For example, banks with financial problems that are also in a constricted liquidity situation may have to dispose of assets at a loss to honor cash outflow obligations, causing capital accounts to absorb such losses. In addition, certain higher-risk activities, such as mortgage banking operations and trading activities, typically have higher liquidity needs and may require higher capital levels. Concentrations in certain volatile funding sources may also expose a bank to interest rate risk, maturity mismatches, and market unpredictability, ultimately affecting capital levels with higher interest expenses and reduced cash flows.

Price Risk

Price risk is the risk to current or projected financial condition and resilience arising from changes in the value of trading portfolios or other obligations that are entered into as part of distributing risk. These portfolios typically are subject to daily price movements and are accounted for primarily on a mark-to-market basis. This risk occurs most significantly from market-making, dealing, and position-taking in interest rate, foreign exchange, equity, commodities, and credit markets. Price risk also arises from bank activities whose value changes are reflected in the income statement, such as assets and liabilities under the fair value option, lending pipelines, other real estate owned, and mortgage servicing rights.

Earnings and capital levels can be negatively affected by a bank's balance sheet sensitivity to the direction of the market price movements. Banks invested in complex financial instruments or involved in complex trading and hedging activities should have the management expertise and sophistication to manage associated price risk.

Operational Risk

Operational risk is the risk to current or projected financial condition and resilience arising from inadequate or failed internal processes or systems, human errors or misconduct, or adverse external events, and is inherent throughout the bank. Operational losses may not include opportunity costs, forgone revenue, or costs related to risk management and control enhancements implemented to prevent operational losses.

Operational failures can lead to significant and immediate losses and capital erosion once uncovered. The inability or unwillingness to update or develop operational systems and processes and human capital can result in a delay in identifying, measuring, monitoring, and controlling risk.

A bank's need for earnings and capital accretion may cause its management to engage in practices that increase operational risk. Examples include not hiring or retaining qualified personnel or staffing levels or engaging in high-risk products or services without proper controls.

Compliance Risk

Compliance risk is the risk to current or projected financial condition and resilience arising from violations of laws or regulations, or from nonconformance with prescribed practices, internal policies and procedures, or ethical standards. This risk exposes a bank to fines, civil money penalties, payment of damages, and the voiding of contracts, which can affect a bank's capital. Compliance risk can result in diminished reputation, harm to bank customers, limited business opportunities, and lessened expansion potential. A bank's practices surrounding capital and dividends can also result in compliance risk if the bank fails to comply with capital and dividend laws or regulations.

Strategic Risk

Strategic risk is the risk to current or projected financial condition and resilience arising from adverse business decisions, poor implementation of business decisions, or lack of responsiveness to changes in the banking industry and operating environment. This risk is a function of a bank's strategic goals, business strategies, resources, and quality of implementation, and includes communication channels, operating systems, delivery networks, and managerial capacities and capabilities. For example, implementing high-risk products or services without appropriate capital support creates strategic risk. In another example, bank management could incorrectly assume that the bank's capital position is sufficient to support additional risk and decide to expand the bank through mergers and acquisitions, but fail to scale risk management practices commensurate with the size and complexity of the bank post-merger.

If a bank's business plan includes, for example, entering into a new market, opening a new branch or loan production office, or initiating a new product, the bank's capital is expected to be sufficient to support such initiatives. To control strategic risk to capital, management

should monitor the bank's capital plan, assess progress toward meeting the bank's strategic goals, and incorporate systems that issue timely alerts to management regarding rising risks or decreasing capital levels.

Reputation Risk

Reputation risk is the risk to current or projected financial condition and resilience arising from negative public opinion. This risk may impair a bank's competitiveness by affecting its ability to establish new relationships or services or continue servicing existing relationships. Reputation risk is inherent in all bank activities, and management should exercise an abundance of caution in dealing with stakeholders, such as customers, counterparties, correspondents, investors, regulators, employees, and the community.

Reputation risk is inherent throughout the bank and can result from lawsuits, foreclosure activity, frequent changes in senior management or directors, regulatory penalties or enforcement actions, actions of third parties, losses from fraud or operational failures, data breaches resulting in customer privacy concerns or identity theft, or unflattering news about the bank or its employees. A bank's reputation may affect its ability to raise new capital.

Risk Management

Each bank's board and management should identify, measure, monitor, and control risk by implementing an effective risk management system appropriate for the size and complexity of bank operations. When examiners assess the effectiveness of a bank's risk management system, they consider the bank's policies, processes, personnel, and control systems.⁷¹

Banks should have an appropriate risk management system that includes controls for compliance with capital and dividend regulations. As part of sound risk governance, management should have a process to identify emerging risks to the bank's capital, mitigate risk early, and maintain satisfactory capital levels to ensure that the bank's safety and soundness are not affected. The board and management should understand financial regulatory reporting and the laws and regulations affecting their bank's capital accounts, dividends, and capital adequacy. Overall, the board should understand the dependence and interaction between risks and capital adequacy. Board oversight includes the responsibility for having an effective system of internal controls and an effective internal audit system in place.

Supervisory Review of Capital Planning and Capital Adequacy

The supervisory review process assesses whether (1) the bank has a sound and effective process commensurate with its overall risk and complexity to determine whether its overall capital is adequate and (2) the bank maintains a capital level that is commensurate with its risks and is consistent with the bank's internal assessment and identified capital needs on an

⁷¹ Refer to the "Corporate and Risk Governance" booklet of the *Comptroller's Handbook* for an expanded discussion of risk management.

ongoing basis and as underlying conditions change (for example, changes in a bank's overall risks or economic conditions). Examiners review the capital planning process at least once during each supervisory cycle. Conclusions about the capital planning process are considered and incorporated in the assessment of the capital and management component ratings.

Examiners should consider the quality of the bank's overall corporate governance of the bank's risk-taking activities, including senior management and board oversight, when assessing capital adequacy. As part of this evaluation, examiners should consider the quality of risk management, internal control, model validation, and audit processes, as well as management's expertise and ability to identify and control financial and operating risks. When serious deficiencies exist in any of these areas, examiners may determine that the bank should hold capital above the level suggested in the bank's assessments of specific risks.

A bank's failure to have an effective capital planning process may be an unsafe or unsound banking practice. If a bank does not have an effective capital planning process that is commensurate with its overall risks, the OCC may require corrective action. An ineffective or weak capital planning process may invalidate the bank's internal capital assessment and cause examiners to determine that the bank should increase its regulatory capital to a more appropriate level. The OCC also may impose a higher capital requirement for a particular bank if the bank's level of capital is insufficient in relation to its risks. Potential actions the OCC may take to ensure that the bank meets or maintains adequate capital levels may include IMCRs, formal or informal enforcement actions, or conditions imposed in writing in connection with the approval of a bank's application.

Examiners should discuss with the board and management any material risks that the capital planning process did not capture and any other material issues regarding capital adequacy or capital planning. The board should direct management to address any gaps in the bank's capital planning process to ensure that the quality and quantity of capital are sufficient to support the risks in the bank.

When examiners identify inconsistencies between the level of capital and a bank's overall risks, they should articulate which key components are missing from the bank's capital planning process and direct management to incorporate and quantify such components in current and future assessments.

Examination Procedures

These examination procedures supplement the capital core assessments in the “Community Bank Supervision” and “Large Bank Supervision” booklets of the *Comptroller’s Handbook*. Examiners should decide which expanded procedures to use, if any, when developing the bank’s supervisory strategy, during examination planning, or after completing the core assessment. Seldom will examiners need to use every objective or step of this booklet’s procedures to satisfy their examination objectives.

Examiners must understand and assess how a bank’s exposure to risks may affect a bank’s capital adequacy. The OCC’s eight categories of risk are not mutually exclusive—any product or service may expose a bank to multiple risks. If a bank does not properly measure, monitor, or control its risk exposures, one or more risks may undermine the bank’s capital position or affect its cost of capital. The “Community Bank Supervision” and the “Large Bank Supervision” booklets of the *Comptroller’s Handbook* discuss in detail the OCC’s risk definitions and risk assessment process.

The following procedures are not meant to be performed strictly in the order presented and should be tailored to the bank’s or examination’s particular circumstances, including whether the bank is an advanced approaches or non-advanced approaches bank. The capital review should be closely coordinated with the reviews of examiners responsible for other component areas of the bank, in particular the areas of earnings and credit risk as they relate to dividends and capital adequacy. Such coordination can reduce burden on the bank and prevent duplication of examination efforts.

Scope

The scope of the examination should take into account any additional work performed by internal and external auditors and through other independent risk control functions. Examiners should coordinate work with examiners responsible for reviewing other areas of the bank. Examiners should perform only those steps that are relevant to the scope of the examination as determined by the following objective.

Objective: To determine the scope of the examination of capital and identify examination objectives and procedures appropriate for the supervisory strategy for the bank.

1. Review the following sources of information to the extent deemed appropriate and note any previously identified concerns related to capital accounts, dividends, and capital adequacy requiring follow-up.
 - OCC supervisory strategy.
 - Examination scope memorandum.
 - The Uniform Bank Performance Report and call report.
 - OCC information systems and OCC reports.
 - Bank management’s responses to previous reports of examination and audit reports.

- Any pending or threatened litigation.
 - Matters requiring attention.
 - Violations of laws or regulations.
 - Open enforcement actions.
2. Obtain and review the bank's strategic and capital plans and the policies, procedures, and reports that bank management and the board use to manage and monitor capital.
 3. Determine the extent of actual or planned changes that could affect the bank's capital or necessitate additional capital, including growth, new products or services, new or materially modified business strategies, plans to raise capital, changes in control, or changes at the holding company (e.g., a reduction in the holding company's source of strength to the bank or an increase in holding company debt service requirements).
 4. Review the following limits, as appropriate, for FSAs:
 - Investments in loans and securities (12 CFR 160 and 12 USC 1464(c)).
 - Refer to the chart at 12 CFR 160.30 for specific limitations applicable to FSAs.
 - Nonresidential real property loans (12 USC 1464(c)(2)(B)).
 - Loans to one borrower (12 CFR 32.3).
 - Extensions of credit to executive officers, directors, and principal shareholders and their related interests (12 USC 1468(b) and 12 CFR 215).
 - Limits on investments in bank premises (12 CFR 5.37(d)).
 - Supervisory loan-to-value limits (12 CFR 160.101).
 - Transactions with affiliates (12 CFR 223).
 - Dividends (12 CFR 5.55).

These lists provide guidance and are not a comprehensive analysis of all the regulations or policies applying limitations based on either GAAP capital or regulatory capital that are applicable to FSAs.

5. Review the bank's capital structure, including the composition of the bank's stock accounts and transactions in the capital accounts from the prior year to understand the type and volume of activity. Consider whether there have been any material or unusual changes to the stock accounts and stock ownership. Include in that review changes in additional paid-in capital and retained earnings. Conclude on the quality of the capital accounts (higher-quality capital includes common stock, additional paid-in capital, and retained earnings).
6. Obtain and review the bank's financial statements (including the footnotes), the appropriate schedules of the call report, and, if the bank is a registrant, the bank's U.S. Securities and Exchange Commission Form 10-K Annual Report or Quarterly Report Form 10-Q (if applicable).
7. If the bank is subject to the market risk rule, discuss relevant exposures with examiners assigned to assess market risk. Obtain core assessments of interest rate risk, price risk,

and other examination conclusions, including key indicators of market risk. Consider the effects on capital adequacy. Refer to appendix E of this booklet and 12 CFR 3, subpart F, for further guidance on compliance with the market risk rule.

8. Discuss with examination staff responsible for reviewing the bank's compliance with the Volcker rule any required capital deductions, if applicable. Refer to table 2, footnote "a" of this booklet and OCC Bulletin 2014-27, "Volcker Rule: Interim Examination Procedures." Review the deductions, as applicable, on the appropriate call report schedule. Note that banks subject to the Volcker rule often are advanced approaches banks.

9. Determine whether the bank

- acts as its own transfer agent.
- handles dividend payments in-house or uses a third party.

Consult with examiners responsible for reviewing transfer agent activities and third-party risk management or review relevant examination conclusions for these areas.

10. Obtain appropriate schedules from the call report to determine whether the bank meets minimum capital requirements for the following ratios (if necessary, verify that the bank's computations are correct):

- CET1 capital, tier 1 capital, and total capital (all banks).
- Leverage ratio (all banks).
- SLR (advanced approaches banks).
- eSLR (depository institution subsidiaries of a GSIB).

11. If the bank is not adequately capitalized, review the OCC's supervisory information systems for correspondence regarding the bank's submission of a capital restoration plan. To determine the scope of the review of the bank's capital restoration plan, review Banking Circular 268 and discuss the bank's plan with the examiner-in-charge (EIC).

12. Based on an analysis of information obtained in the previous steps, as well as input from the EIC, determine the scope and objectives of the capital examination. Select from the following examination procedures the steps needed to meet examination objectives and the supervisory strategy.

Quality of Risk Management

**Conclusion: The quality of risk management is
(strong, satisfactory, insufficient, or weak).**

The conclusion on risk management considers all risks associated with capital and dividends.

Policies

Policies are statements of actions adopted by a bank to pursue certain objectives. Policies guide decisions and often set standards (on risk limits, for example), and should be consistent with the bank's underlying mission, risk appetite, and core values. Policies should be reviewed periodically for effectiveness and approved by the board of directors or designated board committee.

Objective: Determine whether the board has adopted effective capital and dividend policies that are consistent with safe and sound banking practices and appropriate to the size, nature, and scope of the bank's operations.

1. Evaluate the bank's capital and dividend policies and determine whether they provide appropriate guidance for managing the bank's capital and dividends. Consider whether policies
 - are consistent with the board's risk appetite.
 - are reviewed and approved by the board at appropriate intervals.
 - require maintenance of adequate records and documentation of the stock accounts and shareholders, as applicable.
 - provide for compliance with applicable laws and regulations.
 - clearly and completely articulate the bank's objectives for maintaining a satisfactory capital position, including restricting dividends and other capital distributions when the bank does not, or may not, meet required capital levels or internal targets.
 - include requirements for timely and accurate financial, operational, and regulatory reports.
 - include appropriate targets, limits, or floors for dividends, minimum capital ratios, and capital levels.
 - incorporate measures to ensure that sufficient capital remains after the payment of dividends to support the bank's business plans, growth, and business goals as stated in the bank's strategic or capital plans.
 - address the authorization of capital account and dividend transactions.
 - require adequate documentation of capital transactions with affiliates or related organizations.
 - address the employment of an independent stock registrar or stock transfer agent (e.g., review policies for third-party vendors), if applicable.
 - address the selection and use of a third-party dividend paying agent, if applicable.

2. Determine whether policies establish limits on dividends and issuances of capital instruments, redemptions, or repurchases, and delineate prudent actions to be taken if the limits are exceeded. Consider whether policies
 - include sufficient standards for detecting and preventing activities that could materially affect the capital accounts, dividends, and capital adequacy.
 - provide guidelines for setting dividends at appropriate levels relative to the bank's financial position.
 - include processes for reporting and remediating breaches of dividend limits.

3. Review policies and reports to determine whether the bank appropriately captures capital and RWA and accurately quantifies capital ratios. Consider the accuracy of
 - the deduction for financial subsidiaries (national banks) or non-includable subsidiaries (for FSAs), as applicable. Refer to appendix A of this booklet.
 - calculations of limits on CET1, tier 1, and total capital minority interest included in CET1 capital, tier 1 capital, or total capital.
 - deductions for investments in the capital of UFI's pursuant to the corresponding deduction approach. Refer to appendixes A and E of this booklet.
 - for advanced approaches banks, deductions pursuant to the 10 and 15 percent CET1 capital deduction thresholds (MSAs, certain DTAs, and significant investments in the common stock of UFI's), as well as the appropriate risk weight for those items not deducted. Refer to appendixes A and E of this booklet.
 - for non-advanced approaches banks, deductions for MSAs and certain DTAs, and significant investments in the common stock of UFI's, as well the appropriate risk weight for those items not deducted.
 - other net of tax deductions. Refer to appendix A of this booklet.
 - the AOCI account and applicable adjustments if the bank is a non-advanced approaches bank and elected the AOCI opt-out election. Refer to appendix A of this booklet.
 - the risk weights for HVCRE ADC loans and loans exempted from treatment as HVCRE. Refer to appendix C of this booklet.
 - risk weights for the following:
 - Exposures to commitments and associated CCFs.
 - Exposures to modified or restructured loans.
 - Equity investments. Refer to appendix C of this booklet.
 - Securitization and off-balance-sheet items. Refer to appendix C of this booklet.
 - counterparty credit risk reported by the bank. Refer to appendix C of this booklet.
 - post-closing or adjusting journal entries and the recording of subsequent events.
 - the CCB calculation and the amount of buffer needed for the bank to avoid restrictions on dividend or discretionary bonus payments.
 - If applicable, determine the CCyB amount for advanced approaches banks. Refer to the "Regulatory Capital Framework" section of this booklet.

Objective: Determine the adequacy of the bank's capital planning process, including the adequacy of the capital plan, for the overall risk profile, complexity, and corporate structure of the bank.

1. Assess the adequacy of the bank's processes for identifying and evaluating material risks that should be considered in capital planning.
2. Determine whether the capital plan includes appropriate internal capital targets given the bank's risk exposure. Consider whether
 - management routinely compares these targets to actual capital ratios and reports the comparison to the board.
 - the capital plan adequately reflects any capital instrument offerings and the effect on capital accounts and capital adequacy.
 - management incorporates the results of stress testing into capital planning as a means of quantifying the potential impact of identified risks.
 - management considered the following:
 - concentration levels and limits
 - quality of risk management, internal control, and audit processes
 - quality, sustainability, and level of earnings
 - quality, composition, and sources of capital
 - quality of assets and credit administration practices
 - allowance adequacy
 - balance sheet structure, liquidity needs, and interest rate risk
 - the bank's strategic objectives, including whether the bank effectively assesses and controls risks when executing new products and services (this is critical for de novo institutions)
 - historical and planned growth
 - mergers and acquisitions
 - special situations that could cause capital impairment or future losses;
 - form of ownership and access to capital
 - dividend practices
 - a holding company's ability to serve as a source of strength and to contribute capital to the bank
 - a holding company's reliance on dividend payments from the bank to service debt or other obligations
 - effect of affiliates
 - supervisory requirements for corrective action or associated with enforcement actions.
 - management's forecasted numbers and underlying assumptions for its internal capital targets are reasonable given the banks current capital levels, historical performance, and any planned initiatives that could require additional capital.
 - actual regulatory capital ratios are materially different from those in the capital plan. If materially different, determine the reason for the difference and discuss with management or the board, as appropriate.

3. Assess the adequacy of the bank's strategy for maintaining adequate capital and assess the bank's capital contingency plans. Consider whether
 - the capital plan includes an appropriate strategy to maintain capital adequacy and build capital if needed. The strategy should consider both internal and external sources of capital.
 - the capital plan includes appropriate contingency plans relative to the bank's size, complexity, and risk profile.
 - the capital plan includes timely alerts to management regarding deteriorating conditions and a need to improve the bank's capital position, including a need to raise capital.

Processes

Processes are the procedures, programs, and practices that impose order on a bank's pursuit of its objectives. Processes define how activities are carried out and help manage risk. Effective processes are consistent with the underlying policies and are governed by appropriate checks and balances (such as internal controls).

Objective: Determine whether the bank's capital and dividends processes receive proper oversight from senior management and the board.

1. Review board or risk committee minutes for discussions regarding internal risk assessment activities that management uses to supervise capital accounts, dividends, and the bank's overall capital adequacy. Consider risk assessments of the bank's ongoing activities, proposed activities, or noncompliant activities (if any), and the methods used by the committee and management to recognize and monitor risk. Note whether the committee receives information about emerging issues in a timely manner.
2. If a bank's stock is unlisted, obtain and review the bank's procedures for determining a stock price and managing sales of its stock.
3. Determine whether management has effective processes that promote compliance with applicable laws and regulations regarding the capital accounts, dividends, and minimum capital requirements. Consider whether
 - procedures are in place for compliance with applicable laws and regulations.
 - processes exist to determine compliance with applicable laws and regulations.
 - reports to senior management and the board detail any concerns about compliance with applicable laws and regulations, and whether the reports are provided in a timely manner.
4. Obtain a list of capital- or dividend-related deficiencies, if any, noted in the latest internal or external audit reports, and determine whether management has taken appropriate corrective action.

Objective: Assess the adequacy of the bank's dividend processes.

1. Review board minutes for discussions regarding dividends. Assess the bank's procedures for declaring and paying dividends, and determine whether management has implemented a process to evaluate dividend levels periodically.
2. Review the bank's procedures to ensure that dividends (past, declared but not yet paid, and projected) comport with the bank's strategic and capital plans. Consider whether
 - earnings presented in the strategic and capital plans have a history of consistency and stability to support paid or projected dividends.
 - the trends for earnings and financial results are positively correlated to the bank's dividend trends in the plans.
 - actual and, if applicable, projected dividends are reasonable relative to the bank's current and projected capital and earnings levels.
 - projected dividends could adversely affect the bank's capital adequacy.
 - actual or planned dividends up-streamed to the holding company were reasonable and well-documented.
 - the bank may be its own source of funds if a parent bank down-streamed dividends to the bank. Determine whether the bank may be directly or indirectly financing its own capital infusion.
 - the bank's strategic plan, capital plan, and budget reflect the level of dividends paid since the last examination, as well as any dividends planned.

Objective: Assess the bank's compliance with applicable laws and regulations for its capital accounts.

1. If the bank has had a change in control since the last examination, assess the bank's compliance with statutory and regulatory requirements. Refer to the "Specific Requirements for Decreases" section of the "Capital and Dividends" booklet of the *Comptroller's Licensing Manual* and the "Change in Bank Control" booklet of the *Comptroller's Licensing Manual*.
2. For issuances of common stock, preferred stock, or subordinated debt notes since the last examination, determine whether the bank received the necessary OCC approvals for the issuance to be included in regulatory capital as CET1 capital, additional tier 1 capital, or tier 2 capital. Confirm that the bank's treatment of the issuance for regulatory capital purposes is consistent with the OCC's approval. If approval was required and not obtained, and the issuance is not includable in regulatory capital, determine whether the bank should revise its internal capital reporting and refile its call report.
3. If the bank elected S-corporation status since the last examination, assess the bank's compliance with IRS requirements to maintain its subchapter S status.
 - Review the bank's eligibility for the election, such as the number of shareholders, the type of shareholders, and stock issued.

- Review shareholder agreements regarding stock transfers that management will use to maintain compliance with eligibility requirements.
- Verify that management has a method for monitoring ongoing compliance with S-corporation eligibility requirements and periodically tests and reviews the method.

Objective: Determine whether the dividend procedures are appropriate to govern compliance with statutory and regulatory requirements.

1. Review dividend payments and document any that exceed the total of the bank's net income for the current year combined with the retained net income of the prior two years.
 - If the bank has paid dividends since the last examination, note whether the bank is adequately capitalized or better. For national banks, refer to 12 USC 56 and 60 and the regulatory requirements of 12 CFR 5, subpart E. For FSAs, refer to 12 CFR 5.55.
2. Determine whether the bank was required to file a notice or application to pay dividends since the last examination and whether the filing complied with applicable requirements.
 - Document any dividends that exceed undivided profits, and ask bank management to explain.
 - Document any distributions of permanent capital (i.e., payments to shareholders not from retained earnings) that the OCC did not approve.
 - Review and document whether the bank received OCC approval for anticipated dividend payments.
 - For a dividend payable in property other than cash, confirm that the bank received prior OCC approval and met all OCC filing requirements before making the distribution.
 - If an FSA is an eligible bank, document any dividends paid where the institution did not remain well-capitalized or was no longer an eligible bank after the distribution.
3. If the bank is subject to an enforcement action that restricts the payment of dividends, determine whether dividend payments were made in compliance with the requirements of the enforcement action.
4. If the bank's CCB imposes restrictions on dividends, assess the bank's process for complying with the restrictions. Determine whether the bank has complied with any applicable restrictions. (The OCC may provide a waiver for restrictions on dividends determined under the CCB rule, if requested in advance.)

Objective: Determine whether the bank has adequate processes that consider risks to capital over the planning horizon and the effect of any capital actions. For example,

1. Determine whether the bank's projections in its capital plan appropriately address material risks and provide for adequate capital by identifying through discussions with examination staff any material risks to earnings and capital based on previous examination work.

2. Identify any planned capital actions, including dividends and any stock issuances, and determine whether these items are included in the bank's projections.
3. Verify that projected capital actions are consistent with historical evidence and the bank's past capital planning practices.
4. Determine whether the capital plan identifies reasonable alternatives (e.g., suspension of dividends, capital issuances, reduction of overhead or other expenses, or sales of assets) to provide for adequate capital, and note the alternatives.

Objective: Determine whether the bank has adequate processes to assess its access to capital markets and other sources of capital, including support provided by a holding company.

1. Identify sources of capital through discussions with management and by reviewing the bank's capital plan.
 - Assess whether the bank is dependent on limited sources for capital infusions and the adequacy of those sources for funding.
 - Assess the financial strength and willingness of the bank's sources to provide capital.
2. As appropriate, assess the financial condition of the parent company, and that of subsidiaries of the parent company or bank.
 - Consider whether these entities have the financial capacity, separately or collectively, to infuse capital into the bank, as needed.
 - Assess the bank's dependence on these entities for capital.
 - Review whether the bank has incorporated capital infusions from any of these entities into its strategic/capital plans.
3. Review the bank's process to risk weight on- and off-balance-sheet exposures. Refer to appendix C of this booklet or 12 CFR 3.32. If necessary, verify that computations are correct.

Personnel

Personnel are the bank staff and managers who execute or oversee processes. Personnel should be qualified and competent, have clearly defined responsibilities, and be held accountable for their actions. They should understand the bank's mission, risk appetite, core values, policies, and processes. Banks should design compensation programs to attract and retain personnel, align with strategy, and appropriately balance risk-taking and reward.

Objective: Determine whether the board and management possess the knowledge and experience required and engage competent personnel to address capital accounts, dividend, and capital adequacy issues.

1. Assess significant current and previous work experience of the board, management, and other capital accounts and dividends personnel. Consider
 - specialized experience in public and private stock offerings.
 - experience in transfer agent duties, if internally performed.
 - legal and accounting experience (e.g., preparing budgets and variance reports, performing external auditing, general ledger management, preparing regulatory reports, and overseeing third-party contracts such as contracts with third-party transfer agents).

2. If external resources (e.g., third-party providers) are used for raising capital and paying dividends, consider
 - the range of specialized experience in public and private stock offerings.
 - the vendor's reputation as a third-party provider of bank services (e.g., IT, registered agent, payroll, or dividend paying agent). If the bank has third-party relationships that involve critical activities affecting the bank's stock accounts or dividend payments, determine whether oversight is consistent with OCC Bulletin 2013-29, "Third-Party Relationships: Risk Management Guidance," and OCC Bulletin 2017-21, "Third-Party Relationships: Frequently Asked Questions to Supplement OCC Bulletin 2013-29."
 - legal and accounting experience.
 - licensing or certification requirements.

3. Determine the ability, experience, depth, and integrity of management to determine risks to capital.
 - Review management's and the board's record of past performance and their effectiveness in managing the bank's capital adequacy during periods of stress by reviewing board reports, steps taken to identify and address material risks, and overall bank performance.
 - Assess the effectiveness of how management determines the bank's capital needs relative to material risks by reviewing management's internal assessment of the bank's capital adequacy.
 - Determine whether management demonstrates that it understands the regulatory capital rule and minimum regulatory requirements, as applicable to the bank, by reviewing call report exceptions, other reporting errors, or by discussing with management certain areas of operations (e.g., MSAs, securitizations, dividends and the CCB calculation, and AOCI reporting requirements).
 - Determine what steps management takes to ensure that capital-to-asset ratios are maintained within required policy limits.
 - Determine whether management periodically prepares and reviews analyses of the bank's regulatory capital position and the adequacy of the analyses.
 - Determine whether management provides adequate explanations monthly (or otherwise regularly) for variances from the capital plan or budget by reviewing

- variance reports provided to the board and also by reviewing discussions in the board's minutes or in the minutes from the accounting or audit committee.
- Discuss with the EIC relevant information on the quality and depth of management's capabilities given any material effect on the bank's capital adequacy.
4. Assess management's and the board's ability to address emerging needs for additional capital as reflected by the adequacy of stress testing, if applicable.
- If the bank is subject to stress testing under the Dodd–Frank Act, discuss the adequacy of the bank's stress testing processes with the examiner concluding on the stress tests and review any examination conclusions, if available.
 - If a bank is not required to perform stress testing under the Dodd–Frank Act, determine whether the bank tests, in some manner, key areas of its operations with regard to its risks and vulnerabilities that may affect capital adequacy. Key areas typically include the bank's lending, investment, and deposit portfolios.
 - For any stress-testing method(s), assess whether underlying assumptions are reasonable given the bank's overall risk profile, size, sophistication, capital needs, and strategic and/or capital plan(s) or planning process.
 - Review the methodology used to stress test and whether it allows the bank to consider potential adverse outcomes affecting capital levels.
 - Review the adequacy of the bank's interest rate sensitivity analysis. If the bank does not perform any type of interest rate analysis, determine how the bank assesses its sensitivity to changing interest rates.
 - Assess the adequacy of management's plans to maintain capital in times of economic stress.

Control Systems

Control systems are the functions (such as internal and external audits and quality assurance) and information systems that bank managers use to measure performance, make decisions about risk, and assess the effectiveness of processes and personnel. Control functions should have clear reporting lines, sufficient resources, and appropriate access and authority. Management information systems should provide timely, accurate, and relevant feedback.

Objective: Determine whether the bank has information management systems in place to provide accurate and timely assessments of the risks associated with its capital and dividends.

1. Assess whether management receives reports that evaluate risk levels and trends in the bank's capital and dividends.
2. Assess whether the reports address material capital adequacy and dividend issues. If there is no report, or if the report fails to address material issues, determine whether there are other independent risk control functions that effectively serve to inform management of material capital and dividends issues.

Objective: Determine whether the bank has appropriate internal controls in place over capital accounts and dividends.

1. Determine whether the bank has procedures to ensure adequate separation of duties regarding authorization and payment of dividends.
2. Determine whether the bank has procedures to designate officers who approve and review transactions to the capital accounts.
3. Determine whether the bank has procedures to reconcile the proceeds of its capital stock transactions and subordinated debt sales to the general ledger.

Objective: Determine whether the bank has adequate internal and external audit systems in place. Review internal and external audits or other internal or external reports of the bank's capital accounts, dividends, and capital adequacy, and determine whether there are any issues or concerns. Discuss any concerns about the adequacy of the audits or other reviews with the examiner responsible for reviewing corporate governance, internal and external audit, or the management component rating, as applicable.

1. Assess the scope, frequency, effectiveness, and independence of the internal and external audits of capital and dividends.
2. Determine whether an internal or external auditor or a compliance officer reviews the bank's capital and dividends. Consider whether
 - the reviews are adequate in terms of scope, coverage, and frequency of review.
 - the reviews assess capital for accuracy and compliance with laws, rulings, and regulations.
 - dividend payments are reviewed for compliance with statutory and regulatory requirements.
 - changes of control in bank stock and stock issuances are reviewed for compliance with statutory and regulatory requirements.
3. If the bank acts as its own transfer agent or registrar, examine the records pertaining to stock certificates to ensure that controls are adequate to prevent over-issuance of stock.
4. Review the audit report findings on capital and dividends to determine whether any significant or material weaknesses or deficiencies were identified, and verify that management was alerted to the findings in a timely manner by reviewing audit committee reports or board minutes.
 - Where appropriate, verify that management responded in a timely manner to significant or material deficiencies or weaknesses.

Conclusions

Conclusion: The quality of risk management associated with capital and dividends is (strong, satisfactory, insufficient, or weak).
Capital is rated (1, 2, 3, 4, or 5).

Objective: To determine, document, and communicate overall findings and conclusions regarding the examination of capital and dividends.

1. Determine preliminary examination findings and conclusions and discuss with the EIC.
 - Determine whether the bank's capital and dividend practices affect any of the eight risk areas.
 - Conclude on the quality of risk management over capital and dividends.
 - Document any violations or other concerns.

Summary of Risks Associated With Capital and Dividends				
Risk category	Quantity of risk	Quality of risk management	Aggregate level of risk	Direction of risk
	(Low, moderate, high)	(Weak, insufficient, satisfactory, strong)	(Low, moderate, high)	(Increasing, stable, decreasing)
Credit				
Interest rate				
Liquidity				
Price				
Operational				
Compliance				
Strategic				
Reputation				

2. Determine the capital component rating.
 - Consider the following Uniform Financial Institutions Rating System factors:
 - Level and quality of capital and overall financial condition of the bank.
 - Ability of management to address emerging needs for additional capital.
 - Nature, trend, and volume of problem assets, and adequacy of the ALLL and other valuation reserves.
 - Balance-sheet composition, including nature and amount of intangible assets, market risk, concentration risk, and risks associated with nontraditional activities.
 - Risk exposure represented by off-balance-sheet activities.

- Quality and strength of earnings, and reasonableness of dividends.
- Prospects and plans for growth and past experience in managing growth.
- Access to capital markets and other sources of capital, including support provided by a parent holding company.

Note: A bank is expected to maintain capital commensurate with the nature and extent of risks to the institution, and management should demonstrate the ability to identify, measure, monitor, and control these risks. When evaluating the adequacy of capital to assign the capital component rating, examiners should consider the bank's risk profile.

3. If substantive safety and soundness concerns remain unresolved that may have a material adverse effect on the bank, further expand the scope of the examination by completing verification procedures.
4. Discuss examination findings with bank management, including violations, matters requiring attention, and conclusions about risks and risk management practices. If necessary, obtain commitments for corrective action.
5. Compose conclusion comments, highlighting any issues that should be included in the report of examination. If necessary, compose matters requiring attention or violations.
6. Update the OCC's supervisory information system and any applicable report of examination schedules or tables.
7. Update, organize, and reference work papers in accordance with OCC policy.
8. Ensure that any paper or electronic media containing sensitive bank or customer information are appropriately disposed of or secured.

Internal Control Questionnaire

An Internal Control Questionnaire (ICQ) helps an examiner assess a bank's internal controls for an area. ICQs typically address standard controls that provide day-to-day protection of bank assets and financial records. The examiner decides the extent to which it is necessary to complete or update ICQs during examination planning or after reviewing the findings and conclusions of the core assessment. These ICQs apply to national banks, stock FSAs, and federal mutual savings associations, as applicable.

General

1. Does the bank have a formal internal audit plan that covers all significant organization activities affecting the capital accounts and capital adequacy over an appropriate period of time?
2. Is there a formal internal audit report with an opinion about the adequacy of the bank's systems of control, the quality of ongoing operations, and the bank's compliance with previously evaluated systems of control and operations?
 - Are audit findings communicated to the board and senior management in a timely manner?
 - Does management respond in a timely manner to correct or minimize any significant or material concerns noted in the audit findings?
 - Is there an annual summary report of audit activities to the board and senior management that includes an opinion on the overall condition of the bank's controls and operations?
3. Does the bank periodically analyze its capital accounts with respect to both current and future need for capital?
4. Are bank activities (e.g., new services, products, and growth) in alignment with the capital plan and strategic plan?
5. Does the bank prepare a quarterly analysis of its dividend payments and processes?
6. Does the bank prepare a monthly analysis of its regulatory capital risk-based and leverage ratios? Do the quarter-end ratios reconcile to those reported on the regulatory capital schedule in the call report?
7. Were adjustment entries resulting from an external or internal audit required for the capital accounts? Review the entries for completeness and accuracy.
8. Has the bank made any material reporting errors on the call report? Review exception reports and internal and external audit reports, as available. Are any errors repetitive (ongoing)? Note requests by the OCC for corrections and the bank's response. Are errors and irregularities discovered in a timely fashion and promptly corrected?

Conclusion

1. Is the foregoing information an adequate basis for evaluating internal control?
 - Are there any other significant internal auditing procedures, accounting controls, administrative controls, or other circumstances that improperly impair controls or inappropriately mitigate any weaknesses indicated in this section of this booklet? (Explain negative answers briefly, and indicate conclusions as to their effect on specific examination or verification procedures.)
2. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered _____ (strong, satisfactory, insufficient, or weak).
3. Confirm that the bank follows appropriate third-party procedures to review the activities of a third-party transfer agent or registrar.
4. If management tracks historical trends for the bank's stock price, review its methodologies and use of the information in pricing the stock.
5. Does a separately designated officer or internal auditor review recorded transactions to the capital accounts?
6. Document whether the bank maintains a separation of duties regarding the custody of dividend checks, authorization of dividends, preparation, signing of checks, and distribution of the checks, if applicable. Review and determine the propriety of handling of unclaimed dividend checks, whether in-house or by a third-party transfer agent.
7. If the bank is an advanced approaches bank, has it completed its parallel run and received OCC approval to use the advanced approaches rule?

Verification Procedures

Verification procedures are used to verify the existence of assets and liabilities, or test the reliability of financial records. Examiners generally do not perform verification procedures as part of a typical examination. Rather, verification procedures are performed when substantive safety and soundness concerns are identified that are not mitigated by the bank's risk management systems and internal controls. These verification procedures apply to national banks, stock FSAs, and federal mutual savings associations, as applicable.

Capital Stock

1. Are stock and debt issuances properly categorized as CET1 capital, AT1 capital, or tier 2 capital according to the criteria in 12 CFR 3.20(b), (c), and (d), respectively?
2. Is minority interest included in CET1, tier 1, or total capital appropriately classified?
3. Do subordinated debt issuances have maturities of five years or more? Are subordinated debt issuances in the last five years of the issuances' due dates being amortized correctly? Are there any clauses or broad conditions or events of default that are inconsistent with regulatory capital requirements for subordinated debt? Are proper disclosures made by advanced approaches banks? Refer to the "Subordinated Debt" booklet of the *Comptroller's Licensing Manual* and OCC Bulletin 2015-22, "Subordinated Debt: Guidelines and Sample Notes."
4. As applicable, if the bank employs the services of a third-party stock registrar, stock transfer agent, or dividend paying agent, request confirmation from the transfer agent of total shares authorized and issued, and check the information provided.
5. If the bank acts as its own transfer agent and/or registrar,
 - verify outstanding stock by comparing issued shares with the stock certificate records.
 - obtain or prepare a working paper listing transactions since the preceding examination. Transaction information should include the new shareholder's name, number of shares, and certificate number offsetting with the previous shareholder's name(s), number of shares surrendered, and certificate number(s).
6. If applicable, total stockholder ledgers, and reconcile total par value of each class of stock issued and outstanding. Compare the analysis to the appropriate general ledger control accounts.
7. For capital changes since the previous examination,
 - reconcile the proceeds of capital stock sold to investment bankers' statements, prospectuses, option agreements, etc., and trace credit to the general ledger.
 - check disbursements (payments to underwriters, etc.) in connection with the stock sale to contracts, official approvals, or invoices.

8. Are the bank's records of shares authorized, issued, unissued, and the par value of the stock adequate and accurately recorded?
9. If a related-party transaction occurred, review the bank's documentation of such transactions and whether the documentation is accurate.
10. Reconcile stock transactions to the general ledger and appropriate call report schedules and note material discrepancies or exceptions, if any.

Dividends

1. Trace dividend amounts authorized by the board to the amount of cash disbursed.
2. Review the computation of dividends paid by multiplying the number of shares outstanding at each dividend date by the appropriate per share amounts approved by the board.
3. Review and document the flow of dividends from authorization to payment, and determine whether the liability added immediately after declaration of any dividend is equal in amount to the cash dividend declared.
4. Obtain a schedule of any cumulative preferred dividends in arrears.
5. Review the documentation and appropriateness of dividends paid to the parent company.

Capital Adequacy

1. Compare the year-end call report to the bank's audited financial statements. Review post-close or adjusting journal entries from the bank's audited financial statements. Were these adjustments made to the call report?
2. Review the accuracy of the bank's risk-based and leverage ratios reported on the call report by recalculating the ratios. Are CET1 capital, tier 1 capital, and total capital calculated in accordance with the definitions of CET1 capital, tier 1 capital, and total capital as set forth in 12 CFR 3? Verify that the average total consolidated assets is properly calculated and reported.
3. Review the calculation of the CCB.
4. Verify that each on- and off-balance-sheet item has been assigned to the appropriate risk category in accordance with 12 CFR 3. Pay close attention to underlying obligors, collateral, guarantees, and equity investments. Verify that the bank's documentation supports the assignment of any preferential risk weights.

5. Verify that all off-balance-sheet items have been converted properly to credit-equivalent amounts based in 12 CFR 3. Pay close attention to assets sold with recourse, standby letters of credit, and commitments.
6. Review the bank's AOCI account. For banks making the AOCI election, verify that the adjustments outlined in 12 CFR 3 are met.
7. Review the bank's goodwill and other intangible assets and verify that the criteria and limitations in 12 CFR 3 are met. Verify that goodwill and other nonqualifying identifiable intangibles are deducted from CET1 capital.
8. Review deductions for gain-on-sale in connection with a securitization exposure, certain DTAs, defined-benefit pension plans, and nonqualifying capital instruments, and verify that the criteria and limitations in 12 CFR 3 are met.
9. Review capital deductions for investments in the bank's own capital instruments and deductions required under the corresponding deduction approach.
10. If the bank is an advanced approaches bank, verify the bank's calculation of the threshold for nonsignificant investments in the capital of UFIs.
11. If the bank is an advanced approaches bank, review the bank's capital deductions for MSAs, certain DTAs, and significant investments in the capital of UFIs in the form of common stock under the 10 and 15 percent deduction threshold tests. Verify the calculation of capital deduction thresholds and risk weights for amounts not deducted.
12. If the bank is a non-advanced approaches bank, review the bank's deduction for MSAs, certain DTAs, and significant investments in the capital of UFIs in the form of common stock and that the bank applies the appropriate risk weight to amounts not deducted.
13. Depending on whether the institution is a national bank, a stock FSA, a federal mutual savings bank, or an S-corporation, confirm that the institution is following specific regulatory reporting requirements. For example, an FSA has specific requirements to report subordinate organizations that, depending the subordinate organization's activities, may result in a regulatory capital deduction. Refer to 12 CFR 3.22(8)(i). A federal mutual savings association must have adequate retained earnings but no stock in its capital account.
14. If the bank has more than \$50 billion in assets, verify that the bank is in compliance with the disclosure requirements set forth at 12 CFR 3.61 to 3.63. (**Note:** Many of the disclosure requirements may be satisfied by the top-tier legal entity of a banking organization, and since most depository institutions with \$50 billion in assets are owned by a holding company, many of these disclosures likely will be made by holding companies.) If the bank has been approved as an advanced approaches bank, verify that the bank is in compliance with the disclosure requirements set forth at 12 CFR 3.172 and 3.173.

Appendixes

Appendix A: Explanation of the Regulatory Capital Components

This appendix describes the regulatory capital components of tier 1 capital and total capital. Tier 1 capital comprises CET1 capital, AT1 capital, and all applicable adjustments and deductions. Total capital comprises tier 1 capital, tier 2 capital, and all applicable adjustments and deductions.

CET1 Capital

CET1 capital, as one of the components of tier 1 capital, is the sum of the CET1 capital elements, accounting for regulatory adjustments and deductions in 12 CFR 3.22, as applicable. CET1 capital is the most loss-absorbing form of capital. CET1 capital elements include the following:

Common Stock Instruments and Related Surplus Net of Treasury Stock

A qualifying common stock instrument must satisfy the eligibility criteria in 12 CFR 3.20(b)(1)(i) through (xiii) to qualify as CET1 capital. For example, a common stock instrument, to qualify as CET1 capital, must be paid-in, issued directly by the bank, represent the most subordinated claim in a receivership, insolvency, liquidation, or similar proceeding, and have no maturity date.⁷² Common stock instruments must also satisfy all of the following requirements and conditions:

- The holder of the instrument is entitled to a claim on the residual assets of the bank that is proportional with the holder's share of the bank's issued capital after all senior claims have been satisfied in a receivership, insolvency, liquidation, or similar proceeding.
- The instrument can only be redeemed via discretionary repurchases with the prior approval of the OCC, and does not contain any term or feature that creates an incentive to redeem.
- The bank does not create at issuance of the instrument through any action or communication an expectation that it will buy back, cancel, or redeem the instrument, and the instrument does not include any term or feature that might give rise to such an expectation.
- Any cash dividend payments on the instrument are paid out of the bank's net income, retained earnings, or surplus related to common stock and are not subject to a contractual limit.
- The bank must have full discretion at all times to refrain from paying any dividends and making any other distributions on the instrument without triggering an event of default, a

⁷² Refer to 12 CFR 3.20(b)(1)(i).

requirement to make a payment-in-kind, or an imposition of any other restriction on the bank.⁷³

- Dividend payments and any other distribution on the instrument may be paid only after all legal and contractual obligations of the bank have been satisfied, including payments due on more senior claims.
- The holders of the instrument bear losses as they occur equally, proportionately, and simultaneously with the holders of all other common stock instruments before any losses are borne by holders of claims on the bank with greater priority in a receivership, insolvency, liquidation, or similar proceeding.
- The paid-in amount is classified as equity under GAAP.
- The bank, or an entity that the bank controls, did not purchase, or directly or indirectly fund, the purchase of the instrument.
- The instrument is not secured, not covered by a guarantee of the bank or of an affiliate of the bank, and is not subject to any other arrangement that legally or economically enhances the seniority of the instrument.
- The instrument has been issued in accordance with applicable laws and regulations.
- The instrument is reported on the bank's regulatory financial statements separately from other capital instruments.

Retained Earnings

The retained earnings⁷⁴ element of the CET1 capital component reflects a bank's profitability over time. Specifically, it represents accumulated net income less dividends paid out. National banks and FSAs may only pay dividends out of retained earnings or net income.⁷⁵ Certain payments out of retained earnings may require the OCC's prior approval.⁷⁶

Accumulated Other Comprehensive Income

AOCI is an element of CET1 capital that is subject to certain specific adjustments under 12 CFR 3.22. As described in 12 CFR 3.22(b), a non-advanced approaches bank may make an AOCI "opt-out" election on its call report filed for the first regulatory reporting period after the date the bank became subject to the revised regulatory capital rules. For most banks, this was the call report filed for the quarter that ended on March 31, 2015. Banks that elected to opt out make certain regulatory adjustments to CET1 capital for items reported in the AOCI account. These adjustments affect the amount of the bank's CET1 capital.⁷⁷ The opt-out election is not available for advanced approaches banks. Thus, advanced approaches

⁷³ A cancellation of dividends also must not trigger any other requirements or restrictions.

⁷⁴ Refer to 12 CFR 3.20(b)(2).

⁷⁵ Refer to 12 USC 56 and 60 and 12 CFR 5.64(c) (national banks); 12 CFR 5.55 (FSAs).

⁷⁶ Refer to the "Capital and Dividends" booklet of the *Comptroller's Licensing Manual*.

⁷⁷ Refer to 12 CFR 3.22(b) for the regulatory capital adjustments related to AOCI for banks that elected to opt out. Also refer to the "Capital as Equity" section of this booklet for a discussion of AOCI and GAAP.

banks and those non-advanced approaches banks that did not choose the AOCI opt-out election will recognize most AOCI components in CET1 capital.

Advanced Approaches Banks

Advanced approaches banks and any bank that did not make an AOCI opt-out election must, however, deduct any accumulated net gains and add any accumulated net losses on cash flow hedges included in AOCI that relate to the hedging of items that are not recognized at fair value on the balance sheet. Advanced approaches banks must also deduct the credit spread premium over the risk-free rate for derivatives that are liabilities. All banks, regardless of an AOCI opt-out election, must deduct any net gain and add any net loss related to changes in the fair value of liabilities that are due to changes in the bank's own credit risk.

Non-advanced approaches banks that have made an AOCI opt-out election must make the following adjustments in accordance with 12 CFR 3.22(b)(2):⁷⁸

- Subtract any net unrealized gains and add any net unrealized losses on AFS securities.
- Subtract any net unrealized losses on AFS preferred stock classified as an equity security under GAAP and AFS equity exposures.
- Subtract any accumulated net gains and add any accumulated net losses on cash flow hedges.
- Subtract any amounts recorded in AOCI attributed to defined-benefit postretirement plans resulting from the initial and subsequent application of the relevant GAAP standards that pertain to such plans.
- Subtract any net unrealized gains and add any net unrealized losses on held-to-maturity securities that are included in AOCI.

For regulatory capital purposes, regardless of the AOCI opt-out election, banks do not adjust (or neutralize) AOCI with regard to foreign currency translation changes. Foreign currency translation adjustments (positive or negative) flow into AOCI and thus into CET1 capital.

CET1 Minority Interest at 12 CFR 3.2

Minority interest, also called a noncontrolling interest under GAAP, is the portion of equity ownership in a subsidiary not attributable, directly or indirectly, to the parent company.⁷⁹ Capital issued by consolidated subsidiaries and not owned by the parent banking organization creates noncontrolling (minority) interest, which is available to absorb losses at the

⁷⁸ For fiscal years beginning after December 15, 2017, for public business entities, equity securities are no longer classified as either trading or AFS; instead, they are generally measured at fair value, with changes in fair value recognized through net income. Refer to ASU 2016-01. Thus, advanced approaches banks and non-advanced approaches banks that are public business entities do not adjust AOCI for these gains or losses. The ASU is effective in later years for all other banks.

⁷⁹ Refer to FASB Statement No. 160, "Noncontrolling Interests in Consolidated Financial Statements," an amendment of Accounting Research Bulletin No. 51 (Statement 160, codified primarily in ASC 810, "Consolidation").

subsidiary level but may not always absorb losses at the consolidated level. Therefore, the amount of minority interest that a bank may include in CET1 capital may be subject to limitations.⁸⁰ To include CET1 minority interest in the parent bank's CET1 capital, the subsidiary issuing the capital instrument must be a depository institution or foreign bank, and the capital instrument issued must meet all the eligibility criteria in 12 CFR 3.20(b)(1)(i) through (xiii) for CET1 capital, subject to limitations of 12 CFR 3.21(c).⁸¹ An example of calculating CET1 capital minority interest is provided in appendix D of this booklet and in the call report.

Issuances to Employee Stock Ownership Plans

A bank's common stock that is issued to its ESOP, or issued and held in trust for the benefit of its employees as part of an ESOP, may be included in CET1 capital. To be eligible, the shares must already be earned by the employees, and any stock repurchase must be made exclusively as a result of the Employee Retirement Income Security Act of 1974 (ERISA)⁸² for any bank instruments that are not publicly traded.⁸³

AT1 Capital

AT1 capital is a component of tier 1 capital in addition to CET1 capital. AT1 capital is the sum of AT1 capital elements and any related surplus, less any applicable regulatory deductions set forth at 12 CFR 3.22. AT1 capital elements include the following:

Instruments That Meet Criteria of 12 CFR 3.20(c)(1) and Related Surplus

A qualifying AT1 capital instrument must satisfy the eligibility criteria⁸⁴ at 12 CFR 3.20(c)(1)(i) through (xiv) and have the capacity to absorb losses on a

⁸⁰ In general, the minority interest limitation applies only if a subsidiary has surplus CET1 capital (that is, in excess of the subsidiary's minimum capital requirements and the applicable CCB).

⁸¹ For non-advanced approaches banks, CET1 minority interest exceeding the capital rules' minority interest limitations (surplus minority interest) is subject to the transition table 10 at 12 CFR 3.300(d) in accordance with the OCC's "transitions final rule," which maintains the transition treatment of surplus minority interest as of calendar year 2017. Refer to OCC Bulletin 2017-56, "Regulatory Capital Rule: Final Rule," and 82 Fed. Reg. 55309.

⁸² Refer to 29 USC 1002.

⁸³ Refer to 12 CFR 3.20(b)(5). Notwithstanding the criteria for CET1 instruments, common stock issued under ERISA does not violate criteria 12 CFR 3.20(b)(1)(iii), (iv), and (xi). In addition, an instrument issued by a bank to its ESOP must not violate criterion (x).

⁸⁴ Refer to 12 CFR 3.20(c)(1)(i) through (xiv) for the AT1 capital element criteria.

going-concern basis.⁸⁵ These instruments typically include qualifying noncumulative perpetual preferred stock, as well as other qualifying instruments discussed below. An AT1 capital instrument must be issued and paid in, subordinated to depositors and general creditors, and subordinated to debt holders in a receivership, insolvency, liquidation, or similar proceeding. To count as AT1 capital, the instrument must satisfy the following requirements:

- The instrument is not secured, covered by a guarantee of the bank or an affiliate of the bank, or subject to any other arrangement that legally or economically enhances the seniority of the instrument.
- The instrument has no maturity date and does not contain a dividend step-up or any other term or feature that creates an incentive to redeem.
- If callable by its terms, an AT1 capital instrument generally may not be called for a minimum of five years following issuance, but the terms of the instrument may allow the bank to call the instrument before five years because of a regulatory or tax event, or if the issuing entity is required to register as an investment company pursuant to the Investment Company Act of 1940.⁸⁶
- A bank must receive prior approval from the OCC to exercise a call option on the instrument.
- The bank does not create at issuance of the instrument, through any action or communication, an expectation that the call option will be exercised.
- Before exercising a call option, or immediately thereafter, the bank must either replace the instrument to be called with an instrument or instruments of equal value that meet the criteria for an AT1 capital instrument, or demonstrate to the OCC's satisfaction that following redemption, the bank will continue to hold capital commensurate with its risk.
- The redemption or repurchase of the instrument requires prior approval from the OCC.
- A bank must have full discretion to cancel dividends without triggering an event of default, a requirement to make a payment-in-kind, or an imposition of other restrictions on the bank except in relation to any distributions to holders of common stock or instruments that are *pari passu* with the instrument (e.g., dividend stoppers).
- Any distributions on the instrument are paid out of the bank's net income, retained earnings, or surplus related to other AT1 capital instruments.
- The instrument does not have a credit-sensitive feature, such as a dividend rate that is reset periodically based in whole or part on the bank's credit quality, or contain a dividend step-up or any other term or feature that creates an incentive to redeem.⁸⁷ It may have a dividend rate that is adjusted periodically independent of the bank's credit quality, in relation to general market interest rates or similar adjustments.

⁸⁵ Refer to the "Nonqualifying Capital Instruments" section of this appendix for information on the regulatory capital treatment of investments in nonqualifying capital instruments such as trust preferred securities (TruPS) and cumulative preferred stock.

⁸⁶ Refer to 15 USC 80a-1 et seq. Also refer to 12 CFR 3.20(c)(1)(v). A grandfathering exception to the five-year call rule applies to a noncumulative perpetual preferred AT1 capital instrument with terms that allow the bank to call the instrument before five years upon the occurrence of a rating agency event, provided the instrument was issued and included in tier 1 capital before January 1, 2014, and satisfies all criteria in 12 CFR 3.20(c).

⁸⁷ Refer to 12 CFR 3.300(c) for the phase-out periods for nonqualifying capital instruments.

- The paid-in amount is classified as equity under GAAP.
- The bank, or an entity that the bank controls, did not purchase, or directly or indirectly fund the purchase, of the instrument.
- The instrument does not have any features that would limit or discourage additional issuance of capital by the bank, such as provisions that require the bank to compensate holders of the instrument if a new instrument is issued at a lower price during a specified time frame.
- If the instrument is not issued directly by the bank or by a subsidiary of the bank that is an operating entity, the only asset of the issuing entity is its investment in the capital of the bank, and proceeds must be immediately available without limitation to the bank or to the bank's top-tier holding company in a form that meets or exceeds all of the other criteria for AT1 capital instruments.
- If the bank is an advanced approaches bank, the bank's governing agreement, offering circular, or prospectus for the instrument must disclose that the holders of the instrument may be fully subordinated to interests held by the U.S. government in the event that the bank enters into a receivership, insolvency, liquidation, or similar proceeding.

Tier 1 Minority Interest at 12 CFR 3.21(d)

A bank may include qualifying amounts of tier 1 minority interest, which means the tier 1 capital of a consolidated subsidiary of a bank that is not owned by the bank, that were not included in CET1 capital.⁸⁸

Operating Entity

For a parent bank to include noncontrolling (minority) interest as tier 1 minority interest in tier 1 capital, the subsidiary issuing the capital instrument generally must be an operating entity⁸⁹ and the capital instrument (typically, preferred stock) issued by the subsidiary must meet the eligibility criteria for AT1 capital at 12 CFR 3.20(c)(1)(i) through (xii) and (xiv), subject to limitations calculated at 12 CFR 3.21(d) and the applicable transition periods.

Non-Operating Entity

If a subsidiary is not an operating entity, a bank may include noncontrolling (minority) interest as tier 1 minority interest in tier 1 capital under certain conditions. The instrument issued by the subsidiary must meet the eligibility criteria for AT1 capital at 12 CFR 3.20(c)(1)(i) through (xii) and (xiv). In addition, as required by

⁸⁸ For non-advanced approaches banks only, tier 1 minority interest exceeding the capital rule's minority interest limitations (surplus minority interest) is subject to transition table 10 at 12 CFR 3.300(d) in accordance with the OCC's "transitions final rule," which maintains the transition treatment of surplus minority interest as of calendar year 2017. Refer to OCC Bulletin 2017-56, "Regulatory Capital Rule: Final Rule," and 82 Fed. Reg. 55309.

⁸⁹ An operating entity means a company established to conduct business with clients with the intention of earning a profit in its own right. Refer to 12 CFR 3.2 (definitions).

12 CFR 3.20(c)(1)(xiii), the proceeds of the issuance of the subsidiary's capital instrument must be immediately available without limitation to the parent bank, generally through the subsidiary's purchase of a capital instrument that meets or exceeds all of the other criteria for AT1 capital instruments and is issued by the parent bank. The only asset of the subsidiary must be the capital instrument issued by the parent bank.⁹⁰ The amount of tier 1 minority interest included in tier 1 capital is also subject to limitations, as applicable, at 12 CFR 3.21(d), and applicable transition treatments.

While both the instrument issued by the subsidiary not owned by the parent bank and the instrument issued by the bank to the subsidiary must meet the eligibility requirements in 12 CFR 3.20, the type of minority interest (i.e., tier 1 or total minority interest) is determined by the type of instrument issued by the parent bank to its non-operating-entity subsidiary. For example, if the instrument issued by the subsidiary meets the eligibility criteria for CET1 capital at 12 CFR 3.20(b)(1) but the instrument issued by the parent bank to its subsidiary meets the eligibility criteria for AT1 capital at 12 CFR 3.20(c)(1), then the minority interest would be considered tier 1 minority interest under 12 CFR 3.20(c)(2), subject to the limitations calculated under 12 CFR 3.21(d) and applicable transition treatment.

Real Estate Investment Trusts

Some banks have consolidated real estate investment trust (REIT)⁹¹ subsidiaries that may have issued capital instruments, such as preferred stock, that may be included in the regulatory capital of the consolidated parent bank as tier 1 minority interest. Preferred stock (that meets the AT1 capital criteria at 12 CFR 3.20(c)(1)(i) through (xiv)) issued by a REIT subsidiary that is actively managed and meets the regulatory capital definition of an operating entity⁹² generally qualifies for inclusion as tier 1 minority interest. The preferred stock instrument is subject to the limitations calculated under 12 CFR 3.21(d). At 12 CFR 3.20(c)(1)(vii), however, the eligibility criteria provide that the issuer of an AT1 capital instrument must have the ability to cancel dividends. That ability, if exercised, would conflict with the requirement that a REIT must distribute a significant portion of its earnings to maintain its tax-advantaged status. Therefore, the OCC has determined that an acceptable alternative approach for a REIT would be to maintain the ability to declare a consent

⁹⁰ A bank may disregard de minimis assets related to the operation of the issuing entity for purposes of this criterion. Refer to footnote 9 at 12 CFR 3.20(c)(1)(xiii).

⁹¹ A REIT is a company that is required to invest in real estate and real estate-related assets and to make certain distributions in order to maintain a tax-advantaged status. Typically, a REIT must distribute 90 percent of its earnings to maintain its tax-advantaged status.

⁹² REIT subsidiaries that are not actively managed for the purpose of earning a profit in their own right do not qualify as operating entities. Banks that are unsure whether minority interest investments in a particular REIT subsidiary will be includable in the bank's regulatory capital should discuss the concern with the OCC before including any amount of the minority interest in its regulatory capital. Note that the regulatory capital definition of operating entity is different than the definition of a national bank operating subsidiary under 12 CFR 5.34(c)(2). For purposes of determining regulatory capital, banks should follow the definition in the regulatory capital rule.

dividend in the event the OCC's capital rules restrict the REIT's ability to declare a cash dividend.⁹³ A consent dividend does not violate the eligibility criterion at 12 CFR 3.20(c)(1)(vii). If the REIT lacks the ability to declare a consent dividend, minority interest in the REIT may not meet AT1 capital criteria. The minority interest may, however, qualify as total capital minority interest if the instruments meet all of the relevant tier 2 capital criteria, subject also to any regulatory limitations applicable to total capital minority interest.⁹⁴

Other Qualifying Instruments at 12 CFR 3.20(c)

Other instruments that qualify as AT1 capital under 12 CFR 3.20(c) include

- instruments that were included as tier 1 capital under previous capital rules (12 CFR 3, appendix A for national banks or 12 CFR 167 for FSAs) and that were issued either (A) under the Small Business Jobs Act of 2010, or (B) before October 4, 2010, under the Emergency Economic Stabilization Act of 2008 (that includes instruments related to the Troubled Asset Relief Program (TARP)).⁹⁵
- an AT1 capital instrument that the bank issued to its ESOP or that it holds in trust for the benefit of its employees as part of an ESOP,⁹⁶ which does not violate AT1 capital criterion 12 CFR 3.20(c)(1)(iii), provided that any repurchase by the bank of the instrument is required solely by virtue of ERISA if the bank is not publicly traded.⁹⁷
- an instrument with terms providing that it may be called earlier than five years upon the occurrence of a rating agency event provided that the instrument was issued and included in the bank's tier 1 capital before January 1, 2014, and that the instrument satisfies all other AT1 capital criteria.

Tier 2 Capital

Tier 2 capital is the sum of tier 2 capital elements and any related surplus, less any applicable regulatory deductions and adjustments set forth at 12 CFR 3.22. Tier 2 capital is a component of total capital, in addition to tier 1 capital (CET1 capital plus AT1 capital). Tier 2 capital elements include the following:

⁹³ A consent dividend is a dividend that is not actually paid to shareholders, but is kept as part of the bank's retained earnings. The shareholders consent to treat the dividend as if it were paid in cash and include the payment in their individual tax returns as income for tax reporting purposes. A bank must only provide evidence that it has the ability to declare a consent dividend.

⁹⁴ Refer to 12 CFR 3.21(e).

⁹⁵ Refer to 12 CFR 3.20(c)(3).

⁹⁶ Typically, the issuance is in the form of a noncumulative perpetual preferred instrument and would be treated as such but for it being issued or held in trust in connection with an ESOP.

⁹⁷ Notwithstanding the AT1 capital criteria, instruments associated with an ESOP do not violate AT1 capital criteria in 12 CFR 3.20(c)(1)(v) and (xi).

Instruments That Meet Tier 2 Criteria and Related Surplus

A qualifying tier 2 capital instrument must satisfy the eligibility criteria at 12 CFR 3.20(d)(1)(i) through (xi).⁹⁸ Tier 2 capital instruments typically include subordinated debt instruments, and also may include qualifying preferred stock and other instruments. A tier 2 instrument must be issued and paid in, subordinated to depositors and general creditors of the bank, and have an original maturity of at least five years. In the last five years of the life of the instrument, the amount that is eligible to be included in tier 2 capital is reduced by 20 percent of the original amount of the instrument (net of redemptions) and is excluded from regulatory capital when the remaining maturity is less than one year. In addition, the instrument must not have any terms or features that require or create significant incentives for the bank to redeem the instrument prior to maturity, such as a step-up feature⁹⁹ or a conversion feature in combination with a call option that increases the credit spread.¹⁰⁰ Other criteria for a tier 2 capital instrument include the following requirements:

- The instrument, by its terms, generally may be called only after a minimum of five years following issuance, but the terms of the instrument may allow it to be called sooner upon the occurrence of a tax event or an event that would preclude the instrument from being included in tier 2 capital,¹⁰¹ or if the issuing entity is required to register as an investment company. For these events, a bank exercising a call option must receive the OCC's prior approval.¹⁰² In addition, a bank may redeem or repurchase an instrument prior to maturity but only with OCC prior approval.¹⁰³
- The instrument is not secured, not covered by a guarantee of the bank or an affiliate of the bank, and not subject to any other arrangement that legally or economically enhances the seniority of the instrument in relation to more senior claims.

⁹⁸ Refer also to the "Subordinated Debt" booklet of the *Comptroller's Licensing Manual*.

⁹⁹ An instrument with a step-up feature, such as increasing interest at certain dates, is considered to have an incentive to redeem. These instruments are phased out subject to table 9 at 12 CFR 3.300(c).

¹⁰⁰ For example, the agencies would not consider the conversion from a fixed rate to a floating rate (or vice versa) in combination with a call option without any increase in credit spread to constitute an "incentive to redeem." Specifically, a call option combined with a change in reference rate where the credit spread over the second reference rate is equal to or less than the initial dividend rate less the swap rate (that is, the fixed rate paid to the call date to receive the second reference rate) would not be considered an incentive to redeem. For example, if the instrument is a fixed to floating rate instrument, and at the date of pricing, the fixed rate is 2.9 percent and the swap rate to the call date is 1.2 percent, then a credit spread greater than 1.7 percent (2.9 percent less 1.2 percent) would be considered an incentive to redeem. Refer to page 62047 in the regulatory capital final rule at 78 Fed. Reg. 62018 (October 11, 2013).

¹⁰¹ Refer to 12 CFR 3.20(d)(1)(v). As with the AT1 capital criteria, there is a grandfathering exception at 12 CFR 3.20(d)(6) to the five-year call rule for tier 2 capital for certain instruments with terms that allow the bank to call the instrument before five years upon the occurrence of a rating agency event, provided the instrument was issued and included in tier 1 capital before January 1, 2014, and satisfies all criteria in 12 CFR 3.20(d).

¹⁰² Refer to 12 CFR 3.20(d)(1)(v)(A).

¹⁰³ Refer to 12 CFR 3.20(d)(1)(x).

- The bank must receive the prior approval from the OCC to exercise a call option on the instrument.
- At issuance, the bank must not create, through action or communication, an expectation that it will exercise the call option.
- Prior to exercising a call option (with OCC approval), the bank must either replace the amount called with an equivalent amount of an instrument that meets the criteria for regulatory capital under 12 CFR 3.20, or demonstrate to the OCC's satisfaction that following redemption, the bank would continue to hold an amount of capital that is commensurate with its risk.
- A holder of a tier 2 capital instrument must have no contractual right to accelerate the payment of principal or interest on the instrument, except in the event of a receivership, insolvency, liquidation, or similar proceeding.
- The instrument should not have a credit-sensitive feature (such as a dividend or interest rate) that is based in whole or in part on the bank's specific credit standing. Dividend rates may be adjusted periodically independent of the bank's credit standing and in relation to general market interest rates or similar adjustments.
- The bank, or an entity that the bank controls, has not purchased and has not directly or indirectly funded the purchase of the instrument.
- If the instrument is not issued directly by the bank or by a subsidiary of the bank that is an operating entity, the only asset of the issuing entity is its investment in the capital of the bank, and proceeds must be immediately available without limitation to the bank or the bank's top-tier holding company in a form that meets or exceeds all the other criteria for tier 2 capital instruments.
- The OCC must approve any redemption of the instrument before maturity or repurchase.
- Advanced approaches banks must disclose (e.g., in an offering circular or prospectus) that the holders of the instrument may be fully subordinated to any interests held by the U.S. government in the event that the bank enters into receivership, insolvency, liquidation, or similar proceedings.

Total Capital Minority Interest at 12 CFR 3.20(d)(2) and 3.21(e)

A bank may include qualifying amounts of total capital minority interest, which means the total capital of a subsidiary of a bank that is not owned by the bank, that were not included in tier 1 capital.¹⁰⁴

Operating Entity

For a parent bank to include noncontrolling (minority) interest as total capital minority interest in tier 2 capital, the subsidiary issuing the capital instrument generally must be an operating entity, and the capital instrument issued by the subsidiary must meet the eligibility

¹⁰⁴ For non-advanced approaches banks only, total capital minority interest exceeding the capital rules' minority interest limitations (surplus minority interest) is subject to transition table 10 at 12 CFR 3.300(d) in accordance with the OCC's "transitions final rule" that maintains the transition treatment of surplus minority interest as of calendar year 2017. Refer to OCC Bulletin 2017-56, "Regulatory Capital Rule: Final Rule," and 82 Fed. Reg. 55309.

criteria at 12 CFR 3.20(d)(1)(i) through (viii) and (x) through (xi) for tier 2 capital, subject to limitations calculated at 12 CFR 3.21(e) and applicable transition treatment.

Non-Operating Entity

If a subsidiary is not an operating entity, a bank may include noncontrolling (minority) interest as total capital minority interest in tier 2 capital under certain conditions. The instrument issued by the subsidiary must meet the eligibility criteria for AT1 capital at 12 CFR 3.20(d)(1)(i) through (viii) and (x) through (xi). In addition, as required by 12 CFR 3.20(d)(1)(ix), the proceeds of the issuance of the subsidiary's capital instrument must be immediately available without limitation to the parent bank, generally through the subsidiary's purchase of a capital instrument that meets or exceeds all of the other criteria for tier 2 capital instruments and is issued by the parent bank. The only asset of the subsidiary must be that capital instrument issued by the parent bank.¹⁰⁵ The amount of minority interest included in tier 2 capital is also subject to limitations, as applicable, at 12 CFR 3.21(e).

While both the instrument issued by the subsidiary and not owned by the bank and the instrument issued by the bank to the subsidiary must meet the eligibility requirements in 12 CFR 3.20, the type of minority interest (i.e., tier 1 or total minority interest) is determined by the type of instrument issued by the parent bank to its non-operating-entity subsidiary. For example, if the instrument issued by the subsidiary meets the eligibility criteria for an AT1 capital instrument at 12 CFR 3.20(c)(1) but the instrument issued by the parent bank to its subsidiary meets the eligibility criteria for tier 2 capital at 12 CFR 3.20(d)(1), then the minority interest would be considered total capital minority interest for the parent bank under 12 CFR 3.20(d)(2), subject to limitations calculated under 12 CFR 3.21(e).

ALLL at 12 CFR 3.20(d)(3)

Banks may include a portion of their ALLL in tier 2 capital subject to a limitation of 1.25 percent of the bank's standardized total RWA, not including any amount of the ALLL.¹⁰⁶

¹⁰⁵ A bank may disregard de minimis assets related to the operation of the issuing entity for purposes of this criterion. Refer to footnote 14 at 12 CFR 3.20(d)(1)(ix).

¹⁰⁶ A bank subject to the market risk rule would exclude its standardized market RWA from standardized total RWA before applying the 1.25 percent.

Advanced Approaches Banks

The following are additional requirements for advanced approaches banks:

- Advanced approaches banks that successfully exit parallel run must deduct any ALLL included in tier 2 capital.¹⁰⁷
- Advanced approaches banks must add back to tier 2 capital any eligible credit reserves that exceed the bank's total expected credit losses to the extent that the excess reserve amount does not exceed 0.6 percent of the bank's credit RWA when calculating the advanced approaches total capital ratio.¹⁰⁸

Other Qualifying Instruments at 12 CFR 3.20(d)

Under 12 CFR 3.20(d), other qualifying instruments include instruments that were included as tier 2 capital under previous capital rules (12 CFR 3, appendix A, for national banks or 12 CFR 167 for FSAs), and that were issued (1) under the Small Business Jobs Act of 2010 or (2) before October 4, 2010, under the Emergency Economic Stabilization Act of 2008 (that includes instruments related to TARP).¹⁰⁹

Certain Unrealized Gains at 12 CFR 3.20(d)

- Non-advanced approaches banks that made an AOCI opt-out election under 12 CFR 3.22(b)(2) include (or add back) to tier 2 capital 45 percent of pretax net unrealized gains¹¹⁰ on AFS equity securities.¹¹¹
- On the date of calculation of tier 2 capital, advanced approaches banks (beginning January 1, 2014) and non-advanced approaches banks (beginning January 1, 2015) that did not make an AOCI opt-out election include (or add back) (1) the amount of unrealized gains on AFS preferred stock classified as an equity security under GAAP and (2) the amount of unrealized gains on AFS equity exposures.

New Instruments

For new types of instruments not previously included in a bank's regulatory capital components, a bank must receive prior approval from the OCC before including the

¹⁰⁷ Refer to 12 CFR 3.10(c)(3)(ii)(A).

¹⁰⁸ Refer to 12 CFR 3.10(c)(3)(ii)(B).

¹⁰⁹ Refer to 12 CFR 3.20(d)(4).

¹¹⁰ For fiscal years beginning after December 15, 2017, for public business entities, equity securities will no longer be classified as either trading or AFS; instead, they will generally be measured at fair value, with changes in fair value recognized through net income. Refer to ASU 2016-01. Therefore, advanced approaches banks and non-advanced approaches banks that are public business entities make no adjustments to AOCI for these gains or losses. The ASU is effective in later years for all other banks.

¹¹¹ Refer to 12 CFR 3.20(d)(5).

instrument in regulatory capital. The OCC will consider new instruments on a case-by-case basis. In exercising this authority, the OCC expects to consider the criteria required for each capital element, as well as a bank's size, complexity, risk profile, and scope of operations, and whether any public benefit would be outweighed by any risk to the bank or the financial system.¹¹²

Nonqualifying Capital Instruments

Debt or Equity Instruments—National Banks and Federal Savings Associations

Banks may include in regulatory capital certain debt or equity instruments issued before September 12, 2010, that do not meet the criteria in 12 CFR 3.20 for AT1 or tier 2 capital instruments (i.e., instruments that would otherwise be nonqualifying capital instruments) but were included in the bank's tier 1 or tier 2 capital, respectively, as of September 12, 2010, in accordance with the applicable transition treatment.¹¹³ A bank may include these instruments up to the percentage of the outstanding principal amount of such nonqualifying capital instruments as of January 1, 2014, in accordance with the phase-out schedule in table 9 at 12 CFR 3.300(c). The amount of nonqualifying capital instruments not includable in AT1 capital are permitted to be included in tier 2 capital without limitation, so long as the instruments meet the criteria for tier 2 capital set forth at 12 CFR 3.20(d). Bank-issued debt or equity that was issued after September 12, 2010, and that does not meet the criteria for AT1 or tier 2 capital pursuant to 12 CFR 3.20, may not be included in AT1 or tier 2 capital.

Explanation of Adjustments and Deductions Applicable Only to CET1 Capital Pursuant to 12 CFR 3.22(a)

Goodwill

As a general matter, federal law provides that the federal banking agencies must prohibit federally insured banks from including certain intangible assets (including goodwill) in their regulatory capital.¹¹⁴ Goodwill and other intangible assets have long been either fully or partially excluded because of the high level of uncertainty regarding the ability of banking organizations to realize value from these assets, especially under adverse financial conditions.¹¹⁵ This deduction may be net of associated DTLs.

¹¹² Refer to 12 CFR 3.20(e).

¹¹³ Refer to 12 CFR 3.300(c)(4), table 9. These instruments are phased out as of January 1, 2022.

¹¹⁴ Refer to 12 USC 1828(n).

¹¹⁵ Refer to 12 CFR 3.22(a)(1).

Certain Intangible Assets (Other Than Goodwill and MSAs)

Examples of other intangible assets that must be deducted from CET1 capital include purchased credit card relationships (PCCR),¹¹⁶ core deposit intangibles (CDI),¹¹⁷ and non-mortgage servicing rights.¹¹⁸ Although MSAs are also intangible assets, the deduction for MSAs is at 12 CFR 3.22(d).

Certain Deferred Tax Assets

DTAs¹¹⁹ can arise from differences between GAAP accounting and tax accounting rules. The deduction at 12 CFR 3.22(a)(3) pertains to DTAs that arise from net operating losses and tax credit carry-forwards. This deduction may be netted against any related valuation allowances and DTLs.¹²⁰

Any Gain-on-Sale in Connection With a Securitization Exposure

For any increase to CET1 capital resulting from a gain on the sale of loans associated with a traditional securitization,¹²¹ a bank must deduct the after-tax gain-on-sale amount from CET1 capital. The deduction does not include gains that increase CET1 capital if the increase

¹¹⁶ A PCCR is an intangible asset that represents (1) a premium paid over the par value of acquired credit card receivables and (2) the value of the potential profit to come from already established credit card relationships and the right to conduct ongoing credit card services with the cardholders. Refer to the “Credit Card Lending” booklet of the *Comptroller’s Handbook*.

¹¹⁷ A CDI is an intangible asset that is related to certain customer deposit relationships. CDIs may arise during a failed bank acquisition or a purchase business combination and represent, in present value terms, the cost savings resulting from a comparison of the overall cost of the core deposits acquired in the transaction and the overall cost of an alternative funding source over the period the acquired core deposits are expected to be retained.

¹¹⁸ Non-mortgage servicing rights include servicing for loans that are not mortgage loans, such as car loans and student loans. Refer to 12 CFR 3.22(a)(2) and (e) for the deduction of intangible assets other than goodwill and MSAs.

¹¹⁹ Refer to 12 CFR 3.22(a)(3). A bank is not required to deduct DTAs that arise from temporary differences that a bank may realize through net operating loss carry-backs.

¹²⁰ Refer to 12 CFR 3.22(d)(i) and 3.22(e).

¹²¹ Refer to 12 CFR 3.22(a)(4).

results from the bank receiving cash in connection with the securitization or initial recognition of an MSA.¹²²

Amount of Expected Credit Loss That Exceeds Bank’s Eligible Credit Reserves (Advanced Approaches Banks)

The deduction for excess credit loss¹²³ applies only to advanced approaches banks that have completed the parallel run process and received notification from the OCC pursuant to 12 CFR 3.121(d).¹²⁴

Deduction of Equity and Other Interests in Certain Subsidiaries

- National banks must deduct the aggregate amount of outstanding equity investments in financial subsidiaries pursuant to 12 USC 24a and 12 CFR 5.39.¹²⁵
- FSAs must deduct investments in and extensions of credit to subsidiaries engaged in activities that are not permissible for national banks.¹²⁶

If a subsidiary of an FSA is engaged in activities that are not permissible for a national bank, the subsidiary¹²⁷ is considered a “non-includable” subsidiary.¹²⁸ Under 12 CFR 3.22(a)(8)(i),

¹²² The capital rule defines gain-on-sale to mean an increase in the equity capital of a bank resulting from a traditional securitization (other than an increase in equity capital resulting from a bank’s receipt of cash in connection with the securitization or reporting of an MSA). Because of the subjectivity involved in valuations of gains-on-sale, the regulatory capital rule requires a bank to deduct any unrealized gain on sale from CET1 capital. Under GAAP, a bank that sells loans as part of a securitization and retains an interest in the loans, for example, in the form of a residual interest, must record a gain (or loss) on sale associated with the retained interest based on its management’s assumptions about future charge-off rates, repayment rates, and the rate used to discount the expected cash flows from the loans sold. Over time, as borrowers on the underlying exposures pay interest and repay principal or default, the selling bank realizes a gain (or loss) on sale. Because the value of a gain-on-sale changes when actual performance deviates from management’s assumptions, the realized gain-on-sale can differ from the gain-on-sale that bank management has estimated.

¹²³ Refer to 12 CFR 3.22(a)(6).

¹²⁴ Refer to 12 CFR 3.22(a)(6).

¹²⁵ Refer to 12 CFR 3.22(a)(7). A national bank may not consolidate the assets and liabilities of a financial subsidiary with those of the parent bank pursuant to 12 CFR 5.39(h)(1). Refer to 12 CFR 5.39 for the rules applicable to financial subsidiaries. Also refer to the “Investment in Subsidiaries and Equities” booklet of the *Comptroller’s Licensing Manual* for a discussion of national bank financial subsidiaries, operating subsidiaries, and their activities.

¹²⁶ Refer to 12 CFR 3.22(a)(8)(i). Also refer to 12 USC 1464(t)(5)(A).

¹²⁷ The regulatory capital rule typically follows GAAP to determine whether an entity is a subsidiary. Note, however, that the regulatory capital rule has a special definition for “operating entity” that is important with respect to minority interest. Refer to 12 CFR 3.2 for a definition of “operating entity.”

¹²⁸ Although the activities of an FSA’s subsidiary may be permissible under 12 CFR 5.34 and 5.38, if these activities are not also permissible for national banks, the regulatory capital rule defines the subsidiary as a non-includable subsidiary. Refer to the list of activities permissible for a national bank on the OCC’s website.

an FSA must deconsolidate and deduct from CET1 capital its investment in a non-includable subsidiary, including a deduction of any loans or extensions of credit to that subsidiary. The deduction is from both CET1 capital and total assets for purposes of calculating the regulatory capital ratios. If, however, an FSA holds a subsidiary that is itself a domestic depository institution, the OCC may require the FSA to consolidate the assets and liabilities of its subsidiary for the purpose of determining capital adequacy, even if the subsidiary otherwise would be considered a “non-includable” subsidiary.¹²⁹

If all of the FSA subsidiary’s activities are permissible for a national bank, the subsidiary, which could be either a service corporation or an operating subsidiary, is an “includable” subsidiary. If the subsidiary is includable, the FSA consolidates the subsidiary, and no deductions are required.

Gains and Losses Related to Changes in the Value of Bank’s Liabilities Due to Changes in Bank’s Own Credit Risk

Banks must deduct any cumulative gain from and add back any cumulative loss to CET1 capital attributed to changes in the value of a liability that the bank elects to measure at fair value under GAAP arising from changes in the bank’s own credit risk.¹³⁰ For non-advanced approaches banks, this requirement applies to all liabilities that a bank must measure at fair value under GAAP, such as derivative liabilities, and those that the bank elects to measure at fair value under the fair value option. Advanced approaches banks implement this requirement for derivative liabilities by deducting the credit spread premium over the risk-free rate.

Cash Flow Hedges

Advanced approaches banks and those banks that did not make an AOCI opt-out election must deduct accumulated net gains and add back any accumulated net losses on cash flow hedges included in AOCI that relate only to the hedging of items that are not recognized at fair value on the balance sheet.¹³¹ Banks that made the AOCI opt-out election must neutralize all cash flow hedge gains and losses pursuant to the rule at 12 CFR 3.22(b)(2)(i)(C).

Explanation of Other Deductions Pursuant to 12 CFR 3.22(c), (d), (e), (f)

Investments in the Bank’s Own Capital Instruments

A bank must deduct from CET1 capital all direct and indirect investments in, and synthetic exposures related to investments in, the bank’s own common stock instruments to the extent

¹²⁹ Refer to 12 CFR 3.22(a)(8)(iii).

¹³⁰ Refer to 12 CFR 3.22(b)(1)(iii).

¹³¹ Refer to 12 CFR 3.22(b)(1)(ii).

that the instruments are not already excluded under 12 CFR 3.20(b)(1).¹³² Similarly, a bank must deduct an investment in its own additional tier 1 or tier 2 instruments from additional tier 1 capital or tier 2 capital elements, respectively.

Deductions Using Corresponding Deduction Approach

The corresponding deduction approach¹³³ applies to the following investments:

- Reciprocal cross holdings.¹³⁴
- Nonsignificant investments in the capital of UFIs.¹³⁵
- Significant investments in the capital of UFIs that are *not* in the form of common stock.¹³⁶

In accordance with the corresponding deduction approach, a bank must make deductions for these investments from the component of capital for which the underlying instrument would qualify if it were issued by the bank itself, as described at 12 CFR 3.22(c)(2)(i) through (iii).¹³⁷ If a bank does not have a sufficient amount of a specific component of capital to effect a required deduction, the bank must deduct the shortfall from the next higher (that is, more subordinated) component of regulatory capital.

The deductions using the corresponding deduction approach occur after the bank makes the applicable adjustments and deductions to its regulatory capital components required by 12 CFR 3.22 (a) and (b). The deduction amount under the corresponding deduction approach can reflect hedges of the position pursuant to 12 CFR 3.22(h), which details the types of hedges and how to recognize them.

Under the corresponding deduction approach, a bank must comply with the following:

- A bank must treat an investment in an instrument issued by an unregulated financial institution as a CET1 capital instrument if the instrument is common stock or represents

¹³² Refer to 12 CFR 3.22(c)(1)(i).

¹³³ Refer to 12 CFR 3.22(c)(2).

¹³⁴ Refer to 12 CFR 3.22(c)(3).

¹³⁵ Refer to 12 CFR 3.22(c)(4). For the definition of nonsignificant investments, refer to 12 CFR 3.2 and the discussion under “Nonsignificant Investments” in this appendix. The definition of financial institution in the regulatory capital rule at 12 CFR 3.2 provides a list and description of companies defined as financial institutions for purposes of the regulatory capital rule and also lists the entities that are exempt from the definition. Refer also to the discussion under the “Financial Institution Defined” section later in this appendix.

¹³⁶ Refer to 12 CFR 3.22(c)(5).

¹³⁷ As discussed below and at 12 CFR 3.22, when a bank has an insufficient amount of a specific component of capital to effect the required deductions, it deducts the shortfall from the next higher component of regulatory capital.

the most subordinated claim in the liquidation of the issuing financial institution, or as AT1 capital if the instrument is not common stock but is subordinated to all creditors of the issuing financial institution and is senior in liquidation only to common shareholders.¹³⁸

- A bank must treat an investment in an instrument issued by a regulated financial institution (e.g., an insurance company or a bank) as a CET1 capital instrument if the instrument is common stock included in GAAP equity of the issuing financial institution or represents the most subordinated claim in the liquidation of that financial institution.¹³⁹ Similarly, the bank would treat the instrument as an AT1 capital instrument if the instrument is subordinated to all creditors of the financial institution, and senior in receivership, insolvency, liquidation, or similar proceeding only to common shareholders, or as a tier 2 capital if the instrument is not included in GAAP equity but considered regulatory capital by the primary supervisor of the financial institution.¹⁴⁰
- A bank must treat an investment in the form of a nonqualifying capital instrument¹⁴¹ (1) as an AT1 capital instrument if the instrument was included in the issuer's tier 1 capital before May 19, 2010, or (2) as a tier 2 capital instrument if the instrument was included in the issuer's tier 2 capital (but not includable in tier 1 capital) before May 19, 2010.¹⁴² In other words, whether a nonqualifying capital instrument is treated as an AT1 capital instrument or as a tier 2 capital instrument depends on the capital tier in which the issuing bank included the instrument before May 19, 2010. Nonqualifying capital instruments generally include trust preferred securities (TruPS)¹⁴³ and TruPS collateralized debt obligations (TruPS CDO).¹⁴⁴

Volcker Rule

Under section 619 of the Dodd–Frank Act,¹⁴⁵ the Volcker rule prohibits banking entities from engaging in proprietary trading or from acquiring or retaining an ownership interest in,

¹³⁸ Refer to 12 CFR 3.22(c)(2)(i).

¹³⁹ Refer to 12 CFR 3.22(c)(2)(i)(A).

¹⁴⁰ Refer to 12 CFR 3.22(c)(2)(ii).

¹⁴¹ As defined in 12 CFR 3.300(c).

¹⁴² Refer to 12 CFR 3.22(c)(2)(iii).

¹⁴³ Under GAAP, TruPS are hybrid instruments possessing characteristics typically associated with debt obligations. Banks should report these investments as debt securities on the call report, unless there are specific facts and circumstances of a particular issuance that would allow the instruments to be considered an equity investment.

¹⁴⁴ TruPS CDOs are structured financial products for which the underlying collateral is a pool of TruPS issued by U.S. business trusts.

¹⁴⁵ Refer to Pub. L. 111-203, 124 Stat. 1376 (2010), and the Bank Holding Company Act of 1956 (12 USC 1851). Refer also to OCC News Release 2018-69 for information regarding changes to the Volcker Rule pursuant to the EGRRCPA.

sponsoring, or having certain relationships with, a hedge fund or private equity fund (covered funds), subject to certain exemptions. While most covered fund investments and relationships must be divested, the Volcker rule permits banks (and other entities) to retain a limited amount of investments in certain covered funds. The rule, however, requires banks to deduct these investments from tier 1 capital when calculating regulatory capital. These investments also may be subject to deduction under the regulatory capital rule if they meet the definition of an “investment in the capital of a UFI.” The potential overlapping regulatory capital treatment for these investments in covered funds is discussed in the preambles of both the Volcker rule and the regulatory capital rule, which clarify that when an investment in a covered fund is also an investment in the capital of a UFI, the bank should make the regulatory capital deduction first under 12 CFR 3.22(c) and (d), and that such deducted amounts would count toward the amount required to be deducted under the Volcker rule.

TruPS CDOs and the Volcker Rule

The TruPS CDO structure enabled some non-advanced approaches BHCs to raise regulatory capital by issuing TruPS before May 19, 2010. Congress preserved the regulatory capital eligibility of certain TruPS (i.e., legacy TruPS) in the grandfathering provisions of the Dodd–Frank Act at section 171.¹⁴⁶

Consistent with the policy advanced by this grandfathering provision, the federal banking agencies have permitted banks that invested in TruPS CDOs to retain their interests where the underlying assets are legacy TruPS (i.e., qualifying TruPS CDOs) and have not required the investing banks to deduct their investments in qualifying TruPS CDOs from tier 1 capital pursuant to the Volcker rule.¹⁴⁷ These investments, however, still may be subject to deduction under the regulatory capital rule as investments in the capital of a UFI, typically as nonsignificant investments in the capital of a UFI. Amounts not deducted are risk weighted as a securitization exposure.

Financial Institution Defined

For deductions related to investments in the capital of a UFI, 12 CFR 3.2 defines the entities that are considered “financial institutions.” Entities that meet the definition of a financial institution include bank and savings and loan holding companies, depository institutions,

¹⁴⁶ The Collins Amendment, section 171 of the Dodd–Frank Act, requires advanced approaches institutions to use the standardized approach as part of their capital floor calculations. Section 171(b)(4)(C) also allows certain hybrid instruments, such as a TruPS instrument, issued before May 19, 2010, by depository institution holding companies with total consolidated assets of less than \$15 billion as of December 31, 2009, and by organizations that were mutual holding companies on May 19, 2010, to count as tier 1 capital. The Collins Amendment has been codified at 12 USC 5371.

¹⁴⁷ The TruPS CDO structure was the tool that gave effect to the use of TruPS as a regulatory capital instrument before May 19, 2010, and was part of the status quo Congress preserved with the grandfathering provision of section 171. To avoid imposing restrictions that could adversely affect the TruPS CDO market in a manner that could undercut the grandfathering provisions that Congress provided in section 171, the agencies determined that certain TruPS CDOs should be treated as permitted investments for all banking entities under section 619 of the Dodd–Frank Act. Refer to 12 USC 5371(b)(4)(C).

foreign banks, credit unions, insurance companies, and certain securities holding companies, among others. In addition, any other company that is “predominantly engaged” in certain financial activities—such as lending money, securities, or other financial instruments¹⁴⁸—also may be considered a financial entity for this purpose if a bank owns either of the following:

- An investment in GAAP equity instruments of the company with an adjusted carrying value or exposure amount equal to or greater than \$10 million.
- More than 10 percent of the company’s issued and outstanding common shares (or other similar equity interest).

The following entities are exempted from the definition of a financial institution:

- GSEs.¹⁴⁹
- Small business investment companies.¹⁵⁰
- Community development financial institutions.¹⁵¹
- Entities registered with the Securities and Exchange Commission under the Investment Company Act of 1940 or foreign equivalents thereof.¹⁵²
- Entities for which the bank’s investment in the entity qualifies as a community development investment.¹⁵³
- Certain employee benefit plans.¹⁵⁴

Reciprocal Cross Holdings

A reciprocal cross holding exists where there is a formal or informal arrangement between two or more financial institutions to swap, exchange, or hold each other’s capital instruments. Such holdings are subject to deduction. The purpose of the deduction is to prevent the potential inflation of the capital positions of each of the financial institutions involved. Under the corresponding deduction approach, banks with reciprocal cross holdings determine

¹⁴⁸ Other activities include servicing loans; insuring, guaranteeing, and indemnifying against certain losses; underwriting, dealing in, or making a market in securities; certain asset management activities; or as determined by the OCC.

¹⁴⁹ A GSE is a financial services corporation created by the U.S. government and includes the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), the Federal Agricultural Mortgage Corporation (Farmer Mac), Federal Home Loan Banks, Farm Credit Banks, the Resolution Funding Corporation, and the Financing Corporation.

¹⁵⁰ Refer to Small Business Investment Act of 1958 (15 USC 662).

¹⁵¹ Refer to 12 USC 4701 and 12 CFR 1805.

¹⁵² Refer to 15 USC 80a-1.

¹⁵³ Refer to 12 USC 24(Eleventh) of the National Bank Act.

¹⁵⁴ Refer to 29 USC 1002(32).

whether the issuer of the capital instrument is a regulated financial institution, whether the issued instrument is a nonqualifying capital instrument, and the form of the issued instrument. Based on those determinations, a bank must deduct a reciprocally held instrument from the appropriate component of capital (CET1 capital, AT1 capital, or tier 2 capital) according to the corresponding deduction approach at 12 CFR 3.22(c)(2)(i) through (iii).¹⁵⁵

Nonsignificant Investments

A bank with investments in a UFI's capital instruments must follow a multi-step process to determine whether its investment is subject to the deduction for nonsignificant investments in the capital of a UFI,¹⁵⁶ and, if so, how much. At 12 CFR 3.2, the capital rule defines a nonsignificant investment in the capital of a UFI as an investment in the capital of a UFI of which the bank owns 10 percent or less of the issued and outstanding common shares. For example, if a bank owns 5 percent of the UFI's issued and outstanding common shares, and also holds other investments in capital instruments issued by that UFI, regardless of the amount held, all of the bank's investments in the UFI are nonsignificant. The bank makes this determination for each UFI in which it holds capital investments.

Next, the bank must also calculate the 10 percent threshold for nonsignificant investments. The bank first aggregates its total nonsignificant investments (common stock and non-common stock) in all UFIs and determines whether the total exceeds 10 percent of the sum of the bank's CET1 capital elements (after deductions pursuant to 12 CFR 3.22(a) through (c)(3)). The excess represents the total amount to be deducted. The bank then allocates the deduction to a specific component(s) of capital using the corresponding deduction approach to determine which of those investments qualify as (or are deemed to be equivalent to) CET1 capital, AT1 capital, or tier 2 capital.¹⁵⁷

To allocate the deduction, the bank calculates a ratio in which the amount of the bank's nonsignificant investments across UFIs deemed to be equivalent to a specific component of capital (e.g., CET1 capital) is divided by the bank's total nonsignificant investments. The bank multiplies the ratio by the aggregate amount of nonsignificant investments that exceed the 10 percent threshold for nonsignificant investments.

With prior OCC written approval, a bank may obtain an exception from the deduction required for nonsignificant investments for certain investments related to a failed

¹⁵⁵ A reciprocal cross holding instrument is deducted from CET1 capital if it meets the criteria at 12 CFR 3.22(c)(2)(i)(A) or (ii)(A) or from AT1 capital if it meets 12 CFR 3.22(c)(2)(i)(B), (ii)(B), or (iii)(A). It is deducted from tier 2 capital if it meets the criteria in 12 CFR 3.22(c)(2)(ii)(C) or (iii)(B).

¹⁵⁶ Refer to OCC Bulletin 2017-56, "Regulatory Capital Rule: Final Rule," and 82 Fed. Reg. 55309 for the "transitions final rule" applicable to non-advanced approaches banks holding nonsignificant investments in the capital of UFIs that are subject to deduction.

¹⁵⁷ For nonsignificant investments in the capital of UFIs, refer to 12 CFR 3.22(c)(4). Refer also to examples 2 and 2a in appendix D of this booklet for examples of how to use the corresponding deduction approach to calculate the deduction for nonsignificant investments in the capital of UFIs.

underwriting. In addition, an exception is available with prior OCC written approval for nonsignificant investments if the UFI is in distress and the investment was made for the purpose of providing financial support.¹⁵⁸

Significant Investments Not in Form of Common Stock

The corresponding deduction approach also requires a bank to deduct significant investments in the capital of UFIs that are not in the form of common stock (“non-common stock”). A significant non-common stock investment in the capital of a UFI is defined as an investment in the capital of a UFI when the bank also owns more than 10 percent of the issued and outstanding common stock of the UFI. For this purpose, the amount of the non-common stock investment is measured as the bank’s net long position¹⁵⁹ in the investment. If a bank’s common stock ownership exceeds this 10 percent threshold, then all of its other investments in the capital of the UFI are considered significant and are subject to deduction, regardless of the amount held. The deduction for significant non-common stock investments in the capital of a UFI is determined on an investment-by-investment basis, and is not aggregated across investments in different financial institutions.¹⁶⁰ This deduction also does not include investments in a UFI’s issued and outstanding common stock.

Deduction Using 10 and 15 Percent CET1 Capital Deduction Thresholds

10 Percent CET1 Capital Deduction Threshold Test

A bank must make a separate deduction from CET1 capital¹⁶¹ for each of the following items, to the extent each exceeds 10 percent of the sum of the bank’s CET1 capital elements, accounting for any adjustments and deductions required by 12 CFR 3.22(a) through (c).

- **DTAs:** For this item, the bank deducts DTAs arising from temporary differences that it could not realize through net operating loss carry-backs (net of any related valuation allowances and net of DTLs).¹⁶²

¹⁵⁸ Refer to 12 CFR 3.22(c)(4)(i).

¹⁵⁹ Refer to 12 CFR 3.22(h)(1) and (2) for calculating a net long position for investments in the bank’s own capital instruments or an investment in the capital of a UFI.

¹⁶⁰ Refer to 12 CFR 3.22(c)(5). The definition of a significant investment is at 12 CFR 3.2 (definitions). Refer also to example 3 in appendix D of this booklet for an example of how to use the corresponding deduction approach when calculating the deduction for significant investments that are not in the form of common stock. Refer to OCC Bulletin 2017-56, “Regulatory Capital Rule: Final Rule,” and 82 Fed. Reg. 55309 for the “transitions final rule” applicable to non-advanced approaches banks holding significant investments in the capital of UFIs that are not in the form of common stock that are subject to deduction.

¹⁶¹ Refer to 12 CFR 3.22(d). Also refer to the example in appendix D of this booklet. For non-advanced approaches banks, refer to OCC Bulletin 2017-56, “Regulatory Capital Rule: Final Rule,” and 82 Fed. Reg. 55309 for applicable rules and transition treatment.

¹⁶² Any deduction net of DTLs is subject to 12 CFR 3.22(e).

- **MSAs:** A bank deducts MSAs net of associated DTLs.¹⁶³
- **Significant investments:** A bank deducts its significant investments in the capital of UFI in the form of common stock net of DTLs.¹⁶⁴

15 Percent CET1 Capital Deduction Threshold Test

After the bank calculates the deductions for MSAs, temporary difference DTAs, and significant investments using the 10 percent CET1 capital threshold deduction test,¹⁶⁵ the bank must determine whether any additional amounts must be deducted in accordance with the 15 percent CET1 capital deduction threshold test.¹⁶⁶

Deduction for Insufficient Amounts of a Specific Regulatory Capital Component to Effect Deductions ('Shortfall' Deduction)

The shortfall deduction approach¹⁶⁷ applies to any deduction under the corresponding deduction approach when a bank has an insufficient amount of a specific component of capital to effect the required deductions after completing the 10 and 15 percent CET1 capital threshold deductions. A bank must deduct the shortfall from the next higher component of regulatory capital. For example, if a bank's AT1 capital was insufficient to absorb fully a deduction resulting from the corresponding deduction approach, the bank would deduct any remaining amount from the next higher component of regulatory capital, which is CET1 capital. If a bank's tier 2 capital were insufficient to absorb fully a deduction resulting from the corresponding deduction approach, the bank would deduct any amount from the next higher component of regulatory capital, which is AT1 capital.¹⁶⁸

¹⁶³ For more information on MSAs, refer to the "Mortgage Banking" booklet of the *Comptroller's Handbook*.

¹⁶⁴ Refer to 12 CFR 3.2 for the definition of a "significant investment." Significant investments subject to the 10 percent CET1 capital deduction threshold may be reduced by any goodwill embedded in the valuation of such investments deducted by the bank pursuant to 12 CFR 3.22(a)(1). There is also an option at 12 CFR 3.22(d)(3) to elect to exclude certain DTAs and DTLs related to adjustments to CET1 capital under 12 CFR 3.22(b) for purposes of AOCI.

¹⁶⁵ Refer to 12 CFR 3.22(d)(2). The 15 percent threshold is actually 17.65 percent calculated as the proportion of 15 percent to 85 percent. Refer to the discussion regarding transitions at 12 CFR 3.300(b)(4)(i)-(iii) and table 7. Note that under the 15 percent CET1 capital deduction threshold test there is an exception for goodwill previously deducted. Note also that under both the 10 percent and 15 percent CET1 capital deduction threshold tests there is an option at 12 CFR 3.22(d)(3) to elect to exclude certain DTAs and DTLs related to adjustments to CET1 capital under 12 CFR 3.22(b) for purposes of AOCI. Refer to appendix D of this booklet for an example.

¹⁶⁶ Advanced approaches banks risk weight amounts not deducted from CET1 capital under either the 10 or 15 percent CET1 capital deduction threshold tests at 250 percent. Non-advanced approaches banks risk weight amounts not deducted from CET1 capital under either the 10 or 15 percent CET1 capital deduction threshold tests at 100 percent pursuant to the OCC's "transitions final rule." For the "transitions final rule," non-advanced approaches banks should refer to OCC Bulletin 2017-56, "Regulatory Capital Rule: Final Rule," and 82 Fed. Reg. 55309.

¹⁶⁷ Refer to 12 CFR 3.22(f).

¹⁶⁸ Refer to 12 CFR 3.22(f).

Appendix B: Regulatory Capital Requirements by Bank Type

Table 8: Overview of the Regulatory Capital Requirements for GSIBs, Advanced Approaches Banks that are not GSIBs, and Non-advanced Approaches Banks

Requirements	GSIBs		Advanced approaches banks	Non-advanced approaches banks ^a
	Covered BHCs	IDI subsidiaries of covered BHCs		
GSIB surcharge and TLAC charge	✓			
eSLR	✓	✓ ^b		
SLR	✓	✓	✓	
CCyB	✓	✓	✓	
Internal ratings approach	✓	✓	✓	
Advanced measurement approach	✓	✓	✓	
Standardized approach	✓	✓	✓	✓
Capital conservation buffer	✓	✓	✓	✓
AOCI				
Filter approach				✓ ^c
Flow-through	✓	✓	✓	✓ ^d
Disclosures	✓	✓	✓	✓ ^e

^a A non-advanced approaches bank may elect to become an advanced approaches bank and use the advanced approaches rule.

^b Refer to OCC Bulletin 2014-47, "Regulatory Capital: Supplementary Leverage Requirement Final Rule," for the covered IDI standards.

^c The AOCI opt-out election is a one-time, permanent election to effectively continue using the AOCI "filter" approach as defined in 12 CFR 3.22(b)(2) and make the adjustments required under 12 CFR 3.22(b)(2)(i) to calculate regulatory capital when filing the call report. The election is made in the first reporting period after the date upon which the bank becomes subject to the regulatory capital rule. While the election is generally irrevocable (i.e., cannot be changed from one reporting period to the next), refer to 12 CFR 3.22(b)(2)(iv) for the circumstances that allow non-advanced approaches banks to change their AOCI election.

^d A non-advanced approaches bank that does not make an AOCI opt-out election as defined in 12 CFR 3.22(b)(2) must follow GAAP "flow-through" treatment.

^e A non-advanced approaches bank with total consolidated assets of \$50 billion or more as reported on its most recent year-end call report must satisfy the disclosure requirements described in 12 CFR 3.62 and 3.63, unless it is a consolidated subsidiary of a BHC, savings and loan holding company, or depository institution that is subject to the same disclosure requirements or a subsidiary of a non-U.S. banking organization that is subject to comparable public disclosure requirements in its home jurisdiction. Similarly, an advanced approaches bank that has not received approval from the OCC to exit parallel run pursuant to 12 CFR 3.121(d) must make the required disclosures unless it is a consolidated subsidiary of a BHC, savings and loan holding company, or depository institution that is subject to these disclosure requirements or a subsidiary of a non-U.S. banking organization that is subject to comparable public disclosures in its home jurisdiction.

Note: Banks with substantial trading activity are subject to the market risk rule. Refer to 12 CFR 3, subpart F, and appendix E of this booklet for more information.

Appendix C: Risk Weight and Conversion Factor Charts

Table 9: Standardized Approach Risk Weights

Category	Risk weight	Reference
Cash	0%	12 CFR 3.32(l)(1)
Direct and unconditional claims on the U.S. government, its agencies, and the Federal Reserve	0%	12 CFR 3.32(a)(1)(i)
Exposures to certain supranational entities and multilateral development banks	0%	12 CFR 3.32(b)
Cash items in the process of collection	20%	12 CFR 3.32
Conditional exposures to the U.S. government	20%	12 CFR 3.32(a)(1)(ii)
Exposures to GSEs	<ul style="list-style-type: none"> 20% on exposures other than equity exposures and preferred stock. 100% on GSE preferred stock. 	12 CFR 3.32(c)
Debt exposures to U.S. depository institutions and National Credit Union Administration-insured credit unions	<ul style="list-style-type: none"> 20% risk weight for an exposure to a depository institution or a credit union except as otherwise provided under 12 CFR 3.32(d)(3). 100% risk weight for an investment in an instrument included in another banking organization's regulatory capital unless the exposure is <ol style="list-style-type: none"> an equity exposure subject to deduction pursuant to 12 CFR 3.51 through 3.53, a significant investment in the capital of a UFI in the form of common stock subject to deduction pursuant to 12 CFR 3.22(d)(iii), subject to deduction generally under 12 CFR 3.22, or a foreign bank exposure that is subject to a 150% risk weight in accordance with 12 CFR 3.32(d)(2), table 2, or with 12 CFR 3.32(d)(2)(iv) because of an event of sovereign default in either the investing bank's home country or the foreign bank's home country within the prior five years. 	<p>12 CFR 3.32(d)(1)</p> <p>12 CFR 3.32(d)(3)</p>
Exposures to U.S. public sector entities (PSE)	<ul style="list-style-type: none"> 20% for general obligations. 50% for revenue obligations. 	12 CFR 3.32(e)(1)
Industrial development bonds	100%	12 CFR 3.32
One- to four-family loans	<ul style="list-style-type: none"> 50% if first lien, prudently underwritten, owner occupied or rented, not 90 days or more past due or carried in nonaccrual status, and not restructured or modified; 100% otherwise. 	12 CFR 3.32(g)
One- to four-family loans modified under the Home Affordable Modification Program	50% or 100% The bank must use the same risk weight assigned to the loan before the modification so long as the loan continues to meet other applicable prudential criteria.	12 CFR 3.32(g)(3)

Category	Risk weight	Reference
Loans to builders secured by one- to four-family properties presold under firm contracts	<ul style="list-style-type: none"> 50% if the loan meets all criteria in the regulation; 100% if the contract is cancelled; 100% for loans not meeting the criteria. 	12 CFR 3.32(h)
Loans on multifamily properties	<ul style="list-style-type: none"> 50% if the loan meets all the criteria in the regulation; 100% otherwise. 	12 CFR 3.32(i)
Corporate exposures (debt)	<p>100%</p> <ul style="list-style-type: none"> If, however, the exposure is an investment in an instrument included in the regulatory capital of another financial institution, a deduction may apply pursuant to 12 CFR 3.22(c). 	12 CFR 3.32(f)
HVCRE	<p>EGRRCPA provides that, effective upon enactment, the agencies may only require a depository institution to assign a heightened risk weight to an HVCRE exposure if such exposure is an "HVCRE ADC Loan," as defined in section 214 of the Act. Accordingly, a depository institution is permitted to risk-weight at 150 percent only those commercial real estate exposures it believes meet the statutory definition of an HVCRE ADC loan. When reporting HVCRE exposures on Schedule RC-R, part II, of the call report, depository institutions may use available information to reasonably estimate and report only HVCRE ADC loans. Depository institutions may refine these estimates in good faith as they obtain additional information but will not be required to amend previously filed regulatory reports as these estimates are adjusted. Alternatively, a depository institution may also continue to report and risk-weight HVCRE exposures in a manner consistent with the current instructions to the call report, until the agencies take further action.</p> <ul style="list-style-type: none"> Refer to section 51 of the Federal Deposit Insurance Act (12 USC 1831bb), as added by section 214 of EGRRCPA (Pub. L.115–174; 132 Stat.1296). 	12 CFR 3.32(j)
Past-due exposures	<ul style="list-style-type: none"> 150% risk weight is applied to the portion that is not guaranteed or secured (does not apply to sovereign exposures). 100% risk weight is applied to one- to four-family loans that are past due 90 days or more. 	12 CFR 3.32(k)
MSAs, certain DTAs arising from temporary differences, and certain significant investments in the common stock of UFI	<p>Advanced approaches banks apply a 250% risk weight to items that are not deducted.</p> <ul style="list-style-type: none"> Note: Non-advanced approaches banks apply a 100% risk weight pursuant to 12 CFR 3.300(b)(5) (transitions final rule). 	12 CFR 3.32(l), 12 CFR 3.52, and 12 CFR 3.300, table 7
Assets not assigned to a risk weight category, including fixed assets, premises, and other real estate owned	<ul style="list-style-type: none"> 100% 	12 CFR 3.32(l)(5)

^a The purchase or development of agricultural land includes all land known to be used or usable for agricultural purposes (such as crop and livestock production), provided that the valuation of the agricultural land is based on its value for agricultural purposes and the valuation does not take into consideration any potential use of the land for nonagricultural commercial development or residential development.

Category	Risk weight	Reference
Exposures to foreign governments and their central banks	<p>Risk weight depends on country risk classification (CRC) applicable to the sovereign and ranges between 0% and 150%;</p> <ul style="list-style-type: none"> • 0% for sovereigns that are members of the Organization for Economic Cooperation and Development (OECD)^c with no CRC; • 100% for sovereigns that are not OECD members and do not have a CRC; • 150% for a sovereign that has defaulted within the previous five years. <p>Note: If there is a CRC, follow the risk weights in table 1 at 12 CFR 3.32(a)(2).</p>	12 CFR 3.32(a)(2) through (6)
Exposures to foreign banking organizations	<p>Risk weight depends on home country's CRC rating and ranges between 20% and 150%;</p> <ul style="list-style-type: none"> • 100% for a foreign bank whose home country is not a member of the OECD and does not have a CRC; • 20% for sovereigns that are OECD members with no CRC; • 150% in the case of a sovereign default in the bank's home country; • 100% for an instrument included in a bank's regulatory capital (unless that instrument is an equity exposure or is deducted). <p>Note: If there is a CRC, follow the risk weights in table 2 at 12 CFR 3.32(d)(2).</p>	12 CFR 3.32(d)(2)
Exposures to foreign PSE	<p>Risk weight depends on the home country's CRC and ranges between 20% and 150% for general obligations, and between 50% and 150% for revenue obligations;</p> <ul style="list-style-type: none"> • 100% for exposures to a PSE in a home country that is not an OECD member and does not have a CRC; • 20% for sovereigns that are OECD members with no CRC (general obligation bonds); • 50% for sovereigns that are OECD members with no CRC; • 150% for a PSE in a home country with a sovereign default. <p>Note: If the home country of the foreign PSE has a CRC, refer to table 3 (for non-U.S. PSE general obligations) and table 4 (for non-U.S. PSE revenue obligations) at 12 CFR 3.32(e).</p>	12 CFR 3.32(e)(2) to (6)

^c Refer to OECD.

Category	Risk weight	Reference
Mortgage-backed securities, asset-backed securities, and structured securities	<p>Banks must deduct from CET1 capital the after-tax gain-on-sale resulting from a securitization and apply a 1,250% risk weight to the portion of a credit enhancing interest only strip (CEIO) that does not constitute after-tax gain-on-sale.</p> <p>If a securitization exposure does not require deduction under 12 CFR 3.42(a)(1), the bank may assign a risk weight to the securitization exposure using</p> <ol style="list-style-type: none"> (1) the simplified supervisory formula approach (SSFA) at 12 CFR 3.43(a) through (d) (subject to limitations at 3.43(e)), (2) the gross-up approach at 12 CFR 3.43(e) if the bank is not subject to the market risk in subpart F, or (3) a 1,250% risk weight as described in 12 CFR 3.44 if the bank cannot or chooses not to apply the SSFA or gross-up approach to the exposure. <p>If a bank chooses either the SSFA or gross-up approach, it must apply that choice consistently across all of its securitization exposures, except as provided in 12 CFR 3.42(a)(1), (a)(3), and (a)(4).</p> <p>For certain derivative contracts, a bank may choose to set the risk-weighted asset amount of the exposure equal to the amount of the exposure as determined in 12 CFR 3.42(c).</p>	<p>12 CFR 3.22(a)(4)</p> <p>12 CFR 3.42 See 12 CFR 3.2 for the definition of a CEIO.</p> <p>12 CFR 3.42 12 CFR 3.43 12 CFR 3.44</p> <p>12 CFR 3.42</p> <p>12 CFR 3.42</p>
Unsettled transactions	<ul style="list-style-type: none"> • 100%, 625%, 937.5%, and 1,250% for delivery vs. payment or payment vs. payment transactions, depending on the number of business days past the settlement date; • 1,250% for nondelivery vs. payment, and nonpayment vs. payment transactions more than 5 days past the settlement date; <p>Note: The capital requirement for unsettled transactions does not apply to cleared transactions that are marked-to-market daily and subject to daily receipt and payment of variation margin.</p>	12 CFR 3.38

Category	Risk weight	Reference
Equity exposures	<ul style="list-style-type: none"> • 0% risk weight: Equity exposures to a sovereign, certain supranational entities, or a multilateral development bank whose debt exposures are eligible for 0% risk weight; • 20%: Equity exposures to a PSE, a Federal Home Loan Bank, or Farmer Mac; • 100%: Equity exposures to community development investments and small business investment companies and nonsignificant equity investments; • 250%: Significant investments in the capital of UFI that are not deducted from capital; • 300%: Most publicly traded equity exposures; • 400%: Equity exposures that are not publicly traded; • 600%: Equity exposures to certain investment funds (e.g., hedge funds). 	12 CFR 3.51 and 12 CFR 3.52
Equity exposures to investment funds	<p>For equity exposures to investment funds, the rule provides three approaches:</p> <p>Simple modified look-through approach: Risk weight for the exposure is equal to the highest risk-weighted investment the fund is permitted to hold (e.g., multiply the banking organization's exposure by the risk weight applicable to the riskiest asset in the fund).</p> <p>Alternative modified look-through approach: A bank may assign the exposure on a pro rata basis to different risk weight categories based on the investment limits in the fund's prospectus. If a bank uses this approach, the bank must assume that the fund invests to the maximum extent permitted under its investment limits in exposures that receive the highest risk weights.</p> <p>Full look-through approach: If a bank can calculate the RWA amount for its proportional ownership share of each exposure held by an investment fund (calculated as if the proportional ownership share of the adjusted carrying value of each exposure were held directly by the bank), then the bank may set the RWA amount of the bank's exposure to the fund equal to the product of (1) the aggregate RWA amounts of the exposures held by the fund as if they were held directly by the bank; and (2) the bank's proportional ownership share of the fund.</p>	<p>12 CFR 3.53(c)</p> <p>12 CFR 3.53(d)</p> <p>12 CFR 3.53(b)</p>

Table 10: Standardized Approach Conversion Factors

Category	Conversion factors	Reference
Conversion factors for off-balance-sheet items	<ul style="list-style-type: none"> • 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. 	12 CFR 3.33
Derivative contracts	Conversion to an on-balance-sheet amount based on current exposure (e.g., the fair market value of the contract) plus potential future exposure (determined by using a set of conversion factors).	12 CFR 3.34

Table 11: Standardized Approach Credit Risk Mitigants

Category	Credit risk mitigants	Reference
Guarantees	<p>Recognizes eligible guarantees^a from eligible guarantors: sovereign entities and certain international organizations, such as the Bank for International Settlements, International Monetary Fund, and the European Commission; Federal Home Loan Banks, Farmer Mac, a multilateral development bank, a depository institution, a BHC, a savings and loan holding company, a foreign banking organization, a qualifying central counterparty banking organization, or certain entities that have investment-grade debt.</p> <p>Substitution approach that allows a banking organization to substitute the risk weight of the protection provider for the risk weight ordinarily assigned to the exposure. This approach applies only to eligible guarantees and eligible credit derivatives, and adjusts for maturity mismatches, currency mismatches, and cases in which restructuring is not treated as a credit event.</p>	12 CFR 3.36
Collateralized transactions ^b	<p>For financial collateral^c only, the rule provides two approaches:</p> <p>Simple approach:^d A bank may apply a risk weight to the portion of an exposure that is secured by the market value of collateral by using the risk weight of the collateral, with a general risk-weight floor of 20%.</p> <p>Collateral haircut approach:^e Uses standard supervisory haircuts or own estimates of haircuts for eligible margin loans, repo-style transactions, and collateralized derivative contracts.</p>	12 CFR 3.37

^a Refer to the definition of “eligible guarantee” at 12 CFR 3.2.

^b In lending arrangements, collateral is a borrower’s pledge of specific property to a lender to secure the transaction for the lender in case the borrower defaults. There are requirements for banks to recognize collateral and other credit risk mitigants in the capital calculation, including eligibility criteria and risk management requirements.

^c For the definition of financial collateral, refer to the definition at 12 CFR 3.2.

^d The collateralized portion of the exposure generally receives the risk weight applicable to the collateral. The risk weight typically is not lower than 20 percent, although there are exceptions. Refer to 12 CFR 3.37(b)(3) for the exceptions.

^e Under the collateral haircut approach, a bank must determine the exposure amount and the relevant risk weight for the counterparty or guarantor.

Appendix D: Examples

Example 1: Deduction using the fully phased-in 10 and 15 percent deduction threshold applicable to MSAs and DTAs (this example applies to advanced approaches banks).

This example demonstrates deducting MSAs and DTAs using the fully phased-in¹⁶⁹ 10 percent and 15 percent CET1 capital threshold deductions. In this example, assume the bank has \$200 of CET1 capital, \$35 of MSAs, and \$18 of DTAs.

- The example shows how the deduction thresholds work when fully phased in.
- In step 1, the 10 percent CET1 capital threshold deduction allows up to \$20 of MSAs to count toward CET1 capital (\$200 CET1 capital multiplied by 10 percent).
- Separately, the rule allows up to \$20 of DTAs as well. Note that step 1 calculates a deduction for MSAs of \$15 (\$35 total MSAs less \$20 allowed). Since the \$18 of DTAs is less than the allowed amount of \$20, there is no deduction for DTAs. The bank deducts \$15 of MSAs from its CET1 capital under the 10 percent deduction threshold test.
- In step 2, for the fully phased-in rule, all DTAs and MSAs are subtracted from the CET1 capital amount, which is \$200. The resulting \$147 (\$200 less \$53) is then multiplied by 17.65 percent to derive the 15 percent CET1 capital deduction threshold amount of \$26 (\$200 multiplied by 17.65 percent). In step 1, the amount of MSAs and DTAs not deducted under the 10 percent CET1 capital deduction threshold test totaled \$38 (\$20 MSAs and \$18 DTAs). This amount, \$38, exceeds the 15 percent CET1 capital deduction threshold of \$26. Therefore, the amount of the combined balance of the MSAs and DTAs that must be deducted is \$12 (\$38 less \$26).
- The total deductions include the 10 percent CET1 capital deduction threshold amount of \$15 for the MSAs plus the 15 percent CET1 capital deduction threshold amount of \$12 for the combined MSAs and DTAs, or a total of \$27 (\$15 plus \$12). The allowed MSAs and DTAs that may count toward regulatory capital equal \$26 (\$53 less \$27).
- After the rules are fully phased in, the 250 percent risk weight must be applied to the \$26 in allowed MSAs and DTAs.

¹⁶⁹ This fully phased in example applies to advanced approaches banks as of January 1, 2018. The full phase-in for non-advanced approaches banks is frozen at the 2017 transition level. Refer to OCC Bulletin 2017-56, “Regulatory Capital Rule: Final Rule,” and 82 Fed. Reg. 55309 for the OCC’s “transitions final rule” that maintains the transition period treatment of MSAs, temporary difference DTAs, and significant investments in the capital of UFI in the form of common stock as of calendar year 2017.

Assumptions	
CET1	\$200
MSAs	\$35
DTAs	\$18
Total MSAs and DTAs	\$53

Step 1: 10% threshold	Deduct MSAs and DTAs that are each greater than 10% of CET1.	
Calculate amount of DTAs and MSAs that are allowed in CET1 based on the 10% CET1 threshold test.		
CET1	\$200	
10% threshold:	x 10%	
Allowed:	<u>\$20</u>	(for each—DTAs and MSAs)
Do MSAs and/or DTAs exceed the allowed amount? If yes—		
	Allowed	Must deduct
MSAs (\$35 less \$20)	\$20	\$15
DTAs	+ \$18	– \$0
Total allowed	<u>\$38</u>	
Total to deduct		\$15
Make deductions		
CET1:	\$200	
Minus deductions:	<u>– \$15</u>	
CET1 adjusted:	\$185	

Step 2: 15% threshold	MSAs and DTAs combined should not be greater than 15% of CET1 after all deductions.	
CET1 (before step 1):	\$200	
Minus all DTAs & MSAs:	<u>– \$53</u>	
Multiply this amount by 17.65% ^a	\$147	
	= \$26	Deduction threshold (or amount of DTAs + MSAs allowed)
MSAs + DTAs not previously deducted:	\$38	
Minus deduction threshold:	<u>– \$26</u>	
Additional deduction:	\$12	Additional deduction is the excess over the deduction threshold of MSAs and DTAs that was not previously deducted in step 1.

^a The 17.65 percentage is the proportion of 15 percent to 85 percent.

Step 3: Make deductions		
Adjusted CET1 from step 1:	\$185	
Minus additional deduction:	<u>– \$12</u>	
New CET1:	\$173	
Total deductions:	\$27	
Allowed MSAs & DTAs:	\$26	Apply 250% risk weight ^b
Check (allowed 26 / 173 CET1 _{new}) =	15.0%	

^b The 250 percent risk weight is applicable to advanced approaches banks. Non-advanced approaches banks should refer to example 1a for the applicable risk weight.

Example 1a: Transition deduction using the 10/15 percent deduction threshold tests (this example applies to non-advanced approaches banks only).

Non-advanced approaches banks use transition table 7 at 12 CFR 3.300(b)(4)(i)¹⁷⁰ to determine the percentage of additional deductions from regulatory capital. During the transition period, banks use a multiplier of 15 percent when calculating the 15 percent deduction and apply a 100 percent risk weight¹⁷¹ to the aggregate amount of the items subject to the 10 and 15 percent CET1 capital deduction thresholds that are not deducted.

Assumptions	
CET1	\$200
MSAs	\$35
DTAs subject to threshold deductions	\$18
Total MSAs and DTAs	<u>\$53</u>

¹⁷⁰ For non-advanced approaches banks only, refer to OCC Bulletin 2017-56, “Regulatory Capital Rule: Final Rule,” and 82 Fed. Reg. 55309 for the OCC’s “transitions final rule” that maintains the transition period treatment of MSAs, temporary difference DTAs, and significant investments in the capital of UFIs in the form of common stock as of calendar year 2017. Thus, as shown in this example, non-advanced approaches banks deduct from regulatory capital 80 percent of the amount of MSAs, temporary difference DTAs, and significant investments in the capital of UFIs in the form of common stock that are not includable in regulatory capital.

¹⁷¹ Refer to 12 CFR 3.300(b)(5).

Step 1: 10% threshold		Deduct MSAs and DTAs that are each greater than 10% of CET1.	
Calculate the amount of DTAs and MSAs that are allowed in CET1 based on the 10% threshold.			
CET1:	\$200		
10% threshold:	x 10%		
Allowed:	\$20	for each—DTAs and MSAs	
If MSAs and/or DTAs exceed the allowed amount, calculate the following:			
	Allowed	Must deduct	
MSAs (\$35 total)	\$20	\$15	
DTAs (\$18 total)	+ \$18	– \$0	
	<hr/>	<hr/>	
	\$38	\$15	
Transition deduction percentage		80%	
Deduction amount per transition		\$12	
Make deductions—			
CET1:	\$200		
Minus deductions:	<hr/>	– \$12	
CET1 adjusted:	\$188		

Step 2: 15% threshold		MSAs and DTAs combined should not be greater than 15% of CET1 after all deductions.	
CET1 (before step 1):	\$200		
Multiply by 15.0%:	<hr/>	15%	
	\$30	deduction threshold	
The additional deduction is the excess over the deduction threshold of MSAs and DTAs that was not previously deducted in step 1 .			
MSAs + DTAs not previously deducted			
As if fully phased in: ^c	\$38		
Minus deduction threshold:	<hr/>	– \$30	
	\$8		
Transition deduction percentage	<hr/>	80%	
Deduction amount	\$6 (rounded)		

^c Under the call report instructions, the sum of the amounts that would have been deducted before applying the transition period is used to determine the amount not previously deducted for the 15% threshold test. For this threshold test, \$38 (\$18 DTAs plus \$20 MSAs (\$35 less \$15)) is the amount considered not previously deducted. Note that the fully phased-in transition amount, \$15 (not \$12), is the amount used to determine the amounts not previously deducted.

Make deductions—		
Adjusted CET1 from Step 1:	\$188	
Minus additional deduction:	– \$6	
New CET1:	\$182	
Total deductions:	\$18 (\$12+\$6)	
Allowed MSAs & DTAs:	\$35 (\$53–\$18)	apply 100% risk weight ^d

^d Refer to OCC Bulletin 2017-56, “Regulatory Capital Rule: Final Rule,” and 12 CFR 3.300(b)(5) for an explanation of the changes to transition table 7 at 12 CFR 3.300(b)(4) in which non-advanced approaches banks apply a risk weight of 100 percent to MSAs and DTAs that are not deducted.

Example 2: Corresponding deduction approach for nonsignificant investments (the fully phased-in example applies to advanced approaches banks).

For this example, assume that Bank A has CET1 capital of \$100.¹⁷² Financial Institution (1) (FI1) has 60 shares of common stock issued and outstanding (value of \$60), and is not a regulated financial institution. Financial Institution (2) (FI2) has 80 shares of common stock issued and outstanding (value of \$80), and is a regulated financial institution.

Bank A owns the following:	
•	FI1
–	Five shares of issued and outstanding common stock, or 8% (5/60) (\$5 value, or \$1 per share).
–	Six shares of another FI1 capital instrument (M) (\$6 value, or \$1 per share).
•	FI2
–	No common shares owned.
–	Eight shares of another FI2 capital instrument (N) (\$8 value, or \$1 per share).

First, determine whether Bank A’s investments in FI1 and FI2 are nonsignificant.

- Under the definition of a nonsignificant investment, Bank A’s investment in five shares of the issued and outstanding common stock of FI1 is a nonsignificant investment, because the investment equals an 8 percent ownership, which is less than 10 percent of FI1’s total issued and outstanding common stock. Because Bank A’s common stock investment in FI1 is nonsignificant, its investment in instrument M is also a nonsignificant investment.
- Bank A owns no common stock in FI2, so all other investments in the capital instruments of FI2 are considered nonsignificant investments. The investment in instrument N is a nonsignificant investment.

Using the corresponding deduction approach, Bank A must determine the types of investments it has in FI1 and FI2. The common stock investment in FI1 qualifies as CET1

¹⁷² Most non-advanced approaches banks do not make nonsignificant investments in the capital of unconsolidated financial institutions. For those that do, they must apply the transition provisions applicable to calendar year 2017 to the deduction of such non-significant investments. Refer to 12 CFR 3.300(b)(5).

capital under 12 CFR 3.22(c)(2)(i)(A) because it is the common stock of FI1. Bank A finds that its investment in M is equivalent to an AT1 capital instrument because under 12 CFR 3.22(c)(2)(i)(B), the instrument is subordinated to all creditors of FI1 and is senior in liquidation only to FI1 common shareholders. The investment in N is tier 2 capital under 12 CFR 3.22(c)(2)(ii)(C) because the primary supervisor of FI2 considers instrument N to be regulatory capital, even though FI2 does not include N in GAAP equity. To summarize:

Bank A has the following:

- FI1
 - Five shares of issued and outstanding common stock (\$5 value) – CET1 capital
 - Six shares of M (\$6 value) – AT1 capital
- FI2
 - No common shares owned.
 - Eight shares of N (\$8 value) – tier 2 capital

The next step is to determine whether Bank A's aggregate investments exceed 10 percent of its CET1 capital pursuant to the 10 percent deduction threshold for nonsignificant investments.

- Under the 10 percent threshold test, 10 percent of Bank A's CET1 capital is \$10 (10 percent multiplied by \$100).
- Bank A's aggregate nonsignificant investments total \$19 (\$5 plus \$6 plus \$8).
- Bank A's deduction for its nonsignificant investments totals \$9 (\$19 aggregate nonsignificant investments less \$10 (10 percent of Bank A's CET1 capital)).¹⁷³

Next, determine the specific deduction applicable to each investment. Bank A must allocate the \$9 deduction to three components of capital: CET1 capital, AT1 capital, and tier 2 capital. Under 12 CFR 3.22(c)(4)(ii), the amount to be deducted from a specific component of capital is equal to the following:

- Bank A's nonsignificant investments in the capital of UFI's exceeding the 10 percent threshold for nonsignificant investments (or \$9^e), multiplied by
- the ratio of Bank A's nonsignificant investments in the capital of UFI's in the form of such capital component (in this example, Bank A applied the corresponding deduction approach and determined that it had \$5 of CET1 capital, \$6 of AT1 capital, and \$8 of tier 2 capital) to the bank's total nonsignificant investments in UFI's (\$19).

¹⁷³ As of January 1, 2018, a national bank or FSA that is not an advanced approaches bank must apply the transition provisions applicable to calendar year 2017 to the deduction of non-significant investments pursuant to 12 CFR 3.300(b)(5). Refer also to 12 CFR 3.300(b)(4), table 7. For this example, the deduction would be \$7.20 (\$9 multiplied by 80 percent).

Thus, to determine the deduction allocated to Bank A's CET1 capital, the calculation is as follows:

$\frac{\$ 5^a}{\19^b}	X	\$9 ^c	=	\$ 2.34 deduction
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^a The amount of nonsignificant investments in CET1 capital instruments under the corresponding deduction approach equals \$5.

^b The bank's aggregate nonsignificant investments equals \$19.

^c The amount exceeding the 10 percent threshold for nonsignificant investments.

Based on the calculation applied also to AT1 capital and tier 2 capital, the \$9 deduction¹⁷⁴ is allocated as follows:

- The deduction¹⁷⁵ from Bank A's CET1 capital is \$2.34 (\$9 multiplied by (\$5/\$19)).
- The deduction from Bank A's AT1 capital is \$2.88 (\$9 multiplied by (\$6/\$19)).
- The deduction from Bank A's tier 2 capital is \$3.78 (\$9 multiplied by (\$8/\$19)).

The total deductions equal \$9 (\$2.34 plus \$2.88 plus \$3.78).¹⁷⁶ The amount of the investment that is not deducted, \$10 (\$19 less the \$9 deducted), is risk-weighted according to 12 CFR 3, subparts D (standardized approach), E (advanced approaches rule), or F (market risk rule), as applicable.

Example 2a: Corresponding deduction approach for nonsignificant investments (the fully phased-in example applies to advanced approaches banks).

Assume that Bank X has CET1 capital of \$1,000. Assume Financial Institution 1 F-1 is a publicly traded and regulated financial institution that issued the following instruments:

- 100 shares of common stock issued and outstanding (value \$400 or \$4 per share)
- 50 shares of instrument A (value \$50, or \$1 per share)
- 50 shares of instrument B (value \$300, or \$6 per share)
- 60 shares of instrument C (value \$120, or \$2 per share)

¹⁷⁴ For a non-advanced approaches bank, the allocation is as follows:

- The deduction from Bank A's CET1 capital is \$1.90 (\$7.20 multiplied by (\$5/\$19)).
- The deduction from Bank A's AT1 capital is \$2.27 (\$7.20 multiplied by (\$6/\$19)).
- The deduction from Bank A's tier 2 capital is \$3.03 (\$7.20 multiplied by (\$8/\$19)).

¹⁷⁵ The example ignores any tax implications from netting DTLs.

¹⁷⁶ Advanced approaches banks with nonsignificant investments in the capital of UFIs are no longer subject to any transition treatment for these investments.

In this example, Bank X must first determine whether its investment in FI1's capital instruments is nonsignificant. An investment is considered nonsignificant if the ownership interest of a UFI's issued and outstanding common stock is 10 percent or less.

<p>Bank X owns the following:</p> <ul style="list-style-type: none"> • 5 shares, or \$20 (\$4 per share x 5 shares), of FI1's issued and outstanding common stock <ul style="list-style-type: none"> – Bank X's 5 shares equals a 5 percent interest of FI1's issued and outstanding common stock (5 shares/100 shares = 5 percent), which is less than 10 percent under the definition of a nonsignificant investment • 10 shares of A (valued at \$1 per share or \$10 value) • 10 shares of B (valued at \$6 per share, or \$60) • 10 shares of C (valued at \$2 per share, or \$20) <p>Total shares equal 35. Total value is \$110 (\$20 + \$10 + \$60 + \$20)</p>
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Because Bank X's common stock ownership of FI1 is less than 10 percent of FI1's issued and outstanding common stock, all of the investments (35 shares) in FI1 are nonsignificant investments.

Bank X must also determine the types of investments it has in FI1 using the corresponding deduction approach at 12 CFR 3.20(c)(2). For purposes of this example (as shown in the box above), assume the following:

- Bank X's 5 shares in FI1 issued and outstanding common stock qualifies as CET1 capital under 12 CFR 3.22(c)(2)(ii)(A). The bank's total investment in CET1 capital instruments is \$20.
- Bank X's investment in instruments A (10 shares) and B (10 shares) qualify as AT1 capital under 12 CFR 3.22(c)(2)(ii)(B). The bank's total investment in AT1 capital equivalent instruments is \$70 (instrument A (\$10) plus instrument B (\$60)).
- Bank X's investment in instrument C (10 shares) qualifies as tier 2 capital under 12 CFR 3.22(c)(2)(ii)(C). The bank's total investment in tier 2 capital instruments is \$20.

Under 12 CFR 3.22(c)(4), Bank X must calculate a deduction for its investments in FI1. Bank X determines that the total aggregate value of its ownership of FI1 common stock and other investments is \$110 (\$20 common stock plus \$90 in other investments). It then determines the 10 percent threshold for nonsignificant investments by multiplying its CET1 capital (\$1,000) by 10 percent, which is \$100. Bank X determines the total required deduction for these investments by calculating the excess amount of its aggregate nonsignificant investments (\$110) over its 10 percent deduction threshold (\$100), or \$10 (\$110 less \$100).¹⁷⁷ Bank X must then allocate the \$10 deduction to the specific capital elements relevant to its investments in FI1 (in this example, CET1 capital, AT1 capital, and

¹⁷⁷ As of January 1, 2018, a national bank or FSA that is not an advanced approaches bank must apply the transition provisions applicable to calendar year 2017 to the deduction of non-significant investments. Refer to 12 CFR 3.300(b)(4), table 7. For this example, the deduction would be \$8 (\$10 multiplied by 80 percent).

tier 2 capital). As shown in the following calculation, Bank X will allocate \$1.82 as the deduction from CET1 capital as follows:¹⁷⁸

$\frac{\$20^a}{\110^b}	X	$\$10^c$	=	\$1.82 deduction
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^a The amount of nonsignificant investments in the form of CET1 capital under the corresponding deduction approach.

^b The bank's aggregate investments (\$110) in UFls.

^c The excess amount of its aggregate nonsignificant investments (\$110) over its 10 percent deduction (\$110 less \$100).

The total amount of equivalent AT1 capital instruments is \$70 (\$10 plus \$60). The deduction from Bank X's AT1 capital is \$6.36 [(\$70/\$110) x \$10], and for the tier 2 capital investment, the deduction is \$1.82 [(\$20/\$110) x \$10] from the bank's tier 2 capital. Deductions may be net of DTLs.¹⁷⁹ The total deduction from the various capital components of Bank X is \$10 (\$1.82 + \$6.36 + \$1.82). An additional example is in appendix D of this booklet.

Finally, the amount of nonsignificant investments that Bank X does not deduct, or \$100 (\$110 less \$10 deducted), is assigned a risk weight according to 12 CFR 3, subparts D (standardized approach), E (advanced approaches rule), or F (market risk rule), as applicable.

Example 3: Corresponding deduction approach for significant investments not in the form of common stock (the fully phased-in example applies to advanced approaches banks).

Assume the following:

- Financial Institution 1(FI1) has issued and outstanding common stock of 100 shares and has issued 100 shares of a non-common stock instrument, K.
- Financial Institution 2 (FI2) has issued and outstanding common stock of 100 shares and has issued 100 shares of a non-common stock instrument, J.

¹⁷⁸ If Bank X were a non-advanced approaches bank, it would allocate the deduction as follows: \$1.46 (\$20 divided by \$110 multiplied by \$8) from CET1 capital, \$5.09 (\$70 divided by \$110 multiplied by \$8) from AT1 capital, and \$1.46 (\$20 divided by \$110 multiplied by \$8) from tier 2 capital.

¹⁷⁹ For netting DTLs against assets subject to deduction, refer to 12 CFR 3.22(e).

Bank Y¹⁸⁰ owns the following:

- 11 percent of FI1’s common stock and 5 percent of the K shares.
- 12 percent of FI2’s common stock and 6 percent of the J shares.

Because Bank Y owns more than 10 percent of the issued and outstanding common stock of FI1 and FI2,¹⁸¹ Bank Y’s shares of K and J non-common stock are deemed significant investments. Accordingly, Bank Y must deduct its non-common stock investments in K and J shares pursuant to the corresponding deduction approach. For the deduction, Bank Y determines the equivalent component of capital applicable to the K and J instruments using the criteria in 12 CFR 3.22(c)(2)(i)-(iii). For example, if Bank Y’s 5 percent ownership in K shares is determined to be in the form of an AT1 capital instrument, Bank Y deducts the value of its ownership interest in K from its own AT1 capital. If Bank Y’s 6 percent ownership interest in J shares is determined to be a tier 2 capital instrument, Bank Y deducts the value of that ownership interest from its own tier 2 capital.¹⁸² The deduction may be net of DTLs.¹⁸³

Example 4: Calculating minority interest limitations (the fully phased-in example is applicable to advanced approaches banks).

The steps to determine the amount of minority interest includable in a bank’s regulatory capital are illustrated in the following example. In this example, the amount of CET1¹⁸⁴ minority interest includable in the CET1 capital of a bank is the CET1 minority interest of the bank’s subsidiary, minus the ratio of the subsidiary’s CET1 capital owned by third parties to the total CET1 capital of the subsidiary, multiplied by the difference between the CET1 capital of the subsidiary and the lower of

- (1) the amount of CET1 capital the subsidiary must hold to avoid restrictions on capital distributions and discretionary bonus payments, or

¹⁸⁰ Most non-advanced approaches banks do not make significant investments in the capital of unconsolidated financial institutions. For non-advanced approaches banks that have significant investments not in the form of common stock in unconsolidated financial institutions, they must apply the transition provisions applicable to calendar year 2017 to the deduction of such significant investments. Refer to 12 CFR 3.300(b)(5) and table 7 at 12 CFR 3.300(b)(4).

¹⁸¹ The investments in FI1 and FI2 are 11 percent and 12 percent, respectively, so each exceeds 10 percent of each of the FI’s issued and outstanding common stock making any other investments “significant investments.”

¹⁸² Advanced approaches banks holding significant investments in the capital of UFIs that are not in the form of common stock are no longer subject to any transition treatment. A non-advanced approaches bank with significant investments not in the form of common stock in unconsolidated financial institutions is subject to the transition treatment at 12 CFR 3.300(b)(5) and would deduct 80 percent of any such ownership interest.

¹⁸³ DTLs are deducted in accordance with 12 CFR 3.22(e).

¹⁸⁴ Note that a bank may only include minority interest in CET1 if the minority interest is CET1 of a depository institution or foreign bank, i.e., the subsidiary must be a depository institution or foreign bank.

- (2) the total RWA of the bank that relate to the subsidiary, multiplied by the CET1 capital ratio needed by the bank's subsidiary to avoid restrictions on capital distributions and discretionary bonus payments.

In table 12, assume that a consolidated depository institution subsidiary has CET1, AT1, and tier 2 capital of \$80, \$30, and \$20, respectively, and that third parties own 30 percent of CET1 capital (\$24), 50 percent of AT1 capital (\$15), and 75 percent of tier 2 capital (\$15).

If the subsidiary has \$1,000 of total RWA, the sum of its minimum CET1 capital requirement (4.5 percent) plus the CCB (2.5 percent) (assuming a zero CCyB) is 7 percent (\$70), the sum of its minimum tier 1 capital requirement (6 percent) plus the CCB (2.5 percent) is 8.5 percent (\$85), and the sum of its minimum total capital requirement (8 percent) plus the CCB (2.5 percent) is 10.5 percent (\$105).

Table 12: Example of Calculation of Limits on Minority Interest

	(a) Capital issued by subsidiary (\$)	(b) Capital owned by third parties (%)	(c) Amount of minority interest (\$) <i>a * b</i>	(d) Minimum capital requirement plus CCB (%)	(e) Minimum capital requirement plus CCB (\$) <i>RWA*d</i>	(f) Surplus capital of subsidiary (\$) <i>a - e</i>	(g) Surplus minority interest (\$) <i>f * b</i>	(h) Minority interest included at bank level (\$) <i>c - g</i>
CET1 capital	80	30	24	7.0	70	10	3	21
AT1 capital	30	50	15					9.1
Tier 1 capital	110	35	39	8.5	85	25	8.9	30.1
Tier 2 capital	20	75	15					13.5
Total capital	130	42	54	10.5	105	25	10.4	43.6

The surplus CET1 capital of the subsidiary equals \$10 (\$80 less \$70), the amount of surplus CET1 minority interest is equal to \$3 (\$10 multiplied by \$24/\$80), and, thus, the amount of CET1 minority interest that may be included at the consolidated bank level is equal to \$21 (\$24 less \$3).¹⁸⁵

¹⁸⁵ As of January 1, 2018, a national bank or FSA that is not an advanced approaches bank may include in CET1 capital, tier 1 capital, or total capital 20 percent of the CET1 minority interest, tier 1 minority interest, and total capital minority interest outstanding as of January 1, 2014, that exceeds any CET1 minority interest, tier 1 minority interest, or total capital minority interest includable under 12 CFR 3.21 (surplus minority interest). Refer to 12 CFR 3.300(d), table 10. For a non-advanced approaches bank, if the surplus CET1 minority interest of a subsidiary is \$3, then the bank may include \$0.60 (20 percent multiplied by \$3) of the surplus CET1 minority interest in CET1 capital. Thus, the surplus CET1 minority interest amount becomes \$2.40 (\$3 less \$0.60) for purposes of determining the amount of CET1 minority interest includable in CET1 capital. Accordingly, the amount of CET1 minority interest that may be included in CET1 capital at the consolidated bank level is equal to \$21.60 (\$24 less \$2.40).

The surplus tier 1 capital of the subsidiary is equal to \$25 (\$110 less \$85), the amount of the surplus tier 1 minority interest is equal to approximately \$8.90 (\$25 multiplied by \$39/\$110), and thus, the amount of tier 1 minority interest that may be included in the bank is equal to \$30.10 (\$39 less \$8.90). Since the bank already includes \$21 of CET1 minority interest in its CET1 capital, it would include \$9.10 (\$30.10 less \$21) of such tier 1 minority interest in its AT1 capital.¹⁸⁶

The surplus total capital of the subsidiary is equal to \$25 (\$130 less \$105), the amount of the surplus total capital minority interest is equal to \$10.40 (\$25 multiplied by \$54/\$130), and, thus, the amount of total capital minority interest that may be included in the bank's total capital is equal to \$43.60 (\$54 less \$10.4). Since the bank already includes \$30.10 of tier 1 minority interest in its tier 1 capital, it would include \$13.50 (\$43.60 less \$30.10) of such total capital minority interest in its tier 2 capital.¹⁸⁷

¹⁸⁶ For a non-advanced approaches bank, if surplus tier 1 capital of a subsidiary is equal to \$25 (\$110 less \$85) and the amount of the surplus tier 1 minority interest is equal to approximately \$8.90 (\$25 multiplied by \$39/\$110), then pursuant to 12 CFR 3.300(d), table 10, the bank may include \$1.78 (20 percent multiplied by \$8.90) of the surplus tier 1 minority interest in tier 1 capital. The surplus tier 1 minority interest amount becomes \$7.12 (\$8.90 less \$1.78) for purposes of determining the amount of tier 1 minority interest includable in tier 1 capital. Accordingly, the amount of tier 1 minority interest that may be included in the bank's tier 1 capital is equal to \$31.88 (\$39 less \$7.12). Since the bank already includes \$21.60 of CET1 minority interest in its CET1 capital, it would include \$10.28 (\$31.88 less \$21.60) of such tier 1 minority interest as AT1 capital.

¹⁸⁷ If the surplus total capital of a subsidiary is equal to \$25 (\$130 less \$105) and the amount of the surplus total capital minority interest is equal to \$10.40 (\$25 multiplied by \$54/\$130), then pursuant to 12 CFR 3.300(d), table 10, the bank may include \$2.08 of the surplus total capital minority interest in total capital (20 percent multiplied by \$10.40). The surplus total capital minority interest becomes \$8.32 (\$10.40 less \$2.08) for purposes of determining the amount of total capital minority interest includable in total capital. Accordingly, the amount of total capital minority interest that the bank may include in its total capital is \$45.68 (\$54 less \$8.32). Since the bank already includes \$31.88 of tier 1 minority interest in its tier 1 capital, it would include \$13.80 (\$45.68 less \$31.88) of such total capital minority interest as tier 2 capital.

Appendix E: General Overview of the Market Risk Rule

This appendix is intended to provide a broad overview of the market risk rule and a general explanation of its application. Examiners assigned to banks subject to the rule should check periodically for additional guidance or amendments to the rule. The market risk rule applies to banking organizations that have significant trading activities (on a worldwide consolidated basis) such that the bank's aggregate trading assets and trading liabilities (as reported in the bank's most recent call report) are equal to

- 10 percent or more of quarter-end total assets, or
- \$1 billion or more.¹⁸⁸

Market risk is the risk of loss on a position that could result from changes in market prices, and comprises general market risk and specific risk. General market risk is the risk of loss in value due to broad market movements, such as changes in the general level of interest rates, credit spreads, equity prices, foreign exchange rates, or commodity prices. Specific risk is the risk of loss in value due to factors other than broad market movements and includes the following:

- **Event risk**, which is the risk of loss from sudden and unexpected large changes in market prices due to specific events (including natural disasters, national conflicts, political changes, or major corporate restructurings).
- **Default risk and idiosyncratic risk**, which is the risk of loss in value that arises from changes in risk factors unique to that debt or equity position.

A bank must hold capital to support its exposure to general market risk and its exposure to specific risk associated with certain debt and equity positions. A bank subject to the market risk rule must have, among other items, the following.¹⁸⁹

- Clearly defined policies and procedures to identify which of its trading assets and trading liabilities are trading positions and which of its trading positions meet the definition of "correlation trading positions."¹⁹⁰
- Clearly defined trading and hedging strategies for its trading positions that are approved by senior management. In particular, a trading strategy must articulate the expected holding period of, and the market risk associated with, each portfolio of trading positions. In addition, a bank's hedging strategy must articulate for each portfolio the level of market risk the bank is willing to accept and detail the instruments, techniques, and strategies the bank will use to hedge the risk of that portfolio.

¹⁸⁸ Refer to 12 CFR 3.201(b). The OCC may exempt a bank from having to comply with the market risk rule or include a bank within the scope of the market risk rule if necessary or appropriate for safe and sound banking practices.

¹⁸⁹ Refer to 12 CFR 3.203.

¹⁹⁰ Refer to 12 CFR 3.203 and 12 CFR 3.202 (definition of "correlation trading position").

- Clearly defined policies and procedures to actively manage all covered positions.¹⁹¹
- A process for prudent valuation of its covered positions that includes policies and procedures on the valuation of positions, marking positions to market or to model, independent price verification, and valuation adjustments or reserves.
- Prior written approval from the OCC before using any internal model to calculate its risk-based capital requirement under subpart F. A bank must also notify the OCC if, subsequent to approval, any changes are made to the internal model or its use, and must seek written approval from the OCC before implementing any material changes.
- A rigorous process to assess overall capital adequacy in relation to market risk. This assessment must take into account risks that the value-at-risk-based measure may not fully capture, including concentration and liquidity risk under stressed market conditions.
- A risk control unit that reports directly to senior management and is independent from the business trading units.
- A process to validate internal models initially and on an ongoing basis, and an internal audit function independent of business-line management that at least annually assesses the effectiveness of controls.
- A process to adequately document all material aspects of internal models, management and valuation of covered positions, control, oversight, validation and review processes and results, and internal assessment of capital adequacy.

Calculation of Market Risk Risk-Weighted Assets

Trading Book vs. Banking Book

A market risk bank must determine which of its trading assets and trading liabilities under U.S. GAAP are “trading positions” (i.e., positions that a bank holds for short-term resale, or with the intent of benefiting from actual or expected price movements, to lock in arbitrage profits, or to hedge covered positions). The market risk bank must then determine which trading positions are “covered positions” (i.e., positions subject to a market risk capital charge). Positions that are not covered positions are considered banking book positions. Covered positions generally include all foreign exchange and commodity positions, regardless of whether the positions are reported as trading assets or trading liabilities under U.S. GAAP.

A covered position does *not* include the following:

- An intangible asset (including any servicing assets).
- A hedge of a trading position that is outside the scope of a bank’s hedging strategy (required by the market risk rule).
- Any position that, in form or substance, acts as a liquidity facility that provides support to asset-backed commercial paper.

¹⁹¹ Covered positions include trading assets and trading liabilities that are trading positions. Covered positions can include certain debt, equity, and securitization positions. In addition, the market risk rule provides that commodities and foreign exchange positions (whether or not in the trading account) are covered positions. Refer to 12 CFR 3.202 for the full definition.

- A credit derivative recognized as a guarantee for RWA calculation purposes under the risk-based capital rules for credit risk.
- An equity position that is not publicly traded (other than a derivative that references a publicly traded equity).
- A position held with the intent to securitize.
- A direct real estate holding.

A bank reports covered positions according to call report schedule RC-D.

Measure for Market Risk

A market risk bank must calculate its measure for market risk pursuant to 12 CFR 3.204. To calculate its market risk equivalent assets (the amount added to the denominator of its risk-based capital ratios), the bank must then multiply its measure for market risk by 12.5.¹⁹²

As set forth at 12 CFR 3.204(a)(2), a bank's measure for market risk¹⁹³ is equal to the sum of its value-at-risk-based capital requirement,¹⁹⁴ its stressed value-at-risk-based capital requirement,¹⁹⁵ specific risk add-ons,¹⁹⁶ incremental risk capital requirement,¹⁹⁷ comprehensive risk capital requirement,¹⁹⁸ and capital requirement for de minimis exposures.¹⁹⁹

Market Risk Disclosures

A market risk bank must comply with the quantitative and qualitative disclosure requirements of 12 CFR 3.212 unless the bank is a consolidated subsidiary of a BHC, a depository institution, or a non-U.S. banking organization that is subject to comparable public disclosure requirements in its home jurisdiction. In that case, the disclosures of the holding company would suffice. A bank is not required to disclose confidential or proprietary information, but if it chooses not to disclose information set forth in the requirement, the bank must provide general information about the subject matter together with the reason why the information was not disclosed. A bank may satisfy the disclosure requirement by posting

¹⁹² Refer to 12 CFR 3.2 (definition of “advanced market risk-weighted assets” for advanced approaches banks and the definition of “standardized market risk-weighted assets” for non-advanced approaches banks).

¹⁹³ Refer to 12 CFR 3, subpart F.

¹⁹⁴ Refer to 12 CFR 3.205.

¹⁹⁵ Refer to 12 CFR 3.206.

¹⁹⁶ Refer to 12 CFR 3.207.

¹⁹⁷ Refer to 12 CFR 3.208.

¹⁹⁸ Refer to 12 CFR 3.209.

¹⁹⁹ Refer to 12 CFR 3.204(a)(2)(vi).

the required information to its website. Banks subject to the market risk rule must complete and submit quantitative information through FFIEC form 102 found on the FFIEC's website.

Appendix F: Advanced Approaches Framework—Advanced Internal Ratings-Based Approach and Advanced Measurement Approach to Calculate Risk-Weighted Assets

This appendix provides a general overview of the advanced approaches framework that applies only to advanced approaches banks. The framework in 12 CFR 3, subpart E establishes the advanced internal ratings-based (AIRB) approach to measure credit risk and the advanced measurement approach (AMA) to measure operational risk.

The AIRB uses risk parameters determined by a bank's internal systems to generate credit risk capital requirements. Under the AMA, an advanced approaches bank also uses internal estimates to generate an operational risk capital requirement.²⁰⁰ An advanced approaches bank subject to the market risk rule calculates an RWA amount for its market risk exposures and includes that amount in its advanced approaches RWA.²⁰¹

General Qualification Requirements for Advanced Approaches (Parallel Run)

To use the advanced approaches rules, a bank must conduct a satisfactory trial, or “parallel run,” over the course of at least four consecutive quarters in which the bank demonstrates to the OCC that the bank has successfully implemented the risk-measurement and risk-management systems of the advanced approaches rule. Once the OCC determines that the bank has met all the qualification requirements, has conducted a satisfactory parallel run, and has established an adequate process for ongoing compliance, then the bank may calculate its risk-based capital requirements under the advanced approaches rule.

An advanced approaches bank must adopt a written implementation plan that meets the requirements in 12 CFR 3.122²⁰² within six months of its eligibility as an advanced approaches bank. This plan must address how the bank plans to comply with qualification requirements that require the following:

- A rigorous process to assess its overall capital adequacy in relation to its risk profile.
- A comprehensive strategy for maintaining an appropriate level of capital.
- The ability to generate the relevant risk parameters necessary to calculate the bank's risk-based capital requirements.
- Systems and processes to calculate risk-based capital that are consistent with the bank's internal risk management processes and management information reporting systems.
- An appropriate infrastructure with risk-measurement and risk-management processes that meet the qualification requirements of 12 CFR 3.122 and are appropriate given the bank's size and level of complexity.

²⁰⁰ Refer to 12 CFR 3.122(g) and 3.162.

²⁰¹ Refer to 12 CFR Part 3, subpart F, for the market risk provisions.

²⁰² Refer to 12 CFR 3.121(a) and 3.122.

- Risk parameters and reference data to determine risk-based capital requirements that are representative of the bank's own credit risk and operational risk exposures.

Advanced Internal Ratings-Based Approach

Wholesale and Retail Exposures

An advanced approaches bank must have an internal risk rating and segmentation system that accurately and reliably differentiates among degrees of credit risk for the bank's wholesale²⁰³ and retail²⁰⁴ exposures. For wholesale exposures, the bank must be able to assign an obligor a rating that reflects the obligor's likelihood of default. For retail exposures, the bank must have an internal system that groups retail exposures into the appropriate retail exposure subcategories,²⁰⁵ and then regroups those exposures in each subcategory into separate segments with homogeneous risk characteristics. The bank then assigns accurate and reliable probability of default (PD) and loss given default (LGD) estimates for each segment on a consistent basis.

Quantification of risk parameters for wholesale and retail exposures

For wholesale and retail exposures, an advanced approaches bank must estimate certain risk parameters such as PD, LGD, exposure at default (EAD), and for wholesale exposures, effective remaining maturity (M).

- PD, defined in 12 CFR 3.101, is a bank's empirically based best estimate of the long-run average one-year default rate for the rating grade assigned by the bank to the obligor, capturing the average default experience for obligors in the rating grade over a mix of economic conditions (including economic downturn conditions) sufficient to provide a

²⁰³ Refer to 12 CFR 3.122 for qualification requirements. Wholesale exposure means a credit exposure to a company, natural person, sovereign, or governmental entity (other than a securitization exposure, retail exposure, pre-sold construction loan, or equity exposure).

²⁰⁴ Retail exposure means a residential mortgage exposure, a qualifying revolving exposure, or other retail exposure.

²⁰⁵ This includes residential mortgage exposures, qualifying revolving exposures, or other retail exposures. A qualifying revolving exposure is defined at 12 CFR 3.101 and means an exposure (other than a securitization exposure or equity exposure) to an individual that is managed as part of a segment of exposures with homogeneous risk characteristics, not on an individual exposure basis, and is revolving (as defined in the rule), is unsecured and unconditionally cancelable by the bank to the fullest extent permitted by Federal law, and generally has a maximum contractual exposure amount (drawn or undrawn) of up to \$100,000. An "other retail exposure" is also defined at 12 CFR 3.101 and means an exposure that is managed as part of a segment of exposures with homogeneous risk characteristics, not on an individual-exposure basis, and is either an exposure to an individual for nonbusiness purposes or an exposure to an individual or company for business purposes if the bank's consolidated business credit exposure to the individual or company is \$1 million or less. Under the definition, an "other retail exposure" is not a securitization exposure, an equity exposure, a residential mortgage exposure, a pre-sold construction loan, a qualifying revolving exposure, or the residual value portion of a lease exposure.

reasonable estimate of the average one-year default rate over the economic cycle for the rating grade. In other words, PD generally determines the likelihood that an obligor for an exposure will default²⁰⁶ during the coming year. For wholesale and retail exposures, PD estimates must be based on at least five years of default data.

- LGD, defined in 12 CFR 3.101, is a bank's empirically-based best estimate of the long-run default weighted average economic loss divided by the estimated EAD for a wholesale exposure or a retail segment within a one-year horizon. The LGD estimate must be measured using either (a) a mix of economic conditions, including economic downturn conditions, or (b) economic downturn conditions. In other words, LGD generally determines how much a bank can expect to lose, as a percentage of EAD, if an obligor goes into default. For wholesale exposures, the estimates must be based on at least seven years of loss severity data. Retail exposures require five years of loss severity data.
- EAD generally refers to the maximum that the bank could lose if the obligor goes into default and the bank takes a complete write-off of the loss. EAD is specifically defined at 12 CFR 3.101 for (1) the on-balance sheet component of a wholesale exposure or segment of retail exposures and (2) the off-balance sheet component of a wholesale exposure or segment of retail exposures. Refer to the definition at 12 CFR 3.101 for additional information on EAD regarding types²⁰⁷ of off-balance sheet wholesale exposures and segment of retail exposures.

To estimate the general risk parameters of PD, LGD, and EAD, banks use reference data. Reference data may be internal to the bank or may be external. Data used to estimate PD, LGD, and EAD should be relevant to the bank's actual wholesale and retail exposures, and of sufficient quality to support the determination of risk-based capital requirements for the exposures.²⁰⁸ Default, loss severity, and exposure amount data should also include periods of economic downturn conditions. If not, the bank must adjust its estimates of risk parameters to compensate for the lack of such data. Data for both LGD and EAD should consist of defaulted credits, with relevant characteristics, and adequate sample periods. Data for PD should include representative defaulted and non-defaulted obligors, relevant characteristics of those obligors, and a range of economic conditions.²⁰⁹ Annually the bank should conduct a comprehensive review and analysis of reference data to determine relevance of reference data to the bank's exposures, quality of reference data to support PD, LGD, and EAD estimates, and consistency of reference data to the definition of default in 12 CFR 3.101.

²⁰⁶ Default is defined at 12 CFR 3.101.

²⁰⁷ Examples of off-balance sheet exposures include loan commitments, line of credit, and trade-related letters of credit.

²⁰⁸ Refer to 12 CFR 3.122(c)(2). Banks also use data to model how defaults and pending defaults affect losses and drawdowns on loans.

²⁰⁹ For additional discussion regarding the requirements for risk rating and segmentation systems for wholesale and retail exposures, refer to 12 CFR 3.122(b). For a discussion of the quantification of risk parameters for wholesale and retail exposures with reference to PD, LGD, and EAD requirements, refer to 12 CFR 3.122(c).

Mechanics to Calculate Total Wholesale and Retail Risk-Weighted Assets

A bank calculates the RWA amount in four phases pursuant to 12 CFR 3.131 as follows:

- **Phase 1:** The bank categorizes its exposures as wholesale, retail, securitization, or equity pursuant to 12 CFR 3.131(b).
- **Phase 2:** The bank assigns wholesale obligors and exposures to rating grades and retail exposures to segments pursuant to 12 CFR 3.131(c).
- **Phase 3:** The bank assigns risk parameters to wholesale exposures and to segments of retail exposures pursuant to 12 CFR 3.131(d).
- **Phase 4:** The bank calculates RWA amounts pursuant to 12 CFR 3.131(e).

A bank also considers the effect of guarantees and credit derivatives when calculating its RWA,²¹⁰ as well as the various methodologies for recognizing the benefits of financial collateral in mitigating the counterparty credit risk of repo-style transactions, eligible margin loans, and OTC derivative contracts²¹¹ and unsettled transactions.²¹² In addition, an advanced approaches bank must use the methodologies in 12 CFR 3.133 to calculate RWA for any cleared transaction; follow 12 CFR 3.141 through 3.145 to calculate RWA for securitization exposures;²¹³ and follow 12 CFR 3.151 through 3.155 to calculate RWA for equity exposures.

An advanced approaches bank adds these RWA amounts to the amount determined under the AMA for operational risk and the market risk rule to determine the advanced approaches total RWA pursuant to the requirements at 12 CFR 3.10(c)(1)(ii), (2)(ii), and (3)(ii).

Capital Floor

Under section 171 of the Dodd–Frank Act (commonly referred to as the “Collins Amendment”), the federal banking agencies are required to establish generally applicable minimum leverage and risk-based capital requirements to apply to banks and BHCs, regardless of their size or amount of foreign exposures. The federal banking agencies have determined that the standardized approach rules set forth in subpart D are the generally applicable risk-based capital rules for this purpose. Therefore, pursuant to 12 CFR 3.1(f)(1)(i), any advanced approaches bank that has completed the parallel run process must calculate its total RWA under the standardized approach in subpart D, and separately, using total RWA calculated under the advanced approaches in subpart E. The lower ratio for each risk-based capital requirement is used to determine compliance with the minimum capital requirements at 12 CFR 3.10. Note that non-advanced approaches banks and advanced approaches banks that have not completed the parallel run process are only required to use

²¹⁰ Refer to 12 CFR 3.134 and 3.135.

²¹¹ Refer to 12 CFR 3.132.

²¹² Refer to 12 CFR 3.136.

²¹³ Refer to OCC Bulletin 2013-27, “Risk-Based Capital Advanced Approaches: Advanced Approaches Guidance.”

the standardized approach in subpart D to calculate RWA for the purpose of the minimum capital requirements set forth at 12 CFR 3.10.

Disclosures

An advanced approaches bank that has completed the parallel run process and has received notification from the OCC, pursuant to section 12 CFR 3.121(d), must publicly disclose each quarter its tier 1 and total risk-based capital ratios and their components. The components are CET1 capital, additional tier 1 capital, tier 1 capital, total qualifying capital,²¹⁴ and total RWA pursuant to 12 CFR 3.172. Additional qualitative and quantitative disclosure requirements may apply under 12 CFR 3.173 if a bank is not a consolidated subsidiary of a holding company that makes those disclosures on a consolidated basis. All advanced approaches banks, regardless of parallel run status, must also file FFIEC Form 101, which includes additional quantitative data.

Operational Risk and Advanced Measurement Approach

The advanced approaches rule includes requirements for credit, operational, and market risk.²¹⁵ For operational risk, the advanced approaches rule requires an advanced approaches bank to use the AMA to calculate risk-based capital requirements for operational risk.²¹⁶ The mechanics for the calculation are found at 12 CFR 3.162. A qualifying bank's operational risk management processes must meet the requirements listed under 12 CFR 3.122(g)(1)(i)(A) and (B) and its operational risk data and assessment systems must meet the requirements at 12 CFR 3.122(g)(2)(i) and (ii). The OCC expects qualifying banks to have data management systems that provide accurate and timely reporting, allow for adequate monitoring, and have effective qualitative controls (such as board oversight and governance).

²¹⁴ Total qualifying capital means the sum of a bank's tier 1 capital elements and tier 2 capital elements, net of all applicable deductions and adjustments.

²¹⁵ Refer to OCC Bulletin 2011-21, "Advanced Measurement Approaches for Operational Risk: Interagency Guidance on the Advanced Measurement Approaches for Operational Risk."

²¹⁶ Refer to Guidance on Advanced Approaches (GAA) 2014-01, "Supervisory Guidance for Data, Modeling, and Model Risk Management Under the Operational Risk Advanced Measurement Approaches."

Appendix G: Effective Dates and Transitions

Remaining effective dates (as of this booklet's publication date):

Non-Advanced Approaches Banks

As of January 1, 2019

- Fully comply with the requirements for the CCB.

Advanced Approaches Banks in Parallel Run

As of January 1, 2018

- Comply fully with the SLR requirements.

As of January 1, 2019

- Comply fully with the CCB.

Advanced Approaches Banks That Have Exited Parallel Run

As of January 1, 2018

- Comply fully with the SLR requirements.

As of January 1, 2019

- Comply fully with the CCB.

Transition Periods

For advanced approaches banks, transition periods began on January 1, 2014. The transition periods for non-advanced approaches banks began January 1, 2015. The rule establishes transition provisions²¹⁷ for the following items in the tables²¹⁸ at 12 CFR 3.300:

12 CFR 3.300 Table 1

The CCB was effective for all banks as of January 1, 2016, and will be fully phased in as of January 1, 2019.

Transition period (calendar year)	CCB ^a	Maximum payout ratio (as a percentage of eligible retained income)
2018	Greater than 1.875%	No limitation applies
	Less than or equal to 1.875% and greater than 1.406%	60%
	Less than or equal to 1.406% and greater than 0.938%	40%
	Less than or equal to 0.938% and greater than 0.469%	20%
	0.469% or less	0%

^a When the CCyB applies to advanced approaches banks, refer to table 1 at 12 CFR 3.300 for the CCyB percentages.

²¹⁷ In general, the transition provisions are at 12 CFR 3.300. Refer to 12 CFR 3.172(d) and 12 CFR 6.4(c)(2)(iv)(B) with respect to timing requirements for the SLR.

²¹⁸ Table 8 at 12 CFR 3.300 applies to holding companies and is not included in this discussion.

Table 13 below provides a summary timeline for the minimum CET1 capital, tier 1 capital, and total capital requirements as affected by the CCB transition periods.

Table 13: Summary Timeline

Year (as of January 1)	2018	2019
Minimum CET1 capital ratio	4.5%	4.5%
CCB	1.875%	2.5%
CET1 capital ratio plus CCB	6.375%	7.0%
Phase-in of deductions from CET1 capital*	100%	100%
Minimum tier 1 capital ratio	6.0%	6.0%
Minimum tier 1 capital ratio plus CCB	7.875%	8.5%
Minimum total capital ratio	8.0%	8.0%
Minimum total capital ratio plus CCB	9.875%	10.5%

* Includes threshold deduction items that are over the limits.

12 CFR 3.300 Table 2

The regulatory capital deductions listed below pursuant to 12 CFR 3.22(a) were fully phased in as of January 1, 2018:

- Goodwill.
- DTAs that arise from net operating loss and tax credit carry-forwards.
- Gain-on-sale in connection with a securitization exposure.
- Defined-benefit pension fund assets.
- Expected credit loss that exceeds eligible credit reserves (for advanced approaches banks that have completed parallel run successfully).
- Financial subsidiaries.

12 CFR 3.300 Table 3

The deduction from CET1 capital for intangible assets (other than goodwill and MSAs) pursuant to 12 CFR 3.22(a)(2) was fully phased in as of January 1, 2018.

12 CFR 3.300 Table 4

Adjustments related to changes in the fair value of liabilities due to changes in the bank's own credit risk allocated between CET1 capital and tier 1 capital were fully phased in as of January 1, 2018.

12 CFR 3.300 Table 5

The transition adjustments to AOCI for an advanced approaches bank and a bank that has not made an AOCI opt-out election under 12 CFR 3.22(b)(2) were fully phased in as of January 1, 2018.

12 CFR 3.300 Table 6

The percentage of unrealized gains on AFS preferred stock classified as an equity security under GAAP and AFS equity exposures includable in tier 2 capital was fully phased in as of January 1, 2018.

12 CFR 3.300 Table 7

Investments in capital instruments and items subject to the 10 and 15 percent CET1 capital deduction thresholds were fully phased in for advanced approaches banks as of January 1, 2018. For non-advanced approaches banks, refer to OCC Bulletin 2017-56, “Regulatory Capital Rule: Final Rule,” and 12 CFR 3.300(b)(5), which maintains the transition provisions described in 12 CFR 3.300(b)(4)(i) through (iii) applicable to calendar year 2017 for items that are subject to deduction under 12 CFR 3.22(c)(4), (c)(5), and (d).

12 CFR 3.300 Table 8

Applicable to holding companies only.

12 CFR 3.300 Table 9

Debt or equity instruments issued before September 12, 2010, that do not meet the criteria for tier 1 or tier 2 capital (nonqualifying capital instruments) will be fully phased in as of January 1, 2022.²¹⁹

12 CFR 3.300 Table 10

The deductions for minority interest at 12 CFR 3.21 were fully phased in as of January 1, 2018, for advanced approaches banks. For non-advanced approaches banks, refer to OCC Bulletin 2017-56, “Regulatory Capital Rule: Final Rule,” and 12 CFR 3.300(d)(1)(ii) that maintain the transition treatment of surplus minority interest as of calendar year 2017.

²¹⁹ Table 9 at 12 CFR 3.300(c) applies separately to tier 1 and tier 2 nonqualifying capital instruments.

Appendix H: Abbreviations

ADC	acquisition, development, or construction
AFS	available for sale
AIRB	advanced internal ratings-based
ALLL	allowance for loan and lease losses
AMA	advanced measurement approach
AOCI	accumulated other comprehensive income
ASC	Accounting Standards Codification
ASU	Accounting Standards Update
AT1	additional tier 1
BCBS	Basel Committee on Banking Supervision
BHC	bank holding company
CAMELS	capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risk
CCB	capital conservation buffer
CCF	credit conversion factor
CCyB	countercyclical capital buffer
CDO	collateralized debt obligation
CET1	common equity tier 1
CFR	Code of Federal Regulations
CRC	country risk classification
CRE	commercial real estate
DTA	deferred tax asset
DTL	deferred tax liability
EAD	exposure at default
EGRRCPA	Economic Growth, Regulatory Relief, and Consumer Protection Act
EIC	examiner-in-charge
ERISA	Employee Retirement Income Security Act of 1974
eSLR	enhanced supplementary leverage ratio
ESOP	employee stock ownership plan
FFIEC	Federal Financial Institutions Examination Council
FI	financial institution
FSA	federal savings association
GAAP	generally accepted accounting principles
GSE	government-sponsored enterprise
GSIB	global systemically important bank
HOLA	Home Owners' Loan Act of 1933
HVCRE	high-volatility commercial real estate
ICQ	internal control questionnaire
IDI	insured depository institution
IMCR	individual minimum capital requirement
IRS	Internal Revenue Service
LGD	loss given default
MSA	mortgage servicing asset
OCC	Office of the Comptroller of the Currency

OCI	other comprehensive income
OECD	Organization for Economic Cooperation and Development
OTC	over-the-counter
PCA	prompt corrective action
PD	probability of default
PSE	public sector entity
REIT	real estate investment trust
RWA	risk-weighted assets
SLR	supplementary leverage ratio
TARP	Troubled Asset Relief Program
TLAC	total loss absorbing capital
TruPS	trust preferred securities
TruPS CDO	trust preferred securities collateralized debt obligation
UFI	unconsolidated financial institution
USC	U.S. Code

References

Laws

- 5 USC 552, “Freedom of Information Act”
- 12 USC 1817(j), “Change in Control of Insured Depository Institutions”
- 12 USC 1818 (b), “Cease-and-Desist Proceedings”
- 12 USC 1828(n), “Calculation of Capital”
- 12 USC 1831bb, “Capital Requirements for Certain Acquisition, Development, or Construction Loans”
- 12 USC 1831o, “Prompt Corrective Action”
- 12 USC 1851, “Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity”
- 12 USC 4701, “Community Development Banking”
- 12 USC 5365(i), “Stress Tests”
- 12 USC 5371, “Leverage and Risk-Based Capital Requirements”
- 15 USC 80a, “Investment Companies and Advisors”
- 15 USC 662, “Small Business Investment Program”
- 26 USC 1361, “Internal Revenue Code (Subchapter S)”
- 29 USC 1002, “Definitions”
- Pub. L. 111-203, 124 Stat. 1376 (2010), “The Dodd–Frank Wall Street Reform and Consumer Protection Act”
- Pub. L. 115-174, 132 Stat. 1296 (2018), “Economic Growth, Regulatory Relief, and Consumer Protection Act”

National Banks

- 12 USC 24a, “Financial Subsidiaries of National Banks”
- 12 USC 56, “Prohibition on Withdrawal of Capital; Unearned Dividends”
- 12 USC 60, “National Bank Dividends”
- 12 USC 61, “Shareholders’ Voting Rights; Cumulative and Distributive Voting; Preferred Stock; Trust Shares; Proxies, Liability Restrictions; Percentage Requirement Exclusion of Trust Shares”
- 12 USC 62, “List of Shareholders”

Federal Savings Associations

- 12 USC 1461(t), “Capital Standards under the ‘Home Owners’ Loan Act’ (HOLA)”
- 12 USC 1464(b), “Deposits and Related Powers”
- 12 USC 1464(c), “Loans and Investments”
- 12 USC 1468(b), “Transactions With Affiliates; Extensions of Credit to Executive Officers, Directors, and Principal Shareholders”

Regulations

- 12 CFR 3, “Capital Adequacy Standards”
- 12 CFR 5, “Rules, Policies, and Procedures for Corporate Activities”
- 12 CFR 6, “Prompt Corrective Action”
- 12 CFR 44, “Proprietary Trading and Certain Interests in and Relationships With Covered Funds”
- 12 CFR 46, “Annual Stress Test”

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- 77 Fed. Reg. 61238, “Annual Stress Test” (October 9, 2012)
- 78 Fed. Reg. 62018, “Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-Weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule” (October 11, 2013)
- 79 Fed. Reg. 24528, “Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for Certain Bank Holding Companies and Their Subsidiary Insured Depository Institutions” (May 1, 2014)
- 80 Fed. Reg. 41409, “Regulatory Capital Rules: Regulatory Capital, Final Revisions Applicable to Banking Organizations Subject to the Advanced Approaches Risk-Based Capital Rule” (July 15, 2015)
- 82 Fed. Reg. 55309, “Regulatory Capital Rules: Retention of Certain Existing Transition Provisions for Banking Organizations That Are Not Subject to the Advanced Approaches Capital Rules” (November 21, 2017)

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OCC Bulletin 2014-5, "Dodd–Frank Stress Testing: Supervisory Guidance for Banking Organizations With Total Consolidated Assets of More Than \$10 Billion but Less Than \$50 Billion" (March 5, 2014)

OCC Bulletin 2014-18, "Regulatory Capital-Enhanced Supplementary Leverage Ratio Final Rule" (May 1, 2014) and 79 Fed. Reg. 24528 (May 1, 2014)

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Other

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Reporting Form–FFIEC 102, “Market Risk Regulatory Report for Institutions Subject to the Market Risk Capital Rule”
Reporting Form–FFIEC TA-1, “Transfer Agent Registration and Amendment Form”