ARKANSAS STATE BANK DEPARTMENT
EXAMINATION POLICY

Policy Number	98-1
Effective Date	1-1-98
Supersedes	92-1
Approval	

SUBJECT: Capital Adequacy

Capital is the cushion that enables banks to sustain losses due to economic declines and unanticipated financial setbacks. It is the buffer between unreserved losses and the interest of depositors and creditors. As the ownership interest of shareholders, capital instills discipline and motivates bank managers to exercise prudence in the acceptance and management of risk. Adequate capital promotes public confidence and enables banks to more safely support and stimulate economic growth through the ability to attract deposits at reasonable rates and lend money to qualified borrowers.

The federal bank regulatory agencies have adopted uniform risk based capital guidelines and have agreed on a minimum leverage ratio. The primary objectives of risk based capital are to: 1) make regulatory capital requirements more sensitive to differing risk profiles among banks; 2) factor off-balance sheet risk exposure into the assessment of capital adequacy; 3) minimize disincentives to hold more liquid, low risk assets; and 4) achieve greater consistency in the evaluation of bank capital adequacy world-wide.

POLICY

The Arkansas State Bank Department hereby adopts the capital adequacy guidelines established by the Federal Deposit Insurance Corporation and Federal Reserve System for state-chartered banks. These guidelines establish a minimum capital level for: (1) Total risk-based capital ratio; (2) Tier 1 risk-based capital ratio; and (3) The leverage ratio. Specific capital levels and "capital adequacy categories" are identified below. Minimum capital levels are applicable to well managed banks with strong risk management practices in place, and assigned a composite 1 or 2 CAMELS rating by regulatory agencies. Banks not meeting this criteria will be required to maintain higher capital ratios. The Bank Commissioner retains the authority to require higher capital levels based on the condition of the bank and the performance of management and directors.

CAPITAL CATEGORIES AND MINIMUM CAPITAL LEVELS

A **well capitalized** bank:

(i) Has a total risk-based capital ratio of 10.0 percent or greater; and
(ii) Has a Tier 1 risk-based capital ratio of 6.0 percent or greater; and
(iii) Has a leverage ratio of 5.0 percent or greater; and

(iv) **Is not subject to any written agreement, order, capital directive, or prompt corrective action directive issued by regulatory agencies to meet and maintain a specific capital level.**

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An **adequately capitalized** bank;

(i) Has a total risk-based capital ratio of 8.0 percent or greater; and
(ii) Has a Tier 1 risk-based capital ratio of 4.0 percent or greater; and
(iii) Has:
  (A) A leverage ratio of 4.0 percent or greater; or
  (B) A leverage ratio of 3.0 percent or greater if the bank is rated composite 1 under the CAMELS rating system in the most recent examination of the bank and is not experiencing or anticipating significant growth; and
(iv) Does not meet the definition of a well-capitalized bank.

An **undercapitalized** bank:

(i) Has a total risk-based capital ratio that is less than 8.0 percent; or
(ii) Has a Tier 1 risk-based capital ratio that is less than 4.0 percent or
(iii) Has:
  (A) A leverage ratio that is less than 4.0 percent; or
  (B) A leverage ratio that is less than 3.0 percent if the bank is rated composite 1 under the CAMELS rating system in the most recent examination of the bank and is not experiencing or anticipating significant growth.

A **significantly undercapitalized** bank:

(i) Has a total risk-based capital ratio that is less than 6.0 percent; or
(ii) Has a Tier 1 risk-based capital ratio that is less than 3.0 percent; or
(iii) Has a leverage ratio that is less than 3.0 percent.

A **critically undercapitalized** bank has a ratio of tangible equity to total assets that is equal to or less than 2.0 percent.

CAPITAL COMPONENTS

Tier 1 or core capital consists of the following: common stock, surplus, noncumulative perpetual preferred stock, undivided profits and capital reserves, minority interest in consolidated subsidiaries, qualifying portions of mortgage servicing assets (generally limited to: 1) 50% of the bank's equity capital exclusive of serving rights; 2) 90% of the original price of the servicing rights; or 3) 90% of the fair market value of those servicing rights), and qualifying portions of purchased credit card relationships, less ineligible intangible assets, identified losses and ineligible gains or losses on available-for-sale securities.

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Tier 2 or supplemental capital consists of the following: allowance for loan and leases losses (up to a maximum of 1.25 percent of risk-weighted assets), cumulative perpetual preferred stock, subordinated debt with original maturities greater than five (5) years, limited life preferred stock with original maturities greater than five (5) years, long-term preferred stock with a maturity greater than 20 years, mandatory convertible debt, and other capital instruments in compliance with federal regulations. The maximum amount of tier two capital that may be recognized for risk-based capital purposes is limited to 100 percent of tier one capital. The allowable volume of subordinated debt and limited life preferred stock that may be recognized as part of tier two capital is limited to 50 percent of tier one capital.

POLICY CHANGES

Specifics identified in capital categories, minimum capital levels, and capital components will change in order to remain consistent with modifications adopted by the Federal Deposit Insurance Corporation and the Federal Reserve System.