

ARKANSAS STATE BANK DEPARTMENT EXAMINATION POLICY

Policy Number	98-1
Effective Date	01/01/98
Supersedes	92-1
Approval	03/20/25

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 minimum capital ratios. 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.

Since capital adequacy assessments are central to the supervisory process, examiners evaluate all aspects of a financial institution's risk profile and activities to determine whether its capital levels are appropriate and in compliance with minimum regulatory requirements.

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 the: 1) Total Risk-Based Capital ratio; 2) Tier 1 Risk-Based Capital ratio; (3) Common Equity Tier 1 Risk-Based Capital ratio; and 4) Tier 1 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.

PROMPT CORRECTIVE ACTION MINIMUM CAPITAL LEVELS

A well capitalized bank:

- (i) Total Risk-Based Capital ratio of 10.0 percent or greater; and
- (ii) Tier 1 Risk-Based Capital ratio of 8.0 percent or greater; and
- (iii) Common Equity Tier 1 Capital ratio of 6.5 percent or greater; and
- (iv) Tier 1 Leverage ratio of 5.0 percent or greater; and
- (v) 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) Total Risk-Based Capital ratio of 8.0 percent or greater; and
- (ii) Tier 1 Risk-Based Capital ratio of 6.0 percent or greater; and
- (iii) Common Equity Tier 1 Risk-Based Capital ratio of 4.5 percent or greater; and
- (iv) Tier 1 Leverage ratio of 4.0 percent or greater; or
- (v) Does not meet the definition of a well-capitalized bank.

An **undercapitalized** bank:

- (i) Total Risk-Based Capital ratio that is less than 8.0 percent; or
- (ii) Tier 1 Risk-Based Capital ratio that is less than 6.0 percent; or
- (iii) Common Equity Tier 1 Risk-Based Capital ratio that is less than 4.5 percent; or
- (iv) Tier 1 Leverage ratio that is less than 4.0 percent; or

A **significantly undercapitalized** bank:

- (i) Total Risk-Based Capital ratio that is less than 6.0 percent; or
- (ii) Tier 1 Risk-Based Capital ratio that is less than 4.0 percent; or
- (iii) Common Equity Tier 1 Risk-Based Capital ratio less than 3.0 percent; or
- (iv) Tier 1 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

Common Equity Tier 1 Capital

Common Equity Tier 1 Capital is the most loss-absorbing form of capital. It consists of the following: qualifying common stock and related surplus net of treasury stock, retained earnings, certain accumulated other comprehensive income (AOCI) elements if the institution does not make an AOCI opt-out election, plus or minus regulatory deductions or adjustments as appropriate, and qualifying common equity tier 1 minority interests. Several items are to be fully deducted from common equity tier 1 capital such as goodwill, deferred tax assets that arise from net operating loss and tax credit carry-forwards, other intangible assets (except for mortgage servicing assets), gains on sale of securitization exposures, and certain investments in another financial institution's capital instruments. Additionally, banks must adjust for unrealized gains or losses on certain cash flow hedges. Finally, banks must consider threshold deductions for three specific types of assets: mortgage servicing assets, deferred tax assets related to temporary timing differences, and significant investments in another unconsolidated financial institution's common stock. See federal capital guidelines for additional information regarding CET1 deductions.

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Additional Tier 1 Capital

Additional Tier 1 Capital includes qualifying noncumulative perpetual preferred stock, bank-issued Small Business Lending Fund (SBLF) and Troubled Asset Relief Program (TARP) instruments that previously qualified for tier 1 capital, and qualifying tier 1 minority interests, less certain investments in other unconsolidated financial institutions' instruments that would otherwise qualify as additional tier 1 capital.

Tier 2 Capital

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), qualifying preferred stock, subordinated debt, and qualifying tier 2 minority interests, less any deductions in the tier 2 instruments of an unconsolidated financial institution. There are no longer limits on term subordinated debt, limited-life preferred stock, or the amount of tier 2 capital includable in total capital.

COMMUNITY BANK LEVERAGE RATIO (CBLR) FRAMEWORK

I. Background on the Community Bank Leverage Ratio Framework

The community bank leverage ratio framework provides a simple measure of capital adequacy for community banking organizations that meet certain qualifying criteria. The community bank leverage ratio framework implements section 201 of the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA), which requires the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), and the Federal Deposit Insurance Corporation (FDIC) (collectively, the agencies) to establish a community bank leverage ratio of not less than 8 percent and not more than 10 percent for a qualifying community banking organization. Under section 201(c) of EGRRCPA, a qualifying community banking organization whose leverage ratio exceeds the community bank leverage ratio, as established by the agencies, shall be considered to have met the generally applicable risk-based and leverage capital requirements in the capital rule (generally applicable rule), any other applicable capital or leverage requirements, and, if applicable, the "well capitalized" capital ratio requirements for purposes of section 38 of the Federal Deposit Insurance Act. Section 201(b) of EGRRCPA also requires the agencies to establish procedures for the treatment of a qualifying community banking organization whose leverage ratio falls below the community bank leverage ratio requirement as established by the agencies.

In November 2019, the agencies issued a final rule establishing the community bank leverage ratio framework, which became effective January 1, 2020 (2019 final rule). Under the 2019 final rule, the agencies established a community bank leverage ratio of 9 percent using the existing leverage ratio calculation. A qualifying community banking organization that maintained a leverage ratio of greater than 9 percent and elected to use the community bank leverage ratio framework would have been considered to have satisfied the generally applicable rule, any other applicable capital or leverage requirements, and, if

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applicable, the capital ratio requirements to be considered well capitalized.

Under the 2019 final rule, a qualifying community banking organization is any depository institution or depository institution holding company that has less than \$10 billion in total consolidated assets, off-balance sheet exposures (excluding derivatives other than sold credit derivatives and unconditionally cancelable commitments) of 25 percent or less of total consolidated assets, and trading assets and liabilities of 5 percent or less of total consolidated assets. The banking organization also cannot be an advanced approaches banking organization.

In addition, the 2019 final rule established a two-quarter grace period during which a qualifying community banking organization that temporarily failed to meet any of the qualifying criteria, including the leverage ratio requirement, generally would still have been considered well capitalized so long as the banking organization maintained a leverage ratio of greater than 8 percent during that grace period. A banking organization that either failed to meet all the qualifying criteria within the grace period or failed to maintain a leverage ratio of greater than 8 percent would have been required to comply with the generally applicable rule and file the appropriate regulatory reports.

II. Interim Final Rules

On March 27, 2020, the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) became law. Section 4012 of the CARES Act directs the agencies to issue an interim final rule providing that, for purposes of section 201 of EGRRCPA, the community bank leverage ratio shall be 8 percent, and a qualifying community banking organization whose leverage ratio falls below the community bank leverage ratio requirement established under the CARES Act shall have a reasonable grace period to satisfy that requirement. Section 4012 of the CARES Act specifies that the interim final rule is effective during the period beginning on the date on which the agencies issue the interim final rule and ending on the sooner of the termination date of the national emergency concerning the coronavirus disease (COVID-19) outbreak declared by the President on March 13, 2020, under the National Emergencies Act, or December 31, 2020 (termination date).

Accordingly, the agencies issued an interim final rule that implements a temporary 8-percent community bank leverage ratio requirement, as mandated under section 4012 of the CARES Act (statutory interim final rule). In addition, under the statutory interim final rule, a community banking organization that temporarily fails to meet any of the qualifying criteria, including the 8-percent community bank leverage ratio requirement, generally will still be considered well capitalized provided that the banking organization maintains a leverage ratio equal to 7 percent or greater. A banking organization that fails to meet the qualifying criteria after the end of the grace period or reports a leverage ratio of less than 7 percent must comply with the generally applicable rule and file the appropriate regulatory reports.

Since the statutory interim final rule could cease to be effective at any time before December 31, 2020, the

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agencies issued a separate interim final rule pursuant to section 201(b) of EGRRCPA that provides a graduated transition from the temporary 8-percent community bank leverage ratio requirement to the 9-percent community bank leverage ratio requirement as established under the 2019 final rule (transition interim final rule). Specifically, the transition interim final rule provides that, once the statutory interim final rule ceases to apply, the community bank leverage ratio will be 8 percent in the second quarter through fourth quarter of calendar year 2020, 8.5 percent in calendar year 2021, and 9 percent thereafter. The transition interim final rule also modifies the two-quarter grace period for a qualifying community banking organization to account for the graduated increase in the community bank leverage ratio requirement. The interim final rules do not make any changes to the other qualifying criteria in the community bank leverage ratio framework.

The transition interim final rule extends the 8-percent community bank leverage ratio through December 31, 2020, in the event the statutory interim final rule terminates before December 31, 2020. Thus, even if the statutory interim final rule were to terminate prior to December 31, 2020, the community bank leverage ratio would continue to be set at 8 percent for the remainder of 2020. Section 201 of EGRRCPA requires a qualifying community banking organization to exceed the community bank leverage ratio established by the agencies in order to be considered to have met the generally applicable rule, any other applicable capital or leverage requirements, and, if applicable, the “well capitalized” capital ratio requirements, whereas section 4012 of the CARES Act requires that a qualifying community banking organization meet or exceed an 8 percent community bank leverage ratio to be considered the same.

In the 2019 final rule, the agencies adopted a 9-percent community bank leverage ratio requirement on the basis that this threshold, with complementary qualifying criteria, generally maintains the current level of regulatory capital held by qualifying banking organizations and supports the agencies' goals of reducing regulatory burden while maintaining safety and soundness. The agencies intend for the graduated approach under the transition interim final rule to provide community banking organizations with sufficient time to meet a 9-percent community bank leverage ratio requirement while they also focus on supporting lending to creditworthy households and businesses. This latter goal is particularly critical given the recent strain on the U.S. economy caused by COVID-19.

Consistent with section 201(c) of EGRRCPA, under the transition interim final rule, a qualifying community banking organization that temporarily fails to meet any of the qualifying criteria, including the applicable community bank leverage ratio requirement, generally would still be deemed well capitalized during a two-quarter grace period so long as the banking organization maintains a leverage ratio of the following: Greater than 7 percent in the second quarter through fourth quarter of calendar year 2020, greater than 7.5 percent in calendar year 2021, and greater than 8 percent thereafter. A banking organization that fails to meet the qualifying criteria by the end of the grace period or reports a leverage ratio of equal to or less than 7 percent in the second through fourth quarters of calendar year 2020, equal to or less than 7.5 percent in calendar year 2021, or equal to or less than 8 percent thereafter, would be required to comply immediately with the generally applicable rule and file the appropriate regulatory reports.

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The agencies adopted in the 2019 final rule a two-quarter grace period with a leverage ratio requirement that is 1 percentage point below the community bank leverage ratio on the basis that this grace period would appropriately mitigate potential volatility in capital and associated regulatory reporting requirements based on temporary changes in a banking organization's risk profile from quarter to quarter, while capturing more permanent changes in a banking organization's risk profile. The agencies maintained this approach in the interim final rules because they believed that this approach is appropriate and provides a qualifying community banking organization whose leverage ratio falls below the applicable community bank leverage ratio requirement a reasonable amount of time to once again satisfy that requirement. This approach is consistent with section 201(b)(2) of EGRRCPA, which directs the agencies to establish procedures for the treatment of a qualifying community bank whose leverage ratio falls below the community bank leverage ratio requirement as established by the agencies.

The agencies received one public comment that addressed the substance of the interim final rules. The commenter urged the agencies to revert to a 9 percent community bank leverage ratio by January 1, 2022, which is consistent with the transition interim final rule. The agencies are adopting as final the interim final rules with no changes.

III. Final Rule

Under the final rule, a qualifying community banking organization must have a leverage ratio equal to or greater than 8 percent beginning in the second quarter of calendar year 2020. If the national emergency is terminated during 2020, under the final rule, a qualifying community banking organization must have a leverage ratio greater than 8 percent for the remainder of calendar year 2020. Subsequently, a qualifying community banking organization must have a leverage ratio greater than 8.5 percent through calendar year 2021 and greater than 9 percent thereafter.

The final rule also includes the modified two-quarter grace period for a qualifying community banking organization to take into account the graduated increase in the community bank leverage ratio requirement. Specifically, a qualifying community banking organization that temporarily fails to meet any of the qualifying criteria, including the applicable community bank leverage ratio requirement, will generally still be deemed well capitalized during a two-quarter grace period so long as the banking organization maintains a leverage ratio of the following: greater than 7 percent in the second quarter through fourth quarter of calendar year 2020, greater than 7.5 percent in calendar year 2021, and greater than 8 percent thereafter.

The final rule does not make any changes to the other qualifying criteria in the community bank leverage ratio framework. The final rule was made effective November 9, 2020.

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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. Institutions are responsible for maintaining awareness on updates to all Capital rules, regulations, and guidance.

REGULATORY SOURCES

FDIC:

- Part 324 of the FDIC Rules and Regulations: “Capital Adequacy of Supervised Financial Institutions”
- Section 2.1 of the FDIC Risk Management Manual of Examination Policies
- FILs: <https://www.fdic.gov/news/news/financial/index.html>

Federal Reserve:

- Regulation Q – “Capital Adequacy of Bank Holding Companies, Savings and Loan Holding Companies, and State Member Banks”
- Section 3020 of the FRB Commercial Bank Examination Manual
- SR Letters: <https://www.federalreserve.gov/supervisionreg/topics/capital.htm>

Federal Register:

- <https://www.federalregister.gov/documents/2020/10/09/2020-19922/regulatory-capital-rule-temporary-changes-to-and-transition-for-the-community-bank-leverage-ratio>