Introduction - Capital

We're moving towards the end of our exercise. You've read the sections related to liquidity, sensitivity to market risk, asset quality, and earnings, and by now you should have developed a good idea as to what this bank's risk profile looks like. We know that they have weak earnings, and because of lax management, they have developed asset quality problems associated with inadequately controlled growth and substandard credit administration. We know what the exposures are, so we're ready to rate capital. We will begin with the Instructional Content component of the capital exercise.

Instructional Content - Capital

How Much Capital is Necessary?

The level of capital that a board or the regulators will consider satisfactory should vary according to the level of risk in a bank. Of course, the higher the risk, the greater the level of support required. Keep this in mind when we look at the sample bank's Uniform Bank Performance Report (UBPR). Even though a given bank's capital ratios are higher than peer, it does not mean that the bank has satisfactory capital. Peer ratio comparisons don't consider your bank's risk profile and don't provide a conscious assessment of a bank's capital position. You'd be surprised at how many examiners have had to address why a bank with greater than peer capital levels has a less than satisfactory capital rating. **Capital adequacy is rated relative to a given bank's risk profile.**

Also, when examiners and board members assess capital adequacy, we should be assessing capital relative to:

Everything!

That's right. Everything that impacts the bank impacts the need for more or less capital. A short list of things that may impact the need for more or less capital include:

1. **The quality, type, and diversification of assets** - If your bank has high levels of classifications, sub-prime loans, high or unmonitored concentrations, aggressive underwriting, etc., you'll need higher levels of capital.

2. **The quality of management -** If the institution operates with bare minimum staffing levels or lower quality management, the risk profile is higher, requiring higher levels of capital.

3. **The quantity and quality of earnings available for capital augmentation -** When we talk about the quality of earnings, we consider whether earnings are from core banking operations or from anomalies such as gains on the sale of assets. The quantity of earnings is important because we are concerned with the bank's ability to augment capital via retained earnings.

4. **Exposure to changing interest rates -** Higher/lower interest rate risk impacts the risk profile and thus the need for more or less capital.

5. **Anticipated growth (strategic plan/budget)** - Regulators are concerned with what the capital needs will be going forward. This is assessed relative to earnings available for augmentation, as well as existing levels of capital.

6. **Local economic conditions -** If the bank's market is limited to one economic area or one industry, the risk profile is greater. The greater the diversification, the lower the risk.

7. **Dividend requirements to shareholders or a holding company** - Again, regulators are interested in what's available for capital augmentation to support growth and the risk profile.

Key Financial Ratios (UBPR)

The items we just reviewed are qualitative factors. Regulators will also use quantitative factors to assess capital. These ratios are included in your UBPR, which is available for your bank at www.ffiec.gov. The primary ratios used to assess capital adequacy include the following:

1. Tier 1 Leverage Capital ratio (Tier 1 Capital/Average Assets)
2. Tier 1 Risk-Based Capital ratio (Tier 1 Capital/Risk Weighted Assets)
3. Total Risk-Based Capital ratio (Total Capital/Risk Weighted Assets)

To aid you with this module, we provide definitions of Tier 1, Tier 2, and Total Capital.

(See page 11a in your UBPR or Part 325 of the FDIC Rules and Regulations for a more detailed descriptions.)

Total Capital includes:

Tier 1 Capital plus Tier 2 minus investments in unconsolidated subsidiaries.

Tier 1 Capital includes:

1. Common stock, undivided profits, paid-in-surplus;
2. Non-cumulative perpetual preferred stock;
3. Minority interests in consolidated subsidiaries;

Minus

1. All intangible assets (with limited exceptions);
2. Identified losses;
3. Deferred tax assets in excess of the limit set forth in section 325.5(g).

Tier 2 Capital includes:

1. Allowance for loan and lease losses, up to 1.25% of risk-weighted assets;
2. Cumulative perpetual preferred stock, long-termed preferred stock (original maturity of at least 20 years) and any related surplus;
3. Perpetual preferred stock (where the dividend is reset periodically);
4. Hybrid capital instruments, including mandatory convertible debt; and
5. Term subordinated debt and intermediate-term preferred stock.

If you're not familiar with risk-based capital, put simply, the Risk-Based Capital ratios attempt to measure capital relative to the bank's risk profile. How do the Risk-Based Capital ratios adjust for different risk profiles? They do this by adjusting individual asset values relative to their risk. Part 325 assigns each item on the balance sheet a predetermined risk weighting from 0% - 100% according to the likely level of risk. Let's look at a very simple example.

Risk Weighting Assets

Assets	AMT	0%	20%	50%	100%
Cash	$1,675	$1,675			
Federal Funds Sold	$550		$550		
Home Mortgages	$2,500			$2,500	
Commercial Loans	$4,000				$4,000
Fannie Mae Bonds	$1,000		1,000		
Premises	$200				$200
Other Assets	$150				$150
Total Assets	$10,075	$1,675	$1,550	$2,500	$4,350
Total Risk-Weighted Assets = $5,910		$0	$310	$1,250	$4,350

From the example above, you can see that risk weighting has a dramatic impact on "total assets". In this example, total assets equaling $10,075 equate to total risk-weighted assets of just $5,910. The Tier 1 Leverage Capital ratio does not take into account the fact that many of these items have little or no risk, but the Risk-Based Capital ratios do. Some things to note:

1. Cash is a risk-less asset and is accordingly allotted a 0% risk weighting since you really don't need a capital allocation for a risk-less asset.
2. Fannie Mae securities are lower risk government sponsored securities and are therefore risk weighted at 20%
3. Mortgage loans that are current, properly underwritten, and fully secured by first liens on one-to-four family residential properties are risk weighted at 50%
4. Commercial loans are riskier assets and therefore, have a 100% risk weighting.

We could get very detailed, but what's important from a director's perspective and from an analysis perspective, is that the Risk-Based Capital ratios adjust for portfolio risk. Is this the end of your capital analysis? No, there is one obvious flaw to simply using the risk based capital figures to establish a satisfactory level of capital. For example, even though all commercial loans are risk weighted the same, some commercial loans will have substantially greater risk. Because of this type of risk variance among similar types of assets, ratio analysis is just a starting point when assessing capital. The Report of Examination will help us to develop a more accurate assessment of this bank's risk profile. But before we go to the Report, let's look at these three ratios on the UBPR and assess level and trend.

Note that the capital ratios and other ratios relevant to a capital discussion are highlighted in blue. On the following UBPR summary page for First State Bank, identify the following:

1. The level of the Tier 1 Leverage Capital ratio.
2. How does this compare to peer?
3. What is the trend?

CERT# 12345
CHARTER# 311 COUNTY: MADISON

FIRST STATE BANK
SUMMARY RATIOS

		12/31/2004			12/31/2003			12/31/2002	
AVERAGE ASSETS ($000)		182,836			145,180			143,139	
NET INCOME ($000)		2,084			2,018			1,961	
	BANK	PEER	PCT	BANK	PEER	PCT	BANK	PEER	PCT
EARNINGS AND PROFITABILITY:				*EARNINGS*					
PERCENT OF AVERAGE ASSETS:									
INTEREST INCOME (TE)	8.28	7.79	65	7.74	7.56	62	7.67	7.49	66
- INTEREST EXPENSE	3.63	3.55	49	3.36	3.33	51	3.34	3.31	51
NET INTEREST INCOME (TE)	4.65	4.24	66	4.38	4.24	58	4.33	4.18	61
+ NONINTEREST INCOME	0.52	0.75	38	0.58	0.74	35	0.50	0.72	38
- NON-INTEREST EXPENSE	2.89	2.92	46	2.64	2.95	34	2.53	2.87	33
- PROVISION: LOAN&LEASE LOSSES	0.37	0.16	61	0.16	0.17	49	0.16	0.14	51
= PRETAX OPERATING INCOME (TE)	2.01	1.90	63	2.16	1.85	75	2.14	1.87	81
NET INCOME	1.14	1.26	49	1.39	1.23	63	1.37	1.24	59
MARGIN ANALYSIS:									
NET INT INC-TE TO AV EARN ASSET	4.89	4.53	67	4.51	4.55	53	4.44	4.48	45
LOAN & LEASE ANALYSIS:				*ASSET QUALITY*					
NET LOSS / AVERAGE TOTAL LN&LS	0.22	0.12	84	0.14	0.12	56	0.16	0.14	56
LN&LS ALLOWANCE/TOTAL LN&LS	1.13	1.28	43	1.30	1.29	55	1.26	1.3	48
NON-CURRENT LN&LS/ GROSS LN&LS	3.11	0.81	89	1.01	0.83	62	1.02	0.79	63
LIQUIDITY:				*LIQUIDITY*					
NET NONCORE FUND. DEPENDENCE	21.76	15.22	68	15.25	15.09	53	15.05	14.72	54
NET LOANS & LEASES TO ASSETS	76.94	65.74	76	65.01	64.04	55	63.23	66.18	47
CAPITALIZATION:				*CAPITAL*					
TIER ONE LEVERAGE CAPITAL	8.08	9.11	41	9.61	9.09	56	9.18	9.14	54
CASH DIVIDENDS TO NET INCOME	60.55	40.04	88	59.61	40.54	89	55.69	40.35	89
GROWTH RATES:									
ASSETS	33.60	8.58	78	2.77	7.23	14	1.63	8.68	15
TIER ONE CAPITAL	5.89	12.81	42	6.21	12.78	38	7.51	12.45	37
NET LOANS & LEASES	62.56	12.92	69	6.59	11.71	32	1.13	9.72	20
SHORT TERM INVESTMENTS	-50.88	11.28	15	2.37	13.61	35	5.58	11.03	41
SHORT TERM NON CORE FUNDING	35.43	8.16	78	1.91	8.14	37	2.33	12.14	36

Additionally, look to the growth rate section.

1. Can you explain why the Tier 1 Leverage Capital ratio fell so dramatically in 2004?
   - Click to see answer (Capital growth didn't keep pace with asset growth)

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CHARTER# 311 COUNTY: MADISON

FIRST STATE BANK

SUMMARY RATIOS

	12/31/2004			12/31/2003			12/31/2002		
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NET INCOME ($000)		2,084			2,018			1,961	
	BANK	PEER	PCT	BANK	PEER	PCT	BANK	PEER	PCT
EARNINGS AND PROFITABILITY:				*EARNINGS*					
PERCENT OF AVERAGE ASSETS:									
INTEREST INCOME (TE)	8.28	7.79	65	7.74	7.56	62	7.67	7.49	66
- INTEREST EXPENSE	3.63	3.55	69	3.36	3.33	51	3.34	3.31	51
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- NON-INTEREST EXPENSE	2.89	2.92	46	2.64	2.95	34	2.53	2.87	33
- PROVISION: LOAN&LEASE LOSSES	0.37	0.16	61	0.16	0.17	49	0.16	0.14	51
= PRETAX OPERATING INCOME (TE)	2.01	1.90	63	2.16	1.85	75	2.14	1.87	81
NET INCOME	1.14	1.26	49	1.39	1.23	63	1.37	1.24	59
MARGIN ANALYSIS:									
NET INT INC-TE TO AV EARN ASSET	4.89	4.53	67	4.51	4.55	53	4.44	4.48	45
LOAN & LEASE ANALYSIS:				*ASSET QUALITY*					
NET LOSS / AVERAGE TOTAL LN&LS	0.22	0.12	84	0.14	0.12	56	0.16	0.14	56
LN&LS ALLOWANCE/TOTAL LN&LS	1.13	1.28	43	1.30	1.29	55	1.26	1.3	48
NON-CURRENT LN&LS/ GROSS LN&LS	3.11	0.81	89	1.01	0.83	62	1.02	0.79	63
LIQUIDITY:				*LIQUIDITY*					
NET NONCORE FUND. DEPENDENCE	21.76	15.22	68	15.25	15.09	53	15.05	14.72	54
NET LOANS & LEASES TO ASSETS	76.94	65.74	76	65.01	64.04	55	63.23	66.18	47
CAPITALIZATION:				*CAPITAL*					
TIER ONE LEVERAGE CAPITAL	8.08	9.11	41	9.61	9.09	56	9.18	9.14	54
CASH DIVIDENDS TO NET INCOME	60.55	40.04	88	59.61	40.54	89	55.69	40.35	89
GROWTH RATES:									
ASSETS	33.60	8.58	78	2.77	7.23	14	1.63	8.68	15
TIER ONE CAPITAL	5.89	12.81	42	6.21	12.78	38	7.51	12.45	37
NET LOANS & LEASES	62.56	12.92	69	6.59	11.71	32	1.13	9.72	20
SHORT TERM INVESTMENTS	-50.88	11.28	15	2.37	13.61	35	5.58	11.03	41
SHORT TERM NON CORE FUNDING	35.43	8.16	78	1.91	8.14	37	2.33	12.14	36

2. What asset category dominated the growth in total assets in 2004?
   - Click to see answer (Loans)

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FIRST STATE BANK
SUMMARY RATIOS

	12/31/2004			12/31/2003			12/31/2002		
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NET INCOME ($000)		2,084			2,018			1,961	
	BANK	PEER	PCT	BANK	PEER	PCT	BANK	PEER	PCT
EARNINGS AND PROFITABILITY:				*EARNINGS*					
PERCENT OF AVERAGE ASSETS:									
INTEREST INCOME (TE)	8.28	7.79	65	7.74	7.56	62	7.67	7.49	66
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NET INTEREST INCOME (TE)	4.65	4.24	66	4.38	4.24	58	4.33	4.18	61
+ NONINTEREST INCOME	0.52	0.75	38	0.58	0.74	35	0.50	0.72	38
- NON-INTEREST EXPENSE	2.89	2.92	46	2.64	2.95	34	2.53	2.87	33
- PROVISION: LOAN&LEASE LOSSES	0.37	0.16	61	0.16	0.17	49	0.16	0.14	51
= PRETAX OPERATING INCOME (TE)	2.01	1.90	63	2.16	1.85	75	2.14	1.87	81
NET INCOME	1.14	1.26	49	1.39	1.23	63	1.37	1.24	59
MARGIN ANALYSIS:									
NET INT INC-TE TO AV EARN ASSET	4.89	4.53	67	4.51	4.55	53	4.44	4.48	45
LOAN & LEASE ANALYSIS:				*ASSET QUALITY*					
NET LOSS / AVERAGE TOTAL LN&LS	0.22	0.12	84	0.14	0.12	56	0.16	0.14	56
LN&LS ALLOWANCE/TOTAL LN&LS	1.13	1.28	43	1.30	1.29	55	1.26	1.3	48
NON-CURRENT LN&LS/ GROSS LN&LS	3.11	0.81	89	1.01	0.83	62	1.02	0.79	63
LIQUIDITY:				*LIQUIDITY*					
NET NONCORE FUND. DEPENDENCE	21.76	15.22	68	15.25	15.09	53	15.05	14.72	54
NET LOANS & LEASES TO ASSETS	76.94	65.74	76	65.01	64.04	55	63.23	66.18	47
CAPITALIZATION:				*CAPITAL*					
TIER ONE LEVERAGE CAPITAL	8.08	9.11	41	9.61	9.09	56	9.18	9.14	54
CASH DIVIDENDS TO NET INCOME	60.55	40.04	88	59.61	40.54	89	55.69	40.35	89
GROWTH RATES:									
ASSETS	33.60	8.58	78	2.77	7.23	14	1.63	8.68	15
TIER ONE CAPITAL	5.89	12.81	42	6.21	12.78	38	7.51	12.45	37
NET LOANS & LEASES	62.56	12.92	69	6.59	11.71	32	1.13	9.72	20
SHORT TERM INVESTMENTS	-50.88	11.28	15	2.37	13.61	35	5.58	11.03	41
SHORT TERM NON CORE FUNDING	35.43	8.16	78	1.91	8.14	37	2.33	12.14	36

3. Does loan growth typically increase or decrease a bank's risk profile?
   - Click to see answer (A higher percentage of loans to assets traditionally reflects a higher degree of risk)

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CHARTER# 311 COUNTY: MADISON

FIRST STATE BANK

SUMMARY RATIOS

	12/31/2004			12/31/2003			12/31/2002		
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NET INCOME ($000)		2,084			2,018			1,961	
	BANK	PEER	PCT	BANK	PEER	PCT	BANK	PEER	PCT
EARNINGS AND PROFITABILITY:				*EARNINGS*					
PERCENT OF AVERAGE ASSETS:									
INTEREST INCOME (TE)	8.28	7.79	65	7.74	7.56	62	7.67	7.49	66
- INTEREST EXPENSE	3.63	3.55	69	3.36	3.33	51	3.34	3.31	51
NET INTEREST INCOME (TE)	4.65	4.24	66	4.38	4.24	58	4.33	4.18	61
+ NONINTEREST INCOME	0.52	0.75	38	0.58	0.74	35	0.50	0.72	38
- NON-INTEREST EXPENSE	2.89	2.92	46	2.64	2.95	34	2.53	2.87	33
- PROVISION: LOAN&LEASE LOSSES	0.37	0.16	61	0.16	0.17	49	0.16	0.14	51
= PRETAX OPERATING INCOME (TE)	2.01	1.90	63	2.16	1.85	75	2.14	1.87	81
NET INCOME	1.14	1.26	49	1.39	1.23	63	1.37	1.24	59
MARGIN ANALYSIS:									
NET INT INC-TE TO AV EARN ASSET	4.89	4.53	67	4.51	4.55	53	4.44	4.48	45
LOAN & LEASE ANALYSIS:				*ASSET QUALITY*					
NET LOSS / AVERAGE TOTAL LN&LS	0.22	0.12	84	0.14	0.12	56	0.16	0.14	56
LN&LS ALLOWANCE/TOTAL LN&LS	1.13	1.28	43	1.30	1.29	55	1.26	1.3	48
NON-CURRENT LN&LS/ GROSS LN&LS	3.11	0.81	89	1.01	0.83	62	1.02	0.79	63
LIQUIDITY:				*LIQUIDITY*					
NET NONCORE FUND. DEPENDENCE	21.76	15.22	68	15.25	15.09	53	15.05	14.72	54
NET LOANS & LEASES TO ASSETS	76.94	65.74	76	65.01	64.04	55	63.23	66.18	47
CAPITALIZATION:				*CAPITAL*					
TIER ONE LEVERAGE CAPITAL	8.08	9.11	41	9.61	9.09	56	9.18	9.14	54
CASH DIVIDENDS TO NET INCOME	60.55	40.04	88	59.61	40.54	89	55.69	40.35	89
GROWTH RATES:									
ASSETS	33.60	8.58	78	2.77	7.23	14	1.63	8.68	15
TIER ONE CAPITAL	5.89	12.81	42	6.21	12.78	38	7.51	12.45	37
NET LOANS & LEASES	62.56	12.92	89	6.59	11.71	32	1.13	9.72	20
SHORT TERM INVESTMENTS	-50.88	11.28	15	2.37	13.61	35	5.58	11.03	41
SHORT TERM NON CORE FUNDING	35.43	8.16	78	1.91	8.14	37	2.33	12.14	36

In addition to the capital ratios found on the Summary Page of the UBPR, you can find a more complete analysis of capital on page 11a. You can see that at the top of this page, there is a simplified breakdown of Tier 1 and Tier 2 Capital components. In the middle of the page, there is a listing of assets that fall into the 0%, 20%, 50%, and 100% risk weightings. Finally, at the bottom of the page, there are the three principal capital ratios (Tier 1 Leverage Capital ratio, Tier 1 Risk-Based Capital ratio, and Total Risk-Based Capital ratio).

CHARTER# 311 COUNTY: MADISON	CAPITAL & RISK-BASED CAPITAL ANALYSIS		
	12/31/2004	12/31/2003	12/31/2002
RISK-BASED CAPITAL($000)			
TIER ONE CAPITAL			
COMMON EQUITY	14,774	13,952	13,137
NET TIER ONE	14,774	13,952	13,137
TIER TWO CAPITAL			
+ ALLOWABLE LN&LS LOSS ALLOWANCE	1,929	1,253	953
+ UNRL GAIN MKTBL EQY SEC (45%)	0	0	0
NET ELIGIBLE TIER TWO	1,929	1,253	953
TOTAL RISK BASED CAPITAL	16,703	15,205	14,090
RISK WEIGHTED ASSETS			
ON-BALANCE SHEET			
CATEGORY TWO - 20%	22,137	36,943	35,689
CATEGORY THREE - 50%	0	8,126	8,109
CATEGORY FOUR - 100%	155,471	96,920	95,145
TOTAL ON-BALANCE SHEET	197,068	147,815	144,940
MEMO: CATEGORY ONE - 0%	19,460	5,826	5,997
OFF-BALANCE SHEET			
CATEGORY TWO - 20%	0	0	0
CATEGORY THREE - 50%	0	0	0
CATEGORY FOUR - 100%	2,291	35	184
TOTAL OFF-BALANCE SHEET	2,291	35	184
TOTAL RISK-WEIGHTED ASSETS	162,189	108,407	106,521

	12/31/2004			12/31/2003			12/31/2002		
RISK BASED CAPITAL:	BANK	PEER	PCT	BANK	PEER	PCT	BANK	PEER	PCT
TIER ONE RBC TO RISK-WGT ASSETS	9.11	13.52	37	12.87	14.02	45	12.33	13.68	43
TOTAL RBC TO RISK-WEIGHT ASSETS	10.31	14.64	33	14.03	15.17	46	13.23	14.82	46
TIER ONE LEVERAGE CAPITAL	8.08	9.11	41	9.61	9.09	56	9.18	9.14	54

Consider:

1. How do these three ratios compare to peer?
    - Click here to see answer (All three ratios are lower than peer with the Risk-Based Capital ratios being substantially lower than peer)

CHARTER# 311 COUNTY: MADISON	CAPITAL & RISK-BASED CAPITAL ANALYSIS		
	12/31/2004	12/31/2003	12/31/2002
RISK-BASED CAPITAL($000)			
TIER ONE CAPITAL			
COMMON EQUITY	14,774	13,952	13,137
NET TIER ONE	14,774	13,952	13,137
TIER TWO CAPITAL			
+ ALLOWABLE LN&LS LOSS ALLOWANCE	1,929	1,253	953
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TOTAL RISK BASED CAPITAL	16,703	15,205	14,090
RISK WEIGHTED ASSETS			
ON-BALANCE SHEET			
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OFF-BALANCE SHEET			
CATEGORY TWO - 20%	0	0	0
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CATEGORY FOUR - 100%	2,291	35	184
TOTAL OFF-BALANCE SHEET	2,291	35	184
TOTAL RISK-WEIGHTED ASSETS	162,189	108,407	106,521

	12/31/2004			12/31/2003			12/31/2002		
RISK BASED CAPITAL:	BANK	PEER	PCT	BANK	PEER	PCT	BANK	PEER	PCT
TIER ONE RBC TO RISK-WGT ASSETS	9.11	13.52	37	12.87	14.02	45	12.33	13.68	43
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TIER ONE LEVERAGE CAPITAL	8.08	9.11	41	9.61	9.09	56	9.18	9.14	54

2. Which of the three ratios showed the most significant deterioration?
    - Click here to see answer (the Risk-Based Capital ratios suffered the most significant decline)

CHARTER# 311 COUNTY: MADISON	CAPITAL & RISK-BASED CAPITAL ANALYSIS		
	12/31/2004	**12/31/2003**	**12/31/2002**
RISK-BASED CAPITAL($000)			
TIER ONE CAPITAL			
COMMON EQUITY	14,774	13,952	13,137
NET TIER ONE	14,774	13,952	13,137
TIER TWO CAPITAL			
+ ALLOWABLE LN&LS LOSS ALLOWANCE	1,929	1,253	953
+ UNRL GAIN MKTBL EQY SEC (45%)	0	0	0
NET ELIGIBLE TIER TWO	1,929	1,253	953
TOTAL RISK BASED CAPITAL	16,703	15,205	14,090
RISK WEIGHTED ASSETS			
ON-BALANCE SHEET			
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CATEGORY TWO - 20%	0	0	0
CATEGORY THREE - 50%	0	0	0
CATEGORY FOUR - 100%	2,291	35	184
TOTAL OFF-BALANCE SHEET	2,291	35	184
TOTAL RISK-WEIGHTED ASSETS	162,189	108,407	106,521

	12/31/2004			12/31/2003			12/31/2002		
RISK BASED CAPITAL:	BANK	PEER	PCT	BANK	PEER	PCT	BANK	PEER	PCT
TIER ONE RBC TO RISK-WGT ASSETS	9.11	13.52	37	12.87	14.02	45	12.33	13.68	43
TOTAL RBC TO RISK-WEIGHT ASSETS	10.31	14.64	33	14.03	15.17	46	13.23	14.82	46
TIER ONE LEVERAGE CAPITAL	8.08	9.11	41	9.61	9.09	56	9.18	9.14	54

3. Why would one capital ratio deteriorate more than another?
    - Click here to see answer (This bank shifted to a higher risk profile. Expansion was in the loan portfolio at the expense of assets (securities) that are typically lower risk-weighted. The Tier 1 Leverage Capital ratio doesn't take the higher risk profile into account while the Risk-Based Capital ratios do.)

CHARTER# 311 COUNTY: MADISON	CAPITAL & RISK-BASED CAPITAL ANALYSIS		
	12/31/2004	12/31/2003	12/31/2002
RISK-BASED CAPITAL($000)			
TIER ONE CAPITAL			
COMMON EQUITY	14,774	13,952	13,137
NET TIER ONE	14,774	13,952	13,137
TIER TWO CAPITAL			
+ ALLOWABLE LN&LS LOSS ALLOWANCE	1,929	1,253	953
+ UNRL GAIN MKTBL EQY SEC (45%)	0	0	0
NET ELIGIBLE TIER TWO	1,929	1,253	953
TOTAL RISK BASED CAPITAL	16,703	15,205	14,090
RISK WEIGHTED ASSETS			
ON-BALANCE SHEET			
CATEGORY TWO - 20%	22,137	36,943	35,689
CATEGORY THREE - 50%	0	8,126	8,109
CATEGORY FOUR - 100%	155,471	96,920	95,145
TOTAL ON-BALANCE SHEET	197,068	147,815	144,940
MEMO: CATEGORY ONE - 0%	19,460	5,826	5,997
OFF-BALANCE SHEET			
CATEGORY TWO - 20%	0	0	0
CATEGORY THREE - 50%	0	0	0
CATEGORY FOUR - 100%	2,291	35	184
TOTAL OFF-BALANCE SHEET	2,291	35	184
TOTAL RISK-WEIGHTED ASSETS	162,189	108,407	106,521

	12/31/2004			12/31/2003			12/31/2002		
RISK BASED CAPITAL:	BANK	PEER	PCT	BANK	PEER	PCT	BANK	PEER	PCT
TIER ONE RBC TO RISK-WGT ASSETS	9.11	13.52	37	12.87	14.02	45	12.33	13.68	43
TOTAL RBC TO RISK-WEIGHT ASSETS	10.31	14.64	33	14.03	15.17	46	13.23	14.82	46
TIER ONE LEVERAGE CAPITAL	8.08	9.11	41	9.61	9.09	56	9.18	9.14	54

This should give you a general idea as to what is happening with regard to this bank's capital position. Keep in mind that qualitative factors have a significant impact on capital adequacy as you read the bank's capital comment in the Report of Examination

Examination Conclusions and Comments

CAPITAL

Capital ratios have declined substantially due to significant asset growth that has outpaced equity formation. The Tier 1 Leverage Capital ratio and the Tier 1 and Total Risk Based Capital ratios have declined to 8.08%, 9.11%, and 10.31% compared to 9.61%, 12.87%, and 14.03% at the previous examination. Although “Well Capitalized” for Prompt Corrective Action purposes, these ratios are not adequate when considering the bank’s elevated risk profile. The bank’s risk profile has increased due to:

- Lack of adequate board and management oversight
- Declining asset quality
- Aggressive and non-diversified loan growth
    - Commercial real estate loans = 480% of Tier 1 Capital, up from 275%
    - Real estate construction loans = 530% of Tier 1 Capital, up from 290%.
- Weaknesses in management’s loan underwriting and credit administration, and
- Poor loan concentration monitoring
    - Management has routinely exceeded board-established loan concentration limits
    - Policy risk tolerances for loan concentrations were raised to reflect the actual exposure rather than establishing prudent risk limits

Discussion Points - Capital

The Report of Examination identified a number of capital related concerns. First, capital levels are declining:

1. The Tier 1 Leverage Capital ratio declined 153 basis points to 8.08% (and we know this is significantly lower than the peer ratio of 9.11% by looking at the UBPR).
2. The Total Risk-Based Capital ratio declined 372 basis points to 10.31%. Again, the UBPR identifies that the ratio is significantly below the peer ratio of 14.64%.

At this point, the Report hasn't really told you anything you don't know. As active directors, you would have identified the declining trends by looking at the UBPR, and your board reports would have included that information as well.

What else did the examiners identify in the Report of Examination? The examiners noted a number of things that reflect a substantial increase in the risk profile. Such as:

1. Click here to see point number 1 (Deteriorating asset quality)
2. Click here to see point number 1 (Aggressive and non-diversified loan growth)
3. Click here to see point number 3 (Weak loan underwriting and administration)
4. Click here to see point number 4 (Significant loan concentrations and poor monitoring)

As a director, you should have some concerns. The capital ratios are lower than peer and declining, and the risk profile is rising substantially. With this in mind, we're ready to rate capital.

Rating Capital Adequacy

The following is an excerpt from the Uniform Financial Institutions Ratings System. Take a couple minutes to read the ratings guide and rate the capital component for First State Bank.

Uniform Financial Institution Ratings System

A financial institution is expected to maintain capital commensurate with the nature and extent of risks to the institution and the ability of management to identify, measure, monitor, and control these risks. The types and quantity of risk inherent in an institution's activities will determine the extent to which it may be necessary to maintain capital at levels above required regulatory minimums. The capital adequacy of an institution is rated based upon, but not limited to, an assessment of the following evaluation factors.

- The level and quality of capital and the overall financial condition of the institution
- The ability of management to address emerging needs for additional capital
- The nature, trend, and volume of problem assets, and the adequacy of allowances for loan and lease losses 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

Ratings

1. A rating of “1” indicates a strong capital level relative to the institution's risk profile.
2. A rating of “2” indicates a satisfactory capital level relative to the financial institution's risk profile.
3. A rating of “3” indicates a less than satisfactory level of capital that does not fully support the institution's risk profile. The rating indicates a need for improvement, even if the institution's capital level exceeds minimum regulatory and statutory requirements.
4. A rating of “4” indicates a deficient level of capital. In light of the institution's risk profile, viability of the institution may be threatened. Assistance from shareholders or other external sources of financial support may be required.
5. A rating of “5” indicates a critically deficient level of capital such that the institution's viability is threatened. Immediate assistance from shareholders or other external sources of financial support is required.

Consider the ratings definitions above and compare them to the circumstances described in the Report of Examination for First State Bank. What should capital be rated?

1. Strong (link to capital answer)
2. Satisfactory (link to capital answer)
3. Less than satisfactory (link to capital answer)
4. Unsatisfactory (link to capital answer)
5. Critically deficient (link to capital answer)

[Answer:] Examiners rated this bank's capital component a "3". The last examination assigned capital a "2" rating; however, the level of capital has fallen significantly from that date and the risk profile has risen dramatically. The "3" rating was assigned because the capital level was considered inadequate relative to the various qualitative factors (risk profile, portfolio shift, classifications, lax loan administration, etc.) and quantitative factors (Tier 1 Leverage Capital and Risk-Based Capital ratios declined dramatically).

If you felt that the bank's weaknesses and declining ratios justified a "4", keep in mind that a bank with a capital component rated "4" is clearly inadequately capitalized and "viability may be threatened". Since the Tier 1 Leverage Capital ratio is still over 8%, solvency is not yet an issue.

Now let's move on to the management module.