

INTRODUCTION

From a bank regulator's standpoint, the essential purpose of bank earnings, both current and accumulated, is to absorb losses and augment capital. Earnings is the initial safeguard against the risks of engaging in the banking business, and represents the first line of defense against capital depletion resulting from shrinkage in asset value. Earnings performance should also allow the bank to remain competitive by providing the resources required to implement management's strategic initiatives.

The analysis of earnings includes all bank operations and activities. When evaluating earnings, examiners should develop an understanding of the bank's core business activities. Core activities are those operations that are part of a bank's normal or continuing business. Therefore, when earnings are being assessed, examiners should be aware of nonrecurring events or actions that have affected bank earnings performance, positively or negatively, and should adjust earnings on a tax equivalent (TE) basis for comparison purposes. Although the analysis makes adjustments for non-recurring events, examiners should also include within their analysis the impact that these items had on overall earnings performance. Examples of events that may affect earnings include adoption of new accounting standards, extraordinary items, or other actions taken by management that are not considered part of the bank's normal operations such as sales of securities for tax purposes or for some other reason unrelated to active management of the securities portfolio.

The exclusion of nonrecurring events from the analysis allows the examiner to analyze the profitability of core operations without the distortions caused by non-recurring items. By adjusting for these distortions, examiners are better able to compare earnings performance against the bank's past performance and industry norms (e.g., peer group data) over time.

The terms level and trend are used throughout this section of the Manual. Level analysis is the process of reviewing financial statement ratios and volumes as of a specific date. Level analysis allows for a comparison of performance, for example, to industry norms or peer group data. Trend analysis is the process of assessing the general direction or prevailing tendency (i.e., increasing, decreasing, or stable) of operating ratios or volumes over several periods (i.e., generally over a five year period) using the level of each period.

The following tools are available to assist the examiner in the assessment of earnings: the Uniform Bank Performance Report (UBPR), the bank's Consolidated Reports of

Condition and Income (Call Report), the bank's financial statements and subsidiary ledgers, analytical reports prepared for the bank's senior management and board of directors, and the Examination Documentation (ED) Modules.

The UBPR can be used to perform level and trend analysis of key earnings components. Bank-prepared analytical reports can serve the same purpose while also revealing those elements of earnings of strategic interest to management. In conjunction with the UBPR and any internal analytical reports, the bank's Call Report and corresponding bank financial statements and supplementary schedules should be used for more in-depth review. The information gleaned from these schedules may provide the examiner considerable insight into bank earnings. An analysis of earnings is not complete until the examiner has a full understanding of the bank's business activities and its strategic initiatives, and has discussed the bank's financial performance and strategies with management

Further, examiners should consider the bank's marketplace when assessing earnings because institutions that operate in more competitive environments must continually adapt to current national, regional, and local economic and industry conditions to remain viable over time. Also, examiners should determine whether there are any secular, cyclical, or seasonal factors that may favorably or unfavorably affect bank earnings. Current knowledge of such conditions and factors can be obtained by reviewing economic and industry information in newspapers and industrial journals.

Earnings Analysis Trail

Generally the analysis of earnings begins with the examiner reviewing each component of the earnings analysis trail. The earnings analysis trail provides a means of isolating each major component of the income statement for individual analysis. The earnings analysis trail consists of the following income statement components: net interest income, noninterest income, noninterest expense, provision for loan and lease losses, and income taxes.

Each component of the earnings analysis trail is initially reviewed in isolation. Typically, ratios are examined to determine a broad level view of the component's performance. The level of progression along the analysis trail will depend on a variety of factors including the level and trend of the ratio(s), changes since the previous examination, and the institution's risk profile.

The balance sheet composition, or structure, is determined by management. Any material shifts in the balance sheet

structure will cause changes to any ratios using a numerator or denominator from the balance sheet (e.g., average assets and average earning assets). Therefore, examiners should be aware that significant changes in the balance sheet structure can materially affect earnings performance.

Ratio Analysis

Several key UBPR ratios used in the earnings analysis are shown below. Refer to additional ratios and the UBPR User's Guide as needed.

Net Income to Average Assets Ratio

This ratio is also known as the Return on Assets (ROA) ratio and consists of bottom line after-tax net income, including securities gains/losses and extraordinary items, as a percentage of average assets. The ROA is a common starting point for analyzing earnings because it gives an indication of the return on the bank's overall activities. A typical ROA level is different, depending on the size, location, activities, and risk profile of the bank. For example, a "community" bank with a few branches may regularly achieve an ROA ratio that exceeds those realized by large wholesale banks. Although the ROA provides an overall performance measure, the individual components comprising the ROA need to be reviewed. These sub-components will be discussed later in this section.

Net Income Adjusted Subchapter S to Average Assets Ratio

In general, institutions that elect to operate as Subchapter S (Sub S) corporations are treated as pass-through entities and are not subject to Federal income taxes at the corporate level. Therefore, an adjustment to net income is needed to improve the comparability between banks that are taxed at the corporate level and those that are not. Refer to the UBPR User's Guide for specific information.

Various other issues specific to Sub S corporations may also exist. For instance, several states do not recognize Federal Sub S elections. Therefore, Sub S institutions may remain subject to State corporate income taxes. Refer to outstanding guidance for additional information and the potential effects of this election on the institution's overall earnings performance.

Net Interest Income (TE) to Average Assets Ratio

The ratio of Net Interest Income (NII) to Average Assets is also known as the NII ratio and measures annualized total interest income, plus the tax benefit on tax-exempt income, less total interest expense, divided by average assets.

TE adjustments are made to enable meaningful comparisons for banks that have tax-exempt income. These adjustments are discussed in detail in the UBPR User's Guide. Consideration should be given to the impact of tax-free investments and the related adjustment(s) made to the ratio(s) when material.

This ratio typically represents the bank's largest revenue component. While a higher NII ratio is generally favorable, it can also be reflective of a greater degree of risk within the asset base. For example, a high NII ratio could indicate management is making a large number of "high-interest, high-risk" loans (for example, subprime loans). Although an increase in the NII ratio would be evident, this would not necessarily be an improvement.

The NII ratio can be broken down into two sub-component ratios: Interest Income (TE) to Average Assets and Interest Expense to Average Assets. These ratios and their related components can be analyzed to determine the root cause(s) of any changes in the ratio and their subsequent effect on the ROA.

Net Interest Income (TE) to Average Earnings Assets Ratio

This ratio is also known as the Net Interest Margin (NIM). The ratio is comprised of annualized total interest income on a TE basis, less total interest expense, divided by average earnings assets. This ratio indicates how well management employed the earning asset base. The NIM is more useful than the NII for measuring the profitability of the bank's primary activities (buying and selling money) because the denominator focuses strictly on assets that generate income rather than the entire asset base.

The sub-components of the NIM - the ratios of Interest Income to Average Earnings Assets and Interest Expense to Average Earnings Assets - can be analyzed to determine the root causes of NIM changes. These ratios may change for a variety of reasons, for example, management may have restructured the balance sheet, the interest rate environment may have changed, or bank loan and deposit pricing became more or less competitive.

Noninterest Income to Average Assets Ratio

This ratio is comprised of annualized income from bank services and sources other than interest-bearing assets, divided by average assets. Level, trend, and overall contribution of noninterest income to earnings performance should be analyzed. If the contribution represents a major portion of the bank's total revenue, specific sources of noninterest income need to be identified. An assessment as

to whether or not these sources are core versus nonrecurring should be made.

Noninterest income is largely of a fee nature; service charges on deposits, trust department income, mortgage servicing fees, and certain types of loan and commitment fees. The results of trading operations and a variety of miscellaneous transactions are also included. In some institutions, noninterest income is being relied upon more heavily as banks are attempting to diversify their earnings streams.

Noninterest Expense to Average Assets Ratio

This ratio is also referred to as the Overhead (OH) ratio and is calculated by annualizing expenses related to salaries and employees benefits, expenses of premises and fixed assets, and other noninterest expenses, divided by average assets. Levels and trends of each component should be assessed and the types of expenses representing the largest overhead components should be determined. Examples of the type of costs that may lead to an inordinately high level of overhead expenses include: excessive salaries and bonuses, sizable management fees paid to the bank holding company, and high net occupancy expenses caused by the purchase or construction of a new bank building.

Other related ratios such as average personnel expense per employee, average assets per employee, and the efficiency ratio may provide useful information. The level of these ratios and the overall affect on earnings performance should be analyzed. If significant, specific sources of noninterest expense need to be identified. An assessment as to whether these sources are core versus nonrecurring should be considered during the earnings analysis.

The existence of unwarranted and unjust compensation of bank insiders is of particular concern, especially when those expenses are likely to result in harm to the bank and ultimately the deposit insurance fund. In this regard, the FDIC's safety and soundness standards (Appendix A to Part 364) state that both excessive compensation and compensation that could lead to material financial loss to an institution are prohibited as unsafe and unsound practices. While just and equitable employee and directorate compensation is essential for the acquisition and retention of competent management, there are instances where bank insiders profit from unwarranted compensation. Unwarranted and unjust compensation and related expenses to bank insiders should be dealt with through whatever means are necessary to cease these abuses. This is particularly critical in lower-rated banks. In such banks, the directorate should be reminded of their fiduciary responsibility for the preservation and

conservation of bank funds. Additionally, management fees assessed by parent bank holding companies should be considered for appropriateness and level since they may be significant.

Provision for Loan and Lease Losses (PLLL) to Average Assets Ratio

This ratio shows the annualized percentage of PLLL in relation to average assets. Material changes in the volume of PLLL (either positively or negatively) should be investigated. Higher provisions should result if the loan mix changes significantly from loans with lower to higher historical loss experience (e.g., from one-to-four family mortgage loans to commercial loans) or if economic conditions have declined and have produced a deterioration of loan quality. In situations where the economy is improving and loan quality is stabilizing or improving, lower PLLLs may be appropriate.

When assessing the PLLL, examiners need to determine whether the level of the ALLL is appropriate to absorb estimated credit losses inherent in the loan and lease portfolio. An ALLL that is not at an appropriate level may be due to any one or a combination of reasons. For example, an ALLL that is below an appropriate level may be caused by a decline in loan quality identified during the examination, an inaccurate ALLL methodology, or an attempt by management to manipulate earnings. If the ALLL is deemed to be materially insufficient during the examination, management will be required to take an additional PLLL to bring the ALLL to an appropriate level, thereby increasing the bank's expenses and adversely affecting earnings. Earnings ratios affected by this charge to the PLLL should be adjusted and reflected in the earnings analysis..

Refer to the Loans section of this manual and the Call Report Instructions for additional information on the ALLL.

Realized Gains/Losses on Securities to Average Assets Ratio(s)

The ratio of securities gains/losses to average assets shows the annualized percentage of net realized gains or losses on available-for-sale and held-to-maturity securities in relation to average assets. The level, trend, and overall contribution that securities transactions have on earnings performance should be analyzed.

Bank management may purchase and sell securities for many reasons, but most banks limit investment activity to ensure adequate liquidity is available to meet unanticipated funding needs and to invest excess funds (i.e., when loan

demand is low). Examiners should determine whether management actively engages in the sale of securities. When management actively manages their portfolio, this securities activity should be considered part of the bank's core operations. Examiners should assess management's strategies and their implementation. For example, examiners should be alert for instances where investments with unrealized gains are sold while those with unrealized losses are held and should ascertain the reasons for these transactions. Examiners should consider these types of instances when assessing earnings prospects.

While actively selling securities may not be part of a bank's core operations, there are many reasons why management may sell securities. Among the reasons for which management may sell securities that would not be part of a bank's normal operations would be when management needs to restructure the portfolio to maintain or change portfolio duration, to maintain or change portfolio diversification, or to take advantage of some tax implications or some other combination of these reasons. When not part of a bank's core operations, examiners should eliminate the gains or losses adjusted for taxes so as to not distort core operating results. The elimination of these gains or losses allows for level and trend analysis of core operations.

Other Considerations

Income Taxes

It is important to judge whether applicable income taxes, that is, the provision for taxes, seems appropriate and whether a shift in the effective tax rate has occurred. In determining the appropriateness of income taxes, several tax ratios are provided within the UBPR. These ratios generally compare the amount of applicable taxes to net operating income. In order to ensure that only taxable income is compared to applicable income taxes, certain adjustments are necessary for income received on municipal securities and other investments which are tax-exempt in nature. If the tax ratios provided on the UBPR differ significantly from the rate of taxes that should have been paid, based upon the bank's tax bracket, further analysis is necessary to determine the reasons for such a discrepancy. For example, a bank with a high tax ratio may have invested too heavily in tax-exempt assets, with the result that the potential tax savings was not fully realized. In addition, certain tax incentives, such as investment tax credits received in connection with the acquisition of bank equipment, may have the effect of lowering the tax rate. The ability or inability to carryback

or carryforward operating losses for tax purposes will also impact the bank's effective tax rate. Tax ratios may appear abnormal due to management's failure to adequately accrue for income tax expense on a current basis. Appropriate tax accruals should be made on a regular basis and at least with enough frequency to allow for the preparation of accurate Call Reports.

In almost all cases, applicable income taxes reported in the Call Report will differ from the amounts reported to taxing authorities. The applicable income tax expense or benefit that is reflected in the Call Report should include both taxes currently paid or payable (or receivable) and deferred income taxes. Deferred income tax expense or benefit is measured as the change in the net deferred tax assets or liabilities for the period reported. Deferred tax liabilities and assets represent the amount by which taxes payable (or receivable) are expected to increase or decrease in the future as a result of "temporary differences" and net operating loss or tax credit carry forwards that exist at the Call Report date. Refer to the Call Report Glossary for additional information on FAS 109, *Accounting for Income Taxes*.

A higher than normal ratio of applicable income taxes to NOI may result from upstreaming income tax payments to a bank holding company. The FDIC issued a policy statement (refer to FDIC Law, Regulation, and Related Acts) that covers income tax allocation in a holding company structure. In general, the statement requires that cash transfers paid by the bank to the holding company not exceed the amount of tax the bank would have paid had a tax return been filed on a separate return basis. In addition, any payments made to the holding company shall not be required to be remitted until such time as those payments would have been due to the taxing authority. Thus, deferred income taxes on bank's books should not be upstreamed to the holding company until such time as those taxes would be otherwise payable to the taxing authority. Holding companies and subsidiary institutions are encouraged to enter into a written, comprehensive tax allocation agreement tailored to their specific circumstances. The agreement should be approved by the respective boards of directors. The policy statement was not intended to limit any tax elections under the Internal Revenue Code, and the term "separate return basis" recognizes that certain adjustments due to particular tax elections may, in certain periods, result in larger payments by the affiliated bank to the parent than would have been made by an unaffiliated bank to the taxing authority. Refer to the aforementioned policy statement for additional information.

Dividends

Earnings are also evaluated on their ability to support capital. This support includes maintaining capital, as well as increasing capital. High earnings retention increases capital more rapidly, but may or may not be necessary for the bank. If growth is low, profits high and capital strong, in relation to assets, a relatively high dividend payout ratio may be acceptable. On the other hand, if growth is rapid, profits are low, and capital is weak, a high dividend payout stands in the way of retaining needed capital. Under such circumstances, a lower payout ratio would clearly be appropriate.

The retention rate must be analyzed relative to the bank's potential growth rate. A bank in a developing trade area may forecast substantial growth, which cannot be supported by existing capital even if cash dividends are not paid. Since most bank stocks are viewed by the investor as income generating rather than growth related, a low dividend history may hamper the bank's ability to market a new stock offering.

The bank's flexibility to reduce dividend payments should be considered when analyzing the impact of dividends upon earnings. For example, a bank that has a highly-leveraged holding company may lack flexibility to significantly lower dividend declarations, because those dividends are being used to meet debt service requirements. Another example includes institutions that have elected a Sub S status for income tax purposes. In a Sub S institution, shareholders normally pay income taxes on their proportionate share of the institution's taxable income whether or not a dividend payment or other distribution is made. Therefore, shareholders may attempt to limit the bank's flexibility to reduce these distributions.

In undercapitalized banks, steps should be taken to strongly discourage the continuation of cash dividends and/or other distributions. If necessary, additional steps should be taken to administratively prohibit such dividends/distributions where the bank is undercapitalized and has a high risk profile, or is substantially undercapitalized, no matter what the degree of perceived risk. There may be isolated instances where the continuation of cash dividends/distributions is warranted even under fairly severe circumstances. In such cases, the continuation of these payments without supervisory action should be fully supported.

Extraordinary Items

Extraordinary items are material events and transactions that are unusual and infrequent. Both of these conditions must exist in order for an event or transaction to be reported as an extraordinary item.

To be unusual, an event or transaction must be highly abnormal or clearly unrelated to the ordinary and typical activities of banks. An event or transaction that is beyond bank management's control is not automatically considered to be unusual.

To be infrequent, an event or transaction should not reasonably be expected to recur in the foreseeable future. Although the past occurrence of an event or transaction provides a basis for estimating the likelihood of its future occurrence, the absence of a past occurrence does not automatically imply that an event or transaction is infrequent.

Only a limited number of events or transactions qualify for treatment as extraordinary items. Among these are losses that result directly from a major disaster such as an earthquake (except in areas where earthquakes are expected to recur in the foreseeable future), an expropriation, or a prohibition under a newly enacted law or regulation.

For further information, refer to APB Opinion No. 30, *Reporting the Results of Operations*.

Accounting Considerations

The analysis of earnings may be further complicated by the adoption of new accounting standards or changes in accounting methodologies. For instance, prior to the adoption of FAS 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, institutions accounted for loan origination fees and costs in different ways. When analyzing earnings, examiners should be aware of changes in accounting standards that may have materially affected related ratios and, when material, make necessary adjustments to the ratios, on a tax adjusted basis, to be able to perform trend analysis. Over time, however, adjustments will no longer need to be made as reported operating performance will reflect the implementation of the accounting changes over enough periods that trend analysis will not be affected.

FAS 91 applies to all lending and leasing transactions originated since it took effect in 1988. This accounting standard established the accounting for nonrefundable fees and costs associated with lending, committing to lend, and purchasing a loan or a group of loans. In general, FAS 91 specifies that:

1. Loan origination fees should be recognized over the life of the related loan as an adjustment of yield;

2. Certain direct loan origination costs should be recognized over the life of the related loan as a reduction of the loan's yield;
3. Most loan commitment fees should be deferred, except for specified exceptions; and
4. Loan fees, certain direct loan origination costs, and purchase premiums and discounts on loans shall be recognized as an adjustment of yield generally by the interest method based on the contractual term of the loan.

Prior to adopting FAS 91, banks generally could immediately recognize loan origination fees in income to the extent that they represented a reimbursement to the bank for actual origination costs incurred by the bank to originate the loan. This practice is no longer acceptable.

A more detailed discussion of FAS 91 can be found in the Call Report Glossary.

Quality of Bank Earnings

Earnings quality is the ability of a bank to continue to realize strong earnings performance. It is quite possible for a bank to register impressive profitability ratios and high dollar volumes of income by assuming an unacceptable degree of risk. An inordinately high ROA is often an indicator that the bank is engaged in higher risk activities. For example, bank management may have taken on loans or other investments that provide the highest return possible, but are not of a quality to assure either continued debt servicing or principal repayment. Short-term earnings will be boosted by seeking higher rates for earning assets with higher credit risk. Eventually, however, earnings may suffer if losses in these higher-risk assets are recognized.

In addition, certain of the bank's adversely classified and nonperforming assets, especially those upon which future interest payments are not anticipated, may need to be reflected on a nonaccrual basis for income statement purposes. If such assets are not placed on a nonaccrual status, earnings will be overstated. Similarly, material amounts of troubled debt restructured assets may have an adverse impact on earnings.

As previously discussed, an institution's asset quality has a close relationship to the analysis of earnings quality. Poor asset quality may necessitate increasing the PLLL to bring the ALLL to an appropriate level and must be reviewed for impact on earnings quality.

Additionally, short-term earnings performance can be enhanced by extraordinary items and tax strategies. For example, a bank may dispose of high-yielding assets to

record gains in current periods, but may only be able to reinvest the funds at a lower rate of return. Levels and trends in earnings performance would be positive, although future income potential is sacrificed. Conversely, a bank might dispose of assets at a loss to take advantage of tax loss carryback provisions and enhance future earnings potential. Current earnings levels and trends would be poor in such a case, but funds recaptured through this strategy may greatly improve future earnings capacity. The point is that no analysis of earnings is complete without a consideration of earnings quality and a complete investigation and understanding of the strategies employed by bank management.

Planning and Budgeting

Strategic Plan

A strategic plan is a methodology that an organization uses to accomplish important goals and objectives. Regardless of the institution's size, a strategic plan can help an organization outline future goals and objectives and the steps needed to achieve such. For institutions that plan significant growth, new products, new branches, or other initiatives, strategic planning becomes even more important. Many institutions have formal, written strategic plans, while others rely on a much less formal method. If a formal, written strategic plan does not exist, this matter should be discussed with the board/management to determine the institution's overall goals, objectives, and long-term plans. Additional information on Corporate Planning is contained in the Management section of this manual. The Examination Documentation (ED) Modules also provide guidance in this area.

Profit Plan

A profit plan is an overall forecast of the income statement for the period based on management's decisions, intentions, and their estimation of economic conditions. It addresses such things as the anticipated level and volatility of interest rates, local economic conditions, funding strategies, asset mix, pricing, growth objectives, interest rate and maturity mismatches, etc. The accuracy of any such plan is susceptible to the attainability of the aforementioned assumptions.

Budget

Within the profit plan is a budget. The budget is essentially an expense control technique where management decides how much is intended to be spent during the period on individual overhead expense items. The budget should be consistent with the overall business

or profit plan. All banks, regardless of size, should be encouraged to prepare a profit plan and budget that addresses the current year and the next operating year. The degree of sophistication or comprehensiveness of a budget and profit plan may vary considerably based on the size of the institution and the complexity of the assets and income sources.

The FDIC issued Part 364 entitled Standards for Safety and Soundness. Appendix A of Part 364 outlines standard procedures that banks should employ periodically to evaluate and monitor earnings, thereby ensuring that earnings are sufficient to maintain adequate capital and reserves. At a minimum, management's analysis of earnings should:

- Compare recent earnings trends relative to equity, assets, or other commonly used benchmarks to the institution's historical results and those of its peers;
- Evaluate the adequacy of earnings given the size, complexity, and risk profile of the institution's assets and operations;
- Assess the source, volatility, and sustainability of earnings, including the effect of nonrecurring or extraordinary income or expenses;
- Take steps to ensure that earnings are sufficient to maintain adequate capital and reserves after considering asset quality and growth rate; and
- Provide periodic earnings reports with adequate information for management and the board of directors to assess earnings performance.

A bank's profit plan and budget should be reviewed for reasonableness with particular attention paid to the underlying assumptions. The forecast and assumptions should be consistent with what is known about the bank such as the volume of classified assets, nonaccrual and renegotiated debt levels, the adequacy of the ALLL, and other examination findings that have earnings implications. Comparison between the bank's forecast for the previous year to actual performance as displayed in the bank's own reports and in the UBPR can provide a reasonableness check. Any material discrepancies should be discussed with management; and, if the explanation is unreasonable, the bank's forecast may need to be adjusted to determine the effect of more reasonable assumptions.

If there is no bank plan or budget, examiners may need to develop their own forecast to aid in their judgments. In any case, it will normally be necessary to discuss future prospects with management. Care should be taken in these discussions not to present the examiner's forecast as absolute, or to recommend specific strategies or transactions to management based on an examiner's

forecast. Planning is properly the function of management. Examiner efforts are only an attempt to discover any undue risk and highlight any factors that may significantly impact future performance in either a positive or negative manner.

Deficiencies in the profit plan or budget, or the lack thereof, should be documented in the appropriate section of the examination report.

EVALUATION OF EARNINGS PERFORMANCE

Earnings Component Rating

Under the Uniform Financial Institutions Rating System, in evaluating the adequacy of a financial institution's earnings performance, consideration should be given to:

- The level of earnings, including trends and stability,
- The ability to provide for adequate capital through retained earnings,
- The quality and sources of earnings,
- The level of expenses in relation to operations,
- The adequacy of the budgeting systems, forecasting processes, and management information systems in general,
- The adequacy of provisions to maintain the ALLL and other valuation allowance accounts, and
- The earnings exposure to market risk such as interest rate, foreign exchange, and price risks.

RATING THE EARNINGS FACTOR

Earnings rated 1 are strong. Earnings are more than sufficient to support operations and maintain adequate capital and allowance levels after consideration is given to asset quality, growth, and other factors affecting the quality, quantity and trend of earnings. Generally, banks rated 1 will have earnings well above peer group averages.

Earnings rated 2 would be satisfactory and sufficient to support operations and maintain adequate capital and allowance levels after consideration is given to asset quality, growth, and other factors affecting the quality, quantity and trend of earnings. Earnings that are relatively static, or even experiencing a slight decline, may receive a 2 rating provided the institution's level of earnings is adequate in view of the assessment factors listed above.

Earnings rated 3 may need to improve. Earnings may not fully support operations and provide for the accretion of

capital and allowance levels in relation to the institution's overall condition, growth, and other factors affecting the quality, quantity, and trend of earnings.

A rating of 4 indicates earnings that are deficient. Earnings are insufficient to support operations and maintain appropriate capital and allowance levels. Institutions so rated may be characterized by erratic fluctuations in net income or net interest margin, the development of significant negative trends, nominal or unsustainable earnings, intermittent losses, or a substantive drop in earnings from the previous years.

A rating of 5 indicates earnings that are critically deficient. A financial institution with earnings rated 5 is experiencing losses that represent a distinct threat to its viability through the erosion of capital.