**Summary of Community Bank Transitional Capital Rules:**
**Implementation of Basel III Requirements[1]**
**(Components of Capital; Deductions and Adjustments; and Minimum Ratios)**

| | | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
|---|---|---|---|---|---|---|---|---|
| 1 | **New risk weights for total risk-weighted assets, see Appendix A[2] ..** | | | In effect | In effect | In effect | In effect | In effect |
| 2 | | | | | | | | |
| 3 | Common Equity Tier 1 capital ("CET1")[3] would consist of: | | | | | | | |
| 4 | | | | | | | | |
| 5 | *Qualifying common stock instruments* | | | | | | | |
| 6 | *Plus retained earnings and accumulated other comprehensive income ("AOCI") (but see AOCI adjustment at row 8)* | | | | | | | |
| 7 | *Plus any qualifying Common Equity Tier 1 minority interests* | | | | | | | |
| 8 | *Plus / (Less) % of transition AOCI adjustment applied to CET1[4]* | 100% | 80% | 60% | 40% | 20% | 0% | 0% |
| 9 | *Less phase-in % of Regulatory Deductions[5]* | | | | | | | |
| | *% of deduction applied to CET1* ......................................... | | 20% | 40% | 60% | 80% | 100% | 100% |
| | *% of deduction applied to Tier 1*......................................... | 100% | 80% | 60% | 40% | 20% | 0% | 0% |
| 10 | *Less applicable % of investments in certain capital instruments[6]* | | 20% | 40% | 60% | 80% | 100% | 100% |
| 11 | *Less 100% of goodwill, net of deferred tax liabilities ("DTL")[7]* | | | | | | | |
| 12 | *Less applicable % of other intangibles, net of DTL[8]* | | 20% | 40% | 60% | 80% | 100% | 100% |
| 13 | *Less applicable % of "Threshold Deductions"[9]* | | 20% | 40% | 60% | 80% | 100% | 100% |
| 14 | *Plus / (Less) other regulatory adjustments[10]* | | | | | | | |
| 15 | | | | | | | | |
| 16 | **Minimum Ratio of Common Equity Tier 1 Capital:[11]** | **3.5%** | **4.0%** | **4.5%** | **4.5%** | **4.5%** | **4.5%** | **4.5%** |
| 17 | | | | | | | | |
| 18 | Phase-in of Capital Conservation Buffer ("Buffer")[12] | | | | 0.625% | 1.25% | 1.875% | 2.5% |
| 19 | Restrictions on Capital Distributions & Executive Bonuses[13] | | | | In effect | In effect | In effect | In effect |
| 20 | | | | | | | | |
| 21 | **Minimum Ratio of CET1 *Plus* Buffer:** | **3.5%** | **4.0%** | **4.5%** | **5.125%** | **5.75%** | **6.375%** | **7.0%** |

| | | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
|---|---|---|---|---|---|---|---|---|
| 22 | Additional Tier 1 Capital ("AT1")[14] would consist of: | | | | | | | |
| 23 | | | | | | | | |
| 24 | *Qualifying AT1 capital instruments* | | | | | | | |
| 25 | *Plus qualifying Tier 1 minority interests not included in CET1* | | | | | | | |
| 26 | *Plus Tier 1 SLBF and pre-October 2010 TARP*[15] | | | | | | | |
| 27 | *Plus % of Tier 1 non-qualifying capital instruments*[16] | 90% | 80% | 70% | 60% | 50% | 40% | 30% |
| 28 | *Less phase-in % of Regulatory Deductions (see note 5)*<br>*% of deduction applied to CET1* ............................................<br>*% of deduction applied to Tier 1*............................................ | <br><br>100% | <br>20%<br>80% | <br>40%<br>60% | <br>60%<br>40% | <br>80%<br>20% | <br>100%<br>0% | <br>100%<br>0% |
| 29 | *Less applicable % of investments in certain capital instruments (see note 6)* | | 20% | 40% | 60% | 80% | 100% | 100% |
| 30 | | | | | | | | |
| 31 | **Minimum Ratio of CET1 *Plus* Additional Tier 1 Capital:** | **4.5%** | **5.5%** | **6.0%** | **6.0%** | **6.0%** | **6.0%** | **6.0%** |
| 32 | | | | | | | | |
| 33 | **Minimum Ratio of CET1 *Plus* AT1 *Plus* Buffer:** | **4.5%** | **5.5%** | **6.0%** | **6.625%** | **7.25%** | **7.875%** | **8.5%** |
| 34 | | | | | | | | |
| 35 | Tier 2 Capital ("Tier 2")[17] would consist of: | | | | | | | |
| 36 | | | | | | | | |
| 37 | *Qualifying Tier 2 capital instruments* | | | | | | | |
| 38 | *Plus any qualifying minority interests not included in Tier 1* | | | | | | | |
| 39 | *Plus ALLL up to 1.25% of risk-weighted assets* | | | | | | | |
| 40 | *Plus Tier 2 SLBF and pre-October 2010 TARP (see note 15)* | | | | | | | |
| 41 | *Plus % of Tier 2 non-qualifying capital instruments (see note 16)* | 90% | 80% | 70% | 60% | 50% | 40% | 30% |
| 42 | *Less applicable % of unrealized gains on AFS equity securities*[18] | 45% | 36% | 27% | 18% | 9% | 0% | 0% |
| 43 | *Less applicable % of investments in certain capital instruments (see note 6)* | | 20% | 40% | 60% | 80% | 100% | 100% |
| 44 | | | | | | | | |
| 45 | **Minimum Ratio of Tier 2 Capital: ......................................................** | **3.5%** | **2.5%** | **2.0%** | **2.0%** | **1.875%** | **2.0%** | **2.0%** |
| 46 | | | | | | | | |
| 47 | **Minimum Ratio of CET1 *Plus* AT1 *Plus* Tier 2 *Plus* Buffer: ...........** | **8.0%** | **8.0%** | **8.0%** | **8.625%** | **9.125%** | **9.875%** | **10.5%** |

# Notes to Basel II NPR Chart

[1] This Basel NPR Chart summarizes the proposed rules under the Basel NPR which are of most relevance to community banks with consolidated assets less than $15 billion and therefore excludes the impact of the new rules on bank holding companies of less than $500 million (but not their subsidiary banks), thrifts and savings and loan holding companies and large complex banking organizations with consolidated assets in excess of $50 billion. In addition, community banks would neither be subject to certain aspects of the proposed rules such as a new capital buffer called the countercyclical buffer nor subject to the advanced approaches capital rule or the market risk rule, each of which would apply only to large complex banking organizations. The Basel NPR does not diminish the authority of the banking agencies to place additional limitations on capital distributions or their ability to exclude any particular capital element, at any tier, based upon an assessment that characteristics or terms of the capital element diminish an institution's ability to absorb losses or otherwise present safety and soundness concerns. Additionally, under the Basel NPR the banking agencies retain the discretion to require a bank to hold an amount of regulatory capital greater than the minimum levels if the agency determines that the proposed capital levels are not commensurate with the level and nature of all risks to which a particular banking organization may be exposed. All ratios in the table are expressed as a percentage of standardized risk-weighted assets, with the risk weights calculated under the Risk-Weight NPR rules, which are proposed to be effective on January 1, 2015. *See* Appendix A for a summary of the Risk-Weight NPR. The Basel NPR introduces a new Common Equity Tier 1 capital ratio of 4.5%, increases the minimum Tier 1 capital ratio from 4% to 6%, and maintains the minimum total capital ratio at 8%. The current 4% leverage ratio requirement (computed using the proposed new definitions of capital) would continue to apply to all banking organizations, but the exception under the current capital rules allowing strong banking organizations rated CAMEL 1 to maintain leverage ratio at 3% would no longer apply under the proposed rules.

[2] A summary of the proposed new risk weights for assets is attached as Appendix A.

[3] **Common Equity Tier 1 capital.** Common Equity Tier 1 capital (referred to in these notes as "CET1" or "Common Equity Tier 1 capital") is a new concept introduced by the Basel NPR and is intended to ensure that a banking organization's CET1 capital instruments are available to absorb losses as they occur. The Basel NPR includes 13 criteria that capital instruments must satisfy in order to be treated as Common Equity Tier 1 capital. *See* §__.20(b) of the Basel NPR. Under the Basel NPR, Common Equity Tier 1 capital would be the sum of outstanding Common Equity Tier 1 capital instruments and related surplus (net of treasury stock), retained earnings, accumulated other comprehensive income ("AOCI"), and certain Common Equity Tier 1 minority interests, minus certain regulatory adjustments and deductions. Banking organizations are currently subject to a series of deductions from and adjustments to regulatory capital, most of which apply at the Tier 1 capital level. Under §__.22 of the Basel NPR, banking organizations would become subject to a series of deductions and adjustments, the vast majority of which would apply to the calculation of Common Equity Tier 1 capital. The Basel NPR states that the "agencies believe that most existing common stock instruments previously issued by U.S. banking organizations fully satisfy the proposed criteria."

[4] **Flow through of unrealized gains and losses on debt securities, including cash flow hedges**. The Basel NPR includes a new concept that unrealized gains and losses on all available for sale ("AFS") securities would flow through to CET1 by phasing out current regulatory adjustments to a bank's AOCI, referred to as the AOCI adjustment amount. (Under the current rules, unrealized gains and losses on AFS debt securities are not included in regulatory capital. Unrealized losses on AFS equity securities are included in Tier 1 capital and unrealized gains on AFS equity securities are partially included in Tier 2 capital.) The line item in the chart shows the percentage of the AOCI adjustment amount to be applied to CET1, which includes the aggregate amount of net unrealized gains and losses on AFS debt securities, unrealized gains on AFS equity securities, and accumulated net gains and losses on cash flow hedges related to items that are reported on the balance sheet at fair value included in AOCI. If the transition AOCI adjustment amount is positive, it would adjust CET1 by deducting the appropriate percentage of such aggregate amount, and if such amount is negative, it would adjust CET1 by adding back the appropriate percentage of such aggregate amount. The Basel NPR notes that the proposed change could add considerable volatility to required capital ratios and solicits comments on whether unrealized gains and losses on securities of the U.S. government, its agencies and government-sponsored entities (such as Fannie Mae and Freddie Mac) and other debt securities whose values primarily change as a result of changes in benchmark rates should be excluded from regulatory capital. *See* §__.22(b)(1) of the Basel NPR.

[5] During the transition period, the following items that are not deducted from Common Equity Tier 1 capital are deducted from Additional Tier 1 capital instead, include:
(A) Deferred tax assets ("DTA") that arise from operating loss and tax credit carryforwards net of any related valuation allowance and net of deferred tax liabilities ("DTL"), which would be deducted from CET1 because of the high degree of uncertainty regarding the ability of the banking organization to realize value from such DTAs. *See*

§__.22(a)(3) of the Basel NPR. Other DTA are subject to the threshold deductions as described in note 9, and DTA arising from temporary differences that the banking organization can realize through net operating loss carrybacks are not subject to deduction and, instead, receive a 100% risk-weight.
(B) Any gain-on-sale associated with a securitization exposure. *See* §__.22(a)(4) of the Basel NPR.
(C) Changes in the fair value of liabilities due to changes in the banking organization's own credit risk. *See* §__.22(b)(2) of the Basel NPR.

[6] **Capital instruments issued by financial institutions**. Under the Basel NPR, a bank would be required to make deductions from regulatory capital for investments in its own capital instruments and may also be required to deduct investments in equity or other capital instruments issued by other financial institutions. During the transition period, a bank would make the percentage deductions from CET1 as set forth in the line item and would apply a 100% risk-weight to the aggregate amount of such items that are not deducted.

- A banking organization would be required to make the following deductions with respect to investments in its own capital instruments (including any contractual obligation to purchase): (i) deduct from CET1 all investments in the banking organization's own common stock; (ii) deduct from Additional Tier 1 capital all investments in the banking organization's own Additional Tier 1 capital instruments, whether held directly or indirectly; and (iii) deduct from Tier 2 capital all investments in the banking organization's own Tier 2 capital instruments.
- With respect to capital instruments issued by other financial institutions, a bank would be required to make deductions from the same component of capital for which the underlying instrument would qualify if it were issued by the bank itself (referred to in the Basel NPR as the "corresponding deduction approach"). In addition, if the bank does not have a sufficient amount of such component of capital to effect the deduction, the shortfall would be deducted from the next higher (that is, more subordinated) component of regulatory capital (for example, if the exposure may be deducted from Additional Tier 1 capital but the banking organization does not have sufficient Additional Tier 1 capital, it would take the deduction from Common Equity Tier 1 capital).
- A banking organization would be required to use the corresponding deduction approach to calculate the required deductions from regulatory capital for:
  (A) Reciprocal cross-holdings (i.e., a formal or informal arrangement between two financial institutions to swap or exchange each other's capital instruments). *See* §__.22(c)(3) of the Basel NPR.
  (B) Non-significant investments in the capital of unconsolidated financial institutions (i.e., if the bank owns less than 10% of the other institution's common stock, then the investment is deducted only to the extent it exceeds 10% of the bank's CET1, and otherwise it is assigned appropriate risk-weight under the Risk-Weight NPR). *See* §__.22(c)(4) of the Basel NPR.
  (C) Non-common stock significant investments in the capital of unconsolidated financial institutions (i.e., if the bank owns more than 10% of the other institution's issued and outstanding common shares, then 100% of any non-common stock owned must be deducted). *See* §__.22(c)(5) of the Basel NPR.

[7] Banking organizations would be required to deduct the full amount of goodwill (net of any associated deferred tax liabilities), including any goodwill embedded in the valuation of significant investments in the capital of an unconsolidated financial institution in the form of common stock from Common Equity Tier 1 elements. *See* §__.22(a)(1) of the Basel NPR.

[8] Other intangible assets excludes mortgage servicing assets ("MSA"), which are treated separately. *See* note 9. *See* §__22(a)(2) of the Basel NPR.

[9] **Threshold deductions**. Includes deductions of each of the following that, individually, are more than 10% of CET1, less all required adjustments and deductions:
(i) DTA arising from temporary differences that could not be realized through net operating loss carrybacks, net of any associated valuation allowance, and DTL (subject to limitations); (ii) MSA, net of associated DTL; and (iii) significant investments in unconsolidated financial institutions in the form of common stock (i.e., a bank owns more than 10% of the other institution's issued and outstanding common shares). The aggregate amount of the foregoing threshold deduction items <u>cannot</u> exceed 15% of Common Equity Tier 1 capital, net of all deductions. Once the foregoing deductions are made, if the aggregate amounts of the threshold items included in CET1 are greater than 15% of CET1, then all amounts over this 15% cap must also be deducted from CET1. The amounts that are not deducted from CET1 would be assigned a 250% risk-weight pursuant to the Risk-Weight NPR. During the transition period, a banking organization would be required to deduct from CET1 the specified percentages in the line item by which the aggregate sum of the three items exceeds 15% of the banking organization's CET1 less the deductions required under §__.22(a) through (c) of the Basel NPR.

[10] Requires deduction of any associated unrealized gain and addition of any associated unrealized loss to the sum of Common Equity Tier 1 capital elements with respect to:

(i) unrealized gains and 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 and (ii) unrealized gains and losses that have resulted from changes in the fair value of liabilities that are due to changes in the banking organization's own credit risk. *See* §__.22(b)(1)-(2) of the Basel NPR. *See* notes 3 and 4.

[11] The Basel NPR proposes to augment the Prompt Corrective Action ("PCA") capital categories by introducing a Common Equity Tier 1 capital measure for four of the five PCA categories (excluding the Critically Undercapitalized PCA category) as follows:

| | |
|---|---|
| Well Capitalized: | >6.5% CET1 |
| Adequately Capitalized: | >4.5% CET1 |
| Undercapitalized: | <4.5% CET1 |
| Significantly Undercapitalized: | <3.0% CET1 |

Under current rules, an institution is Critically Undercapitalized if its tangible equity to total assets is 2% or less. Tangible equity for PCA purposes is currently defined as including core capital elements, which consist of (i) common stockholder's equity, (ii) qualifying noncumulative perpetual preferred stock (including related surplus), and (iii) minority interest in the equity accounts of consolidated subsidiaries, plus outstanding cumulative preferred perpetual stock, minus all intangible assets except mortgage servicing rights that are included in Tier 1 capital. The Basel NPR proposes to clarify the calculation of the capital measures for the "Critically Undercapitalized" category by revising the definition of tangible equity to consist of Tier 1 capital, plus outstanding perpetual preferred stock (including related surplus) not included in Tier 1 capital.

[12] **Capital conservation buffer**. In addition to the minimum capital requirements, the Basel NPR establishes a capital conservation buffer (the "Buffer"). The Buffer would consist of Common Equity Tier 1 capital elements only and would be calculated based upon overall capital compliance across all tiers by taking the lowest measure between a banking organization's actual capital at each respective tier against the minimum capital requirement for that tier. For example, if a banking organization's Common Equity Tier 1, Tier 1, and total capital ratios are 7.5%, 9.0%, and 10%, respectively, and the banking organization's minimum Common Equity Tier 1, Tier 1, and total capital ratio requirements are 4.5%, 6%, and 8%, respectively, the banking organization's applicable Buffer would be 2% even though its Common Equity Tier 1 and Tier 1 capital ratios are each 3 percentage points above the minimum required for those respective tiers. The Basel NPR restricts capital distributions and discretionary executive bonus compensation as soon as the amount of the Buffer falls below the required phase-in minimum amount. *See* note 13.

[13] **Restrictions on capital distributions and executive bonuses**. The Basel NPR restricts capital distributions and executive bonus compensation as soon as the amount of the Buffer falls below the required phase-in minimum amount. Consequently, as a practical matter, community banks would likely choose to maintain a "buffer" on the Buffer in order to compensate for capital fluctuations, particularly as may occur for matters such as AOCI if securities of the U.S. government, its agencies and government-sponsored entities (such as Fannie Mae and Freddie Mac) and other debt securities, whose values primarily change as a result of changes in benchmark rates, are included in the proposed capital rules when finalized. The restrictions on capital distributions and executive bonus compensation would become applicable on January 1, 2016. No restrictions would apply to institutions possessing a Buffer in excess of 100% of the requirement. However, all capital distributions and bonus compensation would be prohibited if the institution possesses 25% or less of the required amount of Buffer. Otherwise, the applicable percentage of "Eligible Retained Income" available for capital distributions and executive bonus compensation would be as follows:

| Amount of Limitation | % of Required Buffer Amount |
|---|---|
| 60% of Eligible Retained Income | More than 75% up to 100% |
| 40% of Eligible Retained Income | More than 50% up to 75% |
| 20% of Eligible Retained Income | More than 25% up to 50% |

"Eligible Retained Income" is proposed to be defined as net income for the four calendar quarters preceding the current calendar quarter, net of any capital distributions, certain discretionary bonus payments, and associated tax effects not already reflected in net income. The maximum payout amount for the current calendar quarter would be equal to Eligible Retained Income multiplied by the applicable maximum payout ratio. A "capital distribution" would be defined as (i) a reduction of Tier 1 capital through the repurchase of a Tier 1 capital instrument; (ii) a reduction of Tier 2 capital through the repurchase, or redemption prior to maturity, of a Tier 2 capital instrument; or (iii) a dividend declaration on any Tier 1 capital instrument; (iv) a dividend declaration or interest payment on any Tier 2 capital instrument if such dividend declaration or interest payment may be temporarily or permanently suspended at the discretion of the banking organization; or (v) any similar transaction deemed to be a distribution of capital. The term "discretionary bonus payment" would include a payment made to an executive officer where (i) the banking organization retains discretion as to payment or amount of the payment; (ii) the amount paid is determined without prior promise to, or agreement with, the executive officer; and (iii) the executive officer has no contract right, express or implied, to the bonus payment. An "executive officer" would be defined as a person who holds the title or performs the function of president, chief executive officer, executive chairman, chief operating officer, chief financial officer, chief investment officer, chief legal officer, chief lending officer, chief risk officer, or head of a major business line, and other staff that the board of directors of the banking organization deems to have equivalent responsibility.

[14] Additional Tier 1 capital would be the sum of qualifying Additional Tier 1 capital instruments that satisfy certain criteria, plus related surplus, and Tier 1 minority interests that are not included in Common Equity Tier 1 capital (subject to applicable limitations on minority interests), less applicable regulatory adjustments and deductions. Under existing capital rules, non-cumulative perpetual preferred stock, which currently qualifies as Tier 1 capital, generally would continue to qualify as Additional Tier 1 capital under the proposed rules. However, trust preferred securities and cumulative perpetual preferred securities that are eligible for limited inclusion in Tier 1 capital under existing capital rules for bank holding companies would generally not qualify for inclusion in Additional Tier 1 capital (*but see* note 16). In addition, the Basel NPR notes that "some banking organizations may want or need to limit their capital distributions during a particular payout period, but may opt to pay a penny dividend instead of fully cancelling dividends to common shareholders because certain institutional investors only hold stocks that do not pay a dividend." In that regard, in order to increase the loss absorption capacity of Additional Tier 1 capital instruments, the bank regulatory agencies are soliciting comments on a proposal to add a requirement for Additional Tier 1 capital that the banking organization have the right to cancel or substantially reduce dividend payments on those instruments when the bank is paying a penny dividend to its common shareholders.

[15] Capital investments by the U.S. government included in the Tier 1 and Tier 2 capital of banking organizations issued under the Small Business Jobs Act of 2010 or, prior to October 4, 2010, under the Emergency Economic Stabilization Act (for example, Tier 1 instruments issued under the TARP program) would be grandfathered permanently.

[16] Non-qualifying capital instruments issued before September 12, 2010, that were outstanding as of January 1, 2013, such as cumulative perpetual preferred stock and trust preferred securities, may be included in capital up to the percentage shown of the outstanding principal amount of such non-qualifying capital instruments as of January 1, 2013. Under the Basel NPR, the remaining balance of non-qualifying instruments would be further reduced in annual 10% increments until fully phased out in 2022.

[17] Tier 2 capital would be the sum of Tier 2 capital instruments that satisfy certain criteria, related surplus, total capital minority interests not included in Tier 1 capital (subject to certain limitations and requirements on minority interests), and limited amounts of the allowance for loan and lease losses ("ALLL"); less any applicable regulatory adjustments and deductions. Although trust preferred securities and cumulative perpetual preferred securities would not qualify for inclusion in Additional Tier 1 capital, many of these instruments could qualify for inclusion in Tier 2 capital under the proposed eligibility criteria. Further, under the proposal, unlike current rules there would be no limit on the amount of Tier 2 capital that could be included in a banking organization's total capital, subject to the phase-out schedule shown.

[18] Since, as proposed, unrealized gains and losses on AFS securities would flow through to Common Equity Tier 1 capital (*see* note 4), the Basel NPR proposes to eliminate the inclusion of a portion of certain unrealized gains on AFS equity securities in Tier 2 capital.