Important Information About Q2 Call Report Filings: Avoid Capital Calculations Errors

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This QwickViews article contains pertinent information for banks about Basel III credit calculations prepared for the first quarter 2015 Call Report. The calculations may well have contained inadvertent errors and discrepancies if the Q1 filings were based on the instructions document posted on the FFIEC website through the latter part of March. That document contained inaccurate calculation instructions for certain line items. While the instructions were corrected in the FFIEC's current document, which was posted on its website in early April, the miscalculations could have negative implications for the affected banks and should be corrected for Q2 filings.

Discovering the Discrepancies

We discovered the discrepancies in instructions while working on the new Basel III-compliant Capital Planning tool that will be in our Credit Stress Test, and we contacted the FFIEC to discuss our findings and questions. When significant miscalculations began showing up in the Call Report data we were analyzing, we realized that some of the errors likely occurred because banks were using the old draft of the FFIEC instructions, rather than the current correct version. It also became clear that some errors might have occurred because the new regulatory capital sections of the report are more complicated than those used prior to the BASEL III implementation.

The filing instructions reflected that complexity. Changes and corrections were being made to them even as many banks were using the draft instructions to prepare their Call Reports. And when the FFIEC posted its finalized version in early April, some banks may not have been aware that new instructions were (and are) available for preparing their Q2 Call Report filing. Just as important, many banks that relied on the older instructions draft might be making critical banking decisions based on faulty capital calculations.

Addressing the Situation

To help affected banks remedy their situations – and as a service to our subscribers – we're providing information in this QwickViews article that's designed to:

- Help you confirm that you didn't make certain errors in your Q1 Call Report
- Simplify the process if certain corrections are required due to reliance on pre-finalized instructions
- Point out schedule issues that have been problematic for other banks, so you can be aware of them as you file your Q2 Call Report

About *the Author:*

Steve's expertise in the financial analysis of community banks and thrifts has been central to the development of QwickRate's analytic tools, as he works with our members to provide them with more effective and efficient ways to manage their institutions. He has spent his 14-year career working solely with community financial institutions, both public and private, across the United States. Steve's experience in the industry has been focused on Strategic Planning, Valuation-related Services, Shareholder Relations, M&A Advisory, and Capital Planning. He currently holds the series 7, 63 & 79 licenses. Steve earned a BS degree in business administration from Wake Forest University.

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Two Areas of Particular Concern

The shift to Basel III capital calculations for Q1 2015 created changes in Call Report filing requirements – and a considerable a learning curve for the industry. For example, banks had to become familiar with a new regulatory capital section (Schedule RC-R) that includes:

- An entirely new segment of capital, Common Equity Tier 1 (CET1)
- Completely revamped set of rules addressing myriad elections, deductions and exemptions
- Transitional phase-in provisions that can affect each line item in a multitude of ways

As a result, two of the most prevalent discrepancies and changes in the instructions have affected a significant number of our QwickRate bank subscribers. In the paragraphs below we've provided more information about these particular line-item topics.

1. DEFERRED TAX ASSETS (DTAs)

Prior to the implementation of Basel III rules, certain types of DTAs were fully deducted from Tier 1 Capital in the Regulatory Capital schedule. The treatment of DTAs is now more complicated in the new RC-R Part 1, and the DTA calculations will change as a deduction is phased in over a four-year period.

What's required:

- For 2015, 40% of the full amount of DTAs that apply for this line item should be recognized in line item 8 ("LESS: Deferred tax assets that arise from net operating loss and tax credit carryforwards…") in Common Equity Tier 1 Capital ("CET1").
- The remaining 60% of the full amount of DTAs should be entered into Additional Tier 1 capital in line item 24 ("LESS: additional Tier 1 capital deductions").

Correct, detailed instructions:

(from the FFIEC document posted in early April and currently online)

8 **LESS: Deferred tax assets (DTAs) that arise from net operating loss and tax credit carryforwards, net of any related valuation allowances and net of DTLs.** Report the amount of DTAs that arise from net operating loss and tax credit carryforwards, net of associated valuation allowances and net of associated DTLs.

Transition provisions:

(i) Determine the amount as described in the instructions for this item 8.
(ii) Multiply the amount in (i) by the appropriate percent in column A of Table 4 below. Report this product in Schedule RC-R, item 8.
(iii) Multiply the amount in (i) by the appropriate percent in column B of Table 4 below. Report this product as part of Schedule RC-R, item 24, "Additional tier 1 capital deductions."

Table 4 – Deductions of DTAs that arise from net operating loss and tax credit carryforwards, net of any valuation allowances and net of DTLs; gain-on-sale; defined benefit pension fund assets; changes in fair value of liabilities; and expected credit losses during the transition period

Transition period	Column A: Percentage of the adjustment applied to common equity tier 1 capital	Column B: Percentage of the adjustment applied to tier 1 capital
Calendar year 2015	40	60
Calendar year 2016	60	40
Calendar year 2017	80	20
Calendar year 2018 and thereafter	100	0

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- Here's where it gets tricky. If the institution doesn't have sufficient Additional Tier 1 Capital to absorb this deduction, the remainder gets thrown back with the deductions from Common Equity Tier 1 Capital, but not in line item 8. It should be entered in line item 17, with the deductions from Common Equity Tier 1 Capital. ("LESS: Deductions applied to common equity tier 1 capital due to insufficient amounts of additional tier 1 capital and tier 2 capital to cover deduction").

Correct, detailed instructions:
(from the FFIEC document posted in early April and currently online)

> Note for Table 4: An institution may only take a deduction from additional tier 1 capital up to the amount of tier 1 capital that the institution has. For example, if an institution does not have any additional tier 1 capital, then all of the above deduction amount will be from common equity tier 1 capital. In this case, report the amount in item 24 and also include it in item 17 "LESS: Deductions applied to common equity tier 1 capital due to insufficient amounts of additional tier 1 capital and tier 2 capital to cover deductions."

Opportunities for error:

1) Many banks may have mistakenly entered all applicable DTAs into line item 8 (as they had correctly done prior to Basel III).
2) An error in the draft instructions posted prior to April caused banks to calculate this item incorrectly, thus leading them to enter an incorrect value.

Potential implications:
In many cases, these mistakes would result in a relatively minor error with negligible consequences. However, for some banks, the mistakes could result in a misrepresentation of CET1 capital and perhaps even a change in PCA status, which could have significant, wide-ranging implications for the institution.

2. THRESHOLD ITEMS FOR CET1 CAPITAL DEDUCTION

Another prominent filing error that appeared in banks' Q1 Call Reports occurred in line item 16 of the Regulatory Capital schedule – the aggregate 15% Common Equity Tier 1 Capital threshold deduction. This is a complicated item to understand; the instruction document devotes four full pages to calculating this single line item.

What's required:

- Given the amount of complexity involved in this portion of the Regulatory Capital schedule, banks should review the updated instructions for line item 16, paying special attention to the treatment of a negative number.

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Correct, detailed instructions (partial):

(from the FFIEC document posted in early April and currently online)

16 **<u>LESS: Amount of significant investments in the capital of unconsolidated financial institutions in the form of common stock, net of associated DTLs; MSAs, net of associated DTLs; and DTAs arising from temporary differences that could not be realized through net operating loss carrybacks, net of related valuation allowances and net of DTLs; that exceeds the 15 percent common equity tier 1 capital deduction threshold.</u>**

The aggregate amount of the threshold items (that is, significant investments in the capital of unconsolidated financial institutions in the form of common stock, net of associated DTLs; MSAs, net of associated DTLs; and DTAs arising from temporary differences that could not be realized through net operating loss carrybacks, net of related valuation allowances and net of DTLs) may not exceed 15 percent of the institution's common equity tier 1 capital, net of applicable adjustments and deductions (the 15 percent common equity tier 1 capital deduction threshold).

<u>Transition provisions:</u>

A. *For report dates until January 1, 2018*, calculate this item 16 as follows:
   (i) Calculate the aggregate amount of the threshold items before deductions:
      a. Significant investments in the capital of unconsolidated financial institutions in the form of common stock net of associated DTLs (Schedule RC-R, item 13, step 1);
      b. MSAs net of associated DTLs (Schedule RC-R, item 14, step 1); and
      c. DTAs arising from temporary differences that could not be realized through net operating loss carrybacks net of any related valuation allowance and net of DTLs (Schedule RC-R, item 15, step 1).
   (ii) Multiply the amount in Schedule RC-R, item 12 (Subtotal) by 15 percent. This is *the 15 percent common equity deduction threshold for transition purposes*.
   (iii) Sum up the amounts reported in Schedule RC-R, items 13, 14, and 15 (as if those items were fully phased in).
   (iv) Deduct (iii) from (i).
   (v) Deduct (ii) from (iv). If this amount is negative, enter zero in this item 16.
   (vi) Multiply the amount in (v) by the percentage in Table 6 in the instructions for Schedule RC-R, item 13. Report the resulting amount in this item 16.

Opportunities for error:

1) The draft instructions posted prior to April indicated improper steps for making the calculation for *line item 16*.

2) Most importantly, the instructions posted prior to April also failed to direct the banks to enter $0 for this item if the amount is a negative number.

<u>Potential implications:</u>

Banks following the draft instructions posted prior to April could have easily entered a negative value in line item 16 for their 15% aggregate threshold deduction. This error would have caused the following values and ratios to be overstated:

- CET1
- Total Tier 1 Capital
- Total Regulatory Capital

Therefore, all regulatory capital levels could potentially be misrepresented as a result of the error. Fortunately, our analysis shows that this error was not as prevalent as the DTA deductions error discussed above.

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What's Next?

Although we anticipate that many banks will correct these errors in their second quarter Call Report filings, there is a possibility that some institutions may not be aware of the updated instructions and the potential for errors when preparing their reports. For that reason, we wanted to share what we learned about the discrepancies in the instruction documents and to clarify what's needed to correct some of the most critical common errors revealed in our analysis.

- To view the correct instructions to use for your Q2 filing, download the FFIEC document Instructions for Preparation of Consolidated Reports of Condition and Income (FFIEC 031 and 041) at https://www.ffiec.gov/pdf/FFIEC_forms/FFIEC031_FFIEC041_201503_i.pdf

  and an additional partial instructions manual update for Q2 published in June https://www.ffiec.gov/pdf/FFIEC_forms/FFIEC031_FFIEC041_201506_i_updates.pdf

- For further clarification about the calculations, requirements and information discussed here, and for help with Basel III capital calculations, call QwickRate at 800.285.8626 or email **sales@qwickrate.com**

- To simplify compliance with Basel III Capital Planning rules, learn about the newest feature in our QwickAnalytics™ Credit Stress Test: The Capital Planning Tool. You'll be able to automatically measure your capital needs and easily present and communicate the information to directors in a clear and professional format. Call 800.285.8626 or email **sales@qwickrate.com** for more information

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