Your Bank Name & LOGO

January 01, 2022

Sample
Document

Capital Plan

Fiscal year ending month DD, YYYY
Prepared Month DD, YYYY

Capital Plan for Fiscal Year Ending *Month DD, YYYY*
Prepared *Month DD, YYYY*

Contents

Scope of Document 2
Executive Summary 3
Capital Ratios 4
Key Risk Indicators 5
Other Risks 6
Dividends and Other Capital Actions 7
Contingency Actions 7
Policies & Procedures 8
Holding Company 9
References 9

Scope of Document

Use this section to outline what the reach of your bank's capital plan is. You may want to focus on the following:

- Operating Triggers
- Operating Limits
- Operating levels for Key Risk Indicators (KRIs)
- Introducing a summary of your dividend policy (if applicable)
- Introducing the concept of contingency action planning

You should not go into detail on each of these items. Instead, use this section to summarize the bank's approach to capital planning. You may also answer these questions in this section:

- What is a "Trigger"?

Example Text:

"Triggers are designed to serve as early warning indicators well before capital declines to harmful levels. If the Bank breaches a trigger, Management must outline the breach to the Board of Directors. Management should also indicate whether the breach is temporary in nature or if action is required."

- What is a "Limit"?

Example Text:

"Limits are policy thresholds that *require* that the board is informed. Curative measures *must be taken* to address breaches of any limit."

- What happens when a Trigger or Limit is breached?
- How is this information reported to the board (if at all)?

You may also reference any other documentation that the bank used in building the capital plan:

- The Strategic Plan
- Stress Testing
- ALM
- Etc.

These documents should *not be in your capital plan*. Instead, save these for your references section at the end and provide them if they are needed/requested.

Executive Summary

This is a place where many institutions spend far too much time. You should use the summary section for a *high level* summary – the history of your institution, the culture, and what you had for lunch may be interesting discussion topics, but they likely *don't* belong in your capital plan.

Instead, give an outline for how you're planning to navigate the upcoming year (or two depending on how long this capital plan is meant to apply). What are some of the risks that you foresee that will be relevant for your bank. Outline your weaknesses – don't hide from them (we'll use a later section to show how we're managing those weaknesses). Outline your strengths!

Example Text 1:

"The Bank's sensitivity to deposit cost movements provides for a challenge as interest rates continue to rise in the next year. We expect that earnings may experience some pressure from the external environment and will navigate the rate environment as effectively as possible. However, given the bank's strong existing capital position, we don't expect to experience significant distress from a capital perspective."

Example Text 2:

"The Bank's primary lending focus is in Commercial Real Estate with a particular emphasis on residential construction. As a result, the current construction concentration is 143% and CRE concentration is 312%. The bank intends to continue to pursue growth within these sectors and will utilize the capital plan to help monitor the expanding concentration risks."

While the executive summary will vary in length from institution to institution, a good rule of thumb is that this section should not be longer than 1 or 2 pages. Sticking to this rule will force you to narrow the executive summary to *what's really relevant today* for your institution.

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Capital Ratios

The banking capital ratios should be familiar to you, but in this section you should work to relate the capital ratios to the "Limits" and "Triggers". You should also use your stress testing process to arrive at these capital levels. Below is an example table for how this might look:

Capital Ratio Limits and Triggers			*This should come from your bank's stress testing program! Remember stress testing is a primary tool for capital planning!*	*Add the Adequately Capitalized level and the Stress Capital Buffer together to customize your capital limits.*	*Set your trigger level with cushion above the internal Limit to provide for sufficient early warning of any problems.*
Capital Ratios	Adequately Capitalized (PCA)	Reported Level	Stress Capital Buffer	Internal Limit	Trigger
Leverage Ratio	4.0%	9.2%	3.8%	7.8%	8.6%
Common Equity Tier 1 Ratio	4.5%	10.8%	4.2%	8.7%	9.5%
Tier 1 Risk-Based Ratio	6.0%	10.8%	4.2%	10.2%	11.0%
Total Risk-Based Capital Ratio	8.0%	13.8%	5.2%	13.2%	14.0%

You should pay particular attention to the "Stress Capital Buffer." This is the same methodology used by the Federal Reserve in the CCAR program (an annual stress testing program of the largest bank's in the country). Although you likely aren't subject to CCAR, you should leverage these techniques in your capital planning!

The "Total Risk-Based Capital Ratio" Trigger is purposefully shown to fall below the Trigger level in the graphic above. Some sample text for what this might mean in the capital plan is provided below:

Example Text:

"Although the Bank's Total Risk-Based Capital ratio has fallen below the Trigger level, Management is confident that the continued earnings profile of the institution will quickly correct any temporary issues. At this point, no curative action is required."

In some cases, with particularly strong stress performance, you may find that the "Stress Capital Buffer" is not sufficient to generate passable capital Limits. In these cases, it is common to utilize the "Capital Conservation Buffer" from the Basel III framework, or a "Well-Capitalized" framework to control the bank's capital ratios within the capital plan. Regardless of the approach, we still recommend that you perform a capital stress test to verify the appropriate response.

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Key Risk Indicators

The other key risks that should be included within a capital plan will vary by institution. Common metrics include (but are certainly not limited to):

- Classified Assets to Total Capital Ratio
- FFIEC CRE Concentration
- FFIEC Construction Concentration
- Other Concentrations (Regions, products, etc.)
- Liquidity Coverage Ratio (LCR)
- Cash and Securities to Total Assets
- Top 10 Depositor Concentration
- Other Deposit Concentrations
- Etc.

One critical piece of advice for this section is to *quantify as many of these KRIs as your reasonably can*. How much CRE Concentration is too much? When does the Bank's Classified Assets Ratio indicate a problem? It is far too common that these KRI levels are set arbitrarily. While this doesn't necessarily make them *wrong* it does open the door for increased scrutiny that could otherwise be avoided. The primary thing that makes these other KRIs tricky to measure in the capital plan is that there are no 'regulatory minimums' so the bank will be left to its own devices to quantify them.

Below is an example of how you might quantify some of these KRIs:

Other Key Risk Indicators

Capital Ratios	Reported Level	Stress Tested Limit*	Limit	Trigger
CRE Concentration	315.0%	397%	395%	375%
Construction Concentration	132.0%	176%	175%	150%
Classified Assets/Total Capital	4.2%	74%	65%	25%

*Example provided on the next page

Notice that the Limit is set very closely to the "stress tested limit." This is no coincidence – the stress testing framework can and should be utilized to monitor other KRIs as well (even beyond capital ratios). Here is how the stress tested limit for CRE Concentration might be explained:

Example Text:

"The Bank has tested its maximum level of CRE Concentration by simulating a stress scenario with aggressive CRE growth. By adding loans to the balance sheet, and evaluating the post-stress capital levels, the bank was able to establish that at a CRE Concentration level of 397%, the Total Risk-Based Capital Ratio is exactly 13.2%. Based on the Internal Limit above for the Total Risk-Based Capital Ratio, this is the maximum allowable CRE Concentration within the Capital Plan. The CRE Limit is placed at 395% because of this analysis."

Not The same type of analysis can be performed for the construction KRI as well as the Classified Assets/Total Capital KRI. Additional KRIs can be simulated in the same way in an effective and comprehensive stress testing framework that is supportive of capital planning.

Finally, some KRIs will not be 'testable' in this way via the stress test, but may be evaluated using other techniques such as liquidity testing (LCR and others), Asset-Liability modeling, etc.

Other Risks

In addition to risks relating to capital, credit, and markets, your institution may want to carve out a section of the capital plan to address other (less quantifiable) important risks. Use this section to provide clarity to the reader on risks such as:

- Operational risks
- Cybersecurity risks
- Strategic risk
- Fraud risk
- Etc.

Although these risks can be difficult to calculate, it is still important to include them as relevant risks to the bank's capital levels. A general recognition of these risks and how management will relate the ongoing monitoring of these risks to the board should be in any effective capital plan.

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Dividends and Other Capital Actions

This section is straightforward. Outline your anticipated dividend payments (if any). You should also include any significant planned capital actions that will either utilize the bank's capital or buffer the bank's capital. Think of this section as your capital "sources and uses" section.

Contingency Actions

No capital plan is complete without an exploration of possible curative measures. It's great to outline the 'guardrails' for how you plan to protect bank capital, but it isn't the whole story. This section is dedicated to one simple question:

"How will management address and correct any policy issues that emerge?"

We always recommend that you include a list of possible contingency actions along with a designation on how 'difficult' management expects that action to be in the event of significant distress. Below is an example (this list is not exhaustive):

Contingency Action Summary

Action	Rationale (Expected Result)	Degree of Difficulty
Reduced Loan Growth	Slowing the trajectory of the planned growth will allow for earnings to 'catch up' to the growing balance sheet - ultimately increasing capital levels. This would primarily be useful in addressing capital levels but is limited by the structure of the loan portfolio and prepayment expectations.	Low
Complete Deleverage	Originating *no new loans* will significantly reduce the size of the institution over time. This should buffer capital as well, but may be too slow depending on the nature of the capital shortfall vs. the Limits and Triggers.	Medium
Sell Securities/Loans	Selling securities should reduce the sensitivy to the market and further improve liquidity. However, if securities are sold at a loss due to market conditions this may adversely impact regulatory capital levels. May have to be paired with one of the other actions above.	High
Etc.		

Finally – the *best thing you can do in this section is to test the effectiveness of these contingency actions*. You can do so by utilizing your stress testing (for capital), ALM (for liquidity), or any other framework. Simulate these actions and verify that they address the targeted shortfall. Be sure to summarize these tests and their results in your capital plan. Below is an example that shows how the contingency action of "Reduced Loan Growth" and "Deleverage" addresses the Total Risk-Based Capital breach of the Threshold:

Contingency Testing

Capital Ratio	Reported Level	Threshold	Shortfall
Total Risk-Based Capital Level	13.8%	14.0%	**-0.2%**

Action	New Capital Level	Threshold
Reduced Loan Growth	14.1%	14.0%
Deleverage	14.9%	14.0%

Demonstrating that the reduced loan growth and/or deleverage contingency actions push the capital ratio above the breached Threshold is a useful exercise, even if Management is not *bound to correct a Threshold breach within the capital plan*.

Policies & Procedures

This section will cover topics like who is responsible for the capital planning document, how often it should be report, how often it should be updated, etc. These policies will vary *significantly* by the size and complexity of your institution, but should look something like this:

Example Text:

- *The CFO is responsible for maintaining the capital plan and preparing reports for purposes of ongoing monitoring.*
- *Management agrees to provide the Board with a dashboard that shows all KRIs and capital ratios as of the end of each quarter at one of the board meetings during the following quarter.*
- *In the event of a breach of any trigger, Management will make a recommendation to the Board on whether the breach is temporary or if interventive action is required. If action is required, Management will recommend to the Board what those specific actions would be and how long such actions may take to rectify the breach.*
- *In the event of a breach of any limit, Management will make a recommendation to the Board on what specific actions should be pursued and how long such actions may take to rectify the breach.*
- *The capital plan can be amended at any time, but all amendments require the approval of the Board.*
- *The Capital Plan expires at the end of the fiscal year on Month DD, YYYY. Management will present a new capital plan for board approval for the fiscal year ending Month DD, YYYY prior to expiration of the prior fiscal year's Capital Plan. The new capital plan may include adjustments to the triggers and limits which reflect changes in the risk assessment at that point in time.*

Notice the particular emphasis on:

1. Frequency
    a. How often should the bank's Capital Ratios and KRIs be evaluated against the capital plan's Triggers and Limits?
    b. How often should the bank's Triggers and Limits be *re-evaluated and reset* within the Capital Planning framework.
2. Board Involvement
    a. You want to provide the board with an effective means of monitoring bank capital within the capital plan.
    b. You *don't* want to write your capital plan document in such a way that, should adverse conditions arise, Management is handcuffed by board involvement and approval.

Holding Company

Regardless of whether your institution is required to report holding company financials, you should at least consider the impact of significant capital actions on the holding company. Larger institutions should consider adding a "Bank" and "Holding Company" subsection to each of the Capital Ratios, KRIs, Other Risks, Dividend Policies, and Contingency Actions sections above.

References

As stated, the capital plan is not a thesis. It should only be as long as it needs to be. Resist the urge to include other modeling document findings within the capital plan. Instead, extract the major conclusions and build Limits and Triggers for your capital plan. Reference the additional work in this final section for those that need to dig deeper into how you constructed your capital plan.