

EAST WEST BANCORP INC  
Form 10-K  
March 02, 2015

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-K

Mark One

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE  
ACT OF 1934

For the fiscal year ended December 31, 2014

or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE  
ACT OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_.

Commission file number 000-24939

EAST WEST BANCORP, INC.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of incorporation or  
organization)

135 North Los Robles Ave., 7th Floor, Pasadena,  
California

(Address of principal executive offices)

95-4703316

(I.R.S. Employer Identification No.)

91101

(Zip Code)

Registrant's telephone number, including area code:

(626) 768-6000

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, \$0.001 Par Value	NASDAQ "Global Select Market"

Securities registered pursuant to Section 12(g) of the Act:

NONE

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of the Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer	<input checked="" type="checkbox"/>	Non-accelerated filer	<input type="checkbox"/>
Accelerated filer	<input type="checkbox"/>	Smaller reporting company	<input type="checkbox"/>

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

The aggregate market value of the registrant's common stock held by non-affiliates was approximately \$4,967,770,786 (based on the June 30, 2014 closing price of Common Stock of \$34.99 per share).

As of January 31, 2015, 143,583,710 shares of East West Bancorp, Inc. of Common Stock were outstanding.

**DOCUMENT INCORPORATED BY REFERENCE**

Portions of the registrant's definitive proxy statement relating to its 2015 Annual Meeting of Stockholders, are incorporated by reference into Part III.

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EAST WEST BANCORP, INC.  
 2014 ANNUAL REPORT ON FORM 10-K  
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PART I

Certain matters discussed in this Annual Report contain or incorporate statements that East West Bancorp, Inc. (the “Company”) believes are “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933, as amended, and Rule 175 promulgated thereunder, and Section 21E of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), and Rule 3b-6 promulgated thereunder. These statements relate to the Company’s financial condition, results of operations, plans, objectives, future performance or business. They usually can be identified by the use of forward-looking language, such as “likely result in,” “expects,” “anticipates,” “estimates,” “forecasts,” “projects,” “intends to,” or may include other similar words or phrases, such as “believes,” “plans,” “trend,” “objective,” “contingent,” “remain,” or similar expressions, or future or conditional verbs, such as “will,” “would,” “should,” “could,” “may,” “might,” “could,” or similar verbs. You should not place undue reliance on these statements, as they are subject to risks and uncertainties, including, but not limited to, those described in the documents incorporated by reference. When considering these forward-looking statements, you should keep in mind these risks and uncertainties, as well as any cautionary statements the Company may make. Moreover, you should treat these statements as speaking only as of the date they are made and based only on information then actually known to the Company.

There are a number of important factors that could cause future results to differ materially from historical performance and these forward-looking statements. Factors that might cause such a difference include, but are not limited to:

- our ability to achieve the projected synergies of the MetroCorp Bancshares, Inc. (“MetroCorp”) acquisition;
- changes in our borrowers’ performance on loans;
- changes in the commercial and consumer real estate markets;
- changes in our costs of operation, compliance and expansion;
- changes in the U.S. economy, including inflation;
- changes in government interest rate policies;
- changes in laws or the regulatory environment;
- changes in the economy of and monetary policy in the People’s Republic of China;
- changes in critical accounting policies and judgments;
- changes in accounting policies or procedures as may be required by the Financial Accounting Standards Board or other regulatory agencies;
- changes in the equity and debt securities markets;
- changes in competitive pressures on financial institutions;
- effect of additional provision for loan losses;
- effect of government budget cuts and government shut down;
- fluctuations of our stock price;
- success and timing of our business strategies;
- impact of reputational risk created by these developments on such matters as business generation and retention, funding and liquidity;
- impact of potential federal tax increases and spending cuts;
- impact of adverse judgments or settlements in litigation against the Company;
- changes in our ability to receive dividends from our subsidiaries; and
- impact of political developments, wars or other hostilities which may disrupt or increase volatility in securities or otherwise affect economic conditions.

For a more detailed discussion of some of the factors that might cause such differences, see “ITEM 1A. RISK FACTORS” presented elsewhere in this report. The Company does not undertake, and specifically disclaims any obligation to update any forward-looking statements to reflect the occurrence of events or circumstances after the date of such statements, except as required by law.



## ITEM 1. BUSINESS

### Organization

East West Bancorp, Inc. East West Bancorp, Inc. (referred to herein on an unconsolidated basis as “East West” and on a consolidated basis as the “Company” or “we”) is a bank holding company incorporated in Delaware on August 26, 1998 and registered under the Bank Holding Company Act of 1956, as amended (“BHCA”). The Company commenced business on December 30, 1998 when, pursuant to a reorganization, it acquired all of the voting stock of East West Bank, or the “Bank”. The Bank is the Company’s principal asset. In addition to the Bank, the Company has six other subsidiaries established as statutory business trusts as of December 31, 2014 (the “Trusts”) and one subsidiary that provides business and consumer insurance services. The Trusts were set up for the purpose of issuing junior subordinated debt to third party investors.

East West’s principal business is to serve as a holding company for the Bank and other banking or banking-related subsidiaries which East West may establish or acquire. East West has not engaged in any other activities to date. As a legal entity separate and distinct from its subsidiaries, East West’s principal source of funds is, and will continue to be, dividends that may be paid by its subsidiaries. East West’s other sources of funds include proceeds from the issuance of its common stock in connection with stock option and employee stock purchase plans. As of December 31, 2014, the Company had \$28.74 billion in total consolidated assets, \$21.51 billion in net consolidated loans, and \$24.01 billion in total consolidated deposits.

The principal office of the Company is located at 135 N. Los Robles Ave., 7th Floor, Pasadena, California 91101, and the telephone number is (626) 768-6000.

East West Insurance Services, Inc. On August 22, 2000, East West completed the acquisition of East West Insurance Services, Inc. (the “Agency”) in a stock exchange transaction. The Agency provides business and consumer insurance services primarily to the Southern California market. The Agency runs its operations autonomously from the operations of the Company. The operations of the Agency are limited and are not deemed material in relation to the overall operations of the Company.

East West Bank. East West Bank was chartered by the Federal Home Loan Bank Board in June 1972, as the first federally chartered savings institution focused primarily on the Chinese-American community, and opened for business at its first office in the Chinatown district of Los Angeles in January 1973. From 1973 until the early 1990’s, the Bank conducted a traditional savings and loan business by making predominantly long-term, single-family and multifamily residential loans and commercial real estate (“CRE”) loans. These loans were made principally within the ethnic Chinese market in Southern California and were funded primarily with retail savings deposits and advances from the Federal Home Loan Bank (“FHLB”) of San Francisco. The Bank has emphasized commercial lending since its conversion to a state-chartered commercial bank on July 31, 1995 and also provides commercial business and trade finance loans for companies primarily located in the U.S.

As of December 31, 2014, the Bank has three wholly owned subsidiaries. The first subsidiary, E-W Services, Inc., is a California corporation organized by the Bank in 1977. E-W Services, Inc. holds property used by the Bank in its operations. The second subsidiary, East-West Investments, Inc., primarily acts as a trustee in connection with real estate secured loans. The remaining subsidiary is East West Bank (China) Limited.

On November 6, 2009, the Bank acquired United Commercial Bank (“UCB”), a California state-chartered bank headquartered in San Francisco, California. Under the terms of the UCB Purchase and Assumption Agreement, the Bank acquired certain assets of UCB with a fair value of approximately \$9.86 billion and assumed liabilities with a fair value of approximately \$9.57 billion. On June 11, 2010, the Bank acquired certain assets and assumed certain liabilities of Washington First International Bank (“WFIB”), a Washington state-chartered bank headquartered in Seattle, Washington. Under the terms of the WFIB Purchase and Assumption Agreement, the Bank acquired certain assets of WFIB with a fair value of approximately \$492.6 million and liabilities with a fair value of approximately \$481.3 million were assumed. Both of these transactions were Federal Deposit Insurance Corporation (“FDIC”)-assisted acquisitions.

On January 17, 2014, the Bank completed the acquisition of Metrocorp, parent of MetroBank, N.A. and Metro United Bank. MetroCorp, headquartered in Houston, Texas, operated 19 branch locations within Texas and California under its two banks. The Bank acquired MetroCorp to further expand its presence, primarily in Texas, within the markets of

Houston and Dallas, and in California, within the San Diego market. The purchase consideration was satisfied with two thirds in East West stock and one third in cash. Approximately \$1.70 billion of assets were acquired and \$1.41 billion of liabilities were assumed.

The Bank has also grown through strategic partnerships. On August 30, 2001, the Bank entered into an agreement with 99 Ranch Market, the largest Asian focused chain of supermarkets on the West Coast, to provide retail banking services in their stores throughout California. The Bank is currently providing in-store banking services in twelve 99 Ranch Market locations in California.

The Bank continues to develop its international banking capabilities. The Bank's presence includes five full-service branches in Greater China, located in Hong Kong, two in Shanghai including one in the Shanghai Pilot Free Trade Zone, Shantou and Shenzhen. The Bank also has five representative offices in Greater China located in Beijing, Chongqing, Guangzhou, Xiamen and Taiwan. In addition to facilitating traditional letters of credit and trade finance to businesses, these representative offices allow the Bank to assist existing clients, as well as develop new business relationships. Through these offices, the Bank is focused on growing its export-import lending volume by aiding U.S. exporters in identifying and developing new sales opportunities to China-based customers as well as capturing additional letters of credit business generated from China-based exporters through broader correspondent banking relationships.

The Bank continues to explore opportunities to establish other foreign offices, subsidiaries or strategic investments and partnerships to expand its international banking capabilities and to capitalize on the growing international trade business between the United States and Asia.

#### Banking Services

East West Bank is the fifth largest independent commercial bank headquartered in California as of December 31, 2014 based on total assets. East West Bank is the largest bank in the United States that focuses on the financial services needs of individuals and businesses which operate both in the United States and Greater China, as well as having a strong focus on the Chinese American community. Through its network of banking locations in the United States and Greater China, the Bank provides a wide range of personal and commercial banking services to small and medium-sized businesses, business executives, professionals, and other individuals. The Bank offers multilingual services to its customers in English, Cantonese, Mandarin, Vietnamese and Spanish. The Bank also offers a variety of deposit products which includes the traditional range of personal and business checking and savings accounts, time deposits and individual retirement accounts, travelers' checks, safe deposit boxes, and MasterCard and Visa merchant deposit services. The Bank's lending activities include commercial and residential real estate, construction, trade finance, and commercial business, including accounts receivable, small business administration ("SBA"), inventory and working capital loans. The Bank generally provides commercial business loans to small and medium-sized businesses. The Bank's commercial borrowers are engaged in a wide variety of manufacturing, wholesale trade and service businesses. In addition, the Bank is focused on providing financing to clients needing a financial bridge that facilitates their business transactions between Asia and the United States.

The Bank's three operating segments: Retail Banking, Commercial Banking and Other are based on the Bank's core strategy. The Retail Banking segment focuses primarily on retail operations through the Bank's branch network. The Commercial Banking segment, which includes commercial and industrial ("C&I") and CRE, primarily generates commercial loans through the efforts of the commercial lending offices located in California, New York, Texas, Washington, Massachusetts, Nevada and Georgia. Furthermore, the Commercial Banking segment also offers a wide variety of international finance and trade services and products. The remaining centralized functions, including the treasury operations of the Company and eliminations of intersegment amounts have been aggregated and included in "Other." For complete discussion and disclosure, see the information in the "Management's Discussion and Analysis of Financial Condition and Results of Operations" ("MD&A") and Note 20 to the Company's consolidated financial statements presented elsewhere in this report.



### Market Area and Competition

The banking and financial services industry in California generally, and in our market areas specifically, is highly competitive. The increasingly competitive environment is primarily a result of changes in laws and regulations, changes in technology and product delivery systems, as well as continuing consolidation among financial services providers. The Bank competes for loans, deposits, and customers with other commercial banks, and other financial services institutions. Some of these competitors are larger in total assets and capitalization and offer a broader range of financial services than the Bank.

The Bank concentrates on marketing its services in the greater Los Angeles metropolitan area and the greater San Francisco Bay area. Greater China and other Pacific Rim countries continue to grow as California's top trading partners. This provides the Bank with an important competitive advantage to its customers participating in the Asia Pacific marketplace. We believe that our customers benefit from our understanding of Asian markets through our physical presence in the Greater China, our corporate and organizational ties throughout Asia, as well as our international banking products and services. We believe that this approach, combined with the extensive ties of our management and Board of Directors to the growing Asian business opportunities as well as the Chinese-American communities, provides us with an advantage in competing for customers in our market area.

### Legislation and Regulatory Developments

#### The Dodd-Frank Wall Street Reform and Consumer Protection Act

The Dodd-Frank Wall Street Reform and Consumer Protection Act financial reform legislation ("Dodd-Frank"), significantly revised and expanded the rulemaking, supervisory and enforcement authority of the federal bank regulatory agencies. The Dodd-Frank followed the Emergency Economic Stabilization Act of 2008 and the American Recovery and Reinvestment Act of 2009 in response to the economic downturn and financial industry instability. Dodd-Frank authorized the creation of the Consumer Financial Protection Bureau ("CFPB") responsible for consumer protection in the financial services industry. Additional initiatives may be proposed or introduced before Congress, the California Legislature and other government bodies in the future. Such proposals, if enacted, may further alter the structure, regulation and competitive relationship among financial institutions and may subject us to increased supervision, disclosure and reporting requirements. In addition, the various bank regulatory agencies often adopt new rules, regulations and policies to implement and enforce existing legislation. It cannot be predicted whether, or in what form, any such legislation or regulatory changes in policy may be enacted or the extent to which the business of the Bank would be affected thereby. In addition, the outcome of examinations, any litigation, or any investigations initiated by state or federal authorities may result in necessary changes to our operations and increased compliance costs.

Dodd-Frank impacts many aspects of the financial industry and will impact larger and smaller financial institutions and community banks differently over time. Many of the key provisions of the Dodd-Frank affecting the financial industry are now either effective or are in the proposed rule or implementation stages.

### Supervision and Regulation

#### General

East West and the Bank are extensively regulated under both federal and state laws. Regulation and supervision by the federal and state banking agencies are intended primarily for the protection of depositors and the Deposit Insurance Fund administered by the FDIC and not for the benefit of stockholders. Set forth below is a brief description of key laws and regulations which relate to our operations. These descriptions are qualified in their entirety by reference to the applicable laws and regulations. The federal and state agencies regulating the financial services industry also frequently adopt changes to their regulations.

#### East West

As a bank holding company, and pursuant to its election of financial holding company status, East West is subject to regulation and examination by the Federal Reserve Board ("FRB") under the BHCA and its authority to:

- require periodic reports and such additional information as the FRB may require;

require the Company to maintain certain levels of capital (see “ITEM 1. BUSINESS — Supervision and Regulation — Capital Requirements”);

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require that bank holding companies, such as the Company, serve as a source of financial and managerial strength to subsidiary banks and commit resources as necessary to support each subsidiary bank. A bank holding company's failure to meet its obligations to serve as a source of strength to its subsidiary banks will generally be considered by the FRB to be an unsafe and unsound banking practice or a violation of FRB regulations or both;

restrict the receipt and the payment of dividends;

terminate an activity or terminate control of or liquidate or divest certain subsidiaries, affiliates or investments if the FRB believes the activity or the control of the subsidiary or affiliate constitutes a significant risk to the financial safety, soundness or stability of any bank subsidiary;

regulate provisions of certain bank holding company debt, including the authority to impose interest ceilings and reserve requirements on such debt and require prior approval to purchase or redeem our securities in certain situations;

require the prior approval of senior executive officer or director changes and prohibit golden parachute payments, including change in control agreements, or new employment agreements with such payment terms, which are contingent upon termination;

approve acquisitions and mergers with banks and consider certain competitive, management, financial and other factors in granting these approvals.

East West may engage in certain nonbanking activities and broader securities, insurance, merchant banking and other activities that are determined to be "financial in nature" or are incidental or complementary to activities that are financial in nature without prior FRB approval pursuant to its election to become a financial holding company. As a bank holding company within the meaning of the California Financial Code, East West is subject to examination by, and may be required to file reports with, the Department of Business Oversight ("DBO"). DBO approvals may also be required for certain mergers and acquisitions.

#### The Bank

As a California state-chartered bank, the Bank is subject to primary supervision, periodic examination, and regulation by the CFPB, DBO, and by the FRB as the Bank's primary federal regulator. The FRB and the DBO also regulate the Bank's foreign operations. These operations are subject to the supervisory authorities of the host countries in which the Bank's overseas offices reside. Specific federal and state laws and regulations which are applicable to banks regulate, among other things, the scope of their business, their investments, their reserves against deposits, the timing of the availability of deposited funds, and the nature and amount of collateral for certain loans. The regulatory structure also gives the bank regulatory agencies extensive discretion in connection with their supervisory and enforcement activities and examination policies.

#### Permissible Activities and Subsidiaries

California law permits state chartered commercial banks to engage in any activity permissible for national banks, unless such activity is expressly prohibited by state law. Therefore, the Bank may form subsidiaries to engage in the many so-called "closely related to banking" or "nonbanking" activities commonly conducted by national banks in operating subsidiaries, and further, pursuant to the Gramm Leach Bliley Act ("GLBA"), the Bank may conduct certain "financial" activities in a subsidiary to the same extent as may a national bank, provided the Bank is and remains "well-capitalized," "well-managed" and in satisfactory compliance with the Community Reinvestment Act ("CRA"). Presently, none of the Bank's subsidiaries are financial subsidiaries.

#### FHLB and Federal Reserve System

The Bank is a member of the FHLB of San Francisco. As an FHLB member, the Bank is required to own a certain amount of capital stock in the FHLB. The Bank may also access FHLB for both short-term and long-term secured borrowing sources. The FRB requires all depository institutions to maintain interest-bearing reserves at specified levels against their transaction accounts. As of December 31, 2014, the Bank was in compliance with these requirements. As a member bank, the Bank is also required to own capital stock in the Federal Reserve Bank.



### Dividends and Other Transfers of Funds

Dividends from the Bank constitute the principal source of income to East West. The Bank is subject to various statutory and regulatory restrictions on its ability to pay dividends. In addition, the banking agencies have the authority to prohibit or limit the Bank from paying dividends, depending upon the Bank's financial condition, if such payment is deemed to constitute an unsafe or unsound practice. Furthermore, under the federal prompt corrective action regulations, the FRB or FDIC may prohibit a bank holding company from paying any dividends if the holding company's bank subsidiary is classified as "undercapitalized." For more information, see "Capital Requirements" below. It is FRB's policy that bank holding companies should generally pay dividends on common stock only out of income available over the past year, and only if prospective earnings retention is consistent with the organization's expected future needs and financial condition. It is also FRB's policy that bank holding companies should not maintain dividend levels that undermine the company's ability to be a source of strength to its banking subsidiaries. Additionally, in consideration of the current financial and economic environment, the FRB has stated that bank holding companies should carefully review their dividend policy and has discouraged payment ratios that are at maximum allowable levels unless both asset quality and capital are very strong.

### Capital Requirements

Bank holding companies and banks are subject to various regulatory capital requirements administered by state and federal banking agencies. The regulatory agencies' risk-based capital guidelines are based upon the 1988 capital accord ("Basel I") of the International Basel Committee on Bank Supervision ("Basel Committee"). This is a committee of central banks and bank supervisors/regulators from the major industrialized countries that develops broad policy guidelines that each country's supervisors can use to determine the supervisory policies they apply to their home jurisdiction. The federal banking agencies have adopted risk-based minimum capital adequacy guidelines for bank holding companies and banks, which are intended to provide a measure of capital that reflects the degree of risk associated with a banking organization's operations for both transactions reported on the balance sheet as assets and transactions which are recorded as off-balance sheet items. The risk-based capital ratio is determined by classifying assets and certain off-balance sheet financial instruments into weighted categories, with higher levels of capital being required for those categories perceived as representing greater risk. Bank holding companies and banks engaged in significant trading activity may also be subject to the market risk capital guidelines and be required to incorporate additional market and interest rate risk components into their risk-based capital standards.

Under the current Basel I capital adequacy guidelines, a banking organization's total capital is divided into tiers. "Tier I capital" currently includes common equity and trust preferred securities, is subject to certain criteria and quantitative limits. Under Dodd-Frank, depository institution holding companies, such as the Company, with more than \$15 billion in total consolidated assets as of December 31, 2009, will no longer be able to include trust preferred securities as Tier I regulatory capital at the end of a three-year phase-out period in 2016, and may be obligated to replace any outstanding trust preferred securities issued prior to May 19, 2010, with qualifying Tier I regulatory capital during the phase-out period. Tier II capital includes hybrid capital instruments, other qualifying debt instruments, a limited amount of the allowance for loan and lease losses and a limited amount of unrealized holding gains on equity securities. Following the phase-out period under Dodd-Frank, trust preferred securities will be treated as Tier II capital, subject to certain limits and qualifications. The risk-based capital guidelines require a minimum ratio of qualifying total risk-based capital of 8.0% and a minimum ratio of Tier I risk-based capital of 4.0%. An institution is defined as well capitalized if its total risk-based capital ratio is 10.0% or more; its Tier 1 risk-based capital ratio is 6.0% or more; and its Tier 1 leverage ratio is 5.0% or more. Bank holding companies and banks are also required to comply with minimum leverage ratio requirements. The leverage ratio is the ratio of the bank holding company or banking organization's Tier I capital to its total adjusted quarterly average assets (as defined for regulatory purposes). Holding companies and banks are required to maintain a minimum Tier 1 leverage ratio of 4.0%, unless a different minimum is specified by an appropriate regulatory authority. For a depository institution to be considered "well capitalized" under the regulatory framework for prompt corrective action, its Tier 1 leverage ratio must be at least 5.0%. Basel I was replaced by the Basel Committee's new Basel III capital framework effective January 1, 2015, as described in the next section.

As of December 31, 2014, the Company's and the Bank's capital ratios exceeded the minimum capital adequacy guideline percentage requirements of the federal banking agencies for "well capitalized" institutions. For complete discussion and disclosure see "Management's Discussion and Analysis of Financial Condition and Results of Operations — Risk-Based Capital" and Note 19 to the Company's consolidated financial statements presented elsewhere in this report.

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In December 2010, the Basel Committee released its final framework for strengthening international capital and liquidity regulation, now officially identified as “Basel III.” Basel III is designed to significantly enhance the original regulatory capital framework under Basel I. In July 2013, the FRB approved final rules implementing Basel III and certain changes required by the Dodd Frank Act, effective on January 1, 2015 (subject to a phase-in period). On July 9, 2013, the Office of the Comptroller of the Currency (“OCC”) adopted the same rules for national banks and federal savings associations, and the FDIC approved the same provisions, as an interim final rule, for state nonmember banks and state savings associations. The final rules apply to all depository institutions and top-tier bank holding companies with assets of \$500 million or more.

The Basel III capital rules: (i) introduce a new capital measure called “Common Equity Tier 1” (“CET1”) and related regulatory capital ratio of CET1 to risk-weighted assets; (ii) specify that Tier 1 capital consists of CET1 and “Additional Tier 1 capital” instruments meeting certain revised requirements; (iii) mandate that most deductions/adjustments to regulatory capital measures be made to CET1 and not to the other components of capital; and (iv) expand the scope of the deductions from and adjustments to capital as compared to existing regulations. Under the Basel III capital rules, for most banking organizations, the most common form of Additional Tier 1 capital is noncumulative perpetual preferred stock and the most common form of Tier 2 capital is subordinated notes and a portion of the allowance for loan and lease losses, which in each case, are subject to the Basel III capital rules’ specific requirements. Under the Basel III capital rules, the following are the initial minimum capital ratios applicable to the Company and the Bank as of January 1, 2015:

- 4.5% CET1 to risk-weighted assets;
- 6.0% Tier 1 capital (that is, CET1 plus Additional Tier 1 capital) to risk-weighted assets;
- 8.0% total capital (that is, Tier 1 capital plus Tier 2 capital) to risk-weighted assets;
- and
- 4.0% Tier 1 leverage ratio.

The Basel III capital rules also introduce a new “capital conservation buffer,” composed entirely of CET1, on top of these minimum risk-weighted asset ratios. The capital conservation buffer is designed to absorb losses during periods of economic stress. Banking institutions with a ratio of CET1 to risk-weighted assets above the minimum but below the capital conservation buffer will face constraints on dividends, equity repurchases and compensation based on the amount of the shortfall. The implementation of the capital conservation buffer will begin on January 1, 2016 at 0.625% and be phased in over a four-year period (increasing by that amount on each subsequent January 1, until it reaches 2.5% on January 1, 2019). Thus, when fully phased-in on January 1, 2019, the Company and the Bank will be required to maintain this additional capital conservation buffer of 2.5% of CET1, resulting in the following minimum capital ratios:

- 4.5% CET1 to risk-weighted assets, plus the capital conservation buffer, effectively resulting in a minimum ratio of CET1 to risk-weighted assets of at least 7%;
- 6.0% Tier 1 capital to risk-weighted assets, plus the capital conservation buffer, effectively resulting in a minimum Tier 1 capital ratio of at least 8.5%;
- 8.0% total capital to risk-weighted assets, plus the capital conservation buffer, effectively resulting in a minimum total capital ratio of at least 10.5%; and
- 4.0% Tier 1 leverage ratio.

The Basel III capital rules provide for a number of deductions from and adjustments to CET1. These include, for example, the requirement that (i) mortgage servicing rights, (ii) deferred tax assets arising from temporary differences that could not be realized through net operating loss carrybacks and (iii) significant investments in non-consolidated financial entities be deducted from CET1 to the extent that any one such category exceeds 10% of CET1 or all such

items, in the aggregate, exceed 15% of CET1. Implementation of the deductions and other adjustments to CET1 began on January 1, 2015 and will be phased-in over a four-year period (beginning at 40% on January 1, 2015 and an additional 20% per year thereafter). In addition, under the current capital standards, the effects of accumulated other comprehensive income or loss (“AOCI”) items included in stockholders’ equity (for example, unrealized gains or losses on securities held in the available-for-sale portfolio) under U.S. GAAP are excluded for the purposes of determining regulatory capital ratios. Under the Basel III capital rules, the effects of certain AOCI items are not excluded; however, nonadvanced approaches banking organizations, including the Company and the Bank, may make a one-time permanent election to continue to exclude these items. This election must be made concurrently with the first filing of certain of the Company and the Bank’s periodic regulatory reports in the beginning of 2015. At this time, the Company and the Bank expect to make this election in order to avoid significant variations in the level of capital depending upon the impact of interest rate fluctuations on the fair value of its available-for-sale securities portfolio.



The Basel III capital rules prescribe a new standardized approach for risk weightings that expand the risk weighting categories from the current four Basel I-derived categories (0%, 20%, 50% and 100%) to a larger and more risk-sensitive number of categories, generally ranging from 0% for U.S. Government and agency securities, to 600% for certain equity exposures, depending on the nature of the assets. Additional aspects of the Basel III capital rules that are more relevant to the Bank include:

- consistent with the current risk-based capital rules, assigning exposures secured by single family residential properties to either a 50% risk weight for first-lien mortgages that meet prudential underwriting standards or a 100% risk weight category for all other mortgages;

- providing for a 20% credit conversion factor for the unused portion of a commitment with an original maturity of one year or less that is not unconditionally cancellable (currently set at 0%);

- assigning a 150% risk weight to all exposures that are nonaccrual or 90 days or more past due (currently set at 100%), except for those secured by single family residential properties, which will be assigned a 100% risk weight, consistent with the current risk-based capital rules;

- applying a 150% risk weight instead of a 100% risk weight for certain high volatility CRE acquisition, development and construction loans; and