SULLIVAN & CROMWELL LLP

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Community Bank Capital Requirements

FDIC Adopts Final Rule Simplifying Capital Requirements for Qualifying Community Banking Organizations

SUMMARY

On September 17, the FDIC unanimously adopted a final rule that simplifies capital requirements for certain community banking organizations with less than $10 billion in total consolidated assets, which implements Section 201 of the Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018 ("*EGRRCPA*"). The rulemaking finalizes, with a number of important modifications and clarifications, the interagency proposal published by the FDIC, the Federal Reserve and the OCC (collectively, the "*agencies*") in February of 2019. For further information on the proposal, please see our **memorandum to clients**. The Federal Reserve and the OCC are also expected to take action in the near term to adopt the final rule.

Section 201 of EGRRCPA requires the agencies to establish a new "Community Bank Leverage Ratio" ("*CBLR*") of 8% to 10% for qualifying banking organizations. Under the final rule, depository institutions and depository institution holding companies that maintain a leverage ratio of 9% or greater and meet certain other criteria (*e.g.*, limited amounts of off-balance sheet exposures and limited amounts of trading assets and liabilities) would be considered "qualifying community banking organizations" and would be eligible to elect to use the CBLR framework. A qualifying community banking organization that elects to use the CBLR framework would not be subject to risk-based or other leverage capital requirements and, in the case of an insured depository institution, would be considered to have met the well capitalized ratio requirements for purposes of the agencies' Prompt Corrective Action ("*PCA*") framework. The final rule includes a two-quarter grace period that will generally allow a CBLR banking organization that is an insured depository institution to be considered well capitalized for PCA purposes if it does not satisfy the qualifying criteria but its leverage ratio remains greater than 8%. The CBLR banking organization would be required to comply with the generally applicable capital rules if it were unable to comply with all qualifying CBLR criteria by the

end of the two-quarter grace period, if its leverage ratio fell below 8% at any time, or if it no longer satisfied the qualifying criteria due to the consummation of a merger or acquisition.

Under the final rule, a qualifying community banking organization that elects to use the CBLR framework will be required to calculate its leverage ratio taking into account the modifications made by the capital simplification rule and current expected credit losses methodology ("*CECL*") transitions final rule.[1]

The final rule will be effective as of January 1, 2020, to align with the revised effective date for the capital simplification final rule, which was also adopted unanimously by the FDIC on September 17.[2] Banking organizations may utilize the CBLR framework for purposes of their Call Report or Form FR Y-9C for the first quarter of 2020.[3]

FDIC Chairman Jelena McWilliams called the CBLR final rule "an important step in the simplification and tailoring of our regulatory framework" that will allow "community banks to significantly reduce the regulatory reporting associated with capital adequacy on the Call Report."

KEY CHANGES MADE IN THE FINAL RULE

1. Adoption of Tier 1 Capital as the CBLR Numerator

In the most significant change from the proposal, the agencies altered the calculation methodology for the numerator of the CBLR by replacing the proposed measure of tangible equity with the existing measure of tier 1 capital under the generally applicable capital rules. Under the proposal, tangible equity would have been defined as total bank equity capital or total holding company equity capital prior to including minority interests and excluding accumulated other comprehensive income ("*AOCI*"), deferred tax assets ("*DTAs*") arising from net operating loss and tax credit carryforwards, goodwill, and other intangible assets (other than mortgage servicing assets or "*MSAs*"), each as of the most recent calendar quarter.[4] The proposal noted that the introduction of this new measure of capital (the proposed tangible equity measure) would have created additional operational and reporting burden relative to the use of an existing capital measure such as tier 1 capital, particularly for banking organizations switching between the CBLR framework and the generally applicable capital rules.[5]

Under the final rule, the numerator of the CBLR is tier 1 capital as calculated under the agencies' generally applicable capital rules, which is intended to better address the agencies' burden reduction and streamlining goals under the CBLR framework.[6]

The final rule release clarifies that qualifying community banking organizations would not be required to calculate tier 2 capital or make any deductions to tier 2 capital under the generally applicable capital rules. The generally applicable capital rules require deductions from tier 2 capital related to investments in capital instruments of unconsolidated financial institutions when such investments exceed certain limits, which can affect the calculation of tier 1 capital under the corresponding deduction approach. A CBLR banking

organization would only be required to make a deduction from its common equity tier 1 capital or tier 1 capital in this circumstance if the sum of its investments in the capital of an unconsolidated financial institution is in a form that would qualify as common equity tier 1 capital or tier 1 capital instruments of the CBLR banking organization and exceeds the threshold for deduction.[7]

The denominator of the CBLR—total consolidated assets—will be calculated as proposed (that is, as average total consolidated assets, calculated in accordance with the reporting instructions to Schedule RC-K of the Call Report or Schedule HC-K of Form FR Y-9C), except that items deducted from the denominator will align with the deductions from tier 1 capital as the numerator rather than from the proposed tangible equity measure as the numerator.

2. Removal of Qualifying Criteria for MSAs and DTAs

Due to the replacement of the proposed tangible equity measure with tier 1 capital as the CBLR numerator, the proposed threshold deductions for MSAs and temporary difference DTAs, and the qualifying criteria related to these exposures, are eliminated in the final rule. The existing tier 1 capital measure includes the threshold deduction approach for these items, which, the agencies note, provides a mechanism to address exposures to MSAs and temporary difference DTCs.

3. Removal of PCA Proxy Framework

Under the proposal, if a banking organization's CBLR fell below 9%, it would have been required to either comply with the generally applicable capital rules or, alternatively, utilize CBLR-framework proxies for the adequately capitalized,[8] undercapitalized,[9] and significantly undercapitalized[10] PCA capital categories. Commenters expressed a number of concerns with the PCA proxies, including that the proxies were not required under Section 201 of EGRRCPA and that they could become, functionally, a new default minimum capital rule.[11]

The final rule does not include the proposed PCA proxy framework. Under the final rule, CBLR banking organizations that are insured depository institutions with a leverage ratio of greater than 9% will be deemed to have met the well capitalized requirements for PCA purposes.[12] Due to the elimination of the PCA proxy framework, the final rule includes the 9% leverage ratio as a qualifying criterion for the CBLR framework. Community banking organizations will therefore generally be required to maintain a 9% leverage ratio at all times (with the exception of those utilizing the two-quarter grace period, discussed below) to qualify for continued use of the CBLR framework.[13]

Under the final rule, a qualifying community banking organization is defined as a banking organization that is not an advanced approaches banking organization[14] and that has:

- A leverage ratio of greater than 9%;
- Total consolidated assets of less than $10 billion;

- Total off-balance sheet exposures (excluding derivatives other than sold credit derivatives and unconditionally cancelable commitments) of 25% or less of total consolidated assets;[15] and
- Total trading assets plus trading liabilities of 5% or less of total consolidated assets.

With respect to the calibration of the ratio itself, although a number of commenters recommended lowering the calibration of the ratio to 8%, Chairman McWilliams noted that "the agencies estimated that a threshold of 8% could allow a material number of community banks to operate with less capital than is required today" and the final rule therefore maintains the 9% threshold.

4. Two-Quarter Grace Period

The proposal would have allowed a CBLR banking organization a grace period of two consecutive calendar quarters to return to compliance with the qualifying criteria or to demonstrate compliance with the requirements of the generally applicable capital rules. During that time, in the case of an insured depository institution, the CBLR banking organization would have referred to the proposed CBLR-specific PCA proxy framework to determine its applicable PCA category.[16] Due to the elimination of the PCA proxy framework (and the resulting addition of the 9% leverage ratio as an explicit qualifying criterion) in the final rule, the two-quarter grace period in the final rule will be available only for those CBLR banking organizations that maintain a leverage ratio greater than 8%. If a CBLR banking organization fails to meet any other qualifying criterion, it will have two quarters to meet the qualifying criteria or comply with the generally applicable capital rules. The grace period will begin at the end of the quarter during which the CBLR banking organization fails to meet any one of the qualifying criteria.[17] The grace period is not available for a CBLR banking organization that fails to meet the qualifying criteria as a result of a merger or acquisition.[18]

5. Use of Tier 1 Capital in Other Contexts

The final rule amends certain standards referencing total capital so that electing banking organizations can use tier 1 capital in place of total capital.[19] In addition, where certain of the agencies' existing rules refer to "capital stock and surplus" (which is generally defined as tier 1 and tier 2 capital plus allowance for loan and lease losses not included in tier 2 capital) the final rule amends such references so that an electing banking organization can use tier 1 capital plus allowance for loan and lease losses (or adjusted allowance for credit losses, as applicable) as its measure of capital stock and surplus. These modifications will impact a number of other regulations, including the OCC's lending limits and rules on investment securities as well as for purposes of compliance with Section 23A of the Federal Reserve Act and Regulation W.[20]

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ENDNOTES

[1] In February 2019, the agencies published the CECL transitions final rule providing for an optional three-year transition arrangement that will allow a banking organization to phase in any adverse day-one regulatory capital effects of CECL adoption on retained earnings, deferred tax assets, allowance for credit losses, and average total consolidated assets. Under this final rule, the leverage ratio is calculated in the same manner as under the generally applicable capital rules; for this reason, an electing community banking organization may phase in any adverse day-one regulatory capital effects of CECL adoption. For further information on the CECL transitions final rule please see 84 Fed. Reg. 4222 (Feb. 14, 2019) or refer to our client memorandum *Bank Capital Requirements: Federal Banking Agencies Release Final Rule Regarding the Implementation of CECL, and Federal Reserve Provides Guidance on CECL and CCAR* dated December 27, 2018 *available at* https://www.sullcrom.com/files/upload/SC-Publication-CECL-Final-Rule-on-Phase-In-and-FRB-Guidance-on-CECL-and-CCAR.pdf.

Using tier 1 capital as the numerator of the CBLR allows electing community banking organizations to incorporate changes to the tier 1 capital calculation under the simplifications rule, which simplifies the calculation by amending the treatments of MSAs, temporary difference DTAs, investments in capital instruments, and minority interests. For further information on the agencies' capital simplification rule, please *see* 84 Fed. Reg. 35234 (Jul. 22, 2019) or refer to our client memorandum *Bank Capital Requirements: Federal Banking Agencies Finalize Capital Rule Simplifications for Non-Advanced Approaches Banking Organizations* dated July 12, 2019 *available at* https://www.sullcrom.com/files/upload/SC-Publication-Bank-Capital-Requirements.pdf.

[2] The FDIC adopted, simultaneous with the CBLR, a final rule that permits banking organizations not subject to the advanced approaches capital rules to implement the simplifications rule in the quarter beginning January 1, 2020, or to wait until the quarter beginning April 1, 2020. *See* Office of the Comptroller of the Currency, Treasury; the Board of Governors of the Federal Reserve System; and the Federal Deposit Insurance Corporation, *Regulatory Capital Rule: Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996; Revised Effective Date available at* https://www.fdic.gov/news/board/2019/2019-09-17-notice-sum-f-fr.pdf (September 17, 2019) at 2.

[3] Office of the Comptroller of the Currency, Treasury; the Board of Governors of the Federal Reserve System; and the Federal Deposit Insurance Corporation, *Regulatory Capital Rule: Capital Simplification for Qualifying Community Banking Organizations available at* https://www.fdic.gov/news/board/2019/2019-09-17-notice-dis-a-fr.pdf (September 17, 2019) (hereinafter, the "Final Rule") at 45.

[4] 84 Fed. Reg. at 3068.

[5] Based on the agencies' analysis, the proposed tangible equity calculation and the current tier 1 capital figures result in nearly the same amount of required regulatory capital. *See* Final Rule at 29.

[6] Final Rule at 28.

[7] Final Rule at 29-30.

[8] *See* 12 C.F.R. § 324.403(b)(2)(FDIC); 12 C.F.R. § 208.43(b)(2)(FRB); 12 C.F.R. § 6.4(b)(2)(OCC).

[9] *See* 12 C.F.R. § 324.403(b)(3)(FDIC); 12 C.F.R. § 208.43(b)(3)(FRB); 12 C.F.R. § 6.4(b)(3)(OCC).

[10] *See* 12 C.F.R. § 324.403(b)(4)(FDIC); 12 C.F.R. § 208.43(b)(4)(FRB); 12 C.F.R. § 6.4(b)(4)(OCC).

[11] Final Rule at 41-42.

[12] Final Rule at 42.

[13] Final Rule at 17.

[14] Currently, advanced approaches banking organizations are those with total assets of at least $250 billion or consolidated on-balance sheet foreign exposures of at least $10 billion, and depository institution subsidiaries of a company that meets one of those thresholds.

ENDNOTES (CONTINUED)

In October 2018 and April 2019, the agencies proposed to revise the framework for determining which banking organizations would be considered "advanced approaches" banking organizations. For additional information about these proposals, see our Memoranda to Clients: *Regulatory Tailoring for Large U.S. Banking Organizations: Federal Bank Regulators Propose Significant Revisions to the Application of Enhanced Prudential Standards and Capital and Liquidity Requirements for Large U.S. Banking Organizations* dated Nov. 5, 2018 *available at* https://www.sullcrom.com/files/upload/SC-Publication-Regulatory-Tailoring-for-Large-US-Banking-Organizations.pdf and *Regulatory Tailoring for Foreign Banking Organizations: Federal Bank Regulators Propose Significant Revisions to the Application of Prudential Standards to Foreign Banking Organizations and Seek Comment on Whether to Impose Standardized Liquidity Requirements on their U.S. Branches and Agencies* dated Apr. 23, 2019 *available at* https://www.sullcrom.com/files/upload/SC-Publication-Regulatory-Tailoring-for-Foreign-Banking-Organizations.pdf.

15 The agencies received a number of comments and requests for clarification on the off-balance sheet exposures qualifying criterion and provided some clarifications. Specifically: (1) that the qualifying criterion incorporates off-balance sheet exposures currently required to be captured and reported by banking organizations in Schedules RC-L and RC-R of the Call Report or HC-L and HC-R of Form FR Y-9C; (2) that banking organizations are only required to identify off-balance sheet securitizations to the extent that they are not already captured as part of another off-balance sheet exposure category; (3) that hedging techniques related to mortgage banking activities are generally only captured in the off-balance sheet qualifying criterion to the extent such exposures are treated as off-balance sheet exposures and subject to credit conversion factors under the generally applicable capital rules; (4) that put and call options on mortgage-backed securities are also excluded; (5) that a contractual obligation for the future purchase of a "to be announced" (*i.e.*, when-issued) mortgage securities contract (that does not meet the definition of a derivative contract under the generally applicable capital rules) would be captured in the off-balance sheet qualifying criterion as it would be considered a forward agreement under the generally applicable rule and (6) that the sale of mortgages to certain Federal Home Loan Banks ("FHLBs") through the Mortgage Partnership Finance Program may provide a credit enhancement to the FHLB. Credit enhancements that meet the definition of a credit-enhancing representation and warranty (or would otherwise be considered an off-balance sheet securitization) under the generally applicable rule would be included in the off-balance sheet qualifying criterion. Final Rule at 21-24.

16 84 Fed. Reg. 3062, 3071 (February 8, 2019).

17 For example, if the CBLR banking organization no longer meets one of the qualifying criteria as of February 15, and still does not meet the criteria as of the end of that quarter, the grace period for such a banking organization will begin as of the end of the quarter ending March 31 and may continue through the quarter ending June 30. By September 30, the qualifying community banking organization would need to either meet the CBLR qualifying criteria again or comply with the generally applicable capital rules. Final Rule at 39.

18 Final Rule at 71, 95 and 118. A CBLR banking organization that expects that it would not meet the qualifying criteria as a result of a business combination would need to provide its pro forma capital ratios under the generally applicable capital rules to its appropriate regulator as part of its merger application, if applicable, and fully comply with the generally applicable capital rules for the regulatory reporting period during which the transaction is completed. The agencies note that they continue to believe that this approach – which is consistent with the proposal – is appropriate because banking organizations should consider the regulatory capital implications of a merger or acquisition and be prepared to comply with applicable requirements. Final Rule at 39-40.

19 Final Rule at 45. The final rule also amends standards related to risk-weighted assets so that electing banking organizations can use average total consolidated assets, the denominator of the community banking leverage ratio.

20 Final Rule at 45. *See also*, 12 CFR § 206.2; 12 CFR § 1.2; 12 CFR § 223.3.

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