February 21, 2019

Community Bank Capital Requirements

Federal Bank Regulators Propose Simplified Leverage Capital Ratio for Qualifying Community Banking Organizations

SUMMARY

On February 8, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation published a proposal in the *Federal Register* that would simplify capital requirements for certain community banking organizations with less than $10 billion in total consolidated assets, consistent with Section 201 of the Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018 ("*EGRRCPA*").[1]

Section 201 of EGRRCPA requires the agencies to promulgate a rule establishing a new "Community Bank Leverage Ratio" of 8%-10% for qualifying banking organizations. Under the proposal, depository institutions and depository institution holding companies that meet certain criteria (generally, those with limited amounts of off-balance sheet exposures, trading assets and liabilities, mortgage servicing assets, and temporary difference deferred tax assets) ("*qualifying community banking organizations*") would be eligible to use a simple on-balance sheet leverage ratio as the measure of their capital adequacy. A qualifying community banking organization with a community bank leverage ratio ("*CBLR*") of greater than 9% that "elects to use the CBLR framework"[2] would not be subject to other risk-based and leverage capital requirements and would be considered to have met the well-capitalized ratio requirements for purposes of the agencies' Prompt Corrective Action ("*PCA*") framework. The proposal also "incorporates CBLR levels as proxies for the following PCA categories: adequately capitalized, undercapitalized and significantly undercapitalized," under each of which a CBLR banking organization would "be subject to the same restrictions that currently apply to any other insured depository institution in the same PCA category."[3]

The agencies note that the CBLR framework is “intended to be available to a meaningful number”[4] of qualifying community banking organizations while “generally maintain[ing] the current level of capital held by these banking organizations”[5] and “supporting the agencies’ goals of reducing regulatory burden for community banking organizations and retaining safety and soundness in the banking system.”[6]

Comments on the proposal are due by April 9, 2019.

BACKGROUND

In September 2017, the agencies proposed to simplify certain capital requirements for all non-advanced approaches banking organizations,[7] and, in November 2017, the agencies extended transition provisions for certain regulatory capital requirements that would be affected by the September 2017 proposal.[8] The simplifications proposal has not yet been finalized, and, while it was pending, Section 201 of EGRRCPA directed the agencies to develop a CBLR of between 8%-10% for depository institutions and depository institution holding companies (including banks and bank holding companies) with less than $10 billion in total consolidated assets. According to EGRRCPA, if a qualifying community banking organization maintains tangible equity in excess of the established leverage ratio requirement, then it would be deemed to be in compliance with (1) the leverage and risk-based capital requirements promulgated by the agencies; (2) in the case of a depository institution, the capital ratio requirements to be considered “well capitalized” under the agencies’ PCA framework;[9] and (3) “any other capital or leverage requirements” to which the depository institution or holding company is subject.[10] EGRRCPA also directs the agencies to establish procedures for the treatment of qualifying community banking organizations that fall below the CBLR threshold.[11]

EGRRCPA defines the CBLR as the ratio of a qualifying community banking organization’s CBLR tangible equity capital to its average total consolidated assets, further providing that the agencies may make a determination that a banking organization is not a qualifying community banking organization “based on the depository institution’s or depository institution holding company’s risk profile, which shall be based on consideration of (i) off-balance sheet exposures; (ii) trading assets and liabilities; (iii) total notional derivatives exposures; and (iv) such other factors as the appropriate agencies determine appropriate.”[12] EGRRCPA further directs the agencies to “consult with applicable state bank supervisors in carrying out Section 201 of [EGRRCPA] and to notify the applicable state bank supervisor of any qualifying community banking organization that exceeds, or does not exceed after previously exceeding, the CBLR.”[13] Below is a summary of the agencies’ proposal to implement Section 201 of EGRRCPA.

KEY ASPECTS OF THE PROPOSAL

Definition of Qualifying Community Banking Organization

The proposal defines a qualifying community banking organization as a depository institution or depository institution holding company that is not an advanced approaches banking organization[14] and that meets the following criteria:[15]

- **Total consolidated assets of less than $10 billion.** Total consolidated assets would be calculated in accordance with the reporting instructions to Schedule RC of the Call Report (for depository institutions) or Schedule HC of Form FR Y-9 (for holding companies). Total consolidated assets would be determined as of the end of the most recent calendar quarter.
- **Total off-balance sheet exposures of 25% or less of total consolidated assets**. Total off-balance sheet exposures would be calculated as the sum of the notional amounts of certain off-balance sheet items, measured as of the end of the most recent calendar quarter.[16] Total off-balance-sheet exposures would exclude derivatives that are not credit derivatives, including foreign exchange swaps and interest rate swaps. The agencies explain that the notional amount for non-credit derivatives "is not an appropriate indicator of credit risk and could inadvertently disqualify a banking organization" from qualifying to use the CBLR if it "is appropriately hedging its credit risks."[17] The proposed components of off-balance sheet exposures would be generally consistent with off-balance sheet items in the generally applicable capital requirements (except with respect to the inclusion of securities lending and borrowing transactions), but the calculation would be "significantly simpler," according to the agencies, because banking organizations would not be required to convert off-balance sheet exposures to on-balance sheet equivalents and assign a risk weight as required under the current capital rules.
- **Total trading assets and trading liabilities of 5% or less of total consolidated assets**. The ratio of trading assets and trading liabilities would be calculated by dividing the sum of the banking organization's total trading assets and liabilities by its total consolidated assets, each in accordance with the reporting instructions for these items on Schedule RC of the Call Report or Schedule HC of Form FR Y-9C, as applicable, measured as of the end of the most recent calendar quarter. CBLR banking organizations would not need to calculate additional market risk capital requirements under the generally applicable risk-based capital requirements, and the agencies note that the CBLR framework therefore "may not appropriately capitalize for material amounts of trading assets and trading liabilities."[18] The agencies add that "elevated levels of trading activity can produce a heightened level of earnings volatility, which has implications for capital adequacy."[19]
- **Mortgage servicing assets ("*MSAs*") of 25% or less of CBLR tangible equity**. MSAs would be calculated in accordance with the reporting instructions to Schedule RC-M of the Call Report or Schedule HC-M of Form FR Y-9C, as applicable, measured as of the end of the most recent calendar quarter. The agencies note that because the "stringent capital requirements" for MSAs under the generally applicable capital rules "are designed to protect banking organizations from sudden fluctuations in the value of MSAs and from the potential inability of banking organizations to divest themselves of MSAs quickly at their full estimated value during periods of financial stress,"[20] the 25% threshold is intended to provide that banking organizations with high concentrations of MSAs would remain subject to the generally applicable capital requirements.[21] The agencies considered an alternative approach involving deductions of MSAs in excess of 25% of CBLR tangible equity, but did not propose it out of concern that it would "unduly complicate the CBLR framework."[22]
- **Temporary difference deferred tax assets ("*DTAs*") of 25% or less of CBLR tangible equity**. DTAs would be calculated "as described in the capital rule," measured as of the end of the most recent calendar quarter."[23] According to the agencies, temporary difference DTAs are assets that a banking organization may not be able to fully realize because the ability to realize the asset is dependent on future income, an issue that can be "particularly acute when banking organizations are

experiencing financial difficulty."[24] Accordingly, the agencies would not allow banking organizations with high levels of DTAs to use the CBLR framework.

Banking organizations that do not meet the qualifying criteria would remain subject to the generally applicable capital requirements. Advanced approaches banking organizations would not be eligible to use the CBLR framework even if they could otherwise satisfy the qualifying criteria. The agencies note that although "an advanced approaches banking organization with less than $10 billion in total consolidated assets is a relatively small banking organization, it is nonetheless part of a more complex banking organization,"[25] which would not fit within the agencies' intended "limited risk profile" for CBLR eligibility.[26] The agencies further note that they "would monitor the appropriateness of the proposed qualifying criteria over time to ensure that they remain effective in excluding banking organizations with complex or potentially risky off-balance activities from the CBLR framework."[27]

Calculation of the CBLR

The numerator of the CBLR would be "CBLR tangible equity," which the agencies propose to define as a banking organization's total bank equity capital or total holding company equity capital, prior to including minority interests, less (i) all elements of accumulated other comprehensive income ("*AOCI*"),[28] (ii) all intangible assets (other than MSAs), and (iii) DTAs, net of any related valuation allowances, arising from net operating loss and tax credit carryforwards, each as of the end of the most recent calendar quarter. The agencies describe this proposed definition as a "prudent, simple measure of CBLR tangible equity which CBLR banking organizations can calculate using amounts reported on regulatory reports."[29]

The proposal would also allow more flexibility with respect to the types of instruments that may be included in regulatory capital and count toward CBLR capital requirements. Under the generally applicable capital requirements, there are numerous restrictions on the types of instruments that can be included in capital. For example, cumulative perpetual preferred securities (which allow for the accumulation of dividends payable) are generally not included in tier 1 capital because they are viewed by the agencies as "not likely to absorb losses to the degree appropriate for inclusion in tier 1 capital."[30] However, the agencies believe that it would be consistent with the goals of the CBLR framework—to "maintain a simple definition of CBLR tangible equity"—to exclude restrictions on regulatory capital instruments that would otherwise be reported as equity capital on the Call Report or Form FR Y-9C, and to provide more flexibility as to the types of capital instruments that could count toward CBLR tangible equity requirements.[31] Although instruments such as cumulative perpetual preferred stock could qualify as CBLR tangible equity under the proposal, those instruments would remain ineligible to qualify as regulatory capital under the generally applicable capital rules if a qualifying community banking organization were to subsequently become subject to the generally applicable rules. Accordingly, if this aspect of the proposal is adopted, it remains to be seen whether qualifying community banking organizations would issue such capital instruments or whether there will be markets for new types of equity capital instruments for those banking organizations.

CBLR tangible equity would not include minority interests in a consolidated subsidiary because, according to the agencies, minority interests "are available to absorb losses at the subsidiary," but "are not always available to absorb losses at the banking organization's consolidated level."[32] The agencies note that the limits on minority interest in the generally applicable capital rules operate "through a relatively complex calculation." The agencies also explain that the exclusion of minority interests is not expected to have a material impact on the vast majority of qualifying community banking organizations because only a small number of banking organizations with less than $10 billion in total consolidated assets currently report any minority interests in regulatory capital.

The denominator of the CBLR would be based on a banking organization's average total consolidated assets, which would be calculated in accordance with the reporting instructions to Schedule RC-K of the Call Report or Schedule HC-K of Form FR Y-9C, less the items deducted from the CBLR numerator other than AOCI.[33]

Comparison to Generally Applicable Capital Adequacy Requirements

As noted above, a qualifying community banking organization with a CBLR greater than 9% would be considered to have met: (1) the leverage and risk-based capital requirements promulgated by the agencies; (2) in the case of a depository institution, the capital ratio requirements necessary to be considered "well capitalized" under the agencies' PCA framework; and (3) "any other capital or leverage requirements" to which the depository institution or holding company is subject. Qualifying community banking organizations that elect to use the CBLR framework would not be required to calculate any additional capital ratios under the generally applicable capital requirements. EGRRCPA further requires the agencies to establish procedures for the treatment of a CBLR banking organization that falls below the prescribed CBLR after previously exceeding the ratio. Although a CBLR banking organization would always be permitted to comply instead with the generally applicable risk-based capital requirements, the agencies note that some CBLR banking organizations "may find it unduly burdensome" to do so during a decline in their CBLR.[34] As a result, the proposal would establish three CBLR proxies for the following PCA capital categories:[35]

- Adequately capitalized: CBLR of 7.5% or greater; [36]
- Undercapitalized: CBLR of less than 7.5%;[37] and
- Significantly undercapitalized: CBLR of less than 6%.[38]

The proposal would retain the same definition for critically undercapitalized as under the PCA framework, which would continue to include institutions with a ratio of tangible equity to total assets ratios of 2% or less. In addition, consistent with the currently applicable PCA rule requirements, to be considered well capitalized under the CBLR framework, a qualifying community banking organization cannot be subject to any written agreement, order, capital directive, or PCA directive to meet and maintain a specific capital level for any capital measure.[39]

To utilize the CBLR framework, a qualifying community banking organization would indicate its election by completing a CBLR reporting schedule in its Call Report or FR Y-9C.[40] To opt out of the CBLR framework and instead comply with the generally applicable capital requirements, a CBLR banking organization would complete the associated reporting requirements on Schedules RC-R of the Call Report or HC-R of Form Y-9C.[41] The agencies note that "some flexibility to reverse the election to use the CBLR framework is warranted to ensure that banking organizations can adjust their business strategies and activities over time."[42] CBLR banking organizations must "provide a rationale for opting out of the CBLR framework to its appropriate regulators, if requested."[43] A banking organization that has opted out of the CBLR framework would be permitted to opt back in so long as it would satisfy the criteria for qualifying community banking organizations and maintain a CBLR of greater than 9%.[44]

A CBLR banking organization that no longer meets the qualifying criteria would have a grace period of two consecutive calendar quarters either to once again meet the qualifying criteria or to demonstrate compliance with the generally acceptable capital requirements. During the grace period, the banking organization could continue to be treated as a qualifying community banking organization and could therefore continue to employ its CBLR to determine its PCA category.[45] The agencies believe this limited grace period "is appropriate to mitigate potential volatility in capital and associated regulatory reporting requirements based on temporary changes in a banking organization's risk profile from quarter to quarter, while capturing more permanent changes in risk profile."[46]

The proposal would provide a different approach for a CBLR banking organization that fails to meet the qualifying criteria as a result of a business combination. The CBLR banking organization would not have a similar grace period in this circumstance, and the agencies note that they "believe this appraoch is appropriate as banking organizations would need to consider the regulatory capital implications of planned business combinations and be prepared to comply with the applicable requirements."[47] A CBLR banking organization that expects that it would not meet the criteria as a result of a planned business combination would need to provide pro-forma capital ratios under the generally applicable capital requirements to its appropriate regulator as part of its merger application (if applicable) and fully comply with the generally applicable capital requirements at the completion of the transaction.

Finally, the proposal would modify the definition of "capital stock and surplus" and similar definitions in other non-capital rules for CBLR banking organizations.[48] The agencies note that capital stock and surplus is generally defined as tier 1 and tier 2 capital plus the amount of allowance for loan and lease losses not included in tier 2 capital. For CBLR banking organizations, capital stock and surplus would be defined as CBLR tangible equity plus allowance for loan and lease losses. This would differ from the generally applicable capital requirements by excluding tier 2 capital instruments (for example, subordinated debt) from the calculation of capital stock and surplus.

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ENDNOTES

1 Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, *Regulatory Capital Rule: Capital Simplification for Qualifying Community Banking Organizations*, 84 Fed. Reg. 3062 (Feb. 8, 2019).

2 *Id.* at 3065.

3 *Id*.

4 *Id*. at 3064.

5 *Id*. at 3064-65.

6 *Id*. at 3065.

7 Advanced approaches banking organizations include large, internationally active banking organizations—generally include those with at least $250 billion in total consolidated assets or at least $10 billion in total on-balance sheet foreign exposure (and the depository institution subsidiaries of those firms). However, the agencies recently proposed changes to the definition and application of the advanced approaches that would include only firms identified as U.S. G-SIBs and firms with at least $700 billion in total consolidated assets or at least $100 billion in total consolidated assets and at least $75 billion in cross-jurisdictional activity. For further information on the agencies' tailoring proposal, please see the following S&C Memorandum 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 November 5, 2018, *available at* https://www.sullcrom.com/files/upload/SC-Publication-Regulatory-Tailoring-for-Large-US-Banking-Organizations.pdf.

8 For further information on the capital simplification proposal and extended transition period final rule, please see the following S&C Memoranda to Clients: *Bank Capital Requirements: Federal Banking Agencies Extend Certain Transition Provisions for Non-Advanced Approaches Banking Organizations* dated November 22, 2017, *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Bank_Capital_Requirements_112217.pdf; *Bank Capital Requirements: Federal Banking Agencies Propose Capital Rule Simplifications to the Standardized Approach Calculations Applicable Primarily to Non-Advanced Approaches Banking Organizations* dated October 4, 2017, *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Bank_Capital_Requirements_October_04_2017.pdf; *Banking Organization Capital Requirements: Federal Banking Agencies Propose Extension of Certain Transitional Provisions for Non-Advanced Approaches Banking Organizations* dated August 25, 2017 *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Banking_Organization_Capital_Requirements_August_25_2017.pdf.

9 *See* 12 U.S.C 1831*o*; 12 C.F.R. §§ 324.401-405 (FDIC); 12 C.F.R. §§ 208.40-45 (FRB); 12 C.F.R. Part 6.

10 Economic Growth, Regulatory Relief, and Consumer Protection Act, Pub. L. No. 115-174, § 201(c). For further information please see our Memorandum to Clients: *Financial Services Regulatory Reform Legislation: "Economic Growth, Regulatory Relief, and Consumer Protection Act" Is Enacted* dated May 24, 2018, *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Financial_Services_Regulatory_Reform_Legislation_05_24_18.pdf.

11 EGRRCPA at § 201(b)(2).

12 *Id*. at § 201(a)(3)(B).

13 84 Fed. Reg at 3064. The agencies note that, prior to the release of the proposal, they had discussions with the Conference of State Bank Supervisors, which provided input on the proposal. The agencies explain that because they plan to incorporate the CBLR into the Call Report and Form FR Y-9C, it would be available to the public and provide an "operable means of notifying the applicable state bank supervisor of the relevant information about a CBLE banking organization's CBLR." *Id*. at 3074.

14 *See* footnote 6.

15 84 Fed. Reg. at 3064-67.

ENDNOTES (CONTINUED)

16 Total off-balance sheet exposures would include: the unused portions of commitments (except for unconditionally cancellable commitments); self-liquidating, trade-related contingent items that arise from the movement of goods; transaction-related contingent items (including performance bonds, bid bonds, and warranties); sold credit protection in the form of guarantees and credit derivatives; credit enhancing representations and warranties; off-balance sheet securitization exposures; financial standby letters of credit; forward agreements that are not derivative contracts; and securities lending and borrowing transactions (total off-balance sheet exposures). *Id*. at 3066.

17 *Id*.

18 *Id*.

19 *Id*. The proposal further clarifies that "…this criterion is generally consistent with section 203 of [EGRRCPA], which excludes a community banking organization from proprietary trading restrictions if its trading assets and liabilities are 5 percent or less of its total consolidated assets." *Id*. at 3067.

20 *Id*.

21 The proposal notes that "[t]he proposed MSA qualifying criterion is aligned with the proposed threshold for MSAs in the simplifications proposal discussed above." *Id*. *See* footnote 7 for a link to our Memorandum to Clients on the simplification proposal.

22 *Id*.

23 *Id.* *See*, *e.g.*, 12 CFR § 3.22(d)(1)(i) (OCC).

24 84 Fed. Reg. at 3067.

25 *Id*.

26 *Id*.

27 *Id*. at 3065.

28 The agencies note that the exclusion of all AOCI is intended to ease the regulatory burden on banking organizations that qualify for and elect to use the CBLR. The proposed adjustment for AOCI would be simpler than under the generally applicable capital requirements, which allow certain banking organizations to neutralize some but not all AOCI. The agencies note the exclusion is intended to address the same concerns that led to the AOCI opt-out in the generally applicable capital rules. When the agencies adopted their revised capital rules in 2013, they stated "that smaller or relatively less complex banking organizations may not have sophisticated risk management techniques to hedge interest rate risk and that including AOCI in regulatory capital could introduce significant volatility into the capital ratios due to fluctuations in benchmark interest rates." *Id*. at 3068-69.

29 *Id.* at 3068.

30 *Id*.

31 *Id*.

32 *Id*.

33 *See id*. at 3070.

34 *Id*. at 3071.

35 *Id*. at 3071-72.

36 *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).

37 *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).

38 *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).

39 84 Fed. Reg. at 3070.

ENDNOTES (CONTINUED)

40 *Id*. at 3074. The agencies indicate that this CBLR reporting schedule will be proposed at a later date under a separate information collection published in the *Federal Register*. *Id*. at 3065.

41 *Id*. at 3070.

42 *Id*.

43 *See id*.

44 *Id*.

45 *See id*. at 3071. For example, a banking organization that grows to have $10 billion or more in consolidated assets (or fails to meet the qualifying criteria in any other respect) as of February 15 would enter its grace period on March 31. The banking organization could use the CBLR framework as of June 30; however, by September 30, it would need to once again meet the qualifying criteria or comply with the generally applicable capital requirements.

46 *Id*.

47 *Id*.

48 *See id*. at 3073.

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