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# LEGAL UPDATES AND NEWS

## Federal Regulators Propose a Community Bank Leverage Ratio Capital Framework for Community Banks With Less Than $10 Billion in Assets

On November 21, 2018, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation (the "Federal Agencies") jointly issued a *proposed* rule (the "Proposed Rule") to simplify the regulatory capital requirements for eligible community banks and holding companies with less than $10 billion in consolidated assets that opt into the Community Bank Leverage Ratio ("CBLR") framework, as required by Section 201 of the Economic Growth, Relief and Consumer Protection Act (the "Regulatory Relief Act"). The Federal Agencies will jointly issue their *final* rule (expected in the first quarter of 2019) after reviewing all comments on the Proposed Rule, which is summarized below and subject to change.

### I. <u>Background</u>

The Regulatory Relief Act mandates that the Federal Agencies develop a CBLR of not less than 8% and not more than 10% for qualifying community banking organizations. A qualifying community banking organization that exceeds the CBLR threshold would be exempt from the Federal Agencies' current capital framework, including the risk-based capital requirements and capital conservation buffer imposed under Basel III, and would be deemed well-capitalized under the Federal Agencies' prompt corrective action framework. The Regulatory Relief Act defines a "qualifying community banking organization" as a depository institution or depository institution holding company with total consolidated assets of less than $10 billion.

Under the Proposed Rule, a qualifying community banking organization may elect, but is not required, to use the CBLR framework, in which case it will be considered to be well-capitalized so long as its CBLR is greater than 9%. If this election is made, the qualifying community banking organization would satisfy the regulatory capital standards by calculating and reporting a single tangible equity leverage ratio, *i.e*., the CBLR, rather than the three risk-weighted capital ratios and minimum leverage ratio currently required. The CBLR calculation would require significantly less data than needed to calculate the current capital ratios and eliminates the time consuming need to risk-weight assets.

### II. <u>Summary of CBLR Framework under Proposed Rule</u>

**Who is a Qualifying Community Banking Organization?**

There are five criteria for a depository institution or holding company to be considered a qualifying community banking organization: (1) total consolidated assets of less than $10 billion; (2) total off-balance exposures of 25% or less of total consolidated assets; (3) total trading assets and trading liabilities of 5% or less of total consolidated assets; (4) mortgage servicing assets of 25% or less of CBLR tangible equity (as defined below); *and* (5) temporary deferred tax assets, net of any related allowances, of 25% or less of CBLR tangible equity. These criteria would be measured as of the end of the most recent calendar quarter, based on information provided in the institution's Call Report or Form FR Y-9C, as applicable.

The Federal Agencies, however, would have the authority to disallow a banking organization to use the CBLR framework based on its risk profile, even if the above criteria are satisfied.

**How Does a Qualifying Community Banking Organization Calculate the CBLR?**

The CBLR is the ratio of the qualifying community banking organization's CBLR tangible equity to its average total consolidated assets. "CBLR tangible equity" equals: (1) the banking organization's total bank equity capital or total holding company capital, as applicable, determined in accordance with the Call Report or Form Y-9C instructions prior to including minority interests, less; (2) (i) accumulated other comprehensive income ("AOCI"), (ii) all intangible assets other than mortgage servicing assets; and (iii) deferred tax assets, net of any related valuation allowances, that arise from net operating loss and tax credit carryforwards.

The Proposed Rule acknowledges that the definition of CBLR tangible equity is intended to be more simple and straightforward than the definition of Tier 1 capital under the current capital framework. For example, the definition of Tier 1 capital excludes cumulative perpetual preferred stock. The Proposed Rule, however, does not provide for such exclusion and thus provides more flexibility with respect to the types of capital instruments that would be considered CBLR tangible equity.

"Average total consolidated assets" would be calculated in accordance with the banking organization's Call Report or Form Y-9C instructions, as applicable, less the items deducted in the calculation of CBLR tangible equity, except for AOCI.

**How Would a Qualifying Community Banking Organization Elect to Use the CBLR Framework?**

A qualifying community banking organization with a CBLR greater than 9% (measured at the time of election) may elect to use the CBLR framework at any time. Such election would be made by completing a CBLR reporting schedule in the organization's Call Report or Form Y-9C, as applicable. The CBLR reporting schedule will be proposed by the Federal Agencies at a later date, but an illustrative example of the form was released and included with the Proposed Rule.

**May a Qualifying Community Banking Organization Opt Out of the CBLR Framework?**

A qualifying community banking organization may opt out of the CBLR framework at any time by reporting the capital ratios under the current capital framework to its appropriate regulators at the time of opting out. The Proposed Rule does not place restrictions on the ability of a banking organization to switch in and out of the CBLR framework. The preamble to the Proposed Rule, however, indicates that the Federal Agencies anticipate such changes to be rare and driven by significant changes to the banking organization's business activities, and would expect the banking organization to provide a rationale for opting out of the CBLR framework to its appropriate regulators, if requested.

To the extent a banking organization has opted out of the CBLR framework, the banking organization may opt back into the CBLR framework if it is a qualifying community banking organization, as defined above, and has a CBLR greater than 9% at the time of election.

A qualifying community banking organization that elects to use the CBLR framework and no longer meets the qualifying criteria (e.g., grows to $10 billion or larger in total consolidated assets) would be given a two-quarter grace period to either meet the qualifying criteria or begin reporting under the current capital ratio framework. A banking organization that ceases to meet the qualifying criteria because of a merger or business combination would, however, receive no such grace period, as the Federal Agencies believe a banking organization would need to consider the regulatory capital implications of a planned business combination and be prepared to immediately comply with the applicable requirements.

**What are the Implications of Electing to Use the CBLR Framework?**

A qualifying community banking organization that elects to use the CBLR framework will be exempt from complying with the current capital framework and will be considered "well capitalized" under the Federal Agencies' prompt corrective action rules so long as it maintains a CBLR greater than 9%. However, to be considered well capitalized under the CBLR framework, the banking organization must not be subject to any written agreement, order, capital directive or prompt corrective action directive to meet and maintain a specific capital level for any capital measure (even if the CBLR is greater than 9%), which is consistent with applicable Federal Agency rules.

If a qualifying community banking organization's CBLR no longer exceeded the 9% threshold, the organization would <u>not</u> be required to convert back to the current capital framework. Rather, the Proposed Rule establishes the following CBLR levels for determining which prompt corrective action capital category would apply to the banking organization:

- Adequately capitalized – CBLR of 7.5% or greater
- Undercapitalized – CBLR of less than 7.5%; and
- Significantly undercapitalized – CBLR of less than 6.0%.

The Proposed Rule does not change the ratio for determining the applicability of the "critically undercapitalized" category, which would continue to include banking organizations with a ratio of tangible equity to total assets of 2% or below. Therefore, there is no proposed CBLR level for the critically undercapitalized category.

The Proposed Rule clarifies that the Federal Agencies would apply the regulatory, supervisory and enforcement authorities under their prompt corrective action framework and other statutes to qualifying community banking organizations that elect to use the CBLR framework. In this regard, such organizations would be subject to all the requirements and restrictions, including any capital restoration plan requirement and mandatory and supervisory actions, applicable to the banking organization in its prompt corrective action category. Similarly, the Federal Agencies expect to continue applying their current supervisory standards for examining banking organizations for capital adequacy.

## III. <u>Planning Considerations</u>

If adopted, the proposed CBLR framework should be beneficial for many community banks and holding companies by creating a more simplified regulatory capital framework, which should reduce the complexity and costs associated with calculating current capital ratios and risk-weighting assets. While this may be very attractive, before electing to use the CBLR framework, community banking organizations should consider their current and anticipated future capital levels in view of the CBLR requirements, whether they want to increase capital with equity instead of debt, their current and planned asset mix and how it impacts their capital ratios, their anticipated growth rate and how close they are to the key asset thresholds (such as the $3 billion threshold for exempting small bank and savings and loan holding companies from the Federal Reserve's regulatory capital requirements under the Federal Reserve's Small Bank Holding Company Policy Statement and the $10 billion threshold).

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