LUSE GORMAN
attorneys

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LEGAL UPDATES AND NEWS

Federal Regulators Adopt Final Rule Implementing the Community Bank Leverage Ratio Capital Framework for Community Banks With Less Than $10 Billion in Assets

On October 29, 2019, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation (collectively, the "Federal Agencies") adopted a final rule (the "Final Rule") to simply the regulatory capital requirements for eligible community banks and holding companies that opt into the Community Bank Leverage Ratio ("CBLR") framework, as required by Section 201 of the Economic Growth, Relief and Consumer Protection Act of 2018.

Under the Final Rule, a depository institution or holding company that satisfies certain qualifying criteria, including having less than $10 billion in average total consolidated assets and a leverage ratio of greater than 9%, would be considered a "qualifying community banking organization" and may elect (but is not required) to use the CBLR framework. If this election is made, the qualifying community banking organization would be considered to have satisfied the Federal Agencies' generally applicable risk-weighted and leverage capital requirements (the "Basel III capital framework") and would be considered to be well-capitalized under the Federal Agencies' prompt corrective action ("PCA") rules. Under the CBLR framework, a qualifying community banking organization would satisfy the regulatory capital requirements by calculating and reporting a single leverage ratio, i.e., the CBLR, which would require significantly less data than needed to calculate the capital ratios under the Basel III capital framework and eliminate the time consuming need to risk-weight assets.

The Final Rule makes several changes from the proposed rule issued on November 21, 2018 (the "Proposed Rule"). Most significantly, these changes: (1) alter the calculation methodology for the numerator of the CBLR by replacing the proposed CBLR tangible equity measure with the existing measure of tier 1 capital under the Basel III capital framework; (2) eliminate the proposed CBLR-specific PCA proxy levels; and (3) provide for a two-quarter grace period for a CBLR banking organization that fails to satisfy any qualifying criteria of the CBLR framework, including maintaining a CBLR greater than 9%, to continue to use the CBLR framework and be considered well-capitalized if its CBLR is greater than 8%.

The Final Rule will be effective as of January 1, 2020 and qualifying community banking organizations can use the CBLR framework in completing their Call Report or Form FR Y-9C, as applicable, for the first quarter of 2020 (i.e., as of March 31, 2020).

<u>Summary of CBLR Framework under Final Rule</u>

Who is a Qualifying Community Banking Organization?

A qualifying community banking organization is a bank or bank holding company that: (1) has a CBLR greater than 9%; (2) has average total consolidated assets of less than $10 billion; (3) has total off-balance sheet exposures of 25% or less of total consolidated assets; (4) has total trading assets and trading liabilities of 5% or less of total consolidated assets; and (5) is not an advanced approaches banking organization (which is generally defined as a firm with at least $250 billion in total consolidated assets or at least $10 billion in total on-balance sheet foreign exposure, and depository institution subsidiaries of those firms) (the “qualifying criteria”). The Federal Agencies have the authority to disallow a banking organization from using the CBLR framework based on its risk profile, even if the qualifying criteria above are satisfied.

The Final Rule modifies the definition of a qualifying community banking organization by removing qualifying criteria for mortgage servicing assets (“MSAs”) and deferred tax assets (“DTAs”) arising from temporary differences set forth in the Proposed Rule, which were deemed unnecessary by the Federal Agencies due to the change of the CBLR numerator from CBLR tangible equity to tier 1 capital. The existing tier 1 capital measure already requires deductions for MSAs and temporary difference DTAs to the extent they exceed certain regulatory thresholds.

How Does a Qualifying Community Banking Organization Calculate the CBLR?

The CBLR is the ratio of the qualifying community banking organization’s existing measure of tier 1 capital to its average total consolidated assets. Under the Proposed Rule, the numerator of the CBLR would have been a new measure of capital, referred to as the CBLR tangible equity measure. The Final Rule replaces the CBLR tangible equity measure with the existing measure of tier 1 capital (as calculated under the Basel III capital framework). Federal Agencies noted that using tier 1 capital as the numerator would streamline the adoption of the CBLR framework by avoiding the introduction of a new capital measure (i.e., the CBLR tangible equity) and aligning the calculation of the CBLR with the existing leverage ratio under the Basel III capital framework, a calculation methodology with which community banks are already familiar. In addition, using tier 1 capital in the CBLR facilitates comparability among banking organizations and removes the need for qualifying criteria for MSAs and temporary difference DTAs, as discussed above.

The Federal Agencies confirmed that since the CBLR framework does not have a total capital requirement, an electing banking organization is neither required to calculate tier 2 capital nor make any deductions that would have been taken from tier 2 capital under the Basel III capital framework, which could affect the tier 1 capital calculation. Furthermore, the Federal Agencies expect the tier 1 capital numerator of the CBLR to take into account any modifications made in relation to the capital simplification rule and current expected credit losses methodology (“CECL”) transitions final rule.

The denominator of the CBLR, 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 tier 1 capital.

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. The election would be made by completing the associated line items that are required in the organization’s Call Report or Form Y-9C, as applicable. A qualifying community banking organization becomes subject to the CBLR framework upon making the election.

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

A CBLR banking organization may opt out of the CBLR framework by completing the associated reporting items that are required in the organization’s Call Report or Form Y-9C, as applicable. A CBLR banking organization can also opt out of the CBLR framework between reporting periods by providing its Basel III capital ratios to its appropriate regulators at the time of opting out.

To the extent a CBLR banking organization opts out of the CBLR framework, the banking organization may opt back into the CBLR framework if it satisfies the qualifying criteria described above.

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 considered to have met the capital requirements under the Basel III capital framework and to be well-capitalized under the Federal Agencies' PCA rules. 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 PCA 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.

What Happens if CBLR Banking Organization Fails to Satisfy the Qualifying Criteria?

If a CBLR banking organization fails to satisfy one or more of the qualifying criteria, including the failure to maintain a CBLR greater than 9% (unless utilizing the two-quarter grace period discussed below), the banking organization will no longer be allowed to remain in the CBLR framework and must comply with and report under the Basel III capital framework for the quarter in which the qualifying criteria is no longer satisfied.

The Final Rule would allow a CBLR banking organization to continue to use the CBLR framework and be considered well-capitalized for a grace period of up to two quarters so long as its CBLR ratio is greater than 8%. The grace period would begin at the end of the quarter during which the CBLR banking organization fails to satisfy any one of the qualifying criteria. If the CBLR banking organization is able to return to compliance with all qualifying criteria during the grace period, the CBLR banking organization may remain in the CBLR framework. The two-quarter grace period, however, is not available for a CBLR banking organization that fails to satisfy the qualifying criteria due to the consummation of a merger transaction.

The Proposed Rule had established CBLR-specific PCA proxy levels (i.e., adequately capitalized, undercapitalized and significantly undercapitalized) that would have enabled CBLR banking organizations to remain in the CBLR framework indefinitely. However, due to adopting the above-referenced grace period construct, the Final Rule eliminated the proposed CBLR-specific PCA proxy levels. Consequently, except during the two-quarter grace period, CBLR banking organizations must always exceed the 9% CBLR threshold to remain in the CBLR framework.

Planning Considerations

The 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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If you need assistance or would like to talk about how we can help you explore the possibility of electing to use the CBLR framework, please contact:

Eric Luse	■	(202) 274-2002	eluse@luselaw.com
John Gorman	■	(202) 274-2001	jgorman@luselaw.com
Lawrence Spaccasi	■	(202) 274-2037	lspaccasi@luselaw.com
Kip Weissman	■	(202) 274-2029	kweissman@luselaw.com
Kent Krudys	■	(202) 274-2019	kkrudys@luselaw.com
Jeffrey Cardone	■	(202) 274-2033	jcardone@luselaw.com
Scott Brown	■	(202) 274-2013	sbrown@luselaw.com
Benjamin Azoff	■	(202) 274-2010	bazoff@luselaw.com
Gary Lax	■	(202) 274-2031	glax@luselaw.com
Joseph Daly	■	(202) 274-2034	jdaly@luselaw.com

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