

Client Alert

November 2018

Simplifying Capital for Community Banks

Community bankers around the country had something extra to be thankful for this Thanksgiving: a joint notice of proposed rulemaking simplifying capital compliance. Under this proposal, which implements Section 201 of EGRRCPA,¹ banks and their holding companies with total assets of less than \$10 billion could generally opt out of the Basel III capital requirements if they have a “community bank leverage ratio” (CBLR) greater than 9 percent. Banks that opt out and maintain a CBLR greater than 9 percent would be considered well capitalized for purposes of Prompt Correction Action (PCA) requirements. Although the regulators have preliminarily set the threshold higher than many banks would have liked, the CBLR is still lower than the 9.95 percent some regulators have suggested at recent banker conferences or the industry average capitalization. We suspect holding companies with between \$3 billion and \$10 billion in total consolidated assets (and their subsidiary banks) will see limited utility in the 9 percent CBLR requirement to opt out (according to the proposal 56 percent of such holding companies qualify to opt out). Comments to the proposal are due within 60 days of publication in the Federal Register. There is no indication when the proposal would become effective (but likely not sooner than the third quarter of 2019).

Historical Background

For most of this country’s history, bank capital was managed on a supervisory basis, not a legal basis. Capital was not formally a legal requirement until the International Lending Supervision Act of 1983 directed the banking regulators to establish minimum capital ratios. In 1985, the regulators established a total capital ratio of 6 percent and a primary capital ratio of 5.5 percent. There were no risk-weighted capital ratios.

Risk-weighted capital ratios were implemented in 1989 as a result of the Basel I capital accords. Under these new rules, the total risk-weighted capital ratio requirement was 8 percent and the leverage ratio requirement was 3 percent. The calibration of the risk-weighted ratio was taken from the Basel I capital accords, but the 3 percent leverage ratio was pushed through by the OCC over the FDIC’s objection as explained publicly by the then-comptroller of the currency, Robert Clarke:

Now we three bank supervisors don’t disagree with each other often. But sometimes we do. And we at the OCC have such a disagreement with the FDIC over what the leverage ratio in our guidelines should be. The FDIC has indicated that it wants the minimum to be 6 percent, including “hard” capital like stockholder equity and “soft” capital like the loan loss reserve. The OCC believes that a leverage ratio of 3 percent of capital to total assets is more appropriate, with all the capital represented by “hard” capital. We believe we are right and the FDIC is wrong. Here’s why: A 6 percent ratio would, in effect, become the capital standard because it would cause many banks to hold capital in excess of what the risk-adjusted capital guidelines would demand.²

¹ The [Economic Growth, Regulatory Relief, and Consumer Protection Act](#), signed into law by President Trump on May 24, 2018.

² Remarks by Robert L. Clarke, comptroller of the currency, before the Washington Forum, Washington, DC, April 4, 1989.

In 2013 the banking regulators implemented the Basel III capital accords, designed to address weaknesses in the capital framework that became apparent in the financial crisis of 2007–2009. The thing is, the Basel III capital accords were designed and calibrated with large banks in mind because the regulators who developed them are from countries whose banking sectors are dominated by a few large financial institution conglomerates. America is different. Community bankers have long bemoaned the regulatory burden, complexity and costs associated with the Basel III risk-weighting regime. In March 2017, and again in September 2017, the federal banking regulators expressed some sympathy with this view.

EGRRCPA

Enter the Economic Growth, Regulatory Relief, and Consumer Protection Act, which directed the banking regulators to develop a “community bank leverage ratio” (CBLR) of between 8 percent and 10 percent for “qualifying community banking organizations” (QCBO) (generally, banks or their holding companies with total consolidated assets of \$10 billion or less). Under the regulators’ proposal released on November 21, the CBLR would be 9 percent. If a QCBO opts out of Basel III and meets this ratio, then that entity (i) would be considered well-capitalized for purposes of PCA and (ii) would be considered to have met any other capital or leverage requirements. Below is a summary of the proposal in Q&A format:

Who is a QCBO?

A QCBO, or qualifying community banking organization, is a bank or holding company:

1. with total consolidated assets of \$10 billion or less calculated in accordance with Call Report/FR Y-9C instructions as of the end of the most recent calendar quarter;
2. has off-balance sheet exposures of 25 percent or less of its assets (e.g., unused commitments, sold credit protection, off-balance sheet securitization exposures, etc.);
3. has total trading assets and liabilities of 5 percent or less assets;
4. has mortgage servicing assets of 25 percent or less of its CLBR tangible equity; and
5. has temporary difference deferred tax assets (DTAs) of 25 percent or less of its CLBR tangible equity.

A QCBO can elect to opt out of Basel III and in to CBLR if it has a CBLR greater than 9 percent at the time of opt in.

Does “bank” include federal and state savings associations?

Yes.

Can the QCBO regime apply to holding companies?

Yes, it can apply to both bank holding companies and savings and loan holding companies. But remember, a QCBO can only opt out of Basel III if it has a CBLR greater than 9 percent at the time of the opt out. Bank holding companies that qualify as small bank holding companies are not affected by this rulemaking because they are not subject to the capital rule. However, bank holding companies with between \$3 billion and \$10 billion in total consolidated assets can only opt out of Basel III if they meet the greater than 9 percent CBLR requirement at opt-out. According to the proposal, as of June 30, 2018, there were 151 holding companies within this asset range and only 56 percent of such holding companies met the greater than 9 percent CBLR eligibility test. If a holding company is not eligible to opt out, it may be less likely their subsidiary banks would opt out, otherwise the holding company would calculate and report Basel III ratios and the subsidiary banks would calculate and report CBLR, arguably defeating the purpose of capital simplification.

If I qualify as a QCBO, do I have to use the CBLR framework?

No, you can choose to continue to abide by the existing Basel III capital framework.

So can I change my mind and jump back and forth between the CBLR and Basel III frameworks?

Generally, no. According to the proposal:

While the agencies would not place restrictions on the ability of [QCBO] to switch in and out of the CBLR framework, the agencies anticipate such changes to be rare and typically driven by significant changes in the banking organization's business activities. The agencies believe 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. The agencies would expect a CBLR banking organization to be able to provide a rationale for opting out of the CBLR framework to its appropriate regulators, if requested.

What happens if I elect the CBLR framework, but then become disqualified as a QCBO (for example, by surpassing \$10 billion in total assets)?

There is a limited grace period of two calendar quarters after which you either have to requalify as a QCBO or go back to Basel III compliance.

How do I calculate the numerator in the CBLR?

The numerator of the CBLR is referred to as the "CBLR tangible equity." It is the entity's total equity capital, as determined in accordance with Call Report or FR Y-9C instructions, prior to including minority interests, less: (i) accumulated other comprehensive income (AOCI); (ii) all intangible assets (other than MSAs); and (iii) DTAs, net of any related valuation allowances, that arise from net operating loss and tax credit carryforwards, each as of the end of the most recent calendar quarter.

How do I calculate the denominator in the CBLR?

The CBLR denominator is average total consolidated assets calculated in accordance with Call Report or FR Y-9C instructions, less intangible assets and DTAs subtracted from CBLR tangible equity.

What CBLR level do I have to maintain once I have opted in?

In order to meet minimum capital requirements, you must maintain a CBLR of 7.5 percent.

Explain to me the CBLR and the various PCA capital categories.

The agencies are proposing to establish the following CBLR levels for the following PCA capital categories:

- Well capitalized – CBLR greater than 9 percent;
- Adequately capitalized – CBLR of 7.5 percent or greater;
- Undercapitalized – CBLR of less than 7.5 percent; and
- Significantly undercapitalized – CBLR of less than 6 percent.

The standard PCA restrictions and obligations would apply to CBLR banks at these thresholds. Note that there is no threshold for critically undercapitalized. Once a CBLR bank's ratio falls below 6 percent, it must provide its regulator with information necessary to calculate its tangible equity ratio for purposes of determining whether the QCBO would be considered critically undercapitalized.

I am a state bank. How do these requirements interact with any state specific capital requirements?

This question is beyond the scope of this alert. However, there may be an argument that such state requirements are preempted.

I am under a capital maintenance requirement but qualify as a QCBO. If I elect CBLR compliance, how does that effect my capital maintenance requirement?

Arguably, there is no impact because capital maintenance provisions are enforceable in their own right and EGRRCPA says that compliance with the CBLR does not limit the existing flexibility of the banking agencies to demand higher capital levels where warranted. However, there would be little downside to asking the regulator to amend the requirement to provide an equivalent and appropriate CBLR so that the entity is not simultaneously calculating Basel III and CBLR capital ratios.

Will future capital maintenance enforcement provisions be couched as CBLR requirements if the entity qualifies for and abides by the CBLR regime?

It is not clear, and we will just have to wait and see what the regulators decide after the final rule. Presumably, this would be consistent with the regulation's overall stated aim of reducing regulatory burden.

What about all my existing contractual provisions that include representations and warranties, and/or obligations, tied to the Basel III capital framework? What about those?

While the answer to this question will turn on the language of a particular contractual provision, generally, those provisions would continue to apply as a matter of contract law even if an entity qualified as a QCBO and elected CBLR compliance. Entities should keep these thoughts in mind when negotiating future contractual provisions tied to capital compliance.

What other things should I keep in mind when deciding whether to elect CBLR?

The proposal discusses a number of other compliance areas that would change as a result of a CBLR election including federal deposit insurance assessments (which will be subject to a separate forthcoming FDIC proposal), and, at the federal level, any compliance requirement tied to a capital amount (e.g., bank premises approvals, lending limits, Regulation W, etc.).

I am a de novo. Can I qualify for CBLR?

The proposal does not mention de novos. There is nothing that precludes de novos that otherwise qualify as a QCBO from electing CBLR compliance, but it is unclear how the regulators would approach this question from a supervisory perspective.

We hope this summary is helpful. If you have any questions, or have any interest in submitting a comment letter to weigh in on this rulemaking, we would be happy to hear from you.

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