A **BANK INSIGHTS** PUBLICATION

INVICTUS GROUP

Community Bank Leverage Ratio Handbook

January 2020

An Overview of the New Capital Framework

Table of Contents

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Introduction

Community bankers have a big decision to make at the end of the first quarter in 2020: Should they opt into the new community bank leverage framework? The framework allows most qualifying community banks to forgo risk weighting and other capital rules by simply maintaining at least a 9 percent leverage ratio.

But is that the right decision? Invictus has spent much of 2019 exploring the answer to that question. This book compiles all our research, plus certain regulatory guides, in one place. Based on data and analytics, we are advising our clients that they have a fiduciary duty to properly stress test their banks before they decide whether to opt into the new capital framework.

Public data suggests that 96 percent of community banks would be better off by not opting into the new system. To make that case to regulators, banks will need to use loan-level data to document how they can safely operate with lower levels of capital.

Many community banks have decided that the best course of action is to do nothing. But business as usual is not a good strategic policy. It often means continued failure to generate sufficient earnings or a justifiable ROE for shareholders. And your bank's capital plan may encumber unnecessary amounts of capital, which is actually cheating your shareholders.

No matter what your bank decides, the upcoming CBLR decision should be a catalyst to revisit your bank capital planning. In today's era of bank consolidation, the ability to have extra FreeCapital® can be the difference between remaining independent or ending up on the auction block.

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By Adam Mustafa
INVICTUS GROUP CEO

The Business Case for a Careful Consideration of the Community Bank Leverage Ratio

We have been preaching for two months that community banks must **take seriously the decision whether to opt into the Community Bank Leverage Ratio ("CBLR")**. Our analysis suggests that it would be damaging to the vast majority of community banks to opt into the new capital framework because it would encumber unnecessary amounts of capital that could otherwise be put to work. We have also written about **how community banks need to calculate their own customized capital requirement**, and why stress testing is the only tool appropriate for the job.

However, what we have not discussed in enough depth is how to quantify the ROI for doing all of this. The purpose of this piece is to provide a 'back of the envelope' example of what the math looks like. Hopefully, the results will document why this is such an important decision, and why it is essential for management teams and directors of community banks to make it an essential part of their fiduciary responsibilities.

Setting the Stage

Let's say you are a director of a fictitious bank called First Bank, a community bank with $700 million in assets. First Bank has a Leverage Ratio of 10%, meaning it has $70 million in capital. Management of First Bank is evaluating whether to opt into the CBLR. If the bank chooses to opt in, $63 million ($700M x 9%) of the bank's capital would essentially become restricted, leaving the bank with only $7 million of excess capital that can be used to pursue organic growth, acquisitions, or fund capital actions such as dividends and stock repurchases.

Let's also assume that First Bank's financial performance is good but not great – it is generating roughly an 8 percent ROE annually. However, the highest performers in its peer group are consistently generating more than a 10 percent ROE, so Management and the Board of Directors are committed to 10 percent ROE as a goal to increase shareholder value.

Management decides to perform an appropriate stress test to evaluate what its ideal customized capital requirement should be, given the unique characteristics of First Bank's loan portfolio and business model. There is a small upfront investment the bank will need to make to perform this stress test by engaging a third party (more on this later). Management advises the board that it plans to start the analysis immediately, reporting the results in the form of a customized Leverage Ratio requirement in a future board meeting. From there, additional discussions will occur with respect to the implications of these results on the looming decision about the CBLR.

Two months later, Management returns to the board and communicates that the results of the stress test are in: The Bank's ideal Leverage Ratio requirement is 8.1 percent. This estimate is supported by the results of the stress test, which is driven by assumptions that err on the conservative side and include a healthy margin of safety.

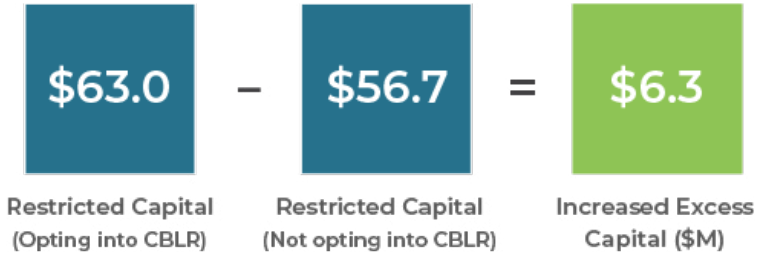
You ask Management a practical question: "I get that our capital requirement could be lower if we do not opt in, but could we be just better off taking the simplest approach and opting in anyway? In other words, what is the true 'cost' of choosing to opt into the CBLR, and is it even material?"

Quantifying the Incremental Earnings Created by Not Opting Into the CBLR

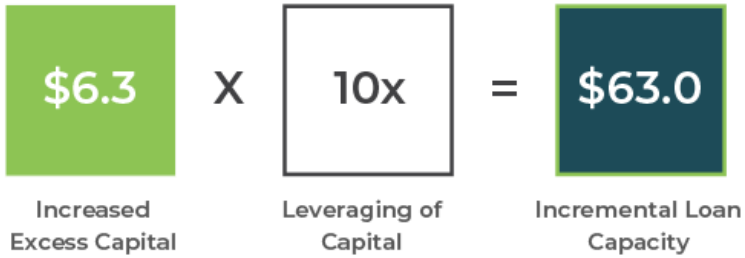
In response to your question, First Bank's CFO begins to lay out the following analysis:

1. With an 8.1 percent requirement as calculated in the stress test, we would only need to restrict $56.7 million of our capital. **As a result, we would have $13.3 million of excess capital.**

2. Since the CBLR would only leave us with $7.0 million of excess capital, we would be increasing our excess capital by $6.3 million.



3. Now let's say we deploy this $6.3 million into loan growth. Since not opting into the CBLR also means that we are subject to the risk-based capital rules framework, let's assume that we leverage our capital by 10x (inverse of 10%) for simplicity. **This means we could use this capital to support $63 million of additional loan growth that is above and beyond what we can achieve if we simply opt into the CBLR.**



Now assume that there is enough loan demand in our market. Loan officers originate $63.0 million of loans over the next twelve months. The loans that are made in the first 30 days will accrue 12 months of interest income, but loans that are made in month 12 will only accrue one month of interest income, so there will be a timing issue in Year 1. Assume for simplicity all the loans are made in the mid-point of year 1 and accrue 6

months of interest income. If we then make certain assumptions regarding loan yield, cost of funds, a one-time loan loss provision expense under CECL, incremental non-interest expenses for items such as loan officer commissions, and tax expenses, we can see that First Bank would basically break even in Year 1. However, when we look at Year 2, and assuming no amortization, prepayments, or defaults for simplicity, we have a full year of interest income for all of the loans, and we no longer have a credit expense for these loans, given that credit deterioration is not more than expected. **As a result, we now have an extra $1.2 million of earnings created by this $63 million of loans that we were only able to originate because we chose not to opt into the CBLR.**

Incremental Impact of Making an Extra $63M of Loans Enabled by Not Opting Into the CBLR

(dollars in millions)	Year 1	Year 2	Assumption	
Interest Income	$1.6	$3.2	Avg. Loan Yield	5.0%
Interest Expense	0.5	0.9	Avg. Cost of Funds	1.5%
Net Interest Income	**$1.1**	**$2.2**		
Loan Loss Provision	0.6	-	CECL Reserve %	1.0%
Non-Interest Expenses	0.3	0.6	Marginal Efficiency Ratio	25.0%
Pre-Tax Income	**$0.2**	**$1.7**		
Tax Expense	0.0	0.4	Tax Rate	25.0%
Incremental Net Income	**$0.1**	**$1.2**		
Improvement to ROE		**+1.8%**		

The extra $1.2 million of earnings also increased the bank's ROE by 1.8 percent, virtually closing the gap between its 8 percent run rate and its 10 percent target.

What if We Can't Make Enough Loans? (And Other Considerations)

While the above math makes theoretical sense, there are some important practical considerations. First and foremost, we are in a low growth/ late-cycle environment in which loan demand is tepid and bankers are on high alert for rising credit risks. Having the capacity to make more loans does not do any good if there are not enough high-quality loans that can be made inside the bank's footprint.

However, simply sacrificing the underlying capital that creates this incremental capacity (in this example, it's $6.3 million) to the CBLR framework is certainly not the right answer, either. In this example, First Bank can explore alternative uses of this freed up capital, such as using it as a source of funding for acquisitions. First Bank may find that using this $6.3 million as a component to funding an acquisition can be the difference in having the economics of the transaction make sense from a shareholder return perspective. After all, the cost of that capital is already being borne by existing shareholders, irrespective of whether First Bank uses this capital in an acquisition, or it doesn't. As a result, First Bank will have to give away $6.3 million less of equity to a target's shareholders or will be able to forgo the cost of capital associated with having to raise an additional $6.3 million of debt or equity to fund such an acquisition. Bottom line – this extra $6.3 million of 'dry powder' may prove to be critical down the road, especially as consolidation continues in the community banking industry.

Ultimately, if First Bank cannot deploy this capital in a manner that creates shareholder value over the longer term, its last resort should be to return this capital to shareholders via dividends or stock repurchases. Shareholders can then redeploy this capital elsewhere on their own. While we are not the biggest fans of having to use excess capital in this manner, it is certainly superior to having it trapped by

the CBLR where it's essentially locked up, earning a rate of return equal to zero for shareholders.

Conclusion: First Bank Should Not Opt into the CBLR

By not opting into the CBLR and instead quantifying and supporting its own internal requirement by using a stress test, First Bank has the potential to significantly increase its earnings by nearly $1.2 million in a full year by deploying the $6.3 million of freed up capital. Meanwhile, the cost of not opting in is ultimately minimal. The bank needs to fill out the risk-based capital schedules on the Call Report – something it has been doing for many years already, and we need to pay for the cost of a stress test. For a bank its size, an annual CCAR-style stress test would only cost around $30,000, which is a fraction of the $1.2 million of earnings per annum we unlock from it, and only $12,000 more than $18,000 the regulators estimate it would cost to opt into the CBLR.*

To be frank, this is a 'no brainer' for First Bank. This freed up capital can be used in other ways, such as M&A, or as a last resort, returned to shareholders. This is especially true for First Bank, which is searching for opportunities to increase its ROE to levels that will help it continue as an independent bank. Banks that opt into the CBLR blindly without undertaking the proper analysis AND have a ROE deficiency are making a decision that is especially egregious. For larger community banks that are publicly traded with assets between $1 billion and $10 billion, the numbers and stakes get even larger.

Even if a community bank chooses to opt into the CBLR, it should at least do so knowing the cost. Management and the board of directors for First Bank may ultimately decide that they value being extra conservative over the opportunity cost of deploying this capital.

While I would not personally agree with such a decision because trapping this $6.3 million of capital would have diminishing value serving as a buffer against stress, at least I can respect the decision because they made it with the proper information at hand. In most situations, each penny of additional capital should be treated as a precious commodity to maximize shareholder value. ☑

**This is a hypothetical example, and any estimate of cost would depend on the bank's size and its unique makeup.*

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By Adam Mustafa
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The Hidden Cost of Ignoring the CBLR

Many community bankers do not realize their own existing capital plans may be more stringent than the community bank leverage ratio (CBLR). We all know bankers like math. So read on to find out how I can prove that simply ignoring the CBLR—without proactive stress testing to document your decision—may be a big and costly mistake.

Our BankGenome™ intelligence system shows that 96 percent of U.S. community banks would be better off not opting into the new standard. However, the decision needs to be data driven. Simply deciding not to opt in without an analysis is actually worse than opting in—and here's why.

It's 2020. Virtually every community bank has a capital plan. To be blunt, most capital plans I have seen are pretty lame—usually nothing more than a check-the-box exercise thrown together to appease regulators. All those capital plans typically contain internal capital thresholds. With few exceptions, almost all the capital ratios are above the PCA guidelines (the written minimums for a 'well-capitalized' bank). The most common set of internal thresholds are:

- Tier 1 Leverage Ratio = 8 percent
- Tier 1 Risk-Based Ratio = 10 percent
- Total Risk-Based Capital Ratio = 12 percent

For purposes of illustration, let's assume that the above thresholds are in the capital plan for a fictitious bank, First Bank. You are the CEO of First Bank. The regulators have never really said anything to you about your capital plan. You conclude "no news is good news" and assume that they are comfortable with it. As a result, you decide that not opting into the CBLR makes sense, and you don't really need to do anything else because you have this capital plan that clearly says your minimum Tier 1 Leverage Ratio is 8 percent, which is less than the 9 percent CBLR.

Makes sense, right? Well, guess what? Your bank's minimum Tier 1 Leverage Ratio is NOT really the 8 percent disclosed in your capital plan. It is actually higher, much higher.

Let's make the following assumptions about your bank ($ in millions):

- Leverage Ratio Assets = $1,000
- Risk-Weighted Assets= $850
- Reported Tier 1 Capital = $100
- Reported Total Risk Based Capital = $105
- Reported Leverage Ratio = 10.0% ($100 / $1000)
- Reported Total Capital Ratio = 12.4% ($105 / $850)

Simple math here says that using the Leverage Ratio, the bank would have $20 million of excess capital based upon the 8 percent minimum stated in

its capital plan. What's the catch then?

Here comes the math part! Using the Total Risk-Based Ratio, the bank's capital requirement is $102 million (equal to $850 in risk-weighted assets times a 12 percent requirement). Except this time, the bank only has $105 million of Total Risk-Based Capital, **meaning the bank only has $3 million of excess capital, not $20 million!**

For this bank, the Total Capital ratio is the constraining ratio, not the Leverage Ratio. Therefore, the Leverage Ratio requirement of 8 percent in the Bank's capital plan is irrelevant. The only thing that matters is the Total Capital Ratio requirement.

We asked BankGenome™ to tell us how many U.S. community banks would first be tripped up by the Total Capital Ratio under stress. The number is startling: 3,542 banks, which is 70 percent of all community banks. This makes a lot of sense; as banks trend more toward becoming 'loaned up', they will have a heavier percentage of their assets in loans that carry a 100 percent risk weight.

So now let's get back to First Bank. You ask your CFO the following question: What does our capital requirement on the Total Capital Ratio translate to in terms of the Leverage Ratio? In other words, what is the equivalent requirement on the Leverage Ratio that would leave you with the same amount of real excess capital as estimated by the Total Capital Ratio?

Your CFO does some quick and easy math. She says, "Well, the Total Capital Ratio is constraining an extra $17 million of our capital versus the Leverage Ratio. If I divide that $17 million by our leverage ratio assets of $1 billion, that will add an extra 1.7% to our Leverage Ratio Requirement of 8.0%. Oh my God...**our real Leverage Ratio requirement is 9.7% percent if we keep our Total Capital Ratio requirement at 12 percent**."

You are stunned. You immediately realize that you would have been better off opting into the CBLR as a 'least bad alternative'. You then ask your CFO: "Why is our Total Capital Ratio requirement 12 percent? Could it be lower? And how do we figure out what it should be?"

Boom. There it is. Not opting into the CBLR but doing nothing else would cost your bank $17 million of capital. This is strictly a self-inflicted wound. And this is why banks need to do the math and take a data-driven approach to determine their capital requirements.

What kind of math is required? **Stress testing is the right tool for the job.** A properly constructed stress test will tell you which ratio is the most constraining for your bank. It will also reveal your unique capital requirements, based upon the characteristics of your loans, composition of your balance sheet, and structure of your business model.

Back to First Bank. Your bank takes the correct course of action and runs a stress test. The results translate to an ideal Total Risk-Based Capital Ratio of 10.5 percent, which is in full compliance with Basel III (which also includes a capital conservation buffer). With this new requirement, your bank now only requires $89.3 million ($850M times 10.5%) of capital, leaving you with $15.7 million of excess capital instead of only $3 million. The equivalent REAL Leverage Ratio requirement? It's now only 8.4 percent, compared with 9.7 percent. Armed with the right information, you have the confidence to opt out of the CBLR. And you also amend your capital plan, based on these new data-driven thresholds backed by a stress test, with full oversight and support from your board.

Choosing not to opt into the CBLR is likely the correct decision for most banks. However, **blindly NOT opting in without doing the work could be even more devastating than blindly opting in**, as the math for First Bank shows above. The cost and time to do the correct math using a stress test is a rounding error compared to the cost of getting this decision wrong. As the old saying goes, "An ounce of prevention is worth a pound of cure."

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By Adam Mustafa
INVICTUS GROUP CEO

The Community Bank Leverage Ratio: What if My Bank Does Nothing?

Many community banks have decided that the best course of action regarding the new community bank leverage ratio (CBLR) is the easiest: Do nothing. Keep the status quo. After all, regulators have seen their capital plans and haven't complained, so why change?

But business as usual is not a good strategic policy. It often means continued failure to generate sufficient earnings or a justifiable ROE for shareholders. And your bank's capital plan may encumber unnecessary amounts of capital, which is actually cheating your shareholders.

The reality is that most community banks have unintentionally overestimated their capital needs in their capital plans for one or more, if not all, of the following reasons:

1. They do not want to invite scrutiny from their regulators;
2. They have not estimated those requirements with any data or analytics, let alone with the correct data and analytics;
3. They fall victim to the "Peer Group Trap." That's when banks with the lowest capital levels in a peer group decide they need to increase their capital, usually after its pointed out to them by the regulators. After they often unnecessarily do so, a new group of banks within the peer group now has the lowest capital levels, and then they raise their ratios. This process repeats itself as if it's a game of musical chairs, and gradually leads to higher and higher levels of capital for all banks over time.

> *"Calculate your own requirements using a stress test, then decide whether to opt in after understanding the benefits and costs of each path."*

4. They don't understand which capital ratio is the most constraining. This is an important point and will be the subject of my next piece on the CBLR. For the vast majority of community banks, the Total Risk-Based Capital ratio is the most constraining ratio, not the Leverage Ratio. A community bank may have an 8.0 percent Leverage Ratio threshold written into its capital plan, but if it has a 12.0 percent Total Risk-Based Capital ratio threshold, that would likely trigger first when the bank is stressed.

The CBLR framework was designed to answer community bank concerns that the regulatory capital system was too complicated. No matter what your bank decides, the CBLR decision is a catalyst to revisit your bank's views on capital. Capital is the lifeblood of a bank. The more capital you can leverage without jeopardizing the bank's safety and soundness, the more value you create for shareholders.

The first step for every bank should be to truly understand how much capital it requires to support its existing balance sheet and business model. The only proper way to do this in a post-2008 world is with a stress test. From there, you can determine how much excess capital the bank has available to deploy.

Management and boards should be scratching and clawing to unlock every possible penny of capital that is above and beyond what is required to support the bank's existing balance sheet. The more excess capital you can justify, the larger the war chest you can potentially deploy to generate excess returns for shareholders. However, the reality is that often banks will find that when doing the right math, their internal capital requirements will seem low relative to peer group levels. This is true even though these thresholds are sufficient, data-driven, and contain a healthy margin of safety.

This course of action will naturally invite a deeper regulatory examination. As someone who has advised well over a hundred community banks on stress testing and capital adequacy over the last 10 plus years, I can assure you that this is actually a good thing — if you are prepared and have your act together. The regulators' job is to challenge you, especially if your bank breaks from the peer group. The longer I'm in this business, the more I believe that if the regulators are NOT challenging you on your internal capital requirements, it likely means you have set them too high.

When you are prepared and have utilized the right process and methodology to determine and support your internal capital requirements, the end result will be more regulatory respect, as well as their acknowledgment that your bank is operating with appropriate — not excess — capital limits.

Here's a question to ask your regulators (off the record): Would they rather oversee a bank with lower capital levels, strong management and a good risk management infrastructure or one with plenty of capital, weak management and insufficient risk management practices. The answer will always be the former.

While I am clearly pushing for community banks to optimize their excess capital, this is both a blessing and a curse. On one hand, excess capital serves as muscle to fuel growth and/or acquisitions. On the other hand, optimizing your excess capital also means you are increasing the pressure on management and the board to deploy this capital in a manner that increases shareholder value. Good management teams and boards want, if not crave, this pressure.

Further exacerbating this pressure are today's banking conditions. In the current environment, organic growth opportunities are limited, with increasing late-cycle credit risk, weak loan yields and incremental net interest margins. But excess capital can potentially be used for acquisitions in an industry that will only continue to consolidate. In fact, the more

excess capital that is available, the more and larger targets a bank can buy. If all else fails and even acquisitions are not a practical option, the bank can always return its excess capital to shareholders via dividends and stock repurchases.

Choosing not to opt into the CBLR framework, but also not properly calculating internal capital requirements may also lead to what I call 'capital creep'. What I mean by this is that the 9 percent CBLR framework could end up being applied to your bank in a de facto manner, or perhaps even worse, regulators may eventually expect you to hold even more capital.

Historically and even under Basel III, the prompt-corrective action ("PCA") minimum for a well-capitalized bank was a 5 percent Tier 1 Leverage Ratio. Prior to 2008, it was common for banks to actually operate at or near this level. However, in today's world, no regulator would allow any bank to operate anywhere near 5 percent without being under a severe regulatory enforcement action. Regulators expect community banks to operate well above these levels. Well, what happens if 9 percent becomes "the new 5 percent" and becomes the baseline to which regulators expect banks to be 'well above'? Then what is acceptable? 10 percent? 11 percent? What happens if Democrats win the presidency in 2020 and replace Trump appointees with their own at the Fed, FDIC and OCC?

Banks that choose not to opt into the CBLR, but also pair that decision with a proactive review of their own internal capital requirements using the correct data and analytics, will be in a far better position to immunize themselves from capital creep.

The course of action that community banks should take when approaching the CBLR is clear: Calculate your own requirements using a stress test, then decide whether to opt in after understanding the benefits and costs of each path. For most banks, that means not opting in, but also taking control of your own destiny by determining or reevaluating your own internal requirements. In other words, don't opt in, but do SOMETHING, not NOTHING.

If banks are planning to opt in and do nothing, I could argue that they are better off blindly opting into the CBLR framework instead. Not opting in and doing nothing is worse than opting in. The costs of doing the latter may not materialize until down the road. But when they do appear, whether in the form of an underperforming ROE or a higher capital requirement, the average banker won't tie this problem back to the real cause: allowing a bank to become overcapitalized and failing to deploy and/or return excess capital to shareholders. Banks that do nothing now are not giving themselves a fighting chance.

Those community banks that are proactive rather than reactive, aggressive rather than passive, and are not pennywise and pound foolish, will separate themselves from the pack and operate with a significant competitive advantage over their peers. Moreover, they will be far more likely to remain as independent entities and/or sell for premium valuations over the next three to five years or even beyond.

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INVICTUS GROUP

By Lisa Getter
PUBLISHER OF *BANK INSIGHTS*

Boards Take Note: The CBLR Mandates a Thorough Exploration of Capital Impact

As third-quarter 10-Qs roll into the Securities and Exchange Commission, one thing stands out: Most public banks are contemplating whether it makes sense to opt into the new community bank leverage ratio framework. The new rule, which requires banks with less than $10 billion to maintain at least a 9 percent leverage ratio if they join the framework, goes into effect in January.

All qualifying public bank boards have a **fiduciary duty** to their shareholders to explore the ramifications of opting into the new capital process. While it will allow banks to forgo risk-weighting requirements, the new rules will lock in the 9 percent capital requirement — even for banks that can prove they can safely operate with lower levels.

And that should give boards pause.

As Invictus CEO Adam Mustafa explained in **"Simpler is Not Always Better: The Community Bank Leverage Ratio Playbook,"** management of every community bank must calculate its unique minimum capital requirement, commensurate with the bank's risk profile.

"Blindly opting into the CBLR is a disservice to shareholders. For most banks, this will result in unnecessary capital being encumbered when it

> *"Choosing not to opt into the CBLR but not having a customized capital requirement calculated and backed by data and analytics is also unacceptable."*

should be available to deploy to generate a return for shareholders," the white paper noted.

At the same time, if a community bank decides NOT to opt into the CBLR, it must be prepared to support and defend that requirement to its board of directors and regulators, ideally with a customized capital analysis.

"Choosing not to opt into the CBLR but not having a customized capital requirement calculated and backed by data and analytics is also unacceptable," Mustafa explains. "It will give your regulator cause for concern because you do not have strong command over how your capital is allocated."

At a time of industry consolidation, the need for banks to optimize their capital is at an all-time high and may ultimately be the determining factor in remaining independent. The ability for banks to generate sufficient returns on equity for shareholders in a low-growth/low-rate environment is becoming increasingly difficult.

Most banks cannot afford to have any amount of precious capital unnecessarily encumbered and generating zero percent return for shareholders, which is exactly the scenario the CBLR will solidify for most community banks.

The law firm of Alston & Bird noted in a **client note** earlier this month that qualifying banks that opt into the new framework will raise their "well-capitalized leverage ratio requirements under the PCA Rules from 5% to 9%." The law firm cautioned banks that opting into the new rules might reduce regulatory burdens, but "its adoption does not come without risk, and such a decision should be made after careful consideration."

In addition, the **Hinshaw law firm** advises bank holding companies with less than $3 billion in total consolidated assets that "it may not make sense" for them to opt into the framework as well.

The only way public banks can fully vet whether they should opt into the framework is to conduct a CCAR-like stress test that analyzes the bank's loans, earnings and entire balance sheet, assessing whether the bank has enough capital to survive an economic downtown. The results of the stress test can be quickly translated to a customized capital requirement for each bank that is commensurate with its unique risk profile.

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Simpler is Not Always Better: The Community Bank Leverage Ratio Playbook

How to Calculate and Defend Your Own Capital Requirement Using Stress Testing

Background

The Federal Deposit Insurance Corporation on Sept. 17 finalized the Community Bank Leverage Ratio ("CBLR"). Community banks with less than $10 billion in assets can opt into the new capital framework and forego risk-based capital rules as long as they maintain at least a 9 percent Tier 1 leverage ratio.

The rule is a byproduct of S.2155 (aka "the Crapo bill"), adopted in 2018 to roll back much of the Dodd-Frank Act. The bill called for regulators to create a new simpler capital framework for community banks, with a CBLR between 8 and 10 percent. Predictably, the regulators settled on the midpoint of that range. The CBLR is on track to go into effect on January 1, 2020. Since banks will use their Call Reports to report their capital levels, the framework will first be available on March 31, 2020.

Banks that opt into the CBLR and remain above the 9 percent threshold would no longer be required to comply with the "Basel III" capital rules, or even calculate their risk-based capital ratios. Touted as easing the regulatory burden, the new framework will primarily free community banks from the paperwork hassle of calculating these ratios.

However, this will come at a severe – yet hidden cost – to shareholders. Using the Invictus BankGenome™ intelligence system, we calculated that 96 percent of community banks could justify a leverage ratio requirement of less than 9 percent. *A $1 billion bank that can support a customized capital requirement of 8 percent would be burning $10 million of capital to the ground simply by opting into the CBLR.*

Fiduciary Responsibility to Know Your Bank

Every community bank is unique. Each operates in a discrete footprint with its own strategy. The composition and risk characteristics of their assets are distinct. Their income streams, cost structures, and efficiencies are different. Yet any one-size-fits-all approach to capital adequacy such as the CBLR will be based upon the lowest common denominator bank. It's no coincidence that examiners often tell banks they must hold a minimum Tier 1 capital ratio of at least 9 percent. That is the fall back, de facto level.

The management team of every community bank must take it upon itself to calculate the minimum capital requirement commensurate with the bank's risk profile. Blindly opting in to the CBLR is a disservice to shareholders. At the same time, if a community bank decides NOT

to opt in to the CBLR, it must be prepared to support and defend that requirement to its board of directors and regulators. Choosing not to opt into the CBLR but not having a customized capital requirement calculated and backed by data and analytics is also unacceptable. It will give your regulator cause for concern because you do not have strong command over how your capital is allocated.

To be frank, even if your regulator ignores or doesn't accept your calculation, management's job is to not go down without a fight. Simply bemoaning that your regulator won't be willing to have such a conversation is no excuse for not having one. That's weak, short-sighted and a disservice to your shareholders. And in our experience, regulators will listen – and they will look at documentation you provide to make your case.

Stress Testing – The Right Tool for the Job

So how does a community bank go about calculating its own capital requirement? The only answer is stress testing. To understand why that's the case, it is critical to examine how the fallout from the 2008 Financial Crisis transformed the very definition of capital adequacy in the banking system.

In a nutshell, regulators deployed three primary tools to force banks to hold more capital in reaction to the Financial Crisis:

1. They implemented new capital rules in 2015 (often referred to as 'Basel III' since it was the means in which U.S. regulators went about applying the accord). The rules redefined capital and risk-weighted assets in a manner that was more restrictive, increased the prompt-corrective action guidelines (i.e. minimum thresholds) from prior levels, and introduced new concepts such as the capital conservation buffer. Net net, the overall impact of the Basel III capital rules resulted in a significant increase in bank capital requirements.

2. They approve or reject the capital plans of the nation's largest banks using the results of the Comprehensive Capital Analysis and Review ("CCAR") stress testing program, an annual exercise in which the Federal Reserve prescribes a two-year severe recession that looks and smells like the 2008 Financial Crisis all over again. A CCAR bank is not permitted to pay dividends or buy back stock without first passing a stress test that includes such capital actions, irrespective of its intention to move forward with them if another recession occurs.

   Regulators do not use the same approach with community banks. There are simply too many of them and they collectively represent too small a percentage of assets in the banking system. Instead, it's far easier for regulators to utilize a 'one-size-fits- all' approach – unless a community bank makes a case for its own capital requirement.

3. Although the Basel III rules tightened capital requirements for community banks (the written rules), individual examiners continue to communicate to community banks that they expect them to hold levels of capital well-above the written minimums (the unwritten rules). This is especially true for community banks with significant concentrations of capital in construction, commercial real estate and agricultural loans. Often these unwritten expectations are somewhere between 8 percent to 10 percent on the Tier 1 Leverage Ratio. Sound familiar? This is the same range that the Crapo bill authorized regulators to work within to determine the CBLR. In other words, the CBLR is formalizing what has already been happening in the community bank industry for years. Unfortunately, many banks have been ill-prepared to defend themselves against this expectation. And many others simply rolled over, despite the importance of freeing up every possible penny of capital to generate enough ROE to ensure their independence.

All these regulatory tactics are designed to ensure that banks have a sufficient capital buffer to absorb another severe recession, irrespective of

the likelihood of it occurring. Therefore, the only way to possibly calculate an individual bank's unique capital requirement in a post-2008 world is by analyzing how the bank would perform under another severe recession. The only tool that does this effectively is a robust, forward-looking stress test that both quantifies the impact of stress on capital across a bank's entire balance sheet and business, but also is based upon the unique risk characteristics of the bank's assets, predominantly its loans.

The Significance of the Stress Capital Buffer ("SCB")

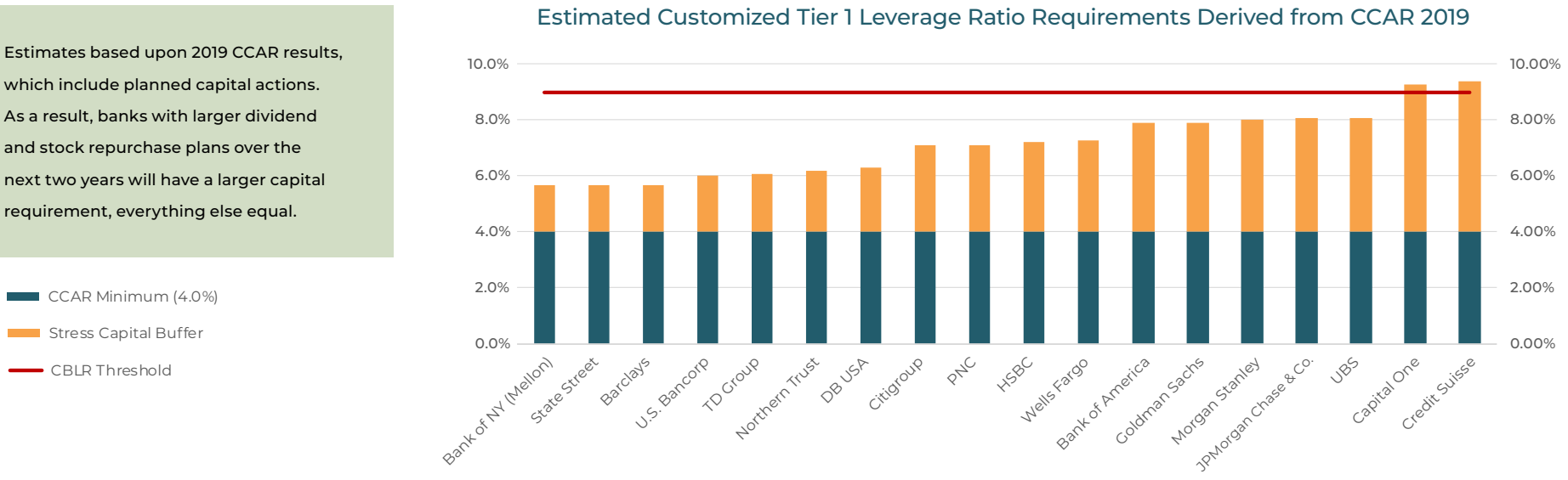
The CCAR stress tests are the only close-to-genuine attempt by regulators to craft individual capital requirements. As controversial, arduous, and expensive as the CCAR stress tests are, they provide a lens for the largest banks to 'tell their story' about their risk profile and how it affects capital.

The CCAR stress tests essentially force the large banks to create a Stress Capital Buffer ("SCB") as the key component of their capital requirement. The SCB is added to the minimum requirement for passing the stress test to calculate a bank's customized capital requirement. For example, if Bank X has 9 percent Leverage Ratio capital today, but their capital drops to 6 percent in a severe recession, their SCB would be 3 percent. The 3 percent buffer is added to the 4 percent regulatory minimum of passing the stress test, giving the bank a customized capital requirement of 7 percent. Since Bank X has 9 percent today, their excess capital would be 2 percent, which they can use for growth, dividends, stock repurchases, etc.

The regulators have been using the CCAR stress tests as the centerpiece to customize capital requirements for the nation's largest banks on a de facto basis since 2012, but last year they **proposed to formalize this moving forward**. The movement to formalize the SCB has been led by Vice Chairman Randal Quarles, who earlier this month elaborated more **on the SCB**.

An analysis of the estimated Tier 1 Leverage Ratio requirements for the large banks using the results of last year's CCAR stress tests shows startling results. Of the 18 banks, 16 can justify leverage ratio requirements less than 9 percent, as this graphic shows:

Estimates based upon 2019 CCAR results, which include planned capital actions. As a result, banks with larger dividend and stock repurchase plans over the next two years will have a larger capital requirement, everything else equal.



Using Big-Bank Tools to Get Results

For community banks, the solution is simple. Stress test your bank and calculate your own SCB and ultimately your own capital requirement. Community banks must realize that stress testing is the perfect weapon to control their own capital requirements. Yes, CCAR is designed for large banks, not community banks. However, community banks need to quit looking at stress testing as simply a check-the-box exercise to please their regulators or to adhere to the **2006 interagency guidance on managing CRE concentrations**.

By taking this approach, community banks will be pleasantly surprised to discover that their regulators will often respond positively. For the regulators, it's all about trust. Can they trust a given bank to properly manage its capital? In defense of regulators, how can the answer possibly be yes if a given bank can't even estimate its own capital requirement or support it with data?

Most community bank regulators will be receptive to a customized capital requirement, even if they are not trained in stress testing, under three conditions:

1. **The bank is genuinely using stress testing to help create and manage their strategic and capital plans.** In other words, the bank is not just running a stress test to appease the regulators. The regulators' conscious or subconscious litmus test will be "would this bank be using stress testing even if it were not regulated?" The answer needs to be yes. Banks cannot fake this. They need to embrace stress testing, or it will never work, no matter how much money, quants, or data they throw at the exercise.
2. **The stress tests CANNOT be a black box that management does not understand.** Do not purchase a model from a vendor without understanding how it works, or what the results mean, and then hand a report to the regulators and say, "here is my stress test". Management does not need to be experts in stress testing, but they do need to have a strong understanding of how their stress test works, why the methodologies utilized are appropriate, and how their inputs (loan-level information) translate into outputs (ultimately their customized capital requirement).
3. **The stress tests must be forward-looking, driven by loan-level information, and able to be validated.** Simply using your historical loss experience from the Great Recession or the 75th percentile worst bank is insufficient. The heart and soul of a bank's vulnerability to stress will be credit risk embedded within the loan portfolio. It is crucial to utilize loan-level information that contains these risk characteristics to drive the loan portfolio stress test component of your capital stress test. It is the only way to perform forward-looking analysis. Validation is also important to regulators, so make sure your model is designed in such as fashion that it's easy to do so. Validation should also be important to you because if you are adhering to condition #1, you want to make sure you are relying on a model that you can trust.

An Autopsy on Community Bank Stress Testing Over the Last 10 Years

We are in 2020, and by now, most community banks are using some form of stress testing. However, while they are often checking the box with regulators, most are also not doing so in a manner that can be used sufficiently for calculating capital requirements and figuring out whether to opt into the CBLR. Below is a list of the most common shortfalls we see with community bank stress tests:

- They are only stress testing their loans. They cannot connect the results to the impact on capital because they are not stressing the rest of their balance sheet or their earnings.

- In many cases, only the CRE loans are being stress tested. Residential mortgages and consumer loans are not included. The irony is that many banks will find they are most vulnerable to losses within the C&I portfolio under stress due to the 'soft' nature of the collateral, but they are not stressing those, either.
- They are performing capital stress tests, but they are shortcutting the calculation for loan loss provisions and net charge-offs by using historical losses from their own bank or other banks, or by applying some multiple to their net charge-offs in 'good times'. What they are missing is a forward-looking analysis using loan-level information. Today's loans were originated under completely different economic and interest rate conditions than loans that were on the books in 2008. Underwriting philosophies and standards have also changed. This all gets completely missed with a 'look back' approach that is used simply to plug in a number.
- They are sending 'flat files' to a vendor and getting a report back in return, but don't understand the report or use it to make any real decisions about their strategic or capital plans.
- They are unable to incorporate planned actions such as loan growth, dividends, stock repurchases, mergers and acquisitions, or investments in new business lines into their stress tests.
- Stress testing is being done in a vacuum and is the sole responsibility of either the Chief Credit Officer or Chief Financial Officer, but there is little to no collaboration across various departments within the bank.
- Stress tests may be done on a recurring basis, but each stress test is its own mutually exclusive exercise with zero trend analysis. What community banks often miss is that the most valuable insights from stress testing are unlocked from performing trend analysis across previous stress tests.

  Stress testing is an imperfect exercise. It is not and never will be a proverbial crystal ball. However, if the same general test is performed over multiple periods, then changes in the results from one period to the next are screaming to tell you a story. The most important result, perhaps, is the capital requirement estimated for a given bank. But this is not a static number. A given bank's capital requirement will change over time as its loan portfolio turns over, as its earnings model changes, as its mix of assets and liabilities fluctuates, etc. Has the stress loss rate on the CRE-non-owner-occupied portfolio increased or decreased versus the prior analysis? And why?

Stress testing as described above is insufficient. Certain loan-only stress tests provide valuable insights for underwriting and monitoring individual loans, but are virtually useless for strategic and capital planning, which are top-down exercises. Community banks will need to do more than they are doing now to properly use their stress tests to determine their own unique capital requirements.

Community banks need to take the next step with respect to stress testing. They need to run CCAR-style stress tests and fill in the above-mentioned gaps, if applicable. Most community bankers brave enough to have read this whitepaper to this point are gasping right now, asking themselves: How are we going to do something that is this complex? How much will it cost?

This type of stress testing is not that difficult nor expensive. Most community banks have much simpler business models than the large money center banks, which often include international operations, investment banking, and massive off-balance sheet derivative exposures. Most community banks gather deposits and make loans, and that is their primary business. Some may have additional revenue streams such as loan sales of mortgages and SBA loans, wealth management, and loan servicing, but these are not overly complex business models, either. Most

community banks have plain vanilla securities portfolios, so analyzing those aren't too difficult.

Community banks are also in a better position today to ensure the stress testing of their loan portfolio is forward-looking and using loan-level information. This is because they (hopefully) are at some sort of stage in the process of preparing for CECL.

A 60-Day Turn-key Solution

Invictus Group has crafted a 60-day roadmap to help community banks quickly run a CCAR-style stress test for the quarter ending of their choice, backed by its loan-level information. The following timeline illustrates how easily and quickly this can be done:

- **Day 1** - Kickoff meeting to discuss data requirements, timeline, and introduce team members.
- **Day 2** – Bank staff downloads loan-level data file from core processing system and uploads to secure portal.
- **Day 9** – Bank staff and Invictus team complete any 'work through' of the loan-level information to make sure it's being properly understood, translated and validated.
- **Day 23** – Invictus team completes development, customization, and operation of an initial draft of a CCAR-style stress test for the selected period using our proprietary BankGenome™ technology platform. Draft analyses, including a high-level board report, supporting backup schedules, pro forma financial statements, a list of critical assumptions, and a loan-level stress test report, are provided to the bank staff. The reports include a calculation of the bank's customized capital requirement, and an analysis of that result compared with the CBLR of 9 percent.
- **Day 25** – Invictus team members meet with bank management to walk through the reports. This meeting leads to action items on both sides to further fine-tune the analysis and its presentation.
- **Day 29** – Invictus team members meet with bank management a second time. The purpose of this meeting is to walk through exactly how the stress test works from the 'ground up'. This should eliminate any perception of the analysis being a 'black box' while also giving bank management the confidence to both trust and own the analysis. This meeting may also lead to additional fine-tuning of the analyses.
- **Day 36** – An updated draft of all reports that reflect the agreed-upon adjustments from the previous meeting are provided by Invictus to bank management.
- **Day 43** – Final reports are issued by Invictus to bank management.
- **Day 50** – Invictus works with bank management to make any necessary adjustments to the bank's formal capital plan using the results of the stress test. This includes the customized capital requirements and a recommendation on whether to adopt the CBLR.
- **Day 54** – Invictus and bank management present the results of the stress test, proposed changes to the capital plan, and recommendation on whether to adopt the CBLR to either the Risk or ALCO committee of the board of directors. The results are presented with a 'medium level' of detail to give committee members the information necessary to further vet the analysis on behalf of the entire board.
- **Day 57** – Invictus and bank management present everything to the entire board of directors. Acting as stewards of the bank's capital, directors will ask questions, and document the discussion in the minutes of the meeting. The board then passes the necessary resolutions that formalize the changes to the bank's capital plan as well as a decision regarding the CBLR.

- **TBD** – Invictus works with the bank to prepare the necessary materials in advance of the bank's next safety and soundness exam with regulators.
- **Early / Mid-2020** – The process is repeated to re-assess the bank's capital requirements. Trend analysis versus the original analysis is performed to extract critical insights that can be used for risk management, capital planning, and strategic decision-making.

The above timeline can obviously be modified as necessary to fit your bank's schedule. To a certain extent, there is no rush to decide on the CBLR since banks can opt in or out at any time. However, the sooner community banks jump on this exercise, the sooner they can free up their capital so it can be used for strategic purposes.

Acting now also makes sure the bank sets the right precedent; changing course after January 1 can technically be done at any time, but in reality, the bank will need to explain, support, and defend any changes with its stakeholders. As with just about everything in life, getting it right up front will make it far easier moving forward.

Wrap Up: Don't Miss the Opportunity

In many ways, the decision regarding the CBLR provides a tremendous opportunity for community banks. They can use this process to support and defend a customized capital requirement. It allows them to put a stake in the ground with their regulators, so they do not have to succumb to a rule-of-thumb that was ultimately based on the lowest common denominator bank.

Banks that do nothing or blindly opt into the new framework risk encumbering unnecessary capital that can be used to drive shareholder value and ensure their ongoing independence in a world where generating the appropriate levels of ROE is becoming increasingly difficult.

By our calculations, $44 billion may be at stake.

The CBLR is an inflection point for community banks.

Many community banks have the raw materials (data) and talent to do this type of stress testing. They must analyze the impact on the entire bank and perform forward-looking analysis on the loan portfolio using loan-level data.

Please **contact me** if you would like to discuss this further. Our **stress testing team** can schedule your bank for the 60-day solution immediately.

Originally published as an Invictus White Paper

INVICTUS GROUP

By Lisa Getter
PUBLISHER OF *BANK INSIGHTS*

Stress Capital Before Opting into the New Community Bank Leverage Framework

Note to community bank execs: The clock is ticking on how you calculate your capital requirements. The FDIC this week finalized the new 9 percent **community bank leverage ratio**, and it goes into effect in January for most banks with total assets of less than $10 billion.

But should you opt into the new framework? Invictus estimates that more than 96 percent of community banks would be better off if they used stress testing to quantify their own unique requirements, based on the composition and characteristics of their assets and earnings. The BankGenome intelligence system found that those banks could safely operate with less than a 9 percent leverage ratio, while still withstanding a severe downturn.

That extra capital, which adds up to $44 billion across the industry, could be deployed elsewhere, giving your bank a competitive advantage.

The biggest benefit of opting into the new framework is not having to calculate and report risk-based capital ratios. The final rule adopts Tier 1 capital as the numerator for the capital ratio. It removes criteria for mortgage servicing and deferred tax assets as well as the PCA proxy framework, parts of the original proposal that had generated industry complaints. The **final rule** also gives banks a two-quarter grace period to be considered well-capitalized if their capital ratios fall below 9 percent but remain above 8 percent.

Banks can opt into the framework when they file their Call Reports—so the first time it will be used would be after the first quarter of 2020. Regulators emphasize that banks can also opt out anytime "without restriction" if they comply with general capital ratios in effect at the time.

The OCC estimates that banks that opt into the new framework will spend "no more than 160 hours" to modify policies and procedures—a cost of approximately $18,240.

Originally published in Invictus Intel Blog

INVICTUS GROUP

By Lisa Getter
PUBLISHER OF *BANK INSIGHTS*

CAPITAL PLANNING: Why Opting into the Community Bank Leverage Ratio Shouldn't Be Automatic

Every community bank should assess its own situation and business model before deciding to opt in to the proposed new community bank leverage ratio (CBLR) framework, regulators advised banks in a December 2018 **teleconference**.

The CBLR framework would consider most banks with assets of less than $10 billion and at least a 9 percent leverage ratio to be well-capitalized, allowing them to forego risk-weighting calculations, file simpler Call Reports, and bypass future risk-based capital rule changes. But that doesn't mean it makes strategic sense for all community banks.

"The agencies are not in a position to say what the advantages of the framework are," regulators said on the **teleconference**. That regulatory message is consistent with an **April 2018 Bank Insights article** that referred to the ratio as "fool's gold" because it would lock banks into a capital regime that may be unnecessarily high.

Banks must realize that if they opt into the framework they will be forced to hold at least 9 percent leverage capital, which may be much more than is needed. And that could be a serious threat to shareholder value because a meaningful amount of capital would be unnecessarily encumbered.

The Invictus Group recommends that banks use capital stress testing with the right analytics to quantify their own capital requirements. Banks that do this, while integrating stress testing into their overall strategic planning and risk management processes, have found overwhelming success, both from a regulatory and strategic standpoint.

A **Deloitte global risk management survey**, released in January 2019, noted that regulators "have come to rely increasingly on stress tests to determine if a financial institution has sufficient capital." The survey found that 71 percent of smaller institutions, or those with less than $10 billion in assets, were relying on capital stress tests to guide their banks. Overall, 87 percent of financial institutions reported using capital stress tests for strategy and business planning.

The agencies estimate that 83 percent of community banks with less than $10 billion in assets would qualify to use the framework, as well as about 150 bank holding companies with assets between $3 billion and $10 billion. But a BankGenome analysis, the Invictus Group intelligence system, found that 92 percent of community banks could safely operate with an 8 percent leverage ratio, even in a severe

downturn. Those banks would benefit most from using stress testing to prove their case.

The **proposed rule** lays out some specifics for what the new capital framework would look like, but expect those to change before the proposal is final. The proposal was mandated under the **Economic Growth, Regulatory Relief, and Consumer Protection Act**, the Republican-led bill that amends Dodd-Frank. It would replace the Basel III guidelines for all banks that decide to use it.

Lawmakers had called for a leverage ratio of anywhere between 8 and 10 percent. Industry groups had lobbied for an 8 percent ratio, but regulators decided more was needed to ensure safety and soundness. The proposal notes that the framework "should be calibrated not to reduce the amount of capital currently held" by qualifying banks.

"It is for banks that exceed 9 percent. This language is very intentional," regulators said on the **teleconference**. "It is not equal to. It is in excess of that."

Bank lawyer Peter Weinstock, a partner with Hunton Andrews Kurth in Dallas, said he had heard that regulators wanted the ratio to be even higher. He predicted that some banks would look at the simpler framework as a "panacea" while "other banks will simply shrug."

Until the actual rule is written, it will be hard to predict the impact of the proposal on acquisitions and other strategic initiatives. "My general viewpoint is having to comply with fewer capital guidelines is a better thing," Weinstock said.

The proposal is vague on many details, including how the new framework would be used to calculate bank assessments, currently based on Tier 1 capital. The proposal notes that if the CBLR framework were to be used, more than 90 percent of banks would have the same or lower assessments.

One drawback for some banks is that the proposal would no longer treat trust-preferred securities as Tier 1 capital instruments, **noted** Bryan Cave Leighton Paisner law partner Robert Klingler in a recent analysis. He concluded that qualifying BHCs between $3 billion and $10 billion would likely not want to opt into the new framework with that restriction.

Under the proposal, CBLR tangible equity would be defined as total bank equity capital or total holding company equity capital prior to including minority interests, and excluding accumulated other comprehensive income (AOCI), DTAs arising from net operating loss and tax credit carryforwards, goodwill, and other intangible assets (other than MSAs). Average total consolidated assets would be calculated similar to the current Tier 1 leverage ratio denominator in that amounts deducted from the CBLR numerator would also be excluded from the CBLR denominator.

Qualifying banks would be able to opt into the framework at "any time." But getting out won't be that simple.

The agencies said they anticipate switching out would be "rare and typically driven by significant changes in the banking organization's business activities." Banks that want to opt out once they are in the framework would have to "provide a rationale" to regulators. Banks would also have to demonstrate to regulators that they have enough regulatory capital to meet the existing rules at the time of opting out.

Originally published in Bank Insights

INVICTUS GROUP

By Adam Mustafa
INVICTUS GROUP CEO

Disruptive Thinking: Is the Community Bank Leverage Ratio Fool's Gold?

The financial regulatory reform bill that recently passed in the Senate contains a number of so-called goodies for community banks. But one of those provisions is actually fool's gold: the "capital simplification" that calls for a new community bank leverage ratio.

Senate bill 2155, known as the Economic Growth, Regulatory Relief, and Consumer Protection Act, calls for bank regulators to develop a community bank ratio, based on tangible equity capital, "of not less than 8 percent and not more than 10 percent."

Though vague on details, the bill suggests that if a bank maintains a capital level above this requirement, it would be well-capitalized. Community banks would be able to opt into the new ratio, and ignore other capital requirements based on risk weightings.

Big Mistake for Most Banks

But most banks that select this option may be making a big mistake. It is likely that regulators will choose a ratio of 9 percent or 10 percent. (The House bill that must be reconciled with the **Senate Bill** called for a regulatory off-ramp for banks that met a 10 percent leverage ratio).

We have seen regulators pushing more and more community banks toward a 10 percent minimum for roughly 18 months now. They have been primarily focused on those banks with high CRE and Agricultural concentration ratios and acquisitive banks (in some cases, quietly holding regulatory approval of a deal hostage until acquirers agree to maintain higher capital levels).

Whatever number the regulators pick will leave community banks with no option to optimize their capital requirements if they can prove that they can operate safely below it. This will be problematic for banks with concentration levels and unique business models that rely on assets with low risk weightings.

Indeed, an Invictus study found that 82.3 percent of community banks can — and should — safely operate with leverage ratios of 8 percent or lower today (see **Exclusive Study** on page 24 for results).

Remember the days when 5 percent was considered enough regulatory capital? Then it became 8 percent, and now it feels like 10 percent will become the norm — unless banks take matters into their own hands.

It is already difficult enough to generate a sufficient enough Return on Equity (ROE) for a community bank to justify its existence. Cementing

in stone a 9 percent or 10 percent leverage ratio will only make it more difficult — and frankly impossible, for many banks.

An illustration of what happens to a $1 billion bank with $100 million in capital.

HOW LEVERAGE RATIOS AFFECT THE BOTTOM LINE

	WITH A **10%** REQUIREMENT	WITH AN **8%** REQUIREMENT
ASSETS	$1 BILLION	$1.2 BILLION
CAPITAL**	$100 MILLION	$100 MILLION
CAPITAL – REQUIRED	$100 MILLION	$96 MILLION
CAPITAL – EXCESS	0	$4 MILLION
NET INCOME (PRE-TAX REFORM)***	$10 MILLION	$12.5 MILLION*
NET INCOME (POST-TAX REFORM)***	$12 MILLION	$15 MILLION
ROE (POST-TAX REFORM)	12%	15%

* Assumes $200m of assets are added as some of the $20m of excess capital is deployed.

** Ignores impact of retained earnings for simplicity as $200m of assets are added.

*** Generally, assumes a 35% tax rate and 21% tax rate, respectively, but numbers rounded for simplicity. Also assumes pre-tax ROA of 1.5% on incremental earnings from $200m of capital deployed.

Community Bank ROE

Community banks must contend with tough headwinds threatening ROE as they transition from a post-crisis recovery cycle to a rising rate environment. As short-term interest rates increase back to normal levels and the Federal Reserve's policy of quantitative easing unwinds in what we call the "Normalization Period", they will face new challenges that typical bank analytics cannot predict.

Loan growth in most parts of the country has declined, deposits are quickly becoming a problem, both in terms of cost and volume, and there is no low-hanging fruit left to optimize the efficiency ratio through organic means.

Many bankers are hopeful that tax reform will change these conditions and spur lending. However, this new surge will have to trump (no pun intended) a Federal Reserve committed to increasing short-term interest rates and reversing QE, which makes it far from a guarantee.

While ROE levels will increase significantly with a lower effective tax rate, investors will also demand higher returns (which will further be exacerbated by rising interest rates). As a result, the cost of capital will significantly increase, and it's only a matter of time before we return to the days when 15 percent ROE was the expectation, not 10 percent.

New Ratio Threatens Independence

Banks that choose the community bank leverage ratio may have less regulatory scrutiny, and perhaps lower compliance costs. But that will come with a significant price. They may find that they cannot generate sufficient ROE for shareholders, and end up putting their bank up for sale.

So, what should bankers do if the new ratio is set at 9 percent or 10 percent? Our opinion: Opt out.

Bankers need to take the bull by the horns and calculate what their capital requirements should be based upon their bank's unique risk profile, risk appetite, business model, and geographic dynamics. They then need to take that analysis to their regulators and fight to make their case. The difference between an 8 percent requirement and 10 percent requirement for a community bank is massive.

Consider a $1 billion bank with $100 million of capital and a pre-tax reform ROA of 1 percent. If this bank can provide evidence that it needs only $80

million of capital, not $100 million, then it essentially frees up a whopping $20 million. If that $20 million is leveraged and deployed, it could create $2 million to $4 million of additional earnings. The table on page 4 illustrates the impact.

Calculating Capital Requirements

The only way a bank can calculate its own capital requirements in a post-2008 world is with a stress test. At the end of the day, the new definition of capital adequacy is based upon a bank's ability to withstand another severe downturn like the 2008 Financial Crisis. This is why regulators use the CCAR stress tests to customize capital requirements for the nation's largest banks. This is why Basel III was created, and why they proposed the creation of a **stress capital buffer** this month.

Think of a stress test as the new calculator. You will need to support your methodology and your assumptions, but the regulators will respect this calculator because it speaks to their holy grail (CCAR). If your calculator shows you only need 8 or even 8.5 percent capital, it is worth fighting for, as our example shows.

Most community banks are only running stress tests today because they feel like they must. It's become a de facto regulatory requirement — especially for banks with CRE or Ag concentrations. What they are missing is that stress testing is not about compliance. It's about capital adequacy.

Those banks that understand this and take that approach will also be the banks that have earned regulatory permission to operate with capital requirements that make more sense for their bank, and not the very expensive safe harbor of 10 percent.

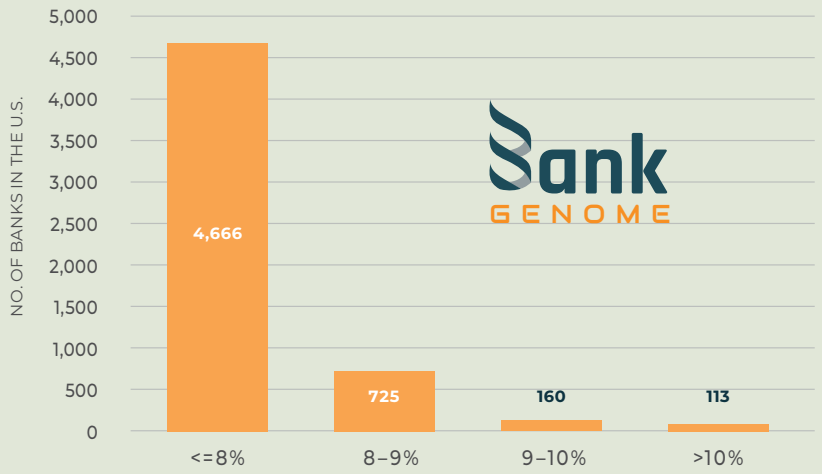
Originally published in Bank Insights

Exclusive Study: Banks Don't Need More Than 8 Percent Capital Leverage Ratios

The vast majority of community banks would be severely damaged by a community bank leverage ratio requirement of 9 or 10 percent, an Invictus study has found. More than 82 percent of community banks have a strong case their requirement should be 8 percent or lower, while only 4.8 percent of banks require a ratio of more than 9 percent.

How the study was done: Invictus used BankGenome™, its powerful intelligence system, to calculate the optimal capital adequacy for all community banks. The system includes quarterly stress tests on every bank in the country driven by unique algorithms that leverage loan-level data as a proxy for regional lending trends. The BankGenome™ stress tests estimate optimal capital requirements for each bank based upon its unique mix of assets, business models, earnings strength, and asset quality profile.

Breakdown of Customized Leverage Ratio Requirements Per BANKGENOME™



Appendix

Regulatory Documents

Banker Webinar

Community Bank Leverage Ratio Framework

Final Rule

Jung Sup Kim, Office of the Comptroller of the Currency
Christopher Appel, Federal Reserve Board
Michael Maloney, Federal Deposit Insurance Corporation
Staff of the Federal Banking Agencies

November 21, 2019

Introduction

On November 13, 2019, the Federal banking agencies issued a final rule which provides for a simple measure of capital adequacy for qualifying community banking organizations, consistent with Section 201 of the *Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA)*.

During today's webinar, staff from the Federal banking agencies will provide an overview of the final rule and answer questions.

Submit questions during the call to RAC@fdic.gov

1

Key Aspects of the Final Rule

- The Community Bank Leverage Ratio (CBLR) framework provides an optional simple leverage capital measure which is generally calculated the same as the generally applicable capital rule's leverage ratio.
- A banking organization (depository institution or depository institution holding company) that has less than $10 billion in total consolidated assets can elect to opt into the framework if its leverage ratio is greater than 9 percent and the banking organization meets the framework's qualifying criteria.
- If a CBLR banking organization fails to satisfy one of the qualifying criteria but has a leverage ratio of greater than 8 percent, the banking organization can continue to apply the CBLR framework and be considered "well capitalized" for a grace period of up to two quarters.

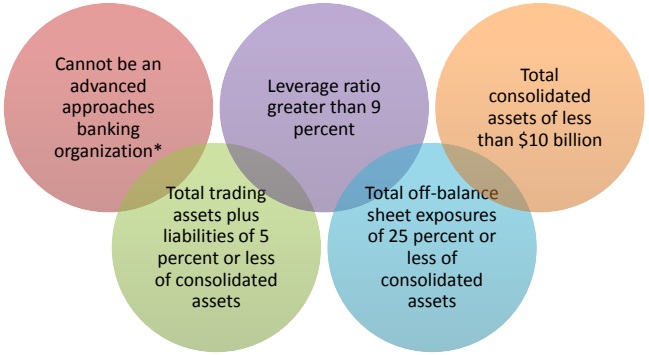
2

Key Aspects of the Final Rule

- If all qualifying criteria are met, the banking organization will be considered to have met the "well capitalized" ratio requirements under the prompt corrective action (PCA) framework and the generally applicable capital rule's requirements.
- Banking organizations electing to use the CBLR framework will not be required to calculate risk-based capital ratios, including complying with HVCRE requirements, or applying heightened risk weights to MSAs, DTAs, or investments in unconsolidated financial institutions.
- Reporting requirements will be simplified for banking organizations using the CBLR framework.

3

What are the requirements to be eligible to use the CBLR Framework?



***Including a subsidiary of an advanced approaches banking organization**

4

Qualifying criteria: Off-balance sheet exposures

Total off-balance sheet exposures of 25 percent or less

- Calculated as the sum of the following items, consistent with the off balance sheet items that attract a capital charge under the generally applicable rule, as a percentage of total consolidated assets.
  - 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, warranties, and performance standby letters of credit;
  - Sold credit protection through
    - (1) Guarantees; and
    - (2) Credit derivatives;
  - Credit-enhancing representations and warranties;
  - Securities lent and borrowed, calculated in accordance with the reporting instructions to the Call Report or to the FR Y-9C as applicable;
  - Off-balance-sheet securitization exposures;
  - Financial standby letters of credit;
  - Forward agreements that are not derivative contracts.

5

Qualifying criteria: Trading assets plus trading liabilities

Trading assets plus trading liabilities of 5 percent or less
• Total trading assets plus trading liabilities, calculated in accordance with the reporting instructions to the Call Report or Form FR Y-9C, as applicable, of 5 percent or less of the banking organization's total consolidated assets, each as of the end of the most recent calendar quarter.

6

Calculation of the CBLR

$$\text{CBLR} = \frac{\text{Tier 1 capital (includes changes related to simplifications final rule and CECL)}}{\text{Average total consolidated assets as of the current quarter* and less deductions from tier 1 capital}}$$

*Reported on Schedule RC-K, line item 9 and FR Y-9C, Schedule HC-K, line item 5

- The community bank leverage ratio is generally calculated in the same manner as the leverage ratio currently calculated by banks.
- The community bank leverage ratio framework does not have a total capital requirement
  - Therefore, an electing banking organization is not required to calculate tier 2 capital or make any tier 2 capital deductions.
  - The generally applicable capital rule requires deductions from tier 2 capital related to investments in capital instruments of unconsolidated financial institutions when such investments exceed certain limits; such deductions can affect the calculation of tier 1 capital.

7

Optionality of the CBLR framework

- A banking organization can opt into the CBLR framework at any time by completing the associated reporting line items that are required on its Call Report and/or Form FR Y–9C, as applicable. The banking organization becomes subject to the CBLR framework when it makes an election.
- CBLR banking organizations may opt out of the framework and become subject to the generally applicable capital rule by completing those reporting requirements on its Call Report and/or Form FR Y–9C, as applicable.
- A banking organization can opt out of the CBLR framework between reporting periods by providing its risk-based capital ratios under the generally applicable capital rule to its appropriate regulators at that time.
- After a banking organization opts out of the CBLR framework it can subsequently opt back in if it meets the qualifying criteria.

8

Grace Period

- If a CBLR banking organization fails to satisfy one or more of the qualifying criteria but maintains a leverage ratio of greater than 8 percent, it would be eligible for a "grace period" of up to two quarters during which it could continue to use the CBLR framework and be deemed to meet the "well capitalized" ratio requirements.
- As long as the banking organization returns to compliance with all qualifying criteria within two quarters, it would continue to meet the "well capitalized" ratio requirements and be in compliance with the generally applicable capital rule.
- A banking organization is required to comply with the generally applicable capital rule and file the relevant regulatory reports if it (i) is unable to restore compliance with all qualifying criteria during the grace period, (ii) has a leverage ratio of 8 percent or less, or (iii) ceases to satisfy the qualifying criteria due to consummation of a merger.

9

Capital and leverage requirements fulfilled by electing to use the CBLR framework

- Qualifying banking organizations that elect to use the CBLR framework and maintain a leverage ratio of greater than 9 percent will be considered to have met:
  - the generally applicable risk-based and leverage capital requirements;
  - if applicable, the well-capitalized ratio thresholds under the PCA framework;
  - any other capital or leverage requirements to which the bank is subject.
- Therefore, CBLR banks will not be subject to the risk-based capital requirements or the capital conservation buffer under the generally applicable rule.

10

Other affected regulations

- The CBLR final rule amends other regulations referencing:
  - "total capital" so that an electing banking organization uses tier 1 capital instead.
  - "risk-weighted assets" so that an electing banking organization uses average total consolidated assets (i.e., the denominator of the leverage ratio) instead.
  - "capital stock and surplus'' (or similar items) so that an electing banking organization uses tier 1 capital plus allowances for loan and lease losses (or adjusted allowance for credit losses, as applicable) instead.

11

Key Aspects of the Final Rule

- The Community Bank Leverage Ratio (CBLR) framework provides an optional simple leverage capital measure which is generally calculated the same as the generally applicable capital rule's leverage ratio.
- A banking organization (depository institution or depository institution holding company) that has less than $10 billion in total consolidated assets can elect to opt into the framework if its leverage ratio is greater than 9 percent and the banking organization meets the framework's qualifying criteria.
- If a CBLR banking organization fails to satisfy one of the qualifying criteria but has a leverage ratio of greater than 8 percent, the banking organization can continue to apply the CBLR framework and be considered "well capitalized" for a grace period of up to two quarters.

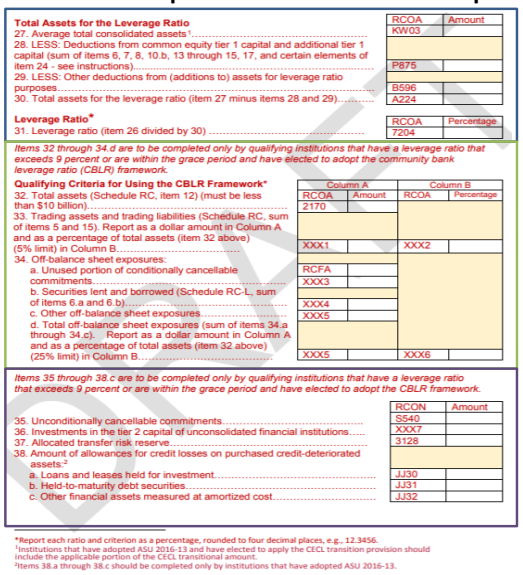
2

CBLR Call Report Changes

- The agencies have proposed changes to reporting requirements for banking organizations that elect to opt into the CBLR framework. For the full proposal go to: https://www.federalregister.gov/documents/2019/10/04/2019-21659/proposed-agency-information-collection-activities-comment-request
- The comment period for the proposal closes on December 3, 2019.

13

Proposed CBLR Call Report Changes



Total Assets for the Leverage Ratio	RCOA	Amount
27. Average total consolidated assets[1]	KW03	
28. LESS: Deductions from common equity tier 1 capital and additional tier 1 capital (sum of items 6, 7, 8, 10.b, 13 through 15, 17, and certain elements of item 24 - see instructions)	P875	
29. LESS: Other deductions from (additions to) assets for leverage ratio purposes	B596	
30. Total assets for the leverage ratio (item 27 minus items 28 and 29)	A224	

Leverage Ratio*	RCOA	Percentage
31. Leverage ratio (item 26 divided by 30)	7204	

Items 32 through 34.d are to be completed only by qualifying institutions that have a leverage ratio that exceeds 9 percent or are within the grace period and have elected to adopt the community bank leverage ratio (CBLR) framework.

Qualifying Criteria for Using the CBLR Framework*	Column A		Column B	
	RCOA	Amount	RCOA	Percentage
32. Total assets (Schedule RC, item 12) (must be less than $10 billion)	2170			
33. Trading assets and trading liabilities (Schedule RC, sum of items 5 and 15). Report as a dollar amount in Column A and as a percentage of total assets (item 32 above) (5% limit) in Column B	XXX1		XXX2	
34. Off-balance sheet exposures:				
a. Unused portion of conditionally cancellable commitments	RCFA			
b. Securities lent and borrowed (Schedule RC-L, sum of items 6.a and 6.b)	XXX3			
c. Other off-balance sheet exposures	XXX4			
d. Total off-balance sheet exposures (sum of items 34.a through 34.c). Report as a dollar amount in Column A and as a percentage of total assets (item 32 above) (25% limit) in Column B	XXX5		XXX6	

Items 35 through 38.c are to be completed only by qualifying institutions that have a leverage ratio that exceeds 9 percent or are within the grace period and have elected to adopt the CBLR framework.

	RCON	Amount
35. Unconditionally cancellable commitments	S540	
36. Investments in the tier 2 capital of unconsolidated financial institutions	XXX7	
37. Allocated transfer risk reserve	3128	
38. Amount of allowances for credit losses on purchased credit-deteriorated assets:[2]		
a. Loans and leases held for investment	JJ30	
b. Held-to-maturity debt securities	JJ31	
c. Other financial assets measured at amortized cost	JJ32	

*Report each ratio and criterion as a percentage, rounded to four decimal places, e.g., 12.3456.
[1]Institutions that have adopted ASU 2016-13 and have elected to apply the CECL transition provision should include the applicable portion of the CECL transitional amount.
[2]Items 38.a through 38.c should be completed only by institutions that have adopted ASU 2016-13.

The leverage ratio calculation has been moved up and is now after the tier 1 numerator calculation

If the bank has a leverage ratio of 9 percent or above or is within the grace period, it must complete the following section. This section collects applicable information for the qualifying criteria

The last section is for informational purposes and was added in order to track CECL impacts as well as CBLR specific issues

14

Additional Resources

- Questions directed to the FDIC can be emailed to regulatorycapital@fdic.gov
- Questions directed to the OCC can be emailed to CapitalPolicy@occ.treas.gov
- Questions directed to the Federal Reserve Board can be emailed to questions@askthefed.org

15

Appendix 1: Summary of Tier 1 Capital Calculation Under the Capital Simplifications Final Rule

Tier 1 Capital*	Simplified Tier 1 Capital
Individual threshold deduction of 10 percent of common equity tier 1 capital for MSAs, certain DTAs, and investments in common stock of unconsolidated financial institutions.	Individual deduction thresholds increased to 25 percent of common equity tier 1 capital for MSAs and DTAs. Separate treatment of investments in common stock of unconsolidated financial institutions eliminated.
Aggregate threshold deduction of 15 percent of common equity tier 1 capital for MSAs, certain DTAs, and investments in common stock of unconsolidated financial institutions.	Eliminates the aggregate 15 percent common equity tier 1 capital deduction threshold.
Deduction treatments for (i) significant investments in the capital of unconsolidated financial institutions in the form of common stock, (ii) significant investments in the capital of unconsolidated financial institutions that are not in the form of common stock, and (iii) non-significant investments in the capital of unconsolidated financial institutions.	Eliminates distinction between significant and non-significant investments in the regulatory capital of unconsolidated financial institutions. Applies a deduction threshold of 25 percent of common equity tier 1 to the aggregate of all investments in the capital of unconsolidated financial institutions.

Limitation on minority interest*	Simplified limitation on Minority Interest
Based on the calculation of the capital ratios of the subsidiary.	Removes allocation based on the subsidiary's capital ratios. Limited to 10 percent of the bank's relevant tier of capital. For example, tier 1 minority interest included in tier 1 capital would be limited to 10 percent of the bank's tier 1 capital.

* As of the effective date of the Capital Simplifications Final Rule, this calculation of tier 1 capital and limitation of minority interest is only applicable to advanced approaches banking organizations.

17

Appendix 2: Additional Proposed Call Report Changes

- The agencies have proposed additional changes to reporting requirements, including changes for banks that are eligible to apply the Capital Simplifications final rule. To review the full proposal go to: https://www.federalregister.gov/documents/2019/10/04/2019-21659/proposed-agency-information-collection-activities-comment-request
- The comment period for the proposal closes on December 3, 2019.

18

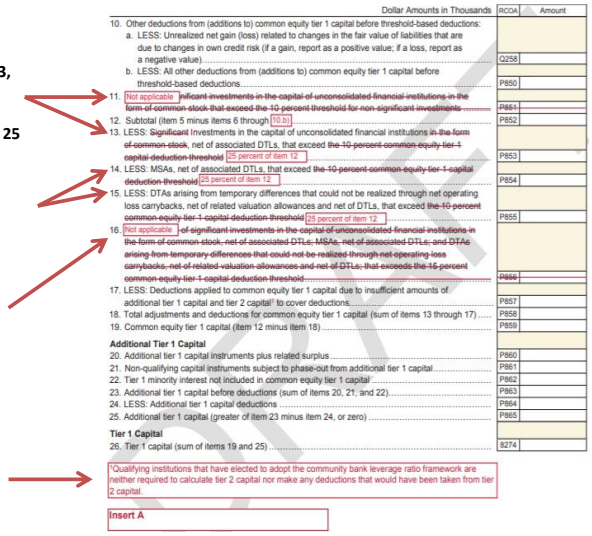
Appendix 2: Capital Simplifications Call Report Changes

Investments in the capital of unconsolidated financial institutions, on lines 11 and 13, will be combined into one category. In addition, the threshold will be increased to 25 percent of line 12

The threshold for lines 14 and 15 will be increased to 25 percent as well

The previous 15 percent aggregate limit on line 16 is removed

As mentioned in the CBLR section, the leverage ratio and CBLR reported items are going to be inserted after the tier 1 calculation

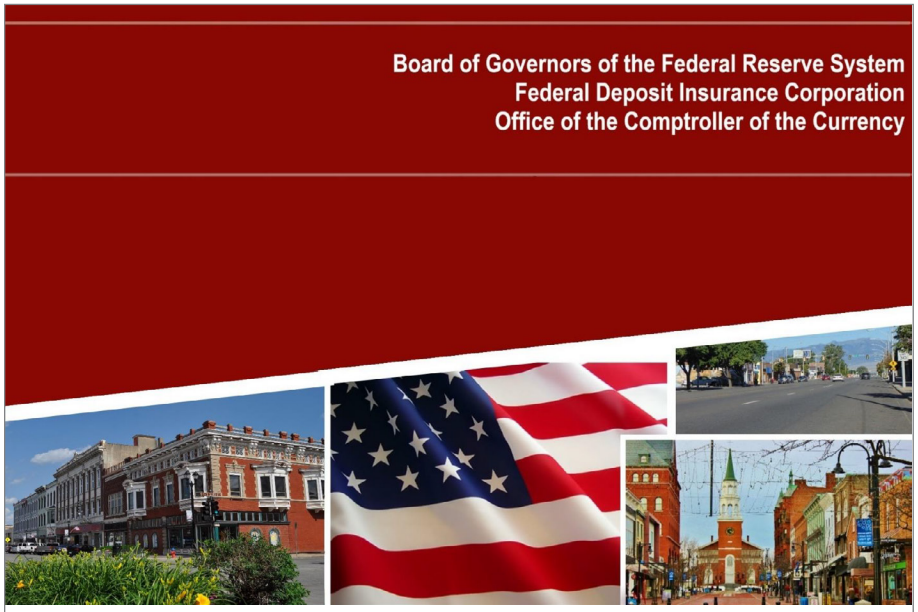


Dollar Amounts in Thousands	RCOA	Amount
10. Other deductions from (additions to) common equity tier 1 capital before threshold-based deductions:		
a. LESS: Unrealized net gain (loss) related to changes in the fair value of liabilities that are due to changes in own credit risk (if a gain, report as a positive value; if a loss, report as a negative value)	Q258	
b. LESS: All other deductions from (additions to) common equity tier 1 capital before threshold-based deductions	P850	
11. Not applicable ~~nificant investments in the capital of unconsolidated financial institutions in the form of common stock that exceed the 10 percent threshold for non-significant investments~~	~~P851~~	
12. Subtotal (item 5 minus items 6 through 10.b)	P852	
13. LESS: ~~Significant~~ Investments in the capital of unconsolidated financial institutions ~~in the form of common stock~~, net of associated DTLs, that exceed ~~the 10 percent common equity tier 1 capital deduction threshold~~ 25 percent of item 12	P853	
14. LESS: MSAs, net of associated DTLs, that exceed ~~the 10 percent common equity tier 1 capital deduction threshold~~ 25 percent of item 12	P854	
15. LESS: DTAs arising from temporary differences that could not be realized through net operating loss carrybacks, net of related valuation allowances and net of DTLs, that exceed ~~the 10 percent common equity tier 1 capital deduction threshold~~ 25 percent of item 12	P855	
16. Not applicable ~~of significant investments in the capital of unconsolidated financial institutions in the form of common stock, net of associated DTLs; MSAs, net of associated DTLs; and DTAs arising from temporary differences that could not be realized through net operating loss carrybacks, net of related valuation allowances and net of DTLs; that exceeds the 15 percent common equity tier 1 capital deduction threshold~~	~~P856~~	
17. LESS: Deductions applied to common equity tier 1 capital due to insufficient amounts of additional tier 1 capital and tier 2 capital[1] to cover deductions	P857	
18. Total adjustments and deductions for common equity tier 1 capital (sum of items 13 through 17)	P858	
19. Common equity tier 1 capital (item 12 minus item 18)	P859	
Additional Tier 1 Capital		
20. Additional tier 1 capital instruments plus related surplus	P860	
21. Non-qualifying capital instruments subject to phase-out from additional tier 1 capital	P861	
22. Tier 1 minority interest not included in common equity tier 1 capital	P862	
23. Additional tier 1 capital before deductions (sum of items 20, 21, and 22)	P863	
24. LESS: Additional tier 1 capital deductions	P864	
25. Additional tier 1 capital (greater of item 23 minus item 24, or zero)	P865	
Tier 1 Capital		
26. Tier 1 capital (sum of items 19 and 25)	8274	

[1]Qualifying institutions that have elected to adopt the community bank leverage ratio framework are neither required to calculate tier 2 capital nor make any deductions that would have been taken from tier 2 capital.

Insert A

19



Community Bank Leverage Ratio Framework

Community Bank Compliance Guide

October 2019

Introduction

This guide[1] is intended to help community banking organizations understand the optional community bank leverage ratio framework recently adopted by the federal banking agencies. The framework provides for a simple measure of capital adequacy for certain community banking organizations, consistent with section 201 of the Economic Growth, Regulatory Relief, and Consumer Protection Act. Depository institutions and depository institution holding companies that have less than $10 billion in total consolidated assets and meet other qualifying criteria, including a tier 1 leverage ratio of greater than 9 percent, are considered qualifying community banking organizations and are eligible to opt into the community bank leverage ratio framework.

This guide summarizes the community bank leverage ratio framework and therefore does not carry the effect of law or regulation. In addition to using this guide, community banking organizations should review the final rule implementing the community bank leverage ratio framework.

Overview of the Community Bank Leverage Ratio Framework

- The community bank leverage ratio framework is an **optional framework** that is designed to reduce burden by removing the requirements for calculating and reporting risk-based capital ratios for qualifying community banking organizations that opt into the framework.
- Qualifying community banking organizations that elect to use the community bank leverage ratio framework and that maintain a leverage ratio of greater than 9 percent are considered to have satisfied the risk-based and leverage capital requirements in the agencies' generally applicable capital rule. Additionally, such insured depository institutions are considered to have met the well-capitalized ratio requirements for purposes of section 38 of the Federal Deposit Insurance Act.
- The main components and requirements of the community bank leverage ratio framework are as follows:

Community Bank Leverage Ratio Framework	
Qualifying Community Banking Organization	• Leverage ratio greater than 9 percent • Less than $10 billion in average total consolidated assets • Off-balance-sheet exposures of 25 percent or less of total consolidated assets • Trading assets plus trading liabilities of 5 percent or less of total consolidated assets • Not an advanced approaches banking organization
Calculation of the Leverage Ratio	$\frac{\text{Tier 1 capital}}{\text{Average total consolidated assets}}$
Leverage ratio Requirement	Greater than 9 percent

[1] This small entity compliance guide is issued in accordance with Section 212 of the Small Business Regulatory Enforcement Fairness Act of 1996, Pub. L. No. 104-121, 110 Stat. 857, reprinted in 5 U.S.C.A. § 601, note.

Community Bank Leverage Ratio Framework	
Grace Period	A two-quarter grace period (which begins as of the end of the calendar quarter in which the electing banking organization ceases to satisfy any of the qualifying criteria) to either meet the qualifying criteria again or to comply with the generally applicable capital rule. • Grace period applies when a banking organization's leverage ratio is 9 percent or less but greater than 8 percent. • A banking organization that fails to maintain a leverage ratio greater than 8 percent would not be permitted to use the grace period and must comply with the generally applicable capital rule and file the appropriate regulatory reports. • Grace period does not apply in the case of a merger or acquisition.

Details of the Community Bank Leverage Ratio Framework

Calculation of the Leverage Ratio

The leverage ratio required for purposes of the community bank leverage ratio framework is calculated as tier 1 capital divided by average total consolidated assets, consistent with how banking organizations calculate their leverage ratio under the generally applicable capital rule.

The calculation of tier 1 capital includes the modifications made in relation to the capital simplifications final rule[2] and current expected credit losses methodology (CECL) transitions final rule.[3]

Note: The generally applicable capital rule requires deductions from tier 2 capital related to investments in capital instruments of unconsolidated financial institutions when such investments exceed certain limits; such deductions can affect the calculation of tier 1 capital. The community bank leverage ratio framework does not have a total capital requirement; therefore, an electing banking organization is not required to calculate tier 2 capital or make any tier 2 capital deductions under the generally applicable capital rule.

Qualifying Community Banking Organization

The community bank leverage ratio framework is optional for a banking organization that meets the following qualifying criteria:[4]

[2] Banking organizations electing to use the community bank leverage ratio framework would incorporate the changes made by the capital simplifications final rule when calculating tier 1 capital, which include an increase in the individual regulatory limit for mortgage servicing assets and certain deferred tax assets from 10 percent to 25 percent of a non-advanced approaches banking organization's common equity tier 1 capital. In addition, the capital simplifications final rule removed the aggregate 15 percent common equity tier 1 capital threshold deduction, streamlined the treatment for investments in the capital of unconsolidated financial institutions, and simplified the calculation for minority interest limitations for non-advanced approaches banking organizations. For more information on the capital simplifications final rule, see 84 FR 35234 (July 22, 2019). The agencies also have adopted a final rule that permits non-advanced approaches banking organizations to implement the capital simplifications final rule in the quarter beginning January 1, 2020, or wait until the quarter beginning April 1, 2020.

[3] *See* 84 FR 4222 (February 14, 2019)

1) *A leverage ratio of greater than 9 percent.*

2) *Total consolidated assets of less than $10 billion:* Total consolidated assets are calculated in accordance with the reporting instructions to Schedule RC of the Call Report or Schedule HC of Form FR Y-9C, as applicable.

3) Total off-balance-sheet exposures (excluding derivatives other than sold credit derivatives and unconditionally cancellable commitments) of 25 percent or less of total consolidated assets: The off-balance sheet qualifying criterion incorporates off-balance sheet exposures currently required to be captured and reported by banking organizations in the Call Report or Form FR Y-9C. The following exposures are included in the calculation:
    a. The unused portions of commitments (except for unconditionally cancellable commitments);
    b. Self-liquidating, trade-related contingent items that arise from the movement of goods;
    c. Transaction-related contingent items (*i.e.*, performance bonds, bid bonds, and warranties);
    d. Sold credit protection in the form of guarantees and credit derivatives;
    e. Credit-enhancing representations and warranties;
    f. Off-balance-sheet securitization exposures (to the extent that they are not captured in other off balance-sheet exposures);
    g. Letters of credit;
    h. Forward agreements that are not derivative contracts; and
    i. Securities lending and borrowing transactions.

4) *Total trading assets plus trading liabilities of 5 percent or less of total consolidated assets:* Total trading assets and trading liabilities are calculated as the sum of those exposures, in accordance with the reporting instructions for these items in the Call Report or Form FR Y 9C, as applicable.

5) *Non-advanced approaches institution:* An advanced approaches banking organization is not eligible to use the community bank leverage ratio framework.

Opting into and out of the community bank leverage ratio framework

A qualifying community banking organization may opt into the community bank leverage ratio framework by completing the associated reporting line items that are required for such firms on its Call Report and/or Form FR Y–9C, as applicable. A qualifying community banking organization becomes subject to the community bank leverage ratio framework when it makes an election.

A banking organization may opt out of the community bank leverage ratio framework and become subject to the generally applicable capital rule by completing the associated reporting requirements on its Call Report and/or Form FR Y–9C, as applicable. A banking organization can opt out of the community bank leverage ratio framework between reporting periods by providing its capital ratios under the generally applicable capital rule to its appropriate regulators at that time.

[4] A non-advanced approaches subsidiary depository institution may opt into the community bank leverage ratio framework if the institution meets all qualifying requirements—even if its parent holding company is not a qualifying banking organization, and vice versa.

A banking organization that opts out of the community bank leverage ratio framework can subsequently opt back into the community bank leverage ratio framework if it meets the qualifying criteria listed above.

Grace Period

If an electing banking organization fails to satisfy one or more of the qualifying criteria but maintains a leverage ratio of greater than 8 percent, that banking organization would have a "grace period" of up to two quarters during which it could continue to use the community bank leverage ratio framework and be deemed to meet the "well capitalized" capital ratio requirements. As long as the banking organization is able to return to compliance with all the qualifying criteria within two quarters, it continues to be deemed to meet the "well capitalized" ratio requirements and be in compliance with the generally applicable capital rule.

A banking organization is required to comply with and report under the generally applicable capital rule and file the relevant regulatory reports if the banking organization (i) is unable to restore compliance with all qualifying criteria during the two-quarter grace period (including reporting a leverage ratio greater than 9 percent), (ii) has a leverage ratio of 8 percent or less, or (iii) ceases to satisfy the qualifying criteria due to consummation of a merger transaction.

FACT SHEET

Federal Deposit Insurance Corporation

September 17, 2019

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FACT SHEET: Overview of the Community Bank Leverage Ratio Framework

- The community bank leverage ratio (CBLR) framework is an **optional framework** that is designed to reduce burden by removing the requirements for calculating and reporting risk-based capital ratios for qualifying community banking organizations that opt into the framework. The framework provides a simple measure of capital adequacy for qualifying community banking organizations, consistent with section 201 of the Economic Growth, Regulatory Relief and Consumer Protection Act.
- Qualifying community banking organizations that elect to use the CBLR framework and that maintain a leverage ratio of greater than 9 percent are considered to have satisfied the risk-based and leverage capital requirements in the generally applicable capital rule. In addition, these institutions are considered to have met the well-capitalized ratio requirements for purposes of section 38 of the Federal Deposit Insurance Act.
- The main components and requirements of the CBLR framework are as follows:

Community Bank Leverage Ratio (CBLR) Framework	
Qualifying Community Banking Organization	• Leverage ratio greater than 9 percent • Less than $10 billion in average total consolidated assets • Off-balance-sheet exposures of 25 percent or less of total consolidated assets • Trading assets plus trading liabilities of 5 percent or less of total consolidated assets • Not an advanced approaches banking organization
Calculation of the Leverage Ratio	Tier 1 capital / Average total consolidated assets
Leverage Ratio Requirement	Greater than 9 percent
Grace Period	A two-quarter grace period (which begins at of the end of the calendar quarter in which the electing banking organization ceases to satisfy any of the qualifying criteria) to either meet the qualifying criteria again or to comply with the generally applicable capital rule. • Grace period applies when a banking organization's leverage ratio is 9 percent or less but greater than 8 percent. • A banking organization that fails to maintain a leverage ratio greater than 8 percent would not be permitted to use the grace period and must comply with the generally applicable capital rule, and file the appropriate regulatory reports. • Grace period does not apply in the case of a merger or acquisition.

A qualifying community banking organization may opt into and out of the community bank leverage ratio framework by completing the associated reporting requirements on its Call Report. To learn more, visit the press release related to capital simplification for qualifying community banking organizations and early adoption of certain related simplifications to the regulatory capital requirements.

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