Client Alert

October 2019

Final Regulatory Capital Rule: Capital Simplification for Community Banks

In November of last year, we provided a question-and-answer summary of the joint notice of proposed rulemaking concerning capital simplification for community banks.[1] On September 17, 2019, the OCC, the Federal Reserve and the FDIC issued their final rule.[2] This alert is a supplement to our earlier client alert, addressing significant differences between the joint notice of proposed rulemaking and the final rule. Those significant differences include: (1) adopting the existing leverage ratio as the community bank leverage ratio ("CBLR"); (2) removing the qualifying criteria for qualifying community banking organizations (QCBO) relating to mortgage servicing assets and deferred tax assets; (3) removing the prompt corrective action ("PCA") proxy levels; and (4) allowing banking organizations that elect to use the CBLR to be considered "well-capitalized" during a two-quarter grace period if their CBLR is 9% or less and greater than 8%.

The final rule takes effect on January 1, 2020. Banking organizations that desire to opt in to the framework can do so through their Consolidated Report of Condition and Income (Call Report) or Form FR-Y9C covering the first quarter of 2020.

Who is a QCBO?

A qualifying community banking organization ("QCBO"), is a bank or holding company that:

1. is not an advanced approaches banking organization;[3]
2. has a leverage ratio of greater than 9%;
3. has total consolidated assets of $10 billion or less calculated in accordance with Call Report/FR Y-9C instructions as of the end of the most recent calendar quarter;
4. has off-balance sheet exposures of 25% or less of its assets (e.g., unused commitments, sold credit protection, off-balance sheet securitization exposures, etc.); and
5. has total trading assets and liabilities of 5% or less of its assets.

The final rulemaking explains that the mortgage servicing assets/deferred tax asset thresholds were removed from the QCBO definition as unnecessary in light of the change in the numerator of the CBLR to the existing definition of tier 1 capital (which already incorporates these intangible asset deductions from capital).

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[1] Our original client alert can be found at the following link: https://www.huntonak.com/en/insights/simplifying-capital-for-community-banks.html

[2] A copy of the final rulemaking can be found at the following link: https://www.fdic.gov/news/board/2019/2019-09-17-notice-dis-a-fr.pdf

[3] An advanced approaches banking organization is generally defined as a firm with at least $250 billion in total consolidated assets or at least $10 billion in total on-balance sheet foreign exposure, and depository institution subsidiaries of those firms. Proposed rulemakings to tailor capital and liquidity requirements applicable to large banking organizations may result in changing the definition of advanced approaches banking organization. *See* 83 FR 66024 (December 21, 2018) and 84 FR 24296 (May 24, 2019).

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

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

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

Technically, yes. In discussing the adoption of the final rule, the regulators stated that:

> … a banking organization can opt out of the community bank leverage ratio framework at any time, without restriction, by reverting to the generally applicable rule and providing the capital ratios under the generally applicable rule to its appropriate regulators at the time of opting out.

However, according to the notice of proposed rulemaking:

> While the agencies would not place restrictions on the ability of [a QCBO] to switch in and out of the CBLR framework, the agencies anticipate such changes to be rare and typically driven by significant changes in the banking organization's business activities. The agencies believe that some flexibility to reverse the election to use the CBLR framework is warranted to ensure that banking organizations can adjust their business strategies and activities over time. The agencies would expect a CBLR banking organization to be able to provide a rationale for opting out of the CBLR framework to its appropriate regulators, if requested.

What happens if I elect the CBLR framework, but then our leverage ratio falls below 9%?

There is a limited grace period of two calendar quarters so long as you maintain a leverage ratio greater than 8%. After this grace period you either have to requalify as a QCBO or go back to the Basel III capital framework. If you fail to maintain a leverage ratio of greater than 8% during the grace period, or are unable to restore compliance with the CBLR within the grace period, you must comply with the Basel III capital framework.

How do I calculate the numerator in the CBLR?

In response to numerous commenters, the regulators declined to adopt the calculation as originally proposed in the joint notice of proposed rulemaking, which would have involved the calculation of a new measure of capital, referred to as "CBLR tangible equity." Instead, the final rule provides that the numerator is the existing measure of tier 1 capital used by non-advanced approaches banking organizations. By using tier 1 capital, the bank regulators responded to comments received concerning whether trust preferred securities and certain other preferred stock instruments, and minority interests would be includable in the numerator to the same extent they are included in the capital numerator under the Basel III capital framework.

It should be noted that the regulators expect the numerator calculation to take into account any modifications made in relation to the capital simplifications rule and current expected credit losses methodology (CECL) transitions rule.[4]

How do I calculate the denominator in the CBLR?

The CBLR denominator is equal to the average total consolidated assets calculated in accordance with Call Report or FR Y-9C instructions, less assets subtracted from tier 1 capital.

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

In the joint notice of proposed rulemaking, the regulators proposed to allow electing banking organizations

[4] *See* 84 FR 35,234 (July 22, 2019); 84 FR 4,222 (February 14, 2019).

to remain in the CBLR framework despite their CBLR falling below 9%, so long as the banking organization maintained certain defined “PCA proxy” capital categories. The final rule, however, eliminates this “PCA proxy” concept, and banking organizations will now generally be required to maintain a CBLR of greater than 9% in order to remain eligible (subject to the two quarter grace period described above).

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

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

We hope this summary is helpful. If you have any questions we would be happy to hear from you.

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