Client Alert

April 2020

The Community Bank Leverage Ratio and the CARES Act

Following the adoption of the Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act") and Section 4012 thereunder, the Federal Reserve, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation issued two interim final rules making substantive changes to the Community Bank Leverage Ratio (the "CBLR"). Section 4012 of the CARES Act required the bank regulators to lower the CBLR from nine percent (9%) to eight percent (8%) and to establish "a reasonable grace period to satisfy" the CBLR when a qualifying community banking organization ("QCBO") falls below the CBLR.

Consistent with Section 4012, on April 6, 2020 the banking regulators made the following changes to the CBLR framework:

1. Beginning in the second quarter of 2020, a community bank need only have a leverage ratio of at least eight percent (8%) in order to qualify as a QCBO, subject to the other qualifying requirements.[1]

2. If a QCBO's leverage ratio falls below eight percent (8%), then the QCBO will have two calendar quarters to maintain a leverage ratio of seven percent (7%) or greater.

The above changes shall take effect when the final rule is published in the Federal Register and shall terminate upon the earlier of the termination of the national emergency related to COVID-19 or December 31, 2020. However, the banking regulators' second interim final rule becomes effective upon the first interim final rule's termination. This second rule provides that the CBLR will be set at eight percent (8%) for the remainder of 2020, eight and one half percent (8.5%) for 2021, and nine percent (9%) thereafter. It also adjusts the grace period CBLR to account for the graduating increase. Thus, in 2020 and 2021, QCBOs utilizing the grace period must maintain a leverage ratio of at least seven percent (7%) and seven and one half percent (7.5%), respectively. Thereafter, QCBOs utilizing the grace period must maintain a CBLR of at least eight percent (8%). If a QCBO fails to maintain the applicable minimum CBLR during the grace period, or if the QCBO is unable to restore compliance with the CBLR within the grace period, then the QCBO will revert to the Basel III capital framework and the normal Prompt Corrective Action ("PCA") capital categories will apply. A bank will be considered to be well capitalized as long as they qualify as a QCBO.

The interim final rules published on April 6, 2020 do not affect any other portion of the CBLR regime.

These lower ratios may make the CBLR regime attractive to more community banks. In general, a bank should consider opting into the CBLR if the bank's risk based capital ratios are the bank's limiting ratios.

[1] In addition to the leverage ratio, the bank must (1) not be an "advanced approaches banking organization", (2) have 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, (3) have 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 (4) have total trading assets and liabilities of 5% or less of its assets. For additional details on the CBLR framework, please refer to our Client Alert published on October 1, 2019 which can be found here: https://www.huntonak.com/en/insights/final-regulatory-capital-rule-capital-simplification-for-community-banks.html

In order words, if the difference between a bank's actual risk-based capital ratios and the minimum capital ratios (plus fully funded capital buffer) is smaller than the difference between the bank's actual leverage ratio and the CBLR ratio of 8%, then the bank may benefit (from a capital standpoint) by opting into the CBLR regime. Here is an example:

	Well-capitalized	Minimum plus capital buffer	Bank A	Bank B
Leverage Ratio	5.00%	4.00%	9.75%	8.00%
Common Equity Tier 1 Ratio	6.50%	7.00%	12.00%	12.50%
Tier 1 Ratio	8.00%	8.50%	12.00%	12.50%
Total Capital Ratio	10.00%	10.50%	12.00%	13.00%

In this case, from a capital standpoint, Bank A would likely benefit from opting into CBLR while Bank B would not. Because Bank B is already operating at a leverage ratio of 8.00% opting in to the CBLR would have the effect of requiring Bank B to raise additional capital to support additional assets. However, if Bank B does not opt into CBLR it could still acquire additional assets, see its ratios lowered, and still be in compliance with both the well-capitalized requirements as well as the minimum capital ratios plus the buffer. For Bank A, on the other hand, opting into CBLR might make sense from a capital standpoint because the difference between the Bank A's total risk based capital ratio (12.00%) and the minimum capital ratio plus the capital buffer (10.50%) is 150bps whereas the difference between Bank A's leverage ratio (9.75%) and the CBLR (8.00%) is 175bps. This suggests that Bank A, as it adds assets to its balance sheet, could breach its risk-based capital ratios under Basel III before it would breach the leverage ratio under the CBLR. This conclusion suggests that Bank A could benefit, from a capital standpoint, from opting into the CBLR.

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

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