Client Alert

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Agencies Propose Simplification of Capital Rules for Community Banks

By Henry M. Fields and Mark R. Sobin

On November 21, 2018, the federal banking agencies[1] (the "Agencies") released a proposal (the "Proposed Rule")[2] to simplify the regulatory capital requirements for qualifying community banking organizations (QCBOs) (*i.e.*, depository institutions and depository institution holding companies with assets of less than $10 billion that meet certain conditions).

If adopted, the Proposed Rule would be the most significant change to the U.S. capital rules for community banks since 2013, when the Agencies adopted Basel III capital rules applicable to all U.S. banks. The 2013 rules, under which community banks continue to operate, established three risk-weighted asset (RWA) minimum capital standards (common equity Tier 1 capital/RWA of 4.5%; Tier 1 capital/RWA of 6%; and total capital/RWA of 8%) and a minimum leverage ratio of 4%.[3]

Since the enactment of the U.S. Basel III capital regime, community banks have expressed concern regarding its complexity and regulatory burden, particularly as applied to banks of their size and limited risk profile. On May 24, 2018, Congress enacted the Economic Growth, Regulatory Relief, and Consumer Protection Act,[4] Section 201 of which directs the Agencies to develop an "off-ramp" from the U.S. Basel III capital regime for qualifying community banks that meet a leverage ratio of tangible equity to average total consolidated assets of not less than 8% or more than 10%.

The Agencies have responded to this congressional directive with the Proposed Rule. The Proposed Rule would enable QCBOs, at their option, to meet regulatory capital standards by calculating and reporting a single tangible equity leverage ratio, referred to as the community bank leverage ratio (CBLR), rather than the risk-weighted asset capital adequacy and leverage ratios currently required. Comments are invited on various aspects of the Proposed Rule. Comments must be received within 60 days after publication of the Proposed Rule in the *Federal Register*.

In designing the framework for implementation of the CBLR, the Agencies sought to ensure that (i) the CBLR framework would be broadly available to community banks; (ii) the capital currently held by QCBOs would not be reduced; (iii) institutions with higher risk profiles would continue to use generally applicable capital requirements; (iv) the prompt corrective action framework and other statutes and regulations reliant on capital standards would be maintained; and (v) meaningful relief for QCBOs from their regulatory compliance burden would be achieved.

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[1] The federal banking agencies include the Board of Governors of the Federal Reserve System; the Federal Deposit Insurance Corporation (FDIC); and the Office of the Comptroller of the Currency.

[2] The Proposed Rule, as released by the FDIC, is available here: https://www.fdic.gov/news/news/press/2018/pr18088.html.

[3] Banks that are subject to the advanced approaches capital rules also need to comply with a supplemental leverage ratio.

[4] Pub. L. 115-174, 132 Stat. 1296.

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The Agencies estimate that the vast majority of banking organizations with less than $10 billion in consolidated assets would meet the QCBO definition and have a CBLR above the required minimum.

WHAT QUALIFIES A BANKING ORGANIZATION TO BE A QCBO?

A depository institution or a depository institution holding company would be considered a QCBO—and therefore may elect to use the CBLR framework for measuring capital adequacy—if that banking organization meets the following criteria:

- The banking organization has less than $10 billion in total consolidated assets;
- The banking organization has total off-balance sheet exposures (excluding derivatives that are not credit derivatives and excluding unconditionally cancellable commitments) of 25% or less of total consolidated assets;[5]
- The banking organization has total trading assets and trading liabilities of 5% or less of total consolidated assets;[6]
- The banking organization has mortgage servicing assets of 25% or less of CBLR tangible equity (defined below);
- The banking organization has temporary difference deferred tax assets, net of any related valuation allowances, of 25% or less of CBLR tangible equity (as defined below);[7] and
- The banking organization is not a banking organization that is subject to the advanced approaches capital rules (*i.e.*, it is not a subsidiary of a banking organization that has, $250 billion or more in total consolidated assets or $10 billion or more in on-balance sheet foreign exposure);

Notwithstanding a banking organization's satisfaction of the conditions described above, the Agencies would reserve authority to disallow use of the CBLR framework, based on the risk profile of the banking organization.

CALCULATION OF THE CBLR

The CBLR for a QCBO would equal the ratio of the institution's "CBLR tangible equity" to its "average total consolidated assets." The calculation of CBLR tangible equity would be based on the equity capital of the banking organization, as reported on Schedule RC of the call report (with the adjustments described below). Notably, CBLR tangible equity would not distinguish among the various gradients of equity under the Basel III regime, such as those instruments that qualify for CET 1 equity, Tier 1 equity or total equity capital.

[5] The limitation of off-balance sheet exposures is proposed because, under the CBLR framework, no capital would be required to be held against off-balance sheet exposures. The Agencies believe that the 25% limitation will not preclude community banks from qualifying as QCBOs by reason of the loan commitments they make in the normal course of their activities. Specific items to be treated as off-balance sheet exposures are listed in the Proposed Rule.

[6] As characterized in the call report instructions.

[7] Temporary difference deferred tax assets are deferred tax assets arising from temporary differences that could not be realized through net operating loss carrybacks, net of any related valuation allowances.

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- **CBLR tangible equity** would equal:
    - Total QCBO equity capital, prior to including minority interests of a consolidated subsidiary,[8] as determined in accordance with the call report instructions; less
    - (i) accumulated other comprehensive income (AOCI); (ii) intangible assets other than mortgage servicing assets; (iii) deferred tax assets, net of any related valuation allowances, that arise from net operating loss and tax credit carryforwards; and (iv) solely for FDIC supervised institutions (non-member banks), identified losses.[9]
- **Average total consolidated assets** would equal total QCBO assets calculated in accordance with the call report instructions, less the deductions taken to determine CBLR tangible equity (except for AOCI).

ELECTION

A QCBO with a CBLR greater than 9% would be permitted to elect to use the CBLR framework at any time by completing a CBLR reporting schedule on its call report. A form for such a schedule will be proposed by the Agencies at a later date but an illustrative example of the form was provided with the introduction to the Proposed Rule, and we have reproduced it as an attachment to this Client Alert.

The Proposed Rule would permit a QCBO to opt out of the CBLR framework by reporting the capital ratios under the generally applicable capital requirements at the time of opting out. This could be done at any time, but the Agencies would expect the QCBO to provide an explanation at the time of opting out and, presumably, a QCBO seeking to arbitrage the two regimes would be discouraged from doing so.

Institutions that no longer meet the criteria for being treated as a QCBO would be given a two quarter grace period to either meet the necessary qualifications or demonstrate compliance with the generally applicable capital requirements.

REGULATORY IMPLICATIONS UNDER THE CBLR FRAMEWORK

QCBOs with a CBLR greater than 9% and that elect to use the CBLR framework will be deemed to have met the generally applicable capital requirements, the standard to be considered “well capitalized,” and any other capital or leverage ratio that applies to such banking organizations. However, consistent with the prompt corrective action framework, a banking organization would not be considered “well capitalized” if it is subject to a written agreement, order, capital directive, or prompt corrective action directive to meet and maintain a specific capital level for any capital measure even if the banking organization already has a CBLR greater than 9%.

The Proposed Rule would also establish the following metrics under the CBLR framework for determining which prompt corrective action capital category would apply to the banking organization:

- Adequately Capitalized = CBLR of 7.5% or greater
- Undercapitalized = CBLR of less than 7.5%
- Significantly Undercapitalized = CBLR of less than 6%

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[8] Such minority interests are not seen as having the same loss absorption capacity as other components of tangible equity.

[9] Identified losses need only be deducted “to the extent that CBLR tangible equity would have been reduced if the appropriate accounting entries to reflect the identified losses had been recorded on the banking organization’s books.” *See* Proposed Rule, n. 21 at p. 25.

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The Proposed Rule would not change the metrics for determining whether an institution is "critically undercapitalized," which would continue to include institutions with a ratio of tangible equity to total assets of 2% or less.

Through these new metrics for determining prompt corrective action categories, other regulations and statutes that rely on prompt corrective action categories to determine the applicability of rules and standards would continue to apply to QCBOs that elect to use the CBLR framework. In addition, the federal banking agencies propose to amend regulations that rely on capital ratios so that the CBLR framework may be used in those contexts as well. For example, where risk-weighted assets are referenced in regulations, the Agencies propose to permit QCBOs using the CBLR framework to instead use average total consolidated assets.

CONCLUSION

The Proposed Rule will not escape criticism. Some will say that the CBLR should have been 8%, and others that it should have been 10%. And there will be different views regarding the calculation of the CBLR and the qualifying criteria for QCBOs. However, these differences will be resolved through the regulatory process. Given the legislative mandate to provide capital relief to community banks in the form of a tangible leverage ratio, significant capital simplification for community banking organizations is on the way.

Contact:

Henry M. Fields
(213) 892-5275
hfields@mofo.com

Mark R. Sobin
(212) 336-4222
msobin@mofo.com

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APPENDIX A

CBLR Tangible Equity (CBLR numerator)		Percent	Amount
1	Total bank equity capital (Schedule RC, item 27.a)		
2	LESS: Accumulated other comprehensive income (Schedule RC, item 26.b)		
3	LESS: Goodwill (Schedule RC-M, item 2.b)		
4	LESS: All other intangible assets (Schedule RC-M, item 2.c)		
5	LESS: Deferred tax assets (DTAs) that arise from net operating loss and tax credit carryforwards, net of any related valuation allowances		
6	Total adjustments and deductions for CBLR tangible equity (sum of items 2 through 5)		
7	CBLR tangible equity (item 1 minus item 6)		
Average Total Consolidated Assets for the Community Bank Leverage Ratio (CBLR denominator)			
8	Total assets (Schedule RC-K, item 9)		
9	Deductions from CBLR tangible equity (sum of items 3, 4, and 5, above)		
10	Average total consolidated assets (item 8 minus item 9)		
Community Bank Leverage Ratio			
11	Community bank leverage ratio (item 7 divided by item 10)		
Qualifying Criteria for Using the CBLR framework			
12	Total assets (from Schedule RC, item 12); (must be less than $10 billion)		
13	MSAs (from Schedule RC-M, item 2.a.) as a percentage of CBLR tangible equity (25% limit)		
14	DTAs arising from temporary differences that could not be realized through net operating loss carrybacks, net of any related valuation allowances as a percentage of CBLR tangible equity (25% limit)		
15	Trading Assets and Trading Liabilities (Schedule RC, sum of items 5 and 15) as a percentage of total consolidated assets (5% limit)		
16	Off-balance sheet exposures		
a	Unused portion of conditionally cancellable commitments		
b	Off-balance sheet securitizations		
c	Securities lent and borrowed (Schedule RC-L, sum of items 6.a and 6.b)		
d	Other off-balance sheet exposures		
e	Total off-balance sheet exposures (sum of items 16a through 16d) as a percentage of total consolidated assets (25% limit)		
17	Memo item: Unconditionally cancellable commitments		

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Financial Services Team

California		New York	
Alexis A. Amezcua	(415) 268-6557	Robert J. Baehr	(212) 336-4339
Elizabeth Balassone	(415) 268-7585	James M. Bergin	(212) 468-8033
Roland E. Brandel	(415) 268-7093	Meghan E. Dwyer	(212) 336-4067
Sarah N. Davis	(415) 268-7478	David J. Fioccola	(212) 336-4069
Henry M. Fields	(213) 892-5275	Marc-Alain Galeazzi	(212) 336-4153
Joseph Gabai	(213) 892-5284	Adam J. Hunt	(212) 336-4341
Angela E. Kleine	(415) 268-6214	Jessica Kaufman	(212) 336-4257
Jim McCabe	(415) 268-7011	Mark P. Ladner	(212) 468-8035
James R. McGuire	(415) 268-7013	Jiang Liu	(212) 468-8008
Mark David McPherson	(212) 468-8263	Barbara R. Mendelson	(212) 468-8118
Ben Patterson	(415) 268-6818	Michael B. Miller	(212) 468-8009
Sylvia Rivera	(213) 892-5734	Jeffrey K. Rosenberg	(212) 336-4130
William L. Stern	(415) 268-7637	Mark R. Sobin	(212) 336-4222
Nancy R. Thomas	(213) 892-5561	Joan P. Warrington	(212) 506-7307
Lauren Lynn Wroblewski	(415) 268-6458		

Washington, D.C.			
Marcie Brimer	(202) 887-6932	Steven M. Kaufmann	(202) 887-8794
Rick Fischer	(202) 887-1566	Jeremy R. Mandell	(202) 887-1505
Adam J. Fleisher	(202) 887-8781	Elyse S. Moyer	(202) 778-1616
Natalie A. Fleming Nolen	(202) 887-1551	Obrea O. Poindexter	(202) 887-8741
Calvin D. Funk	(202) 887-6930	Sean Ruff	(202) 887-1530
Susan I. Gault-Brown	(202) 887-1597	Trevor R. Salter	(202) 887-1527
Julian E. Hammar	(202) 887-1679	Nathan D. Taylor	(202) 778-1644
Oliver I. Ireland	(202) 778-1614	Jennifer S. Talbert	(202) 887-1563
Crystal N. Kaldjob	(202) 887-1687		

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