



Financial Services & Products ADVISORY ■

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What's Your Leverage? Most Community Banks Can Soon "Opt In" to the Community Bank Leverage Ratio Framework

On September 17, 2019, the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation (FDIC) (collectively, the "agencies") adopted a final rule implementing Section 201 of the 2018 regulatory reform law known as the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA). The [final rule](#) provides certain community banking organizations the ability to opt in to a new community bank leverage ratio (CBLR) intended to simplify regulatory capital requirements and to allow qualifying banking organizations to avoid the burden of calculating and reporting risk-based capital ratios. The final rule becomes effective on January 1, 2020.

Background

On May 24, 2018, the EGRRCPA amended provisions in the Dodd–Frank Wall Street Reform and Consumer Protection Act as well as other law. Among other things, Section 201 of the EGRRCPA was intended to provide community banking organizations with regulatory relief from the complexities and burdens of the generally applicable risk-based capital rules (including the Basel III requirements implemented in the U.S.), while still ensuring a high quality and quantity of capital consistent with the safety and soundness goals of regulatory capital standards. Specifically, the EGRRCPA directed the agencies to promulgate rules providing for a CBLR between 8% and 10% for qualifying community banking organizations (QCBO—generally, a depository institution or its holding company with total consolidated assets of less than \$10 billion).

Pursuant to the EGRRCPA, the agencies published a joint notice of proposed rulemaking on February 8, 2019, which, among other things, proposed a CBLR of greater than 9%. Some banking industry groups advocated for an 8% threshold, arguing that a 9% standard was higher than necessary. According to the Congressional Research Service, of the 5,078 FDIC-insured depository institutions that qualify based on size and risk criteria, approximately 4,440 (or 83% of all U.S. banks) would exceed a 9% threshold and would be eligible to enter the CBLR framework without having to hold additional capital. If the threshold were set at 8%, an additional 515 banks (9.6%) would exceed the lower threshold. Thus, the difference between 8% or 9% could provide appropriate regulatory relief to or remove important safeguards from almost 10% of the nation's banks, which collectively hold about 2% of total U.S. banking industry assets. Banks that would be CBLR-compliant at a 9% threshold are similar in size, activities, and off-balance-sheet exposures to 8% threshold banks. The agencies ultimately settled on the 9% threshold, while also providing for a leverage ratio of 8% in certain limited circumstances, and issued a final rule implementing the CBLR framework on September 17, 2019.

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Summary of the Final Rule

Importantly, QCBOs subject to the risk-based capital ratios contained in the agencies' existing capital rules will no longer have to report those ratios if they opt in to the CBLR framework, beginning the first quarter of 2020. QCBOs may opt in to the CBLR framework by completing a CBLR reporting schedule in its call report or Form FR Y-9C. The proposed CBLR reporting schedules, as well as revisions to the FDIC's deposit insurance assessment system, will be finalized separately.

In response to public comments, the final rule implements a few important changes to the proposed rule, including the following:

- Adoption of tier 1 capital, instead of tangible equity, as the leverage ratio numerator, in conformance with the existing regulatory leverage ratio.
- Allowing a banking organization that elects to use the CBLR framework to continue to be considered "well capitalized" for prompt corrective action (PCA) purposes during a two-quarter grace period if its leverage ratio is 9% or less but greater than 8%.

Under the final rule, a QCBO cannot have elected to be treated as an advanced approaches banking organization and must have: (1) a leverage ratio (equal to tier 1 capital divided by average total consolidated assets) greater than 9%; (2) total consolidated assets of less than \$10 billion; (3) total off-balance sheet exposures (excluding derivatives other than sold credit derivatives and unconditionally cancelable commitments) of 25% or less of total consolidated assets; and (4) a sum of total trading assets and trading liabilities 5% or less of total consolidated assets.

A QCBO that elects to use the CBLR framework will be required to calculate its leverage ratio by considering the modifications made by the agencies' capital simplification rule and the current expected credit losses methodology (CECL) transitions rule (each finalized earlier this year). If a QCBO maintains a leverage ratio of greater than 9%, it will be considered to have satisfied the generally applicable risk-based and leverage capital requirements, the "well capitalized" ratio requirements for purposes of Section 38 of the Federal Deposit Insurance Act (generally known as the PCA Rules), and any other capital or leverage requirements applicable to the QCBO.

The final rule also includes a two-quarter grace period during which a QCBO that temporarily fails to meet any of the qualifying criteria, including the greater than 9% leverage ratio requirement, would generally still be deemed well capitalized if the QCBO maintains a leverage ratio greater than 8% during those two quarters. At the end of the grace period, the banking organization must return to compliance with the QCBO criteria to qualify for the CBLR framework, or otherwise must comply with and report under the generally applicable capital rules.

QCBOs may subsequently opt out of the CBLR framework by completing their call report or Form FR Y-9C and reporting the capital ratios required under the generally applicable capital rules. A QCBO that has opted out of the CBLR framework and desires to opt back in would need to meet the qualifying criteria discussed above.

The CBLR's Impact on QCBOs

Most QCBOs have simplified balance sheets compared with larger banking organizations, for which the Basel III risk-based capital rules were primarily intended. As a result, the CBLR provides significant regulatory relief to QCBOs that would otherwise report under the generally applicable risk-based capital rules. Opting in to the CBLR allows for a QCBO to be considered "well capitalized" under the PCA Rules through one simple calculation (assuming the organization is not also subject to any written agreement, order, capital directive, or as applicable, PCA directive). Additionally,

calculating the CBLR involves an existing measure already used by QCBOs for calculating leverage—tier 1 capital. Thus, a QCBO can experience the benefits of the new rule while also using familiar methods and calculations. The cost of adoption is low as well. If qualified, a depository institution simply has to adopt CBLR in its call reports or Form FRY-9C. The two-quarter grace period offers further flexibility. For instance, if a QCBO engages in a major transaction or has an unexpected event that impacts the 9% leverage ratio, that QCBO will have the ability to reestablish compliance with the CBLR without having to revert to the generally applicable risk-based capital rules. Since the CBLR is voluntary, it is within each QCBO's discretion whether the benefits are sufficient enough to adopt the new rule.

QCBOs should be aware that opting in to the CBLR essentially raises its well-capitalized leverage ratio requirements under the PCA Rules from 5% to 9%. Since the QCBO would use the CBLR to comply with the PCA Rules, the QCBO must ensure its CBLR is above 9% or find itself attempting to comply with both the CBLR and the risk-based capital rules. Such a situation would be counterproductive to the purpose of the CBLR. QCBOs should be aware that by opting in to the CBLR framework, a QCBO commits to a new definition of "well capitalized" under the PCA Rules, requiring the retention of more capital compared with organizations that do not opt in to the CBLR.

Additionally, certain community banking industry representatives have suggested that the CBLR may create a new de facto expectation from the agencies that a properly capitalized QCBO should have a leverage ratio greater than 9%. As the final rule points out, "commenters expressed concern that banking organizations that do not opt in could be seen as outliers." If this becomes a de facto standard, then QCBOs could be pressured into adopting a leverage ratio that some organizations (such as the American Bankers Association and the Independent Community Bankers of America) considered too high to begin with. Though the agencies emphasized that the CBLR is voluntary, QCBOs should still be thoughtful in their decision to use the CBLR. While QCBOs can opt in and opt out of the CBLR, the agencies noted that they expect such changes to be rare and typically driven by significant changes, such as an acquisition or divestiture of a business. The agencies have further indicated that a QCBO electing to opt out of the CBLR framework may need to provide a rationale for opting out if requested.

While the CBLR will be useful in reducing regulatory burdens on QCBOs, its adoption does not come without risk, and such a decision should be made after careful consideration.

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