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NEW COMMUNITY BANK CAPITAL RULES

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As of January 1, 2020, banks with less than $10 billion in consolidated assets may opt-in to a new simplified leverage capital ratio regulatory scheme. A decision to opt-in will allow banks to avoid certain costs and expenses, provided they maintain a 9% Tier 1 Leverage Ratio.

1. Background

Preparation of capital ratios for community banks has always been complicated and subject to criticism. To address this, Congress passed the Economic Growth, Regulatory Relief and Consumer Protection Act, which directed federal banking agencies to adopt a simplified leverage capital ratio for community banks.

The ABA and other industry groups argued that the correct minimum Tier 1 Leverage Ratio should be set at 8%. However, the regulators disagreed and determined that the Tier 1 Leverage Ratio required to avoid the risk-based capital requirements should be 9%.

The Final Rule, published on September 17, 2019, applies to banks with consolidated assets of less than $10 billion. Under the new Rules, banks that meet the 9% leverage capital requirement and elect to be covered will be considered "well capitalized" by regulators and will not be required to report on, or comply with, risk-based capital ratios as was previously required.

2. New Rules and Election

To be subject to the new leverage capital ratio scheme, a bank may affirmatively "opt-in" in its Call Report. Banks that opt-in are only required to maintain a 9% Tier 1 Leverage Ratio. If a Bank opts-in but fails to satisfy the 9% ratio in any quarter, it will have two succeeding quarters to bring the leverage ratio back to 9%. A bank need not opt-in right away and may opt-in at any time in the future. Further, a bank that opts-in now may retract its election in the future without prejudice.

3. Alternative Options

Alternatively, a community bank may decide not to elect to be covered by the new Rules. In this case, a combination of the bank's current "capital plan," together with the current existing Tier 1 Leverage Ratio (8%); a Risk-Based Ratio of 10%; and a Total Risk-Based Capital Ratio of 12%, would set the capital compliance minimums

However, for a bank that does not opt-in to the new Rules, there is a possibility that regulators may eventually require increased capital to get the bank's capital closer to the 9% Leverage ratio under the new Rules.

Finally, some banks may instead want to commission a loan portfolio stress-test analysis to demonstrate to regulators that it can safely and soundly operate under its business plan without undue risk at an 8% Leverage Capital ratio. Arguably, the additional 1%

capital commitment could negatively impact the bank's operations and income by removing this "excess" capital amount from an earning asset category.

Obviously, obtaining a stress-test is not free. Such a test may cost $10,000 or more, depending on the size and complexity of the bank's portfolio. Any extra income generated by the bank's use of its "excess capital" would have to be offset by this charge for stress-testing. Further, a regulator that accepts a stress-test of a loan portfolio now in support of reduced capital may require future tests to re-analyze the data.

These are all considerations for banks deciding whether to opt-in to the new "Community Bank Leverage Ratio" program at this time.

Many community banks have initially decided not to make an election to be covered by the new CBLR Program. Instead, they are keeping the "capital status quo" with their regulators who presumably have seen and approved of their current capital plans.

These banks likely don't see value in making a change when their regulators know what they are doing and have not complained in the past. However, the potential concern with this "do nothing" approach is if the bank has been overestimating its capital needs, then the bank also has likely been underperforming vis-à-vis its peers on a ROE basis.

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While answers to this question will differ for community banks based on their individual situations, it should make sense for most traditional community banks to make the election to be covered by the new CBLR Capital Program, assuming of course they already satisfy the 9% Leverage Capital Ratio. A decision not to opt in now could lead to unknown capital complications with your regulators at some point in the future, and an increase in your capital requirements when you least expect it.

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