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New Community Bank Capital Rules

POSTED:

Feb 5, 2020

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As a result of regulations recently adopted, banks with less than $10 billion in consolidated assets are now subject to a new simplified leverage capital ratio regulatory scheme, should they elect to be covered by the new Rules. New community bank capital requirements became effective on January 1, 2020, including the election a bank has to make to opt-in to these new Rules. A decision to opt-in to the new leverage capital framework will permit banks to forego the calculation and compliance costs and expenses with existing regulatory risk-based capital rules, provided that they maintain a 9% Tier 1 Leverage Ratio.

Background

The calculation and preparation of capital ratios for community bank regulatory purposes has always been overly complicated, somewhat arcane, and subject to industry criticism. Congress recognized this in 2018 when it passed and President Trump signed the Economic Growth, Regulatory Relief and Consumer Protection Act, which directed the federal banking agencies to come up with a new simplified leverage capital ratio for community banks, of not less than 8% nor more than 10%.

For the next several years the banking regulators met, puzzled, deliberated, talked with industry officials, and issued a proposed rule for comment, about what the "correct" Tier 1 Leverage Capital Ratio should be under this new rule for banks with less than $10 billion in consolidated assets.

The ABA and other banking industry groups argued to no avail with regulators that the correct minimum Tier 1 Capital Leverage Ratio should be set at 8%, not 9%. The regulators finally agreed that the proper Tier 1 Leverage Capital Ratio required to avoid the risk-based capital requirements would be 9%.

The FDIC's Final Rule on "Community Bank Leverage Ratios" was published jointly by the banking agencies on September 17, 2019. Note that these new capital Rules apply generally to both state-chartered and national banks with consolidated assets of less than $10 billion. Under the new Rules, a bank that meets this 9% leverage capital requirement and elects to be covered would be considered "well capitalized" by regulators and would not have to calculate and report on its risk-based capital ratios any longer.

The New Community Bank Capital Ratio Rules and Election

Under the new Rules, a bank may elect in its Call Report filing to qualify and "opt-in" to agree to maintain a 9% Tier 1 Leverage Capital Ratio, and forego any further requirement to determine and report its Risk-Based Capital Ratios (as was formerly the case). For banks making this election, they are only required to maintain and report on Call Reports a 9% Leverage Capital Ratio.

The process of no longer having to prepare schedules, data and to comply with the Risk-Based Capital Ratio requirements will no doubt save banks management time and money, if they elect this option. Note that the Rules provide that if a bank has opted-in but misses satisfying its 9% ratio in any quarter, it will have two succeeding quarters to bring the leverage ratio back to 9%.

Other Options Available to a Bank

Alternatively, a community bank may decide not to elect to be covered by the new 9% leverage capital requirement, or may decide at any point in the future to make the election to be covered by the 9% ratio. The new rule even permits a bank to retract without prejudice its "election to 9%" in the future if it wants to do so, so there is truly "no harm, no foul" in making or not making an opt-in election.

If a community bank does not make an election to be subject to the new 9% leverage capital rule, then what are the capital ratios to which the bank is subject? In this case, a combination of what the bank already has filed and agreed to with regulators as its "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 appear to set the capital compliance minimums.

However, for a bank that does nothing and makes no election to opt-in, there is a concern that over time, regulators under an abundance of caution may require increased capital to get the bank's capital closer to the 9% Leverage ratio in the new Community Bank Leverage Ratio Program.

Finally, a bank in some cases may instead want to commission a loan portfolio stress-test analysis by an independent third party consultant, to demonstrate to regulators that it can safely and soundly operate under its business plan without undue risk at an 8% Leverage Capital ratio. Under this theory, the additional 1% capital commitment (from 8% to 9%) by opting-in to the new Rule can negatively impact the bank's operations and income potential by removing this "excess" capital amount from an earning asset category where it can support new loan growth and market opportunities that present themselves.

Obviously, obtaining a third-party stress-test of the loan portfolio is not free of charge. We would expect a community bank might have to pay $10,000 or more to obtain this analysis for regulators, with the cost being dependent on the size and complexity of the portfolio. Any extra income generated by the bank's use of its "excess capital" for lending purposes would have to be offset by this outside charge for stress-testing. In addition, there is no certainty that a regulator which accepts a stress-test analysis of a loan portfolio now in support of reduced capital may not want another one prepared in three years to re-analyze the data at that time, particularly if there has been any unusual stress to the portfolio.

Note further that if your bank is in a market with less-than-stellar current opportunities for retail, commercial or other loan growth, you probably are not in a position where you need to deploy any excess capital at present, nor would your Board want you to do so to chase marginal credits. A community bank seeking to optimize its "excess capital" to permit loan growth and higher revenues is putting increased pressure on its Management and Board to effectively use this capital in a way that increases shareholder value.

These are all considerations for bank management and the Board to take when deciding whether to opt-in to the new "Community Bank Leverage Ratio" program or to do nothing at this time. Instead, should the bank commission an independent loan portfolio stress-test from a third party, to support a leverage capital ratio analysis of less than 9% for the bank?

Based on discussions we have had with a number of community banks, it appears that many of them have decided initially <u>not</u> to make an election to be covered by the new CBLR Program. This amounts to a decision by the bank simply to keep the "capital status quo" with their regulators who presumably have seen and approved of their capital plans that have been filed.

Perhaps this view is based on the understandable "why change anything" about capital requirements if our regulators know what we are doing and have not complained in the past? As expressed above, the potential concern with this "do nothing" attitude is, if in fact, 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.

While answers to this question will differ for community banks based on their individual situations, our advice is that 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.

Any questions you have about this subject can be directed to Jim Sheriff (414-298-8413; jsheriff@reinhartlaw.com), or John Reichert (414-298-8445; jreichert@reinhartlaw.com).[note]For background information, see Financial Institutions Letters, Community Banker Leverage Ratio Framework (Nov. 4, 2019), https://www.fdic.gov/news/news/financial/2019/fil19066.html; and see Community Banker Leverage Ratio Compliance Guide (Oct. 2019), https://www.fdic.gov/regulations/resources/cbi/cblr-guide.pdf.[/note]