September 17, 2019

MEMORANDUM TO: Board of Directors

FROM: Doreen R. Eberley, Director
Division of Risk Management Supervision

SUBJECT: Regulatory Capital Rule: Capital Simplification for Qualifying Community Banking Organizations

Summary: Staff are presenting for the approval of the Federal Deposit Insurance Corporation ("FDIC") Board of Directors ("FDIC Board") a request to publish the attached interagency final rule that would provide for a simple measure of capital adequacy for certain community banking organizations, consistent with section 201 of the Economic Growth, Regulatory Relief, and Consumer Protection Act ("final rule"). Under the final rule, depository institutions and their holding companies that have less than $10 billion in total consolidated assets and meet other qualifying criteria, including a leverage ratio (equal to tier 1 capital divided by average total consolidated assets) of greater than 9 percent, would be eligible to opt into the community bank leverage ratio ("CBLR") framework ("qualifying community banking organizations"). Qualifying community banking organizations that opt into the CBLR framework and that maintain a leverage ratio of greater than 9 percent would be considered to satisfy the generally applicable risk-based and leverage capital requirements in the federal banking agencies' capital rules ("generally applicable capital rule") and the definition of well-capitalized for purposes of Prompt Correction Action ("PCA") rules that were promulgated under section 38 of the Federal

Concur:

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Deposit Insurance Act. The final rule would include a two-quarter grace period during which a qualifying community banking organization that temporarily fails to meet any of the qualifying criteria, including the greater than 9 percent leverage ratio requirement, would still be deemed well-capitalized for PCA purposes so long as it maintains a leverage ratio greater than 8 percent. At the end of the grace period, the banking organization must meet all CBLR framework criteria or must apply and report under the generally applicable capital rule. An organization that fails to maintain a leverage ratio greater than 8 percent would not be permitted to use the grace period and must comply with the capital rule's generally applicable requirements and file the appropriate regulatory reports.

Recommendation: FDIC staff are requesting the FDIC Board to approve this final rule and authorize its publication in the *Federal Register* with an effective date of January 1, 2020. This effective date would coincide with the revised effective date for the interagency capital simplifications interagency final rule, if approved by the federal banking agenices. The FDIC Board is considering this revision to the effective date in the capital simplifications final rule as a separate matter at this Board Meeting.

Discussion:

I. Background

On February 8, 2019, the Office of the Comptroller of the Currency ("OCC"), the Board of Governors of the Federal Reserve System ("FRB"), and the FDIC (collectively, the "agencies") published a notice of proposed rulemaking ("NPR" or "proposal") to implement section 201 of the Economic Growth, Regulatory Relief, and Consumer Protection Act ("section

201”), and to establish a CBLR for qualifying community banking organizations as a simple method to measure capital adequacy. The proposal was intended to simplify regulatory capital requirements and provide material regulatory compliance burden relief to qualifying community banking organizations that opt into the CBLR framework.

Section 201 directs the agencies to develop a CBLR for qualifying community banking organizations of not less than 8 percent and not more than 10 percent. Section 201 provides that a qualifying community banking organization is a depository institution or depository institution holding company with total consolidated assets of less than $10 billion that satisfies such other factors, based on its risk profile, that the agencies determine to be appropriate. Pursuant to section 201, a qualifying community banking organization that exceeds the CBLR level established by the agencies shall be considered to have met: (i) the generally applicable capital rule; (ii) the definition of well capitalized under the PCA framework (for insured depository institutions); and (iii) any other applicable capital or leverage requirements. In addition, section 201 directs the agencies to establish procedures for the treatment of qualifying community banking organizations that fall below the CBLR level.

Section 201 defines the CBLR as the ratio of a qualifying community banking organization’s tangible equity capital to its average total consolidated assets, both as reported on the qualifying community banking organization’s applicable regulatory filing. In addition, section 201 states that the agencies may determine that a banking organization is not a qualifying community banking organization based on the banking organization’s risk profile, based on consideration of off-balance sheet exposures, trading assets and liabilities, total notional derivatives exposures, and such other factors as the agencies determine appropriate.

A. CBLR Framework NPR

The agencies proposed the CBLR framework as a simple alternative methodology to measure capital adequacy for qualifying community banking organizations, that would have been defined as a depository institution or depository institution holding company that met the following criteria:

A. Total consolidated assets of less than $10 billion;
B. Total off-balance sheet exposures (excluding derivatives other than sold credit derivatives and unconditionally cancelable commitments) of 25 percent or less of total consolidated assets;
C. Total trading assets and trading liabilities of 5 percent or less of total consolidated assets;
D. Mortgage servicing assets ("MSAs") of 25 percent or less of tangible equity (as defined in the proposal); and
E. Temporary difference deferred tax assets ("DTAs") of 25 percent or less of tangible equity.

Under the proposal, the CBLR would have been calculated as the ratio of tangible equity to average total consolidated assets. Tangible equity would have been defined as total bank equity capital or total holding company equity capital, as applicable, prior to including minority interests, and excluding accumulated other comprehensive income ("AOCI"), deferred tax assets arising from net operating loss and tax credit carryforwards, goodwill, and other intangible assets (other than MSAs), each as of the most recent calendar quarter and calculated in accordance with a qualifying community banking organization's regulatory reports. Average total consolidated assets would have been calculated in a manner similar to the generally applicable capital rule's

leverage ratio denominator in that amounts deducted from the numerator would also have been excluded from the denominator. Under the proposal, a qualifying community banking organization could have elected to use the CBLR framework if its CBLR was greater than 9 percent.

The proposal would have permitted a community banking organization to remain in the CBLR framework even in cases where such an institution's CBLR subsequently fell to 9 percent or less. In this situation, the proposal would have continued to provide for the agencies' supervisory actions under the agencies' PCA framework and other applicable statutes and regulations. Specifically, for insured depository institutions, the proposal would have incorporated CBLR levels as proxies for the following PCA categories: adequately capitalized, undercapitalized and significantly undercapitalized. If an electing banking organization had met certain CBLR levels, it would have been considered to have met the capital ratio requirements within the applicable corresponding PCA category and been subject to the same restrictions that currently apply to any other insured depository institution in the same PCA category.

II. Summary of Comments on the CBLR Framework NPR

Collectively, the agencies received approximately 50 public comment letters and approximately 500 form letters on the proposal from depository institutions, depository institution holding companies, trade associations, and other interested parties. Commenters generally supported the agencies' efforts to propose a simpler regulatory capital framework but expressed concerns with some aspects of the proposal.

Several commenters expressed concern that calibrating the CBLR at 9 percent would be unnecessarily punitive and would disqualify too many banking organizations from being able to use the CBLR framework. These commenters favored calibrating the CBLR at 8 percent.

Commenters also expressed concern that the proposed PCA proxy levels would have added unnecessary complexity to the CBLR framework. Many commenters criticized the proposed PCA proxy levels and recommended their elimination in the final rule. Some commenters also expressed concern that the agencies would not permit an insured depository institution with a CBLR at or below 9 percent to demonstrate that it is well capitalized under the generally applicable capital rule before assigning it a PCA category other than well capitalized. Other commenters indicated that some of the qualifying criteria were unnecessary (such as that for MSAs and DTAs), overly complex to calculate (such as the off-balance sheet exposures criterion), or did not appropriately reflect the risks of underlying assets.

Multiple commenters suggested that the proposed numerator of the CBLR should be based on tier 1 capital, as defined under the generally applicable capital rule, rather than on a new regulatory capital measure. Commenters expressed concern that examiners may penalize banking organizations for opting into or out of the CBLR framework, and that the CBLR could become the de facto minimum capital requirement for all community banking organizations.

Section 201 directs the agencies to consult with applicable state bank supervisors in carrying out section 201 and to notify the applicable state bank supervisor of any qualifying community banking organization that exceeds, or does not exceed after previously exceeding, the CBLR level established by the agencies. Prior to and after the publication of the NPR, the agencies conducted various meetings with applicable state bank supervisors regarding their concerns regarding the implementation of section 201 in conjunction with this rulemaking.

III. CBLR Framework Final Rule

In response to comments received on the proposal and consultations with applicable state bank supervisors, the agencies would make a number of changes in this final rule. In addition,

the final rule would clarify other important aspects of the CBLR framework. The key changes being made to the final rule include:

- The adoption of tier 1 capital as the numerator for the CBLR framework;
- The removal of the qualifying criteria for MSAs and DTAs;
- The removal of the proxy PCA framework; and
- Allowing a banking organization that elects to use the CBLR framework to be considered well-capitalized during a two-quarter grace period if its leverage ratio is 9 percent or less but greater than 8 percent.

Under the final rule, the numerator of the CBLR would be the existing measure of tier 1 capital[1,2] under the agencies' generally applicable capital rule. The use of tier 1 capital for the numerator of this leverage ratio would reduce complexities that would have been created with the proposed introduction of a new definition of capital into the CBLR framework and would also have the benefit of including the existing threshold deduction approaches for MSAs and DTAs, which would enable the agencies to remove the qualifying criteria related to these exposures from the CBLR framework. Due to the adoption of tier 1 capital, the CBLR would generally be calculated in the same manner as the generally applicable capital rule's leverage

[1] Under the final rule, a qualifying community banking organization that elects to use the CBLR framework will calculate their leverage ratio taking into account the modifications made in relation to the capital simplifications rule and current expected credit losses methodology ("CECL") transitions final rule. *See* 84 FR 35234 (July 22, 2019) and 84 FR 4222 (February 14, 2019), respectively. Staff of the agencies anticipate that the tier 1 capital amount used in the numerator of the calculation will reflect any future modifications made to the tier 1 capital definition.

[2] For purposes of the CBLR framework, a qualifying community banking organization that elects to use the CBLR framework is not required to calculate tier 2 capital and therefore would not be required to make any deductions that would be taken from tier 2 capital or potentially tier 1 capital due to insufficient tier 2 capital.

ratio, i.e., tier 1 capital divided by average total consolidated assets. As a result, the final rule would incorporate and refer to the generally applicable capital rule's leverage ratio.

The final rule would modify the definition of a "qualifying community banking organization" to include the leverage ratio as one of the qualifying criteria and provide for a two-quarter grace period for breaching any of the criteria in response to concerns that the proposed proxy PCA levels caused unnecessary complexity in the CBLR framework.

The final rule would provide that to be a "qualifying community banking organization," a banking organization must not be an advanced approaches banking organization and must meet the following qualifying criteria: (i) a leverage ratio of greater than 9 percent; (ii) total consolidated assets of less than $10 billion; (iii) total off-balance sheet exposures (excluding derivatives other than sold credit derivatives and unconditionally cancelable commitments) of 25 percent or less of total consolidated assets; and (iv) total trading assets and trading liabilities of 5 percent or less of total consolidated assets. Consistent with section 201, the final rule would provide that qualifying community banking organizations that opt into the CBLR framework ("electing community banking organizations") would be deemed "well capitalized" and in compliance with the agencies' generally applicable capital rule, would not be required to calculate their risk-based capital ratios.

Notably, in this final rule, the agencies would maintain the 9 percent leverage ratio along with the other qualifying criteria in order to maintain the current level of regulatory capital held by electing banking organizations. Further, the incorporation of the leverage ratio into the CBLR framework and the two-quarter grace period would facilitate the transition back to the generally applicable capital rule. Banking organizations would opt into and out of the framework through their Call Report or Form FR-Y9C.

If a qualifying community banking organization that has opted into the CBLR framework subsequently fails to satisfy one or more of the qualifying criteria but continues to report a leverage ratio of greater than 8 percent, the banking organization could continue to use the CBLR framework and would be deemed "well capitalized" for a grace period of up to two quarters. As long as the banking organization is able to return to compliance with all the qualifying criteria within two quarters, it would continue to be deemed "well capitalized" and in compliance with the generally applicable rule. A banking organization would be required to apply and report under the generally applicable rule if it is unable to comply with the greater than 9 percent leverage ratio requirement and all other qualifying criteria by the end of the two-quarter grace period), has a leverage ratio of 8 percent or less at any time, or ceases to satisfy the qualifying criteria due to consummation of a merger transaction.

Staff of the agencies believe that the final rule would provide a simple framework that would simultaneously meet safety and soundness goals and would be responsive to the concerns conveyed through comments received on the proposal. Additionally, the final rule would continue to meet the policy objectives described in the proposal. First, the CBLR framework would be available to a meaningful number of well-capitalized banking organizations with less than $10 billion in total consolidated assets. Second, the CBLR framework would be calibrated to approximately maintain the amount of capital currently held by qualifying community banking organizations. Third, banking organizations with higher risk profiles would remain subject to the generally applicable capital rule to ensure that such banking organizations hold capital commensurate with the risk of their exposures and activities. Fourth, the agencies would maintain the authority to take supervisory action under the PCA framework and other statutes and regulations based on a banking organization's capital ratios and risk profile. The final rule

also would provide regulatory compliance burden relief as the CBLR would be simple to apply and allow a qualifying community banking organization to avoid the burden of reporting under the generally applicable capital rule.

Based on reported data as of March 31, 2019, there are 5,221 insured depository institutions with less than $10 billion in total consolidated assets and 231 depository institution holding companies with less than $10 billion in total consolidated assets that file the form FR Y-9C. Approximately 85 percent of such insured depository institutions and approximately 76 percent of such depository institution holding companies would qualify to use the CBLR framework under the 9 percent calibration and qualifying criteria. Staff of the agencies believe the CBLR framework in this final rule, including a 9 percent calibration, meets the objectives described above.

The final rule will be effective as of January 1, 2020, and banking organizations can utilize the CBLR framework for purposes of filing their Call Report or Form FR Y–9C, as applicable, for the first quarter for 2020 (i.e., as of March 31, 2020). A banking organization's compliance with capital requirements for a quarter prior to the final rule's effective date shall be determined according to the agencies' generally applicable capital rule until the institution has filed their Call Report Form or FR Y–9C, as applicable, for the first quarter of 2020 and has indicated whether or not it has elected the CBLR framework.

Conclusion: FDIC staff are requesting the FDIC Board to approve the attached interagency final rule and authorize its publication in the *Federal Register* with an effective date of January 1, 2020.

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