November 20, 2018

MEMORANDUM TO: Board of Directors

FROM: Doreen R. Eberley, Director

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

Summary: Staff is seeking the approval of the Federal Deposit Insurance Corporation ("FDIC") Board of Directors ("FDIC Board") to publish the attached interagency notice of proposed rulemaking ("proposal" or "NPR") to amend the regulatory capital rule of the FDIC, the Office of the Comptroller of the Currency ("OCC"), and the Board of Governors of the Federal Reserve System ("FRB") (collectively, the "agencies") to provide for a simplified measure of capital adequacy for certain community banking organizations, in accordance with section 201 of the Economic Growth, Regulatory Relief, and Consumer Protection Act ("EGRRCPA"). Under the proposal, most insured depository institutions and depository institution holding companies with less than $10 billion in total consolidated assets that meet certain qualifying criteria ("qualifying community banks") and that have a community bank leverage ratio ("CBLR") (as defined below) greater than 9 percent would be eligible to opt into the CBLR framework. Such qualifying community banks that elect to use the CBLR would not be subject to other capital and leverage requirements, and would be considered to have met the "well capitalized" ratio requirements under federal law and regulations, as applicable, and the generally applicable capital requirements.

Concur:

Charles Yi
General Counsel

Recommendation: Staff recommends that the FDIC Board approve the interagency NPR and authorize its publication in the *Federal Register* with a public comment period that closes 60 days after publication.

Discussion:

I. Background

In 2013, the agencies adopted a revised regulatory capital rule ("capital rule") in response to the financial crisis of 2007-09, including the generally applicable risk-based and leverage capital requirements ("generally applicable capital requirements").[1] The capital rule strengthened the capital requirements applicable to banking organizations supervised by the agencies by improving both the quality and quantity of banking organizations' regulatory capital and increasing the risk-sensitivity of the capital rule. Since the issuance of the capital rule in 2013, community banking organizations have raised concerns regarding the regulatory burden, complexity, and costs associated with certain aspects of the capital rule.

On May 24, 2018, EGRRCPA amended provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act[2] as well as certain other statutes administered by the agencies.[3] Section 201 of EGRRCPA, titled "Capital Simplification for Qualifying Community Banks," directs the agencies to develop a CBLR of not less than 8 percent and not more than 10 percent for qualifying community banks. EGRRCPA defines a qualifying community bank as an insured depository institution or depository institution holding company with total consolidated assets of less than $10 billion. A qualifying community bank that exceeds the CBLR level

[1] The agencies issued a joint final rule on October 11, 2013 (78 FR 62018) and the FDIC issued a substantially identical interim final rule on September 10, 2013 (78 FR 55340). In April 2014, the FDIC adopted the interim final rule as a final rule with no substantive changes. 78 FR 55340 (April 14, 2014).
[2] Pub. L. No. 111-203, 124 Stat. 1391, 12 U.S.C. 5301 et seq.
[3] Pub. L. No. 115-174 (May 24, 2018).

established by the agencies is considered to have met: (i) the generally applicable capital requirements; (ii) the capital ratio requirements in order to be considered well capitalized under the agencies' prompt corrective action ("PCA") framework (in the case of insured depository institutions); and (iii) any other applicable capital or leverage requirements. In addition, EGRRCPA directs the agencies to establish procedures for the treatment of qualifying community banks that fall below the CBLR level established by the agencies.

Section 201 of EGRRCPA defines the CBLR as the ratio of a qualifying community bank's CBLR tangible equity (as described below) to its average total consolidated assets, both as reported on the qualifying community bank's applicable regulatory filing. In addition, section 201 states that the agencies may determine that a banking organization is not a qualifying community bank based on the banking organization's risk profile. EGRRCPA states that such a determination shall be 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. Section 201 also specifies that the CBLR framework developed by the agencies does not limit the authority of the agencies in effect as of the date of enactment of EGRRCPA.

Finally, EGRRCPA directs the agencies to consult with applicable state bank supervisors in carrying out the requirements to develop the CBLR and to notify the applicable state bank supervisor of any qualifying community bank that is subject to the CBLR framework. Staff of the agencies have had discussions with the state bank supervisors and staff of the Conference of State Bank Supervisors, and expect to continue engaging with the state bank supervisors throughout the remaining rulemaking process.

II. The Proposed CBLR Framework

The proposed CBLR framework, based on the requirements of section 201 of EGRRCPA, is a simpler alternative methodology to measure capital adequacy for qualifying community banks. The proposal would entail simpler calculations and reporting schedules, thereby providing material regulatory relief to qualifying community banks that opt into the CBLR framework.

The proposed CBLR framework takes into account multiple considerations that seek to balance the simplicity of the framework with safety and soundness goals. First, the regulatory relief provided by the CBLR framework should be available to a meaningful number of well capitalized banking organizations with less than $10 billion in total consolidated assets. Second, the CBLR should be calibrated to not reduce the amount of capital currently held by qualifying community banking organizations. Third, the banking organizations with higher risk profiles should remain subject to the generally applicable capital requirements to ensure that such banking organizations hold capital commensurate with the risk of their exposures and activities. Fourth, consistent with the Act, the agencies would maintain the supervisory actions available under the PCA framework and other statutes and regulations based on the capital ratios and risk profile of a banking organization. Finally, the CBLR framework is intended to provide meaningful burden relief and be relatively simple for banking organizations to implement because the CBLR would be based on data that are currently reported in regulatory filings.

A. Qualifying Community Bank Definition

Under the proposal, a qualifying community bank would be defined as an insured depository institution or depository institution holding company that is not an advanced approaches banking organization and that meets the following criteria ("qualifying criteria"):

- Total consolidated assets of less than $10 billion;
- Total off-balance sheet exposures (excluding derivatives that are not credit derivatives and unconditionally cancelable commitments) of 25 percent or less of total consolidated assets;
- Total trading assets and trading liabilities of 5 percent or less of total consolidated assets;
- Mortgage servicing assets of 25 percent or less of CBLR tangible equity; and
- Deferred tax assets (DTAs) arising from temporary differences that a banking organization could not realize through net operating loss carrybacks of 25 percent or less of CBLR tangible equity.[4]

B. Community Bank Leverage Ratio

Under EGRRCPA, the CBLR would be calculated as the ratio of tangible equity capital ("CBLR tangible equity") divided by average total consolidated assets. The proposal would define CBLR tangible equity as total bank equity capital or total holding company equity capital, as applicable, prior to including minority interest, and excluding accumulated other comprehensive income, DTAs arising from net operating loss and tax credit carryforwards, goodwill and other intangible assets as reported on a qualifying community bank's regulatory filings. Average total consolidated assets would be calculated in a manner similar to the current tier 1 leverage ratio denominator. Specifically, average total consolidated assets would exclude amounts deducted from the CBLR numerator.

[4] In addition, the agencies would reserve the authority to disallow use of CBLR framework by a depository institution or depository institution holding company, based on the risk profile of the banking organization. See 12 CFR 3.1(d) (OCC); 12 CFR 217.1(d) (FRB); 12 CFR 324.1(d) (FDIC).

The proposal would set the entry CBLR level at greater than 9 percent. The agencies have determined that a CBLR greater than 9 percent in conjunction with the proposed definitions of a qualifying community bank and CBLR tangible equity would ensure that the CBLR framework results in capital requirements consistent with the current well-capitalized ratio requirements under the PCA framework. As stated above, a qualifying community bank with a CBLR greater than 9 percent would be considered to have met: (i) the generally applicable capital requirements; (ii) the well capitalized capital ratio requirements under the agencies' PCA framework in the case of an insured depository institution; and (iii) any other capital or leverage requirements to which the banking organization is subject. Additionally, to be considered well capitalized under the CBLR framework, and consistent with the agencies' current PCA rule, a qualifying community bank must not be subject to any written agreement, order, capital directive, or PCA directive.

C. Election of CBLR Framework

Under the proposal, a qualifying community bank may elect to use the CBLR framework ("CBLR bank") if its CBLR is greater than 9 percent in any regulatory filing. A CBLR bank may opt out of the CBLR framework and begin reporting its capital ratios under the generally applicable capital requirements. While the proposal does not place restrictions on the ability of qualifying community banks to switch in and out of the CBLR framework, such changes are expected to be rare. A CBLR bank that has opted out of the CBLR framework would need to meet the qualifying criteria included in the definition of a qualifying community bank and have a CBLR of greater than 9 percent to be able to opt back into the CBLR framework. This proposed approach is intended to balance the need for flexibility in applying capital requirements tailored to banking organizations' different and potentially shifting business models with the goal of discouraging arbitrage between capital frameworks.

D. Treatment of Banking Organizations That Cease to Qualify for the CBLR Framework

1. Ceasing to Meet Any of the Qualifying Criteria

Under the proposal, a CBLR bank that no longer meets the qualifying criteria would be required, within a limited grace period, to meet either the qualifying criteria or comply with the generally applicable capital requirements. The grace period would begin as of the end of the calendar quarter in which the CBLR bank ceases to meet the qualifying criteria and end after two consecutive calendar quarters. During this grace period, the banking organization could continue to be treated as a qualifying community bank and could be expected to continue calculating and reporting a CBLR. This grace period is intended to mitigate potential volatility in a CBLR bank's qualifying criteria from quarter to quarter, thereby reducing the possibility that the banking organization may temporarily cease to be a qualifying community bank. However, a CBLR bank that no longer expects to meet the qualifying criteria as a result of a business combination should be prepared to fully comply with the generally applicable capital requirements as of the completion of the transaction.

2. Ceasing to Meet the 9-Percent CBLR Level

A CBLR bank whose CBLR subsequently falls to 9 percent or less would be considered less than well capitalized. Therefore, for PCA purposes, the proposal incorporates additional CBLR levels as proxies for the existing capital ratios for the following PCA categories and be deemed to satisfy statutory capital requirements[5]:

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[5] See, e.g., 12 U.S.C. 5371 (establishing a capital floor for banking organizations); section 201 of EGRRCPA (requiring development of a CBLR for which a qualifying community bank

- Adequately capitalized – CBLR of 7.5 percent or greater;
- Undercapitalized – CBLR of less than 7.5 percent; and
- Significantly undercapitalized – CBLR of less than 6 percent.

If a CBLR bank reports a CBLR that meets one of the corresponding proxy CBLR levels, it would be deemed to have met the capital ratio requirements within the relevant PCA category and be subject to the same requirements or restrictions that currently apply to any other banking organization in the same PCA category. Further, the agencies would be permitted to take any supervisory actions consistent with their supervisory authority under the current PCA framework or other statutes or regulations.

The proposal does not include a proxy CBLR level for the critically undercapitalized category, which would continue to be calculated as the ratio of tangible equity to total assets (as defined under the current capital rule) of 2 percent or below. Because the information necessary to calculate the PCA tangible equity ratio under the current capital rule may not be readily available to a CBLR bank, the proposal would require a CBLR bank with a CBLR of less than 6 percent, to provide information to its appropriate regulators to support the calculation of its tangible equity ratio. Additionally, under the proposal, the appropriate regulators may request the information necessary to determine the tangible equity ratio at any time, and the CBLR bank would be required to provide it.

The proposal would seek comments on alternative approaches for the treatment of a CBLR bank whose CBLR falls to 9 percent or less, including requiring the bank to report under the generally applicable capital requirements, subject to a reasonable transition period.

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exceeding that ratio would be considered to meet the requirements to be treated as well capitalized under PCA); and 12 U.S.C. 1831o (PCA).

III. Impact on Other Regulations

A. Other Federal Regulations

Under the proposal, a CBLR bank would no longer be required to calculate or report the components of capital used in the calculation of risk-based capital or the tier 1 leverage ratio, such as tier 1 capital, total capital or risk weighted assets. Various federal banking rules, outside of the capital rule (non-capital rules) contain references to these regulatory capital terms. To ensure that these non-capital rules continue to operate as intended, the agencies propose that references to "tier 1 capital" or "total capital" would be replaced by "CBLR tangible equity" for CBLR banks.

In addition, certain of the agencies' non-capital rules refer to "capital stock and surplus" (or similar items), which is generally defined as tier 1 and tier 2 capital plus the amount of allowance for loan and lease losses not included in tier 2 capital.[6] The proposal would provide that, for purposes of capital stock and surplus, a CBLR bank would calculate capital stock and surplus as CBLR tangible equity plus all allowances for loan and lease losses.

B. Deposit Insurance Assessments Regulations

FDIC deposit insurance assessments regulations would be affected by the proposed CBLR framework. CBLR banks would no longer be required to report tier 1 capital or the tier 1 leverage ratio. The FDIC, however, uses these measures as part of its deposit insurance assessment system.

Staff intend to seek the FDIC Board's approval to publish a separate notice of proposed rulemaking to address the application of the CBLR framework as it relates to the deposit insurance assessment system. The rulemaking would address, among other things, how the

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[6] See, e.g., 12 CFR 223.3(d).

CBLR framework can be applied in lieu of the tier 1 leverage ratio and in lieu of tier 1 capital when calculating a bank's assessment. Staff do not expect that any changes to its deposit insurance assessment system would have a material impact on aggregate assessment revenue or on rates paid by individual institutions.

Conclusion:

FDIC staff recommends that the FDIC Board approve the attached interagency NPR and authorize its publication in the *Federal Register* with a public comment period that closes 60 days after publication.

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