Goodwin Alerts

March 02, 2020

## Practical Considerations When Contemplating the Community Bank Leverage Ratio Framework

by William E. Stern, Alexander J. Callen

The community bank leverage ratio framework (CBLR Framework) is available for use beginning with the March 31, 2020 Call Report and Form FR Y-9C (consolidated financial statements for holding companies). A qualifying community banking organization may elect to opt in or out of the CBLR Framework at any time and for any reason through the organization's Call Report or Form FR Y-9C. Opting into the CBLR Framework alleviates the burdens of periodically calculating and reporting risk-weighted measures of capital. On the other hand, the CBLR Framework could require more capital, given that the minimum required capital under the CBLR Framework will often be greater than the minimum that would be required to satisfy the generally applicable risk-based and leverage capital requirements.

### BACKGROUND

In the fall of 2019, the federal banking agencies adopted a final rule (Rule) implementing the optional simplified measure of capital adequacy for qualifying community banking organizations, commonly known as the community bank leverage ratio, as required by Section 201 of the Economic Growth, Regulatory Relief, and Consumer Protection Act.

In order to qualify for the CBLR Framework, a banking organization must:

- Not be an advanced approaches banking organization (generally, those part of an organization with at least $250 billion in consolidated assets or at least $10 billion of on-balance sheet foreign exposures),
- Have a leverage ratio of greater than 9%,
- Have less than $10 billion in total consolidated assets,
- Hold 25% or less of total consolidated assets in off-balance sheet exposures, and
- Hold 5% or less of total consolidated assets in trading assets and trading liabilities.

A non-advanced approaches depository institution may opt into the CBLR Framework even if its parent holding company is not a qualifying community banking organization, and vice versa.

For organizations that have opted into the CBLR Framework but subsequently fall to or below the 9% leverage ratio requirement (while remaining above 8%), the Rule establishes a two-quarter grace period to either meet the qualifying criteria again or comply with the generally applicable risk-based and leverage capital requirements in the agencies' capital rules. During the grace period, such an organization will continue to be treated as a qualifying community banking organization and will be considered to continue to satisfy the "well capitalized" ratio requirements and to be in compliance with the generally applicable risk-based and leverage capital requirements in the agencies' capital rules. Of course, the possibility of falling out of compliance with the CBLR Framework may limit the extent to which an organization utilizes some of the benefits offered by the CBLR Framework.

### THE BENEFITS OF OPTING INTO THE CBLR FRAMEWORK

A qualifying community banking organization that opts into the CBLR Framework and maintains a leverage ratio of greater than 9% will be considered under the Rule to have met the generally applicable risk-based and leverage capital requirements in the agencies' capital rules; the well-capitalized ratio requirements in the agencies' prompt corrective action regulations; and any other capital or leverage requirements.

Opting into the CBLR Framework not only facilitates compliance with the agencies' capital rules but also alleviates the burdens of periodically calculating and reporting risk-weighted measures of capital, allowing an organization to devote its resources to other matters.

Further, participation in the CBLR Framework could permit an organization to increase its assets that would attract higher risk-weights under the generally applicable capital rules. Because the CBLR Framework does not require a participating organization to meet minimum risk-based capital ratios, such organizations may hold higher risk-weight assets that may offer better rates of return than lower risk-weight assets without being required to hold more capital. For example, an organization might shift some of its exposures from qualifying first-lien residential mortgages to HVCRE or corporate exposures, subject to applicable concentration limits and safety and soundness considerations. Of course, such organizations would be required to maintain a leverage ratio of more than 9%, which is greater than is otherwise required.

Adopting the CBLR Framework could also permit an organization to increase the portion of its capital consisting of elements other than common stock. The leverage ratio used in the CBLR Framework is based upon tier 1 capital, which consists of common equity tier 1 capital (essentially, common stock) and additional tier 1 capital. Because an organization that opts into the CBLR Framework is not required to determine a common equity tier 1 capital ratio, the limitations imposed by that ratio on an organization's capital structure would disappear. Additionally, organizations participating in the CBLR Framework would not be subject to potential limitations on distributions and discretionary bonus payments imposed by the capital conservation buffer, since they would not be required to comply with the generally applicable risk-based capital rules. This feature of the Rule may be more beneficial at the holding company level due to the fact that subsidiary banks are typically wholly owned. That being said, bank regulatory agency expectations that voting common stock be the predominant form of capital and safety and soundness considerations may temper this flexibility.

## THE BENEFITS OF STAYING OUT OF THE CBLR FRAMEWORK

In many cases, an organization's minimum required capital under the CBLR Framework will be greater than the minimum that would be required to satisfy the generally applicable risk-based and leverage capital requirements. Accordingly, opting into the CBLR Framework could unnecessarily lock up capital. An organization with a well-designed capital plan could otherwise allocate this capital more productively, and the earnings derived from the deployment of such capital could both offset the costs of periodically calculating and reporting risk-weighted measures of capital and exceed any potential returns from the organization's increased exposures to risky assets unlocked by participation in the CBLR Framework.

The Rule also amends several important activities limitations and standards, such as those identified below, which are calculated with reference to an organization's capital and surplus or total capital (i.e., the sum of tier 1 capital and tier 2 capital), such that an organization participating in the CBLR Framework would instead calculate them with reference to tier 1 capital. Calculating such limitations and standards with reference solely to tier 1 capital, rather than the broader denominator, may curtail an organization's ability to engage in a variety of activities, including investments in banking premises, subsidiaries, and pass-throughs; community development and public welfare investments; personal property leasing; general lending and concentration limits; insider credit transactions (subject to Regulation O); affiliate transactions (subject to Regulation W); and more.

## NEXT STEPS

Our team is ready to help you evaluate the CBLR Framework's impact on your organization. For additional information, please contact one of the authors or another member of Goodwin's Banking practice, part of its Financial Industry group.

## ABOUT GOODWIN:

Goodwin's financial services practice is one of the most highly regarded and largest financial services practices in the United States. Our clients include most of the largest global banks on Wall Street and throughout the world, including full-service and specialty banks; bank and financial holding companies; credit card, mortgage and other lenders, servicers and insurers; companies offering mutual, hedge and private equity fund products; investment advisers; broker-dealers; institutional investors; and providers of technology and other consumer financial services. We represent many of the most prominent financial institutions worldwide in connection with complex FinTech investments and other strategic initiatives. Our global team has led some of the largest bank consortium deals to date across a wide variety of sub-verticals, including blockchain, trading platforms, technology infrastructure, communications platforms and utilities. Our global multidisciplinary team is cohesively integrated to provide strategic advice and deal execution on behalf of the most impactful participants at the intersection of financial services and technology, from early-stage startup companies (through their entire life cycle) and bulge bracket enterprises.

# CONTACTS:

**William E. Stern**
Partner
+1 212 813 8890
wstern@goodwinlaw.com

**Alexander J. Callen**
Associate
+1 212 459 7122
acallen@goodwinlaw.com

© 2020 Goodwin Procter LLP. All rights reserved. This informational piece, which may be considered advertising under the ethical rules of certain jurisdictions, is provided with the understanding that it does not constitute the rendering of legal advice or other professional advice by Goodwin Procter LLP, Goodwin Procter (UK) LLP or their attorneys. Prior results do not guarantee similar outcome.

Goodwin Procter LLP is a limited liability partnership which operates in the United States and has a principal law office located at 100 Northern Avenue, Boston, MA 02210. Goodwin Procter (UK) LLP is a separate limited liability partnership registered in England and Wales with registered number OC362294. Its registered office is at 100 Cheapside, London EC2V 6DY. A list of the names of the members of Goodwin Procter (UK) LLP is available for inspection at the registered office. Goodwin Procter (UK) LLP is authorized and regulated by the Solicitors Regulation Authority.

**IRS Circular 230 Disclosure:** To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. tax advice contained in this informational piece (including any attachments) is not intended or written to be used, and may not be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.