WILARY WINN LLC

Advice to Strengthen Financial Institutions

Community Bank Leverage Ratio Finalized

Released September 26, 2019

INTRODUCTION

On September 17, 2019, the three federal banking agencies issued the final Regulatory Capital Rule: Capital Simplification for Qualifying Community Banks. The rule provides for the use of Community Bank Leverage Ratio ("CBLR"). Use of the CBLR is optional and the rule becomes effective January 1, 2020.

The rule is designed to simplify the calculation of regulatory capital and allow community banks to calculate a leverage ratio based on total assets. Qualifying banks would thus no longer have to calculate risk-weighted assets.

KEY TAKEAWAY

Wilary Winn provides robust life-of-loan credit loss estimates that quantify capital at risk under various macroeconomic scenarios.

HOW CAN WE HELP YOU?

Founded in 2003, Wilary Winn LLC and its sister company, Wilary Winn Risk Management LLC, provide independent, objective, fee-based advice to nearly 600 financial institutions located across the country.

We provide the following services:

CECL & ALM

Holistic solutions to measure, monitor and mitigate interest rate, liquidity, and credit risk on an integrated basis.

MERGERS & ACQUISITIONS

Independent, fee-based determinations of fair value for mergers and acquisitions.

VALUATION OF LOAN SERVICING

Comprehensive and cost-effective valuations of servicing arising from the sale of residential mortgage, SBA 7(a), auto, home equity and commercial loans.

ADDITIONAL SERVICES

Services to support our CECL, ALM, Fair Value and Loan Servicing product offerings.

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Qualifying Community Banking Organization

A qualifying community banking organization is defined as a depository institution or depository institution holding company that is not an advanced approaches banking organization and that meets the following criteria:

- CBLR greater than 9 percent;
- Total consolidated assets of less than $10 billion;
- Total off-balance sheet exposures (excluding derivatives other than credit derivatives and unconditionally cancelable commitments) of 25 percent or less of total consolidated assets; and
- Total trading assets and trading liabilities of 5 percent or less of total consolidated assets.

Calculation of the CBLR

The CBLR would be calculated as the ratio of Tier 1 Equity to average total consolidated assets. The Federal Banking Agencies estimate that as of March 31, 2019, there were 5,221 insured depository institutions with less than $10 billion in total assets and that 85% would qualify to use the CBLR. We further note that the three-year phase-in of the potential adverse impacts from CECL on regulatory capital remain in effect.

Off-Balance Sheet Exposures

While most of the qualifying criteria are relatively straightforward, off-balance sheet exposures require further explanation. Under the proposal, total off-balance sheet exposures would be calculated as the sum of the notional amounts of certain off-balance sheet items as of the end of the most recent calendar quarter. Total off-balance sheet exposures would include:

- The unused portions of commitments (except for unconditionally cancellable commitments);
- Self-liquidating, trade-related contingent items that arise from the movement of goods;
- Transaction-related contingent items including performance bonds, bid bonds, warranties and performance standby letters of credit;
- Sold credit protection through
  1. Guaranties
  2. Credit derivatives
  3. Credit enhancing representations and warranties
- Securities lent and borrowed, calculated in accordance with reporting instructions to the Call Report;
- Financial Standby Letters of credit;
- Forward agreements that are not derivative contracts; and
- Off-balance sheet securitization exposures.

Total off-balance sheet exposures would not include derivatives (such as foreign exchange swaps and interest rate swaps) but would include credit derivatives.

The off-balance sheet exposure limitation has a direct effect on FHLB MPF® clients. The regulators will continue to treat the sale of loans to the FHLBanks with a CE obligation as a synthetic securitization. The rule notes that the off-balance sheet limitation is based on the notional amounts outstanding. The question is whether the notional amount of the CE obligation amount is the dollar amount itself, given

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that it is a separate contract from the sale of the loan, or whether the measurement will be based on the dollar amount of loans now reported in RC-R Part II, Risk-Weighted Assets, Line 10.

CBLR less than 9%

What happens if a community bank elects the CBLR and then falls below it, because of growth in total assets and/or declines in Tier One equity. If a community bank falls below the 9% CBLR threshold, it could revert to use of the existing rules. If a community bank elects to remain in the CBLR framework, the rule provides a two-quarter grace period to restore the ratio. Nevertheless, to remain in the CBLR framework during the grace period, a community bank would have to meet the requirements to be well-capitalized under the existing rules.

Changes from the Proposed Rule

The key changes made to the final rule include:

- Adoption of tier 1 capital versus tangible equity;
- Removal of the qualifying criteria for mortgage servicing assets and deferred tax assets arising from temporary differences;
- Removal of CBLR regulatory capital proxy rules when a community bank's CBLR fell below 9% and it wanted to remain in CBLR framework; and
- Insertion of the two-quarter grace period.

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