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Risk-Managed Internal Audit and Credit Review Expertise

NEWS

More Options for Capital Management

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AuditOne LLC Advisory

From Bud Genovese, Chairman

This advisory provides a summary of the potential effect of the new law impacting small bank regulator capital options. It is presented by our ALM Practice Director, David Kellerman, in a concise and informative manner. Also, we understand that a rules clarification is still needed from the regulators. Please share with others as appropriate, and we hope this advisory will be beneficial to you! – Bud

EGRRCP Act

With President Trump's signing of the Economic Growth, Regulatory Relief, and Consumer Protections (EGRRCP) Act, banks with under $10 billion in assets now have more flexibility when managing their capital to meet regulatory standards. The regulatory bodies (the Federal Reserve Board (FRB), Office of the Comptroller of the Currency (OCC), and Federal Deposit Insurance Corporation (FDIC)) still have work to do to define terms. Effort is also needed to communicate how this new law will integrate into the Basel III simplification framework which was proposed in September 2017.

Banks over $10 billion in asset size have to comply with the Basel III capital framework. Banks under $10 billion in asset size will now have three regulatory capital options, each of which is explained in more detail below:

1. Basel III
2. Small Bank Holding Company Policy Statement (if assets are under $3 billion)
3. Opt out of Basel III and adopt the Community Bank Leverage Ratio with minimum tangible equity to tangible assets of between 8% and 10%.

These alternatives will allow banks the flexibility to choose the structure that best fits with their individual strategic plans and risk profile. Banks should consider within their strategic plan how asset growth rates and which sources of capital the institution may have in determining which alternative to choose.

Each alternative carries its own complexities and potential benefits:

Basel III

Basel III was finalized in 2013 and the fully phased-in effective date is January 1, 2019. Minimum ratios are defined as:

Tier 1 leverage ratio (average assets)

Common Equity Tier 1 ratio (risk weighted assets)

Tier 1 leverage ratio (risk weighted assets)

Total capital ratio (risk weighted assets)

Capital Conservation Buffers should also be considered. The capital conservation buffer of 2.5%, comprised of Common Equity Tier 1, is established above the regulatory minimum capital requirement (including all regulatory ratios except for the Tier 1 leverage ratio). Capital distribution constraints will be imposed on a bank when capital levels fall within this range. Banks will be able to conduct business as normal when their capital levels fall into the conservation range as they experience losses. The constraints imposed only relate to distributions, not the operation of the bank.

Complexity comes in the form of the computation of capital in the ratios as there are numerous adjustments required. As mentioned previously, the Basel III simplification proposes additional changes to the computations that should be considered once it is finalized. Among the several potential benefits of this alternative are flexibility in the use of Tier 2 capital and lower risk weightings for lower risk assets.

Small Bank Holding Company Policy Statement

Implemented in 1986, the Policy Statement is now applicable to holding companies with less than $3 billion in assets as well as to savings and loan holding companies. One of the most significant considerations of this alternative is that there cannot be significant non-bank activities. The alternative does allow for a more generous use of debt at the holding company level which can be down-streamed to the subsidiary banks as Tier 1 capital. This permits debt to be used to help finance mergers and acquisitions. As an example of the added flexibility of this structure, Small Bank Holding Companies can carry 75% debt to 25% equity (which needs to be reduced to 25% debt within 12 years) versus Basel II maximum debt usage for Bank Holding Companies over $10 billion of just 19%. Each subsidiary bank must be well-capitalized and there are potential dividend restrictions as well. If your Bank is near the $3 billion threshold and are utilizing this framework, plans to transition to either Basel III or the new Community Bank Leverage Ratio (Tangible Equity to Tangible Asset) framework need to be considered.

Community Bank Leverage Ratio (Tangible Equity to Tangible Assets from 8% to 10%)

This alternative is a very much simplified framework for small banks and bank holding companies. There are no guidelines yet as to what qualifies as tangible capital, but stay tuned to communications from your regulator. If your institution has higher risk weighted assets or significant deductions from Basel III common equity Tier 1 capital, you may want to review the merits of this regulatory capital alternative. Based on recent Call Report filings, most small banks already meet the 10% tangible equity to tangible assets requirement. Those institutions could opt out of Basel III and into the new Community Bank Leverage Ratio with no intervening steps needed. Benefits of this alternative include not being subject to Basel II capital penalties or adverse risk weightings. Alternatively, institutions with low risk-weighted assets would recognize no benefit for those holdings.

Conclusion

While the new EGRRCP Act provides for simplification of capital requirements for small banks and small bank holding companies, the decision making as to which regulatory capital framework to choose is potentially not a simple one. Financial advisors should be consulted as more information becomes available from regulators.

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