March 20, 2018

The Pendulum Swings

- Regulatory Relief Advances in the Legislative Channel
- If Passed by the House as Approved by the Senate, SIFI and CCAR Relief for Banks Between $50 to $250 Billion
    - Potential for More Rapid Capital Return Including Dividends
    - More Active Acquirers May Emerge
- Current Bill Could Accelerate Loan Growth for Single Family Residential and Commercial Real Estate
- Also Provides Expanded Capital Options for Community Banks

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Regulatory relief continues to move forward in very concrete terms with the passage of the Senate's Economic Growth, Regulatory Relief, and Consumer Protections Act (EGRRCP or S.2155) on March 14, 2018. If the bill is approved by the House of Representatives as passed by the Senate in S.2155, several important changes would be made the Dodd-Frank Act (DFA); but perhaps the most far-reaching effect will be how this legislation becomes a reality. We are considering this legislation as the second stage of a three-stage transition in regulation.

The first stage for relief has arguably been an improvement in dialogue and tone with various regulatory bodies in concert with several high-level leadership changes over the last year and some movement in areas not requiring legislative action. Much of this was highlighted in Treasury's 147-page "Core Principles" exposition last June based on their exhaustive consultations with government entities, offices and related entities (18), consumer advocates (14), academics (13), think tanks (15) and industry and trade groups (245).[1] This publication was followed by the Federal Reserve's proposed community bank simplifications published in late September, and then by the more encompassing Basel III Simplification Notice of Proposed Rulemaking released jointly by the Federal Reserve Board (Fed), the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC). (see Sandler O'Neill's Basel III Simplification of Capital Rules dated October 10, 2017).

This bottom-up, fact-based approach to analyzing the DFA and related issues along with substantial out-reach to solicit other opinions appears to have facilitated the opening of legislative channels to accept the view that certain elements

[1] U.S. Department of Treasury. (June 2017) Report to President Donald Trump. Executive order 13772 on Core Principles for Regulating the United States Financial System. Washington, D.C., Steven Mnuchin Secretary.

of the DFA are potentially counterproductive if not unwarranted. This has led to the current second stage as seen in the Senates EGRRCP bill. While an indiscriminate and populist philosophy hampered the re-writing of financial sector regulation for nearly a decade, the political pendulum has clearly reversed allowing more rational but concrete improvement in bank oversight. The EGRRCP legislation is largely focused on community and regional banks that cannot be floodlit with the fear of systemic importance.

With the U.S. economy entering its ninth year of subdued growth, regulatory relief centered on community and regional banks is now critical. This echelon of banks is responsible, among other things, for a disproportionate share of lending to small and mid-sized businesses, which are the primary driver of new job growth. And the banks serving this side of our economy, which is already straining under severe labor force limitations, are also running increasingly high loan-to-deposit ratios and struggling under equally disproportionate regulatory burdens and historically high efficiency ratios. In addition to business credit, commercial real estate is a major financing activity of regional and community banks that also drives employment and local infrastructure growth.

Adding to the urgency for a more streamlined and efficient banking sector is the likely upside to economic growth from both business and consumer spending that will result from the Tax Cuts & Jobs Act (TCJA) tax reductions. While we adhere to our 2% real GDP growth outlook for the U.S. economy in the long term, we now also see considerable potential to exceed that trend line over the next year or two. Credit support must accompany this.

The EGRRCP clearly recognizes these issues and has thoughtfully tailored its legislative response accordingly. It is now crucial to remove unnecessary burdens on credit formation and supply. Only extremists, in our view, are still defending the entirety of the DFA as a mandatory safety-and-soundness concern irrespective of size and consequence. With S.2155 they are increasingly seen in the minority.

That regulatory relief is finally being delivered by Congress at all is perhaps the most encouraging revelation with the most long-term promise. The Senate began this journey in earnest last November while the House began a comparable effort (The Financial CHOICE Act) in September of 2016 and that passed on a party line vote in June of last year. As the two bills are substantively different in size and scope, Senator Mike Crappo crafted the Senate final bill only to the maximum scope that would carry true bipartisan support in the Senate with the House Bill’s author, Representative Jeb Hensarling, hopefully understanding the pragmatics of the possible.

We would call this a classic return to “Regular Order” in the sense that Congress has collaboratively enacted legislation rather than confrontationally failed. Hopefully this is a harbinger of what is to come and the House will approve this bill quickly. This focus on bipartisan action seems to have carried forward to EGRRCP which calls for nine studies (Section 501 – 509), two Government Accountability Office (GAO) reports on Cyber Security (Section 216) and Puerto Rico foreclosures (Section 311), and a solicitation of alternative credit scoring models (subject to validation and approval) to be used by the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) to better serve consumers. Results from these studies and analysis may well form the basis of future bipartisan legislation.

A third stage of regulatory relief – possibly better described as regulatory restructuring – should and could eventually address the counterproductive and unintended consequences affecting our largest financial institutions in areas such as severely vacated capital markets liquidity. But the better part of this final phase will hopefully address the nonbanks, which are far more powerful than most think. Only 25% of credit in America is extended by banks and bank credit

actually remained stable during the 2008-9 crisis while nonbank credit collapsed dramatically. We hope this matter will be discussed in the future.

In light of all the above, perhaps much relief is still in the future, but in summary we consider there are at least three key features to the latest DFA Reform as proposed in EGRRCP:

1. **Systemic Risk Resized and Redefined:** Sections 401, 402 and 403 substantively resize risk and redefine key capital and liquidity ratios. Applauded by all, the most onerous category for compliance including the Comprehensive Capital Analysis and Review (CCAR) is now limited, unless otherwise warranted, to banks in excess of $250 billion. All U.S. banking institutions with less than $250 billion in assets will be exempt from company-run stress tests. This will potentially release over 100 banks from $10 billion up to $250 billion in assets from such stress testing, many of whom could opt for higher dividend payouts or stock repurchases. This should also add new acquirers to otherwise self-imposed dormant groups, such as those below the $50 billion current threshold for CCAR or $10 billion threshold for company run stress tests that are compliant with CCAR or other stress testing requirements but hesitate to acquire those that are not. In addition to resizing risk, EGRRCP redefined risk as measured by key ratios including the treatment of municipal deposits for the Liquidity Coverage Ratio (LCR) and the exclusion of custodial deposits from the Supplementary Leverage Ratio (SLR) for custody banks.

2. **Loan Growth Accelerated:** Sections 101, 104 and 214 all address certain restraints and restrictions on real estate lending particularly important to regional and community banks by reducing administrative barriers and costs and underwriting constraints for single family residential (SFR) loans while avoiding a substantial increase in risk weighting for certain types of CRE related loans. The removal of Home Mortgage Disclosure Act (HMDA) data burden to smaller banks is perhaps one of the most helpful and powerful changes supporting on balance sheet local residential mortgage creation. The automatic classification as Qualified Mortgages (QM) for SFR loans originated and retained by banks with less than $10 billion in assets that meet certain requirements will also likely spur more SFR loan originations.

3. **Capital Options Expanded for Community Banks:** Section 201 substantially broadens the capital options for community banks by offering three alternatives for regulatory capital structure:
   - The Small BHC Policy Statement (increased from $1 billion to $3 billion in assets) which enables qualifying BHCs to support growth with higher levels of lower cost debt and hybrid capital,
   - A Community Bank Leverage Ratio of 8-10% tangible equity/tangible assets (to be determined by regulators), or
   - Basel III with regulatory capital ratios based on risk-weighted assets and subject to numerous deductions from tangible capital.

   With 95% of U.S. banks having total assets of less than $3 billion, the vast majority of community banks will gain considerable balance sheet flexibility through Section 201. With that flexibility comes the reality that community banks will still have to conform to Basel III requirements as they approach the $10 billion assets threshold.

Systemic Risk Resized and Redefined

There are at least three key elements of EGRRCP that resize/redefine risk for financial institutions. Section 401 raises asset size for the SIFI designation from $50 billion to $250 billion. Section 402 amends the SLR definition to exclude those banks primarily engaged in custody with funds deposited at a central bank (such as the Federal Reserve) from the SLR calculation. Section 403 includes qualifying investment grade, liquid and readily marketable municipal bonds in the definition of level 2B High Quality Liquid Assets (HQLA) to calculate the LCR.

The DFA defined SIFIs as those with total assets of $50 billion or more. Among this group, financial institutions determined by the Bank for International Settlements (BIS) Committee to be particularly important to the global banking system were classified as Global Systemically Important Banks (GSIBs).

As originally introduced in the DFA, all financial companies with more than $10 billion were required to conduct an annual company-run stress test. Banks with $50 billion or more in assets were subject to an additional mid-cycle stress test and the Federal Reserve's supervisory stress test commonly referred to as the CCAR stress test as well as being subject to enhanced prudential standards. There are currently about 123 banks subject to either company run stress testing or the Federal Reserve's CCAR stress testing which covers about 86% of U.S. banking assets causing an enormous burden and cost to the banks to support and perform.

Section 401 of the EGRRCP will eliminate U.S. based banks with total assets less than $250 billion from the automatic SIFI designation along with the application of enhanced prudential standards. Only those banks that are GSIBs or have total assets of $250 billion or more will be subject to CCAR stress testing and prudential risk management standards. All U.S. based banks with total assets of less than $100 billion would be exempt from the SIFI designation or enhanced prudential standards immediate upon the effective date of the legislation. Banking entities with $100 billion or more in assets but less than $250 billion (that are not GSIBs) will be generally be exempt from SIFI designation and prudential risk standards after 18 months. A provision was added to Section 401 of the final version of EGRRCP to clarify that this legislation did not impact the Federal Reserve's existing Regulation YY as it applies to foreign banking organizations (FBOs) with $100 billion or more in assets. As such, it appears that such FBOs may not benefit from the regulatory relief otherwise available to U.S. based banks in the same size range.

As shown in the Chart A below, nine of the banks between $100 billion and $250 billion are the subsidiaries of foreign banks operating in the U.S.

Chart A

	Company Name	Total Assets ($000s)	CCAR Qualification
1	JPMorgan Chase & Co.	2,533,600,000	
2	Bank of America Corporation	2,281,477,000	
3	Wells Fargo & Company	1,951,757,000	
4	Citigroup Inc.	1,842,465,000	**GSIBs**
5	Goldman Sachs Group, Inc.	916,787,000	
6	Morgan Stanley	851,733,000	
7	Bank of New York Mellon Corporation	371,758,000	
8	State Street Corporation	238,496,136	
9	U.S. Bancorp	462,040,000	
10	PNC Financial Services Group, Inc.	381,450,622	**Non-GSIBs**
11	TD Group US Holdings LLC	380,907,238	**>=$250 B**
12	Capital One Financial Corporation	365,692,669	
13	HSBC North America Holdings Inc.	273,486,377	
14	Barclays US LLC	157,927,000	
15	MUFG Americas Holdings Corporation	154,557,404	
16	DB USA Corporation	148,248,000	
17	RBC USA Holdco Corporation	141,974,824	**Foreign Banks**
18	Credit Suisse Holdings (USA), Inc.	141,413,215	**with U.S. Offices**
19	UBS Americas Holding LLC	140,698,850	**>=$100 B but <**
20	BNP Paribas USA, Inc.	139,136,085	**$250 B**
21	BMO Financial Corp.	131,102,466	
22	Santander Holdings USA, Inc.	128,267,739	
	Banking Assets Subject to CCAR	14,134,975,625	
	Total Banking Assets	21,433,782,518	
		65.95%	

Source: SNL Financial

If and when EGRRCP becomes law, twenty-two banks representing about 66% of U.S. banking assets will likely be subject to CCAR and prudential risk standards going forward either due to a GSIB classification, having total assets exceeding $250 billion, or representing the U.S. office of a foreign bank with $100 billion but less than $250 billion in assets. The Federal Reserve does retain the authority to apply enhanced prudential standards to banks between $100 and $250 billion in the event of financial difficulties at the bank.

To go from 123 banks representing about 86% of U.S. banking assets being subject to stress testing to 22 banks representing about 66% of U.S. banking assets subject to CCAR and the enhanced prudential standards represents a substantial yet sensible re-sizing of systemic risk and will hopefully lead to a much needed reduction in expense and reporting burden.

Section 402 excludes custodial deposits retained at the Federal Reserve (or other Central Bank) from the total value of deposits in calculating the SLR for any depository institution that is "predominantly engaged in custody, safekeeping, and asset servicing activities". This will clearly benefit two GSIBs, Bank of New York Mellon and State Street that are principally engaged in custodial activities but not other banks that also offer custodial services but are not principally engaged in providing custodial services. This classification of the deposits based on the predominate focus of the banking organization rather than the characteristics of the deposit seems generally inconsistent with the pragmatic approach otherwise demonstrated in the EGRRCP legislation.

The exclusion of qualifying, investment grade and liquid municipal debt from Level 2B HQLA for purposes of the LCR has been hotly debated since the Basel III rules were finalized. In 2016, the Federal Reserve amended their definition of the LCR to include such municipal bonds as level 2B assets in HQLA, but the FDIC and OCC have not done so. Section 403 explicitly directs all the banking agencies to amend their LCR rules and any other regulation that incorporates similar liquidity definitions within 90 days after the date of enactment of this legislation.

There are several other items of resizing and redefining risk of most interest to small banks including Section 202 which offers a limited exception for reciprocal deposits to not be considered brokered deposits if the bank is well capitalized and the reciprocal deposit amount is less than (i) $5 billion and (ii) 20% of total liabilities. Section 203 exempts banking organizations from the Volcker Rule if they have either (i) less than $10 billion in assets or (ii) trading assets of less than 5% of total assets. Section 205 offers short form call reports for Q1 and Q3 if the reporting bank is below $5 billion in assets. Section 210 extends the examination cycle for well-managed and well-capitalized banks to 18 months. Taken together these enhancements will help with access to liquidity funds to support growth, eliminate concerns about Volcker Rule compliance, and reduce the regulatory reporting burden for small banks.

Loan Growth Accelerated

To encourage more SFR loan origination by community banks, Section 101 provides a safe harbor for Qualified Mortgage (QM) mortgages originated and retained by an insured depository institution or credit union with less than $10 billion in total assets. Loans that meet certain conditions including limits on prepayment penalties, points and fees, negative amortization, interest-only features, and documentation will be deemed in compliance with the "ability to repay" (ATR) requirement under the Truth in Lending Act (TILA).

SFR mortgage loan origination by community banks will also be encouraged by Section 104 changes to HMDA to increase the minimum number of loans originated by community banks before being subject to HMDA disclosure requirements. HMDA was originally passed by Congress in 1975 and implemented by the Federal Reserve Board through Regulation C. The FFIEC originally administered HMDA but with the passage of the DFA, the rule-writing and administration authority transferred to the CFPB in 2011. Since then all depository institutions with $41 million in assets in 2012 increasing to $44 million in assets in 2017 that originate at least 25 closed-end mortgages or 500 open-end lines of credit in each of the last two years were required to collect and report at least 22 fields of information from each borrower.[2]

Effective January 1, 2018, the number of HMDA required data fields increased to 59. Based on numerous discussions with small bank CEOs, the cost of gathering and reporting this information along with the risk of fines from the CFPB if not done properly has been a major reason why so many community bank have dropped out of providing single-family residential mortgages. For example, one bank CEO with approximately $500 million in assets reported that the annual cost of compliance with HMDA was $40,000 to $50,000 based on allocation of the compliance officer's time and the cost of annual review by a consultant. The bank only originated 25 loans per year. That equates to $2,000 per loan which is cost prohibitive.

Under the Section 104 of the EGRRCP, banks that have satisfactory CRA ratings and originate less than 500 closed-end mortgages and less than 500 open-end lines of credit in each of the last two years will be exempt from HMDA reporting

[2] A guide to HMDA Reporting. Getting it Right! 2018 Edition. FFIEC. Page 3.

requirements thereby materially improving the economics of this type of lending. We would expect to see many community banks reenter this market particularly as they seek to grow and diversify their loan portfolios.

To support more commercial real estate lending by community banks, Section 214 would provide regulatory relief to commercial real estate lenders in three ways:

1. Expands the definition of equity that can be counted towards the 15% requirement needed to avoid classification of a construction loan as a High Volatility Commercial Real Estate (HVCRE) loan to include cash, unencumbered marketable securities, paid development costs, and contributed real property or improvements compared to just cash and marketable securities.
2. Offers greater flexibility to return all or a portion of the initial 15% equity requirement once the loan is reclassified as non-HVCRE Acquisition Development Construction loan (subject to acceptable LTVs) rather than requiring the sale of the property or conversion to a permanent loan to remove from the HVCRE classification and 150% risk weighting.
3. Allows reduction in risk weighting to 100% as non-HVCRE ADC once the cash flow is sufficient to support debt service and expenses of the property in accordance with the bank's loan underwriting policy for permanent financing compared to 150% for HVCRE loans or 130% for HV ADC loans proposed under the Basel III Simplification NPR.

There has been substantial concern expressed by community bankers that the 150% risk weighting applied to HVCRE exposures was too high and the criteria for determining whether an ADC loan qualified for an exemption from HVCRE classification was confusing and did not track relevant or appropriate risk drivers. In particular, bankers expressed concern over the contributed capital exemption that allowed ADC projects that included a 15% borrower equity contribution and certain loan-to-value limits to avoid consideration as HVCRE. This 15% equity contribution was required to remain in the project for the life of the project. Conversion of the credit facility from HVCRE could only be accomplished by arranging permanent financing or paying it off.[3]

To address these concerns, with the Basel III Simplification NPR, the agencies developed the revised definition for HVADC to eliminate the 15% contributed capital exemption and restriction on the release of internally generated capital. The agencies also narrowed the definition of ADC exposures to only include exposures used primarily (more than 50%) for the financing or refinancing of the ADC of land, development of land or new structures, and the construction of buildings. Excluded from the HVADC definition are ADC exposures for residential properties, community development properties, and agricultural land. Finally, the agencies changed the exit criteria for the life of a project to classify a credit facility as a permanent loan if it has a clearly identified ongoing source of repayment sufficient to service amortizing principal and interest payments without reliance on the sale of the property. With these changes in definition, the Agencies expected that as much as 18% more loans would be considered HVADC loans under the Simplification NPR than under Basel III.

The prospect of a significant increase in HVADC classification led to much commentary submitted by community bankers to the regulators under the Basel III Simplification NPR process and ultimately the inclusion of Section 214 in EGRRCP. These Section 214 changes will likely reduce the amount of CRE loans classified as HVCRE, lower the risk weighting on the CRE loan portfolios for many lenders, and, as a result, stimulate more lending activity and job formation in our communities.

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[3] Joint Report to Congress. Economic Growth and Regulatory Paperwork Reduction Act. Federal Financial Examination Council. March 2017. Page 20.

Capital Options Expanded for Community Banks

Section 201 provides community banking institutions with total assets below $10 billion with significant flexibility in their choice of capital structure. They can select between Basel III, the Small BHC policy Statement (assets <$3 billion), or alternatively, opt out of Basel III, and comply with the new Community Bank Leverage Ratio with tangible equity/tangible assets of 8 to 10%. This flexibility is highlighted in Chart B below where small banks with less than $10 billion in assets have the most capital regime alternatives to best match their business plan, risk profile, growth rate and sources of available capital. This chart also highlights the fact that banks with less than $10 billion in assets comprise 98% of the total number of banks and about 13% of the total amount of assets. It also shows that smaller banks (<$3 billion) generally have much stronger levels of TE/TA with a median of 10.44% compared to 8.46% for the GSIBs.

Chart B

Summary of Capital Regimes by Asset Size Under the EGRRCP

Institutions	Asset Size	Capital/Liquidity Framework	TE/TA (%) Median
Number 8 % 0.1% Total Assets 11.0 % 51.4%	• U.S. GSIB	• Basel III with LCR, NSFR and TLAC	8.46
Number 5 % 0.1% Total Assets 1.9 % 8.9%	• >= $250 B but < U.S. GSIB	• Basel III with LCR and NSFR	9.34
Number 110 % 2.0% Total Assets 5.7 % 26.6%	• >= $10 B but < $250 B	• Basel III	9.25
Number 176 % 3.2% Total Assets 1 % 4.7%	• >= $3 B but < $10 B	• TE/TA >= 8 to 10% OR • Basel III	9.28
Number 5,169 % 94.5% Total Assets 1.8 % 8.4%	• < $3 B	• Small BHC Policy Statement, TE/TA >=8 to 10% OR • Basel III	10.44

Number	5,468
Assets ($T)	21.4

Source: SNL Financial

To select the optimal capital regime for the community bank to follow, a short review of the options is in order.

The Small BHC Policy Statement

The Federal Reserve Board implemented the Small Banking Holding Company Policy Statement (the "Policy Statement") in 1986. Since then, the initial qualifications and ongoing requirements of the Policy Statement have not changed other than (i) an increase in asset size from less than $150 million in 1986 to less than $3 billion now proposed and (ii) the inclusion of savings and loan holding companies. A summary of these requirements is provided below in Chart C.

Chart C

Small BHC Policy Statement Initial and Ongoing Requirements

Consideration	2018
Maximum permitted asset size ($MM)	$3,000
No significant non-bank activities [1]	✓
No significant off-BS activities through non-bank subs [1]	✓
No material amt of SEC registered debt or equity (ex. TPS) [2]	✓
BHC debt must be repaid within 25 years	✓
Max debt-to-equity ratio of 3.0 (75% debt)	✓
Debt < .30:1 (25% debt) or less within 12 years	✓
Each subs bank well capitalized under Basel III rules	✓
No dividends until the D/E ratio reduced to 1.0:1 or less	✓

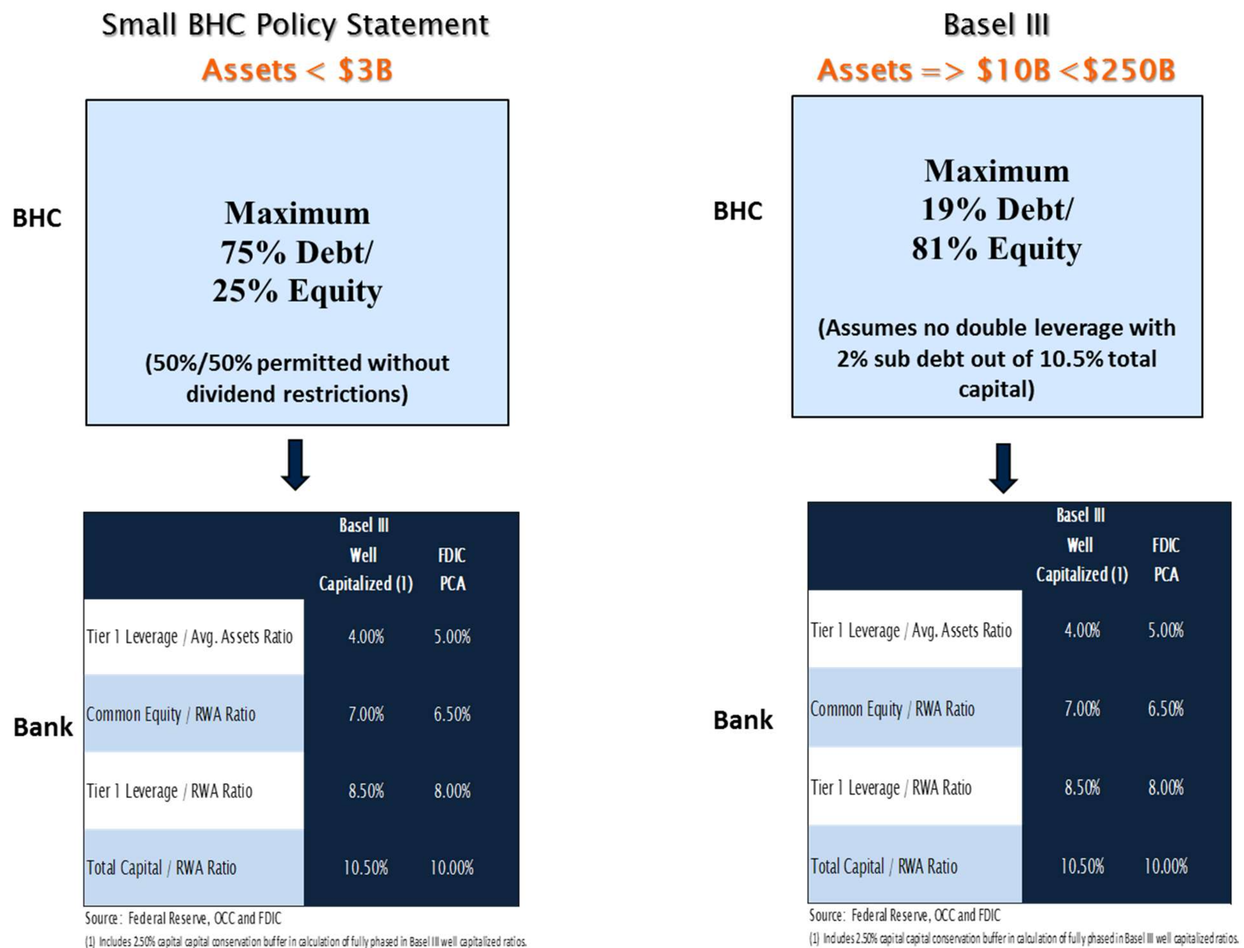
(1) The determination of whether a BHC engages in significant non-bank activities will continue to depend on a consideration of the size of the activities, the nature and level of risk of the activities, and the condition of the BHC and the subsidiary depository institution.

(2) Determinations of materiality are made by the Fed on a case-by-case basis based on: the number and type of classes and series of stock issued; the holding company's market capitalization; the number of outstanding shares; the average trading volume; the holding company's history of issuing equity and debt securities, including whether the entity has issued any other securities that are not registered with the SEC (e.g., privately-place securities); the nature and distribution of ownership; whether the securities are listed on a national exchange; whether the holding company qualifies as a "smaller reporting company" pursuant to the SEC's regulations and related interpretations; and the amount, type, and terms of any debt instruments issued by the entity.

The Federal Reserve will make a case-by-case determination on the qualifications of a BHC to use the Policy Statement. Those institutions that have off-balance sheet activities conducted through a non-bank subsidiary or have issued SEC registered debt or equity (excluding TPS) should check with their regulators to ensure they would qualify. The additional leverage available to the BHC under the Policy Statement is significant as shown below.

Chart D

Comparison Between Small BHC Policy Statement and Basel III



Small BHC Policy Statement (Assets < $3B) – Bank:

	Basel III Well Capitalized (1)	FDIC PCA
Tier 1 Leverage / Avg. Assets Ratio	4.00%	5.00%
Common Equity / RWA Ratio	7.00%	6.50%
Tier 1 Leverage / RWA Ratio	8.50%	8.00%
Total Capital / RWA Ratio	10.50%	10.00%

Source: Federal Reserve, OCC and FDIC

(1) Includes 2.50% capital capital conservation buffer in calculation of fully phased in Basel III well capitalized ratios.

Basel III (Assets => $10B <$250B) – Bank:

	Basel III Well Capitalized (1)	FDIC PCA
Tier 1 Leverage / Avg. Assets Ratio	4.00%	5.00%
Common Equity / RWA Ratio	7.00%	6.50%
Tier 1 Leverage / RWA Ratio	8.50%	8.00%
Total Capital / RWA Ratio	10.50%	10.00%

Source: Federal Reserve, OCC and FDIC

(1) Includes 2.50% capital capital conservation buffer in calculation of fully phased in Basel III well capitalized ratios.

The Federal Reserve clearly recognizes that "….a high level of debt at the parent holding company impairs the ability of a bank holding company to provide financial assistance to its subsidiary bank(s) and, in some cases, the servicing requirements on such debt may be a significant drain on the resources of the bank(s). For these reasons, the Board has not favored the use of acquisition debt in the formation of bank holding companies or in the acquisition of additional banks. Nevertheless, the Board has recognized that the transfer of ownership of small banks often requires the use of acquisition debt. The Board, therefore, has permitted the formation and expansion of small bank holding companies with debt levels higher than would be permitted for larger holding companies."[4]

As of year-end 2017 data from SNL Financial, banking institutions with less than $3 billion in assets comprised $1.9 trillion in assets among 5,169 banking institutions. These banks represented about 95% of the 5,468 in total U.S. banking institutions and approximately 8.6% of the $21.4 trillion in total assets. As such, assuming these institutions either had a BHC or could add a BHC structure if desired, the Policy Statement would provide capital structure flexibility for almost 95% of the 5,468 total banking institutions in the U.S. But the ongoing Policy Statement requirements and asset size limit at $3 billion threshold mean that an exit strategy from the Policy Statement to either Basel III or the TE/TA regime should also be considered.

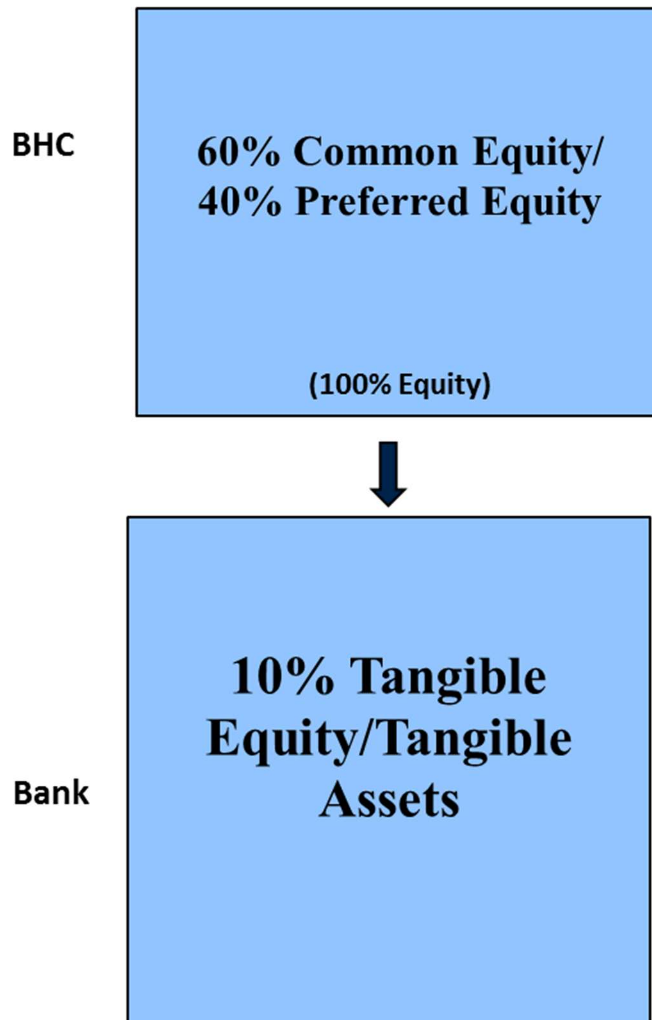
[4] Federal Register. Vol 80, No. 72/ Wednesday, April 15, 2015. Page 20154.

Community Bank Leverage Ratio (TE/TA 8 to 10%)

With a focus on offering well-capitalized community banks a simple capital regime, the House Banking Committee included a simple leverage ratio in the Financial Choice Act passed in 2016. EGRRCP includes this concept in Section 201 that requires Federal banking regulators to develop a new Community Bank Leverage Ratio consisting of 8 to 10% tangible equity/tangible assets for banks and BHCs with less than $10 billion in assets. (see Chart E below) If the BHC maintains capital in excess of the Community Bank Leverage Ratio, it would be deemed to comply with the leverage and risk-based capital requirements of Basel III and the bank would be considered well-capitalized under the prompt corrective action regime (assuming an acceptable risk profile). As such, the community bank could "opt out" of other Basel III requirements. There are no guidelines currently available for the composition of the tangible equity, but it is reasonable to assume that common equity would be required to comprise a majority of tangible equity. This could create additional capital flexibility for community banks that want to supplement tangible equity with preferred stock.

Chart E

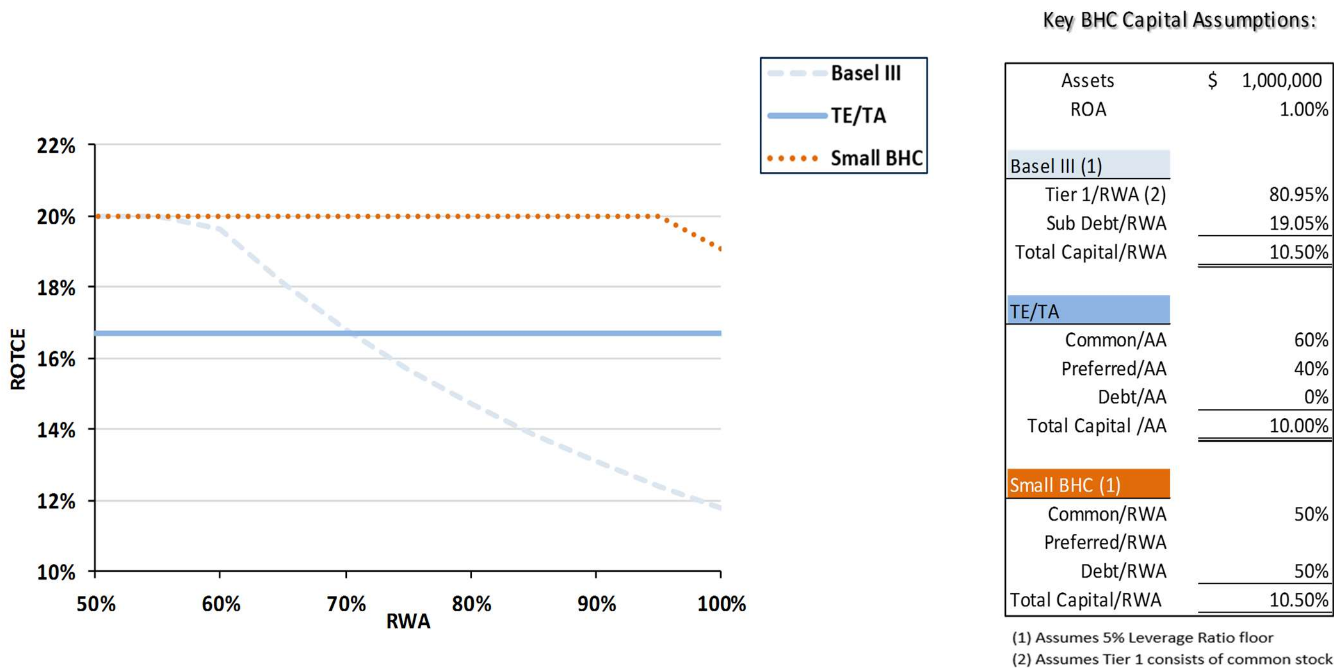
Community Bank Leverage Ratio



While the Community Bank Leverage Ratio may offer a very attractive, simple alternative for many community banks that have high risk weighted assets or substantial Basel III deductions from common equity tier 1, there is a trade-off on basing the capital ratio on average tangible assets compared to risk weighted assets. The diagram in Chart F below shows that return of average tangible common equity is highest with the Small BHC Policy statement due to greater use of debt but the TE/TA regime is best until risk weighted assets (RWAs) fall below about 70%.

Chart F

Comparison of ROTCE with Basel III, Small BHC and the New TE/TA Capital Frameworks



Assets	$ 1,000,000
ROA	1.00%
Basel III (1)	
Tier 1/RWA (2)	80.95%
Sub Debt/RWA	19.05%
Total Capital/RWA	10.50%
TE/TA	
Common/AA	60%
Preferred/AA	40%
Debt/AA	0%
Total Capital /AA	10.00%
Small BHC (1)	
Common/RWA	50%
Preferred/RWA	
Debt/RWA	50%
Total Capital/RWA	10.50%

(1) Assumes 5% Leverage Ratio floor
(2) Assumes Tier 1 consists of common stock

This is a hypothetical analysis based on assumptions listed in the box above along with an assumed maximum return ROTCE of 20%. This framework offers an example of the type of comparison of capital regimes that prudent community banks may consider as they evaluate the best capital strategy to fit their business model, risk profile and growth plans. More on this after the regulators agree on the ratio definition.

Ultimately, the decision on the optimal capital regime for any particular bank will also be based on cost and availability of capital. The cost of capital will vary based on whether the bank is issuing common stock, preferred stock, subordinated debt or senior debt among other options. The cost of common stock will be impacted by many factors including asset size, stock liquidity, public or private ownership, risk profile and financial performance along with many other factors. Preferred stock generally has lower required returns than common stock but dividends on both are not tax deductible. The recent reduction in corporate tax rates under the TCJA from 35% to 21% has lowered the benefit of the tax deductibility of senior or subordinated debt payments. In substantially all cases senior or subordinated debt will have a lower after-tax cost of capital than preferred stock due to the tax deductibility of payments.

In terms of capital availability, as of year-end 2017, small banking institutions with less than $3 billion in assets reported very strong tangible equity/tangible assets ratios of 11.85% (mean) and 10.44% (median), respectively. This suggests that a majority of small banks already meet the 10% tangible equity/tangible assets requirement and could simply opt out of Basel III and into the Community Bank Leverage Ratio with no other capital action needed. A substantial number of institutions between $3 billion and $10 billion also meet or exceed the 10% tangible equity/tangible assets requirement with a mean ratio of 10.29% and median of 9.28%.

Chart H

Comparison of Tangible Equity and Risk Weighted Assets for Banks < $10 billion in Assets

	<$3 Billion	$3 Billion - $10 Billion
# of Banks	5,169	176
% Total Banks	94.53%	3.22%
Total Assets ($M)	1,849,097	963,230
% Total Assets	8.63%	4.49%
Tang Equity/ Tang Assets (%)		
Mean	11.85	10.29
Median	10.44	9.28
Risk Weighted Assets/ Assets (%)		
Mean	67.80	75.99
Median	69.54	77.61

Source: SNL Financial

Summary and Conclusion

The EGRRCP legislation is being been crafted through a bottoms-up, bipartisan approach that has recently been sorely lacking in Washington. This legislation includes many common sense and practical adjustments to reduce the regulatory burden on banks without unduly increasing the risk profile.

The regulatory burden has been particularly hard on the community banks with less than $10 billion in assets and most of the relief is granted to them with expanded capital options, relief from the Volcker rule, and QM and HMDA flexibility for SFR loan origination. Important clarifications and greater flexibility will likely accelerate CRE loan growth.

While larger banks did not get capital relief, they could receive relief perhaps even more dear – an increase from $50 billion to $250 billion in the SIFI threshold and CCAR testing requirement. There is still much work to do to address problems in the banking system including the overhang from shadow banks and numerous other issues identified in this legislation, but this is a very positive step forward for regulatory relief and bipartisan problem solving.

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