Understanding Capital and the New Community Bank Leverage Ratio

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With passage of the Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018 (S. 2155), community banks gained exemption from several key facets of the post-crisis financial regulatory framework. Included among the provisions of S. 2155 was the Community Bank Leverage Ratio (CBLR), a special alternative capital framework available only to banks holding less than $10 billion in assets.

Under the requirements of the CBLR, qualifying institutions are provided the option to meet a simple leverage ratio of 9% tier 1 capital to average total consolidated assets, instead of the risk-weighted requirements currently in place. Proponents of the measure argue that by reducing burdensome risk-weighting requirements, the CBLR standard provides community banks a more level playing field on which to compete with large institutions.

Capital Regulation Fundamentals

In order to understand the potential impact of the CBLR, it is important to have some background on the basics of capital regulation.

In a basic sense, capital represents the amount of funding a financial institution has secured from equity, and thus the amount of losses it can sustain without defaulting on its obligations to creditors. Regulators use several measures to assess a bank's capital adequacy, established under an international regulatory accord known as Basel III.

The simplest measure of capital adequacy is a leverage ratio, which measures a bank's proportion of core capital – consisting mostly of common stock and retained earnings – to average total assets over a quarterly period. Regulators often use several complementary leverage ratios which distinguish between the quality of capital held in order to capture a full picture of a bank's overall solvency.

Leverage Ratio

In addition, regulators use risk-weighted ratios, which assign each asset on a bank's balance sheet a weight based on likelihood of default, to provide a more complete picture of an institution's exposure to risk. Under current Basel III rules, banks must maintain a total risk-based capital ratio of 8%, with an additional buffer of 2.5%.

Total Risk-Based Capital Ratio

For example, US Treasury Securities are assigned a risk weight of 0% under current capital rules. Consequently, banks are not required to hold capital against US Treasuries on their balance sheet. However, if the same bank holds $5 million in senior debt securities issued by ABC Widgets Inc. – which are risk weighted at 100% – it must recognize $5 million of risk-weighted assets for that particular exposure. In order to meet its 10% total risk-based capital requirement under Basel III, the bank must hold at least $500,000 in capital against the exposure.

To learn more about eligibility requirements for the CBLR and its potential impact on community banks, visit the FDIC Community Banking Initiative website.

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