Asset Liability Management: Will Simplified Capital Rules Affect Community Bank Debt Issuance?

“When you come to the fork in the road, take it.” – Yogi Berra.

Community banking institutions may elect to comply with one new regulatory capital requirement instead of four due to final rule changes adopted by Federal banking agencies on October 29, 2019. The new rules are intended to simplify capital requirements; and should help ease the burdens of calculating and reporting regulatory capital. In order to qualify for the new Community Bank Leverage Ratio (“CBLR”), a bank or bank holding company (“BHC”), must have average total consolidated assets below $10 billion and a leverage ratio above 9.0%. Among other things, the CBLR (the “Final Rule”) eliminates the need to calculate risk-weighted capital/assets. The CBLR uses the existing definition of Tier 1 capital as the numerator and average total consolidated assets as the denominator. BHCs are also subject to all bank capital requirements and can qualify for the CBLR option.

We believe the Final Rule will not significantly impact the community bank debt market. The regulatory treatment of subordinated debt (“sub debt”) as Tier 2 capital is eliminated when the CBLR option is used, but there are other important reasons why community banks issue debt. Debt issuances are used to fund acquisitions, refinance higher-cost debt, and repurchase stock. It seems likely, however, that institutions that elect the CBLR option will tend to issue senior debt vs. sub debt. In theory, senior debt should price more favorably given the higher ranking in the capital structure.

- On October 29, the Federal Reserve, OCC, and FDIC finalized new rules to simplify the standard needed for banks and bank holding companies to qualify as “well capitalized”.
- Many banks will probably adopt a “wait and see” approach to the new rule. Anecdotal evidence suggests that the time and effort needed to calculate and report the existing capital ratios considerably varies among community banks.
- The new issuance debt market is near-ideal due to a supply/investor demand imbalance, low Treasury yields, and relatively tight credit spreads.
- Senior and subordinated debt are effective forms of financing on a risk/reward basis for banks that seek capital to support growth.
- The ability to issue debt facilitates the use of cash to fund acquisitions, which is significant as common equity raises can be more difficult for smaller institutions. Non-stock deals appeal to sellers seeking to “cash out”.
- Regulators and bank investors appreciate proactive asset/liability management, which use funding that more or less matches the expected duration or maturities of assets.
- Although important to regulators, banks, and debt markets, it appears that equity analysts and investors are not focused on the Final Rule, which becomes effective on January 1, 2020.
New Capital Rule – Game Changer or Nothingburger,*

On October 29, 2019, the Federal Reserve Board ("Fed"), Office of the Comptroller of the Currency (the "OCC"), and the Federal Deposit Insurance Corporation ("FDIC") finalized new rules needed for commercial banks and bank holding companies to qualify as “well capitalized”. In order to qualify for the CBLR, a bank or bank holding company must have average total consolidated assets below $10 billion and a leverage ratio above 9.0%. (There are a few other conditions that we do not specify herein as they do not apply to most community banking institutions.)

The simplified regulatory capital requirement should reduce the complexity and costs associated with calculating current capital ratios and risk-weighting assets. While simplicity is usually better, banking organizations should consider current and anticipated capital levels before electing to use the CBLR.

A qualifying banking organization may elect to use the CBLR option at any time. The same institution is permitted to opt out of the CBLR option between reporting periods by providing its Basel III capital ratios to the appropriate regulators at the time of opting out. There apparently is no regulatory limit regarding how many times an institution can switch between the current capital requirements and the CBLR standard. The Final Rule provides for a two quarter grace period for a CBLR banking institution to be considered “well-capitalized” if its CBLR ratio is between 8-9%. There is no grace period if the ratio falls below 8%.

Smaller institutions, in particular, should consider key asset thresholds, such as the $3 billion threshold that exempts small bank and savings and loan holding companies from the Federal Reserve’s regulatory capital requirements under the Federal Reserve’s Small Bank Holding Company Policy Statement and the $10 billion threshold.

Many banks will probably adopt a “wait and see” approach to the new rule. In addition to the normal uncertainties created by adoption of a new regulatory rule, the timing of the CBLR rule is peculiar given that capital ratios at some community banks could be skewed in the near-term due to the implementation of the Current Expected Credit Losses (CECL) model in 2020. (Small companies are not compelled to comply with CECL until 2023.) In any event, we don’t believe that it makes much sense for banks that are nearing the $10 billion asset threshold to adopt the CBLR.

Fourth Quarter Portfolio Goal: Optimize Your Risk/Reward Ratio for 2020

Sensible action can be taken to offset some of the net interest margin pressure that will likely occur if the yield curve stays flat for the foreseeable future. As discussed below, PNC FIG Advisors continues to recommend prudent approaches regarding the role of investment securities to enhance profitability while effectively managing interest rate risk and liquidity considerations. These tailored strategies have historically satisfied both investors and regulators, but tactics should be modified given the characteristics of today’s interest rate environment.
• The environment remains conducive to issuing both senior debt and subordinated debt, depending on your institution’s needs. Debt may be preferable to equity given that common shareholders will not be diluted and there are no voting rights attached to these instruments. Due in part to its tax-deductibility, the cost of capital on debt is often lower than that of equity capital for community banks.

• Most banks have a securities portfolio with a duration of 3-5 years. Depending upon an individual bank’s financial condition and risk tolerance, today’s interest rate conditions may merit consideration of a slightly more aggressive strategy that selectively layers in some assets with durations of 5-7 plus years. We believe this approach comfortably fits within acceptable risk/reward ratios of both investors and regulators.

• The start of a new start year typically presents opportunities to selectively sell municipal bonds at attractive prices. This seasonal strategy arises because the new issue, tax-exempt municipal bond supply is typically light from New Year’s Day through mid-February. Demand, however, is generally quite strong despite the light supply as buyers (high net-worth individuals, mutual funds, hedge funds, etc.) actively need to buy bonds. Consequently, secondary muni prices tend to move higher on this seasonal supply/demand dynamic that is unique in January.

Banks that seek steady returns should be encouraged to consider senior or sub debt as an alternative form of capital. As a supplement to equity, debt (arguably under-utilized) can help banks achieve a higher earnings per share and return on equity. The marketing and pricing of senior and sub debt issuances by community banks are not “cookie cutter” and therefore, should be carefully planned on an individualized basis. **Please feel free to contact a member of the PNC FIG Advisory team to discuss if issuing now makes sense for your institution.**

*The phrase “nothingburger”, which is usually associated with Twitter users, was coined in the 1950s by Hollywood gossip columnist, Louella Parsons.*
Appendix

Under Basel III regulations, sub debt is included as Tier 2 capital for bank holding companies (“BHCs”). These regulations permit BHCs to “push down” proceeds to the subsidiary bank where they are included as Tier 1 capital. This often helps banking organizations meet or exceed total risk-based capital requirements, which are 10.5% under Basel III regulations.

A sub debt issuance qualifies as capital as long as the maturity date is five years or more. At the five year point, the percentage that is includable as capital at the holding company declines by 20% each year. Companies, therefore, that issued sub debt in 2014 should be incented to issue new debt and use the proceeds to repay the earlier debt issuance.

Due in part to Basel III regulations, senior debt is not as prevalent as sub debt among community banks but there are occasional new issue deals. Senior debt does not get the Tier 2 treatment at the holding company which isn’t necessarily a problem for banks below $3 billion. In theory, senior debt should price more favorably given the higher ranking in the capital structure, but the limitations around capital treatment at the holding company potentially made this a less common source of capital.

The historically low interest rate environment was a key factor for the pick-up in sub debt issuance from 2014-2017. Other reasons for the more widespread use of sub debt financing was the prevalence of Troubled Asset Relief Program (“TARP”) and Small Business Lending Fund (“SBLF”) financing that needed to be redeemed before these instruments reset to 9.0% coupon rates. Other factors that contributed to more sub debt issuances included the realization that investors and regulators demanded higher total capital ratios; the Federal Reserve change to the Small Bank Holding Company Policy Statement that allowed for significantly higher leverage for BHCs under $1 billion in assets (subsequently amended to $3 billion); and last, but not least, a more receptive market for debt issuances.
This material is not considered research and is not a product of any research department. PNC FIG Advisory, Inc. or its affiliates may trade the securities/instruments that are the subject of/mentioned in this material for its own account for resale to clients and, as a result, may have an ownership interest in these financial instruments. The author is a fixed income trader or salesperson for PNC FIG Advisory and its affiliate PNC Capital Markets LLC (“PNCCM”) and those firms may have purchased or sold the financial instruments that are the subject of this material prior to publication.

This material is informational only and is not intended as an offer or a solicitation to buy or sell any security/instrument or to participate in any trading strategy. This material does not provide individually tailored investment advice. It has been prepared without regard to the individual financial circumstances and objectives of persons who receive it. PNC FIG Advisory believes the information contained herein to be reliable and accurate, however; neither PNC FIG Advisory nor its affiliates make any guaranty or warranty as to its reliability or accuracy.

PNC FIG Advisory is not providing investment, legal, tax, financial, accounting or other advice to you or any other party. PNC FIG Advisory is not acting as an advisor or fiduciary in any respect in connection with providing this information, and no information or material contained herein is to be construed as either projections or predictions. Past performance is not indicative of future results.

PNC FIG Advisory, member FINRA and SIPC, is a wholly-owned subsidiary of PNC Bank, National Association (“PNC Bank”). PNC Bank and PNCCM are subsidiaries of The PNC Financial Services Group, Inc. (“PNC”). Investment banking and capital markets activities are conducted by PNC through its subsidiaries PNC Bank, PNCCM and Solebury Capital LLC. Services such as public finance investment banking, securities underwriting, and securities sales and trading are provided by PNCCM.

Important Investor Information: Brokerage and insurance products are:

<table>
<thead>
<tr>
<th>Not FDIC Insured</th>
<th>Not Bank Guaranteed</th>
<th>Not A Deposit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not Insured By Any Federal Government Agency</td>
<td>May Lose Value</td>
<td></td>
</tr>
</tbody>
</table>