Photo: kenmo/iStock

Banking Trends

Regulatory Changes and Community Banks During COVID

Small banks that received capital relief appear to have been more resilient.

PJ Elliott
Banking Structure Associate
FEDERAL RESERVE BANK OF PHILADELPHIA

The views expressed in this article are not necessarily those of the Federal Reserve.

In the first quarter of 2020, while the economy was being shocked by an unprecedented pandemic, a new banking regulation—the Community Bank Leverage Ratio (CBLR)—coincidentally took effect. This regulation, which was formulated long before COVID, permitted community banks to elect to use a single, simplified capital requirement in exchange for a higher minimum capital level. This article contrasts the subsequent behavior of those banks that elected to use the CBLR with those that didn't. The results show that in 2020 and 2021, asset and loan growth at CBLR-compliant banks caught up to growth at banks that did not participate, and they also reported more consistent dividend payments.

What Is the CBLR?

To understand the CBLR, we must define capital ratios, a key component of bank regulation. Regulators care about capital ratios because they demonstrate a bank's ability to weather an economic downturn. The simplest capital ratio is the leverage ratio, or bank capital divided by the dollar value of bank assets. Currently, the minimum leverage ratio in the U.S. is 5 percent. Banks that fail to maintain this minimum ratio face regulatory action such as restrictions on paying dividends or limitations on permitted activities.

A second capital ratio, the risk-weighted asset ratio, accounts for the riskiness of the bank's assets. For example, consider two different types of bank assets: home loans and business loans. Home loans

such as residential mortgages have a moderate risk and receive a 50 percent risk weight. Business loans are riskier and often receive a risk weight of 100 percent.[1] Once we determine risk-weighted assets, we can calculate a capital ratio by dividing capital by risk-weighted assets.[2] Consider a bank that has $200 in assets, $100 in Treasury securities (weighted 0 percent), and $100 in residential mortgages (weighted 50 percent). If this bank holds $20 in capital, then its leverage ratio would be 10 percent ($20/($100+$100)) and its risk-weighted capital ratio would be 20 percent ($20/($0 + $100)). In the U.S., the standard minimum risk-weighted capital ratio is 8 percent.[3]

To reduce the regulatory burden on community banks (defined as banks with less than $10 billion in assets), Congress introduced the CBLR as part of the Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018. Community banks may opt into this framework as long as they have a low-risk profile.[4] Under the CBLR, they need only satisfy a minimum leverage ratio to be considered well capitalized, and they no longer need to satisfy the risk-weighted capital ratio regulations. Risk weighting can be time consuming because accurately assessing the risk of different assets is a complex process.[5] Although community banks have to comply with many regulations beyond asset weighting, removing this component could allow staff to spend time and resources elsewhere. However, the CBLR does present a trade-off for banks, because the CBLR leverage requirement was set at 9 percent, well above the standard 5 percent. In other words, banks that opt in have a higher minimum leverage ratio, but that becomes their only regulatory capital requirement.

Although all banks with less than $10 billion in assets and relatively low-risk portfolios were eligible to adopt the CBLR framework, only some eligible banks chose to adopt the framework. (I call these "CBLR banks.") Others chose not to. (I call these "non-CBLR banks.") Out of approximately 3,600 community banks that met qualifying criteria at the end of 2020, about 50 percent of them elected to use the CBLR framework.

The CBLR was finalized and officially implemented in the first quarter of 2020, the same quarter that the COVID-19 pandemic began. Though the CBLR minimum was set at 9 percent, the Coronavirus Aid, Relief, and Economic Security (CARES) Act provided a form of capital relief for CBLR banks, lowering the capital minimum requirement to 8 percent in 2020 and 8.5 percent in 2021 before returning to the standard 9 percent in 2022.[6] Unfortunately, the concurrent timing of the CBLR and the CARES Act makes it impossible to disentangle their effects, so the following analysis likely reflects both regulatory changes.

CBLR Banks and Non-CBLR Banks Prior to the Pandemic

Banks that adopted the CBLR tended to be smaller than those that did not. From 2015 through 2019, CBLR banks held an average of $294 million in assets. Over this same period, non-CBLR banks held an average of $620 million in assets, more than twice that of CBLR banks.

This difference might be due in part to the nature of the CBLR framework. Congress created the CBLR to reduce the regulatory burden for community banks, and this burden may have been more onerous for smaller community banks, making the CBLR more attractive for those banks. To understand why, we need to understand capital buffers. Banks typically choose to hold capital above the minimum required level–that is, they hold a capital buffer–to ensure that a temporary or unexpected negative shock doesn't lead to a breach of the capital requirement. The larger the capital buffer, the higher that bank's capital ratio will be, so a bank that already holds capital well above the minimum requirement will find it easier to voluntarily raise that minimum. In general, we expect small banks to hold a large buffer because a downturn in the local economy could lead to substantial losses for a very small bank's loan portfolio, which would normally be dominated by loans to local borrowers. A larger bank can more easily diversify its portfolio across many localities, protecting itself against a downturn in any one locality.

In the five-year period preceding the pandemic, CBLR banks had an average leverage ratio of 12.4 percent, and non-CBLR banks had an average leverage ratio of 11.7 percent. That is, the smaller CBLR banks maintained a higher capital buffer than the larger non-CBLR banks. As a result, increasing the minimum leverage ratio from 5 percent to 9 percent might pose less of a burden for the smaller banks, especially if their leverage ratio is normally well above 10 percent. Also, smaller banks may find it harder to bear the costs of calculating their risk-based capital ratio. For example, to pay an accountant to manage the risk-weighting calculations, a small bank may need to restrict the staff hours of branch tellers.

If a bank finds itself with excess capital, it may choose to pay a portion of that out in dividends, and CBLR and non-CBLR banks do indeed exhibit different dividend behavior. As a fraction of assets, non-CBLR banks paid dividends above 0.6 percent of assets each year from 2015 through 2019; in two of those years, they paid dividends above 0.7 percent. Over the same period, CBLR banks always paid dividends of only around 0.6 percent and never exceeded 0.63 percent of assets in any year.

CBLR

$294 mn
Average assets
2015–2019

12.4%
Average leverage ratio
2015–2019

~0.6%
Paid dividends
% of assets, 2015–2019

Non-CBLR

$620 mn
Average assets
2015–2019

11.7%
Average leverage ratio
2015–2019

>0.7%
Paid dividends
% of assets, 2015–2019

Source: Federal Financial Institutions Examination Council (FFIEC) Reports of Condition and Income (Call Reports).

CBLR and Non-CBLR Banks During the Pandemic

In the five years prior to the pandemic, CBLR banks grew more slowly than non-CBLR banks. This was a relatively stable period of good economic growth, after the adoption of new, post-Great Recession regulations. Non-CBLR banks tend to be larger than CBLR banks, so they are likely to be more efficient and experience better financial performance. In a 2016 paper examining community bank performance based on size, Rutgers University economics professor Joseph P. Hughes and his coauthors "find that better financial performance is associated with larger asset size."[7] This is consistent with my findings, as CBLR banks grew 2 percentage points slower before the pandemic than their non-CBLR counterparts as estimated from their asset growth (Figure 1).[8]

But early in the pandemic—in the second quarter of 2020—the growth of assets and loans at CBLR banks caught up to the growth at non-CBLR banks. Both groups saw a high level of loan growth in 2020, reaching more than 10 percent annual growth, well above loan growth during the preceding five years at CBLR banks. After the onset of the pandemic, CBLR and non-CBLR banks had nearly identical growth rates in subsequent quarters in both asset and loan growth. This catching up is true for all categories of loans (consumer, commercial, and real estate), and was not due to the Paycheck Protection Program (PPP).[9] Indeed, non-CBLR banks made more PPP loans (as a share of assets) than CBLR banks (Figure 2).

From 2015 through the second quarter of 2020, the average leverage ratios for CBLR and non-CBLR banks tended to move in tandem, with CBLR banks holding a leverage ratio consistently about 0.5 percentage point higher than the leverage ratio at non-CBLR banks. During the pandemic, banks in both groups lowered their leverage ratios closer to (but still well above) their minimum requirements. However, CBLR banks continued to lower their leverage ratios throughout 2021 (Figure 3). This may be evidence that CBLR banks took advantage of the capital relief provided through the CARES Act.

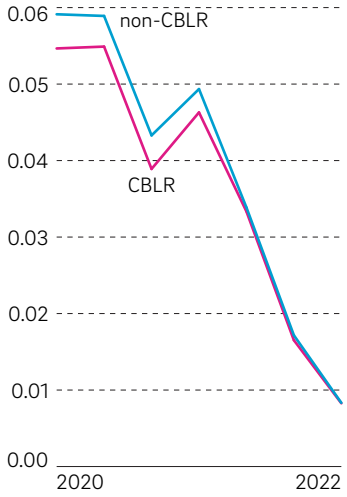
In 2020 and 2021, non-CBLR banks' dividend payments fell to a level just above that of CBLR banks (Figure 4). Non-CBLR

FIGURE 2

PPP Loan Growth at CBLR Banks Was Not Larger Than at Non-CBLR Banks

CBLR bank asset growth was not due to more PPP lending going to CBLR banks.

Total PPP loans outstanding over total assets, CBLR and non-CBLR banks, 2020–2021



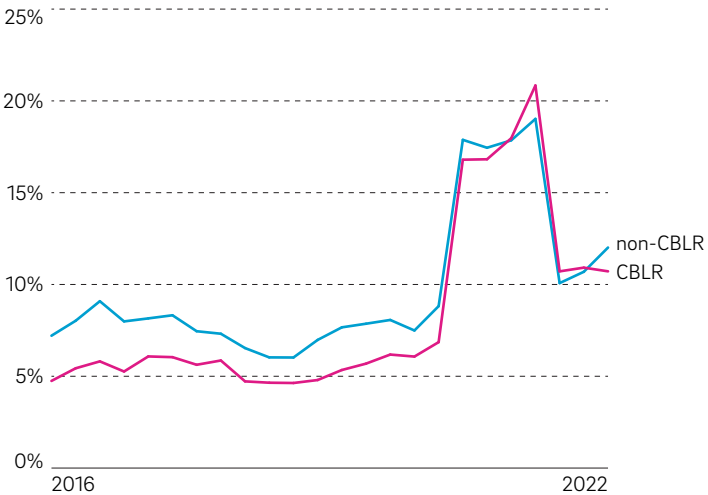
Source: Federal Financial Institutions Examination Council (FFIEC) Reports of Condition and Income (Call Reports).

FIGURE 1

Total Asset Growth at CBLR Banks Lagged Before COVID

Assets at CBLR banks grew as fast as assets at non-CBLR banks during the pandemic.

Total asset growth, CBLR and non-CBLR banks, 2016–2021



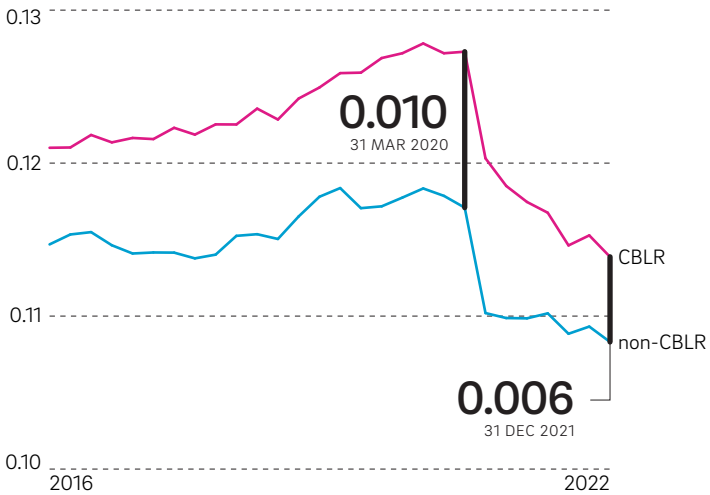
Source: Federal Financial Institutions Examination Council (FFIEC) Reports of Condition and Income (Call Reports).

FIGURE 3

Leverage Ratios at CBLR Banks Fell by More in 2021

This may be partially explained by the capital relief provided through the CARES Act.

Aggregate leverage ratio, CBLR and non-CBLR banks, 2016–2021



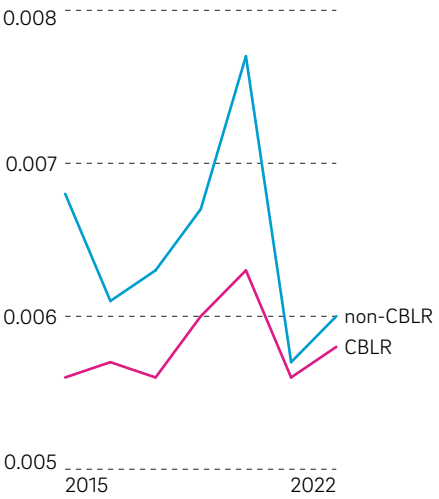
Source: Federal Financial Institutions Examination Council (FFIEC) Reports of Condition and Income (Call Reports).

FIGURE 4

Dividends Fell by More at Non-CBLR Banks

Dividend payments at CBLR banks were consistent during the downturn.

Total dividends over total assets, CBLR and non-CBLR banks, 2015–2021



Source: Federal Financial Institutions Examination Council (FFIEC) Reports of Condition and Income (Call Reports).

banks, which did not receive any capital relief, may have needed to retain more earnings in order to keep their capital at a desired level. Unlike non-CBLR banks, CBLR banks continued to pay dividends comparable to the prepandemic level. CBLR banks had more flexibility in their capital requirements, thanks to the 1-percentage-point reduction in their anticipated minimum capital requirement of 9 percent. Thus, CBLR banks may have been able to use that capital to pay additional dividends to their shareholders.

These comparisons do not prove that the regulatory change caused the subsequent behavior. Since the program was voluntary, we can't rule out the possibility that banks that intended (or expected) to grow faster and reduce their required capital, even without the CBLR option, incidentally chose to become CBLR banks.[10] Although the evidence is suggestive, we can't conclusively demonstrate causality without a more careful analysis.

Conclusion

Before the 2020 recession, assets and loans at CBLR banks tended to grow slower than at non-CBLR banks, but during the downturn, CBLR and non-CBLR banks grew at a similar rate. This is unexpected: In a difficult economic environment, we would not normally expect the smaller, slower-growing CBLR banks to grow at the same rate as the non-CBLR banks. CBLR banks also reduced their leverage ratios significantly more than non-CBLR banks during the downturn, although both remained well capitalized. The declining leverage ratio suggests that CBLR banks may have had an advantage in the form of capital relief, which initially lowered their capital requirement by 1 percentage point. At the same time, CBLR banks maintained their dividend payments, even as other small banks reduced their dividend payments and regulators imposed limits on payouts to stockholders by large banks.

Overall, it appears that CBLR banks were more resilient than non-CBLR banks during the pandemic, and my evidence supports the view that this was due to the new capital regime and capital relief. EI

Notes

1 This example draws on the first iteration of the Basel Accords, Basel I, which uses a simpler version than the current risk-weighting asset groups.

2 Tier 1 capital, or core capital, is mostly made up of retained earnings and common stock on a bank's balance sheet.

3 See D'Erasmo (2018) for a more in-depth discussion of risk-weighted capital ratios.

4 A low-risk profile requires that the banks have low off-balance-sheet exposure (less than 25 percent of assets) and trading assets and liabilities are de minimis (less than 5 percent of assets). All requirements for the CBLR are ongoing, although banks can take a two-quarter grace period if they fall out of compliance.

5 In a 2012 survey by the Federal Deposit Insurance Corporation (FDIC), community bankers shared that "they have increased staff over the past ten years to support the enhanced responsibility associated with regulatory compliance."

6 According to the Congressional Research Service, "Section 4012 of the CARES Act temporarily lowers the CBLR to give qualifying banks using this capital measure more leeway to continue lending and stay above the threshold as the pandemic's economic effects unfold."

7 Hughes et al. (2019).

8 Growth of the loan portfolio is similar. Loan growth at CBLR banks was 1.5 percentage points slower.

9 The PPP was a part of the CARES Act. The program allowed banks to make loans to small businesses directly; eligible loans then qualified for government loan forgiveness. The program expanded bank lending during this period.

10 Figures 1, 3, and 4, show that the changes in the behavior of CBLR banks were not a continuation of some prior trend—that is, the data obey parallel trends, a necessary condition for establishing causality.

References

Congressional Research Service. "Community Bank Leverage Ratio (CBLR): Background and Analysis of Bank Data" (2019), accessed July 20, 2022, from https://sgp.fas.org/crs/misc/R45989.pdf.

D'Erasmo, Pablo. "Are Higher Capital Requirements Worth It?" Federal Reserve Bank of Philadelphia *Economic Insights* (Second Quarter 2018), pp. 1–8, https://www.philadelphiafed.org/the-economy/banking-and-financial-markets/are-higher-capital-requirements-worth-it.

Federal Deposit Insurance Corporation. "FDIC Community Banking Study" (December 2012), accessed July 20, 2022, from https://www.fdic.gov/resources/community-banking/report/2012/2012-cbi-study-full.pdf.

Joseph P. Hughes, Julapa Jagtiani, Loretta J. Mester, Choon-Geol Moon. "Does Scale Matter in Community Bank Performance? Evidence Obtained by Applying Several New Measures of Performance," *Journal of Banking & Finance*, 106 (2019), pp. 471-499,