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Senate Bipartisan Banking Bill Offers Relief from Stress Testing, Capital and Liquidity Requirements

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The Bipartisan Banking Bill would provide banking organizations with relief from their stress testing, capital and liquidity requirements by adjusting the thresholds, frequency and substance of these rules. The bill – which recently passed in the Senate, as described in a recent post **here** – is now being considered in the House, where Rep. Jeb Hensarling (R-TX) and other representatives have said they plan to propose a series of amendments.

This post summarizes how the Bipartisan Banking Bill would change the U.S. banking agencies' stress testing, capital and liquidity rules – including by adding a new and unusual statutory override of the U.S. banking agencies' Basel III capital rules for higher-risk commercial real estate exposures that was not included in earlier versions of the bill.

We will publish a visual memorandum soon that will go into more detail on these and other elements of the bill.

Changes Surviving from Earlier Drafts of the Bill

As passed by the Senate, the Bipartisan Banking Bill preserves most of the changes that earlier versions of the bill would have made to the stress testing, capital and liquidity rules – as discussed in our previous posts **here**, **here** and **here**. These changes include the following:

- **Supplementary Leverage Ratio (SLR) for Custody Banks**. The bill would direct the U.S. banking agencies to exclude certain central bank deposits from the total leverage exposure (the SLR denominator) of a custody bank—defined as a "depository institution holding company predominantly engaged in custody, safekeeping and asset servicing activities," together with its insured depository institution subsidiaries. Central bank reserves of a custody bank would be excluded only to the extent of the value of client deposits at the custody bank that are linked to fiduciary, custody or safekeeping accounts.
  - The bill does not specifically define "predominantly engaged."
  - The bill specifically includes a rule of construction that nothing in this provision would limit the U.S. banking agencies' authority to tailor or adjust the SLR or any other leverage ratio for any bank that is **not** a custody bank.
- **Treatment of Municipal Securities under the Liquidity Coverage Ratio (LCR)**. The U.S. banking agencies would be required to consider certain investment grade municipal securities as Level 2B high quality liquid assets for purposes of the LCR. These proposed changes to the LCR are consistent with H.R. 1624, which passed the House on October 3, as discussed in an earlier post **here**.
- **Thresholds and Frequency of Dodd-Frank Act Company-Run Stress Tests**. The statutory thresholds for Dodd-Frank Act company-run stress tests for BHCs would increase to $250 billion from their current levels—more than $10 billion for annual company-run stress tests and $50 billion or more for mid-year company-run stress tests. In addition, the bill would eliminate the statutory requirement that company-run stress tests be conducted at an annual or semi-annual frequency, depending on the size of the company—adopting instead a more flexible standard of "periodic" stress tests.
- **Thresholds and Frequency of Dodd-Frank Act Supervisory Stress Tests**. For BHCs with total consolidated assets of $100 billion or more and less than $250 billion, the Federal Reserve would be required to conduct "periodic," rather than annual, supervisory stress tests. We note that this requirement is in Section 401(e) of the Bipartisan Senate Bill and does not also appear in the part of the bill that would amend the Dodd-Frank Act.

- **Number of Dodd-Frank Act Stress Test Economic Scenarios**. The bill would also reduce the required number of economic scenarios from three to two, eliminating the middle-of-the-road adverse scenario from the Dodd-Frank Act stress testing framework and leaving the baseline and severely adverse scenarios.
- **Impact on CCAR?** While the changes above technically apply to the Dodd-Frank Act stress testing requirements rather than the Federal Reserve's CCAR capital planning framework, it is difficult to imagine the Federal Reserve taking a different approach in terms of making corresponding changes to its capital planning regulations.
- **Community Bank Leverage Ratio**. The U.S. banking agencies would be directed to establish via rulemaking a community bank leverage ratio—of tangible equity capital to average total consolidated assets—for qualified depository institutions and depository institution holding companies with total consolidated assets of less than $10 billion. An institution or holding company exceeding the community bank leverage ratio—the calibration of which the bill specifies as being not less than 8% and not more than 10%—would be deemed to meet its otherwise applicable capital requirements, including the leverage ratio and risk-based capital requirements, and, in the case of an insured depository institution, the ratios required to be considered well-capitalized for prompt corrective action purposes.
  - The bill would also require the U.S. banking agencies (1) to consult with the relevant state banking supervisors in implementing the community bank leverage ratio and (2) to notify the relevant state banking supervisor of any qualifying community bank with respect to its compliance with the community bank leverage ratio.

New Provision on the Capital Treatment of Commercial Real Estate Exposures

The Bipartisan Banking Bill includes a new change relating to the capital treatment of high volatility commercial real estate (**HVCRE**) exposures, which was not included in earlier versions of the bill.

Currently, the U.S. Basel III capital rules define a category of HVCRE exposures that are subject to a heightened, 150% risk weight for purposes of calculating a banking organization's risk-based capital requirements. The Bipartisan Banking Bill would define a new category of **HVCRE ADC loans** and would amend the Federal Deposit Insurance Act to prevent the U.S. banking agencies from applying heightened risk weights to an HVCRE exposure unless the exposure also falls within the definition of an HVCRE ADC loan – effectively creating a specific statutory capital regulation requiring the U.S. banking agencies to align their rules with this definition.

The following table summarizes the definition of an HVCRE exposure under the current U.S. Basel III capital rules, the definition of an HVCRE ADC loan under the Bipartisan Banking Bill, and our initial analysis as to the significant differences between the two definitions:

Current Capital Rules – Defining HVCRE Exposure	Bipartisan Banking Bill – Defining HVCRE ADC Loan	Analysis of Difference
	Scope of Definition	
HVCRE exposure includes a credit facility that finances or has financed the acquisition, development, or construction (**ADC**) of real property, subject to the exemptions noted below and the provision regarding the conversion to permanent financing.	HVCRE ADC loan includes a credit facility that: • Is secured by land or improved real property; • Primarily finances, has financed, or refinances the ADC of real property; • Has the purpose of financing the acquisition, development or improvement of real property into income-producing (i.e., commercial) real property; and • Is dependent on future income from or proceeds from the sale of (or the refinancing	• The Bipartisan Banking Bill's more granular definition may have the effect of narrowing the scope of credit facilities subject to the heightened, 150% risk weight, as all elements of the definition must be satisfied.

Current Capital Rules – Defining HVCRE Exposure	Bipartisan Banking Bill – Defining HVCRE ADC Loan	Analysis of Difference
	of) such real property for repayment. The scope of an HVCRE ADC loan is subject to the exemptions noted below and the provision regarding the reclassification as a non-HVCRE ADC loan.	
	Exemptions	
No comparable provision.	**Grandfathering.** Any loan made prior to January 1, 2015.	• January 1, 2015 was the first effective date for non-advanced approaches banking organizations to calculate risk-weighted assets using the standardized approach under the U.S. Basel III capital rules. This exemption would apply to any outstanding credit facility that was made prior to the effective date of

Current Capital Rules – Defining HVCRE Exposure	Bipartisan Banking Bill – Defining HVCRE ADC Loan	Analysis of Difference
		the current HVCRE exposure definition.
No comparable provision.	**Cash Flow-Generating Property.** Any credit facility, secured by a mortgage on existing income-producing real property: • That finances the acquisition or refinance of or improvements to that property; • If the cash flow being generated by the real property is sufficient to support the debt service and expenses of the real property, in accordance with the institution's applicable loan underwriting criteria for permanent financings.	• This new exemption both sensibly covers ADC projects for which the banking organization would not be taking on any more risk than a typical secured loan and aligns with the existing exemption for a credit facility that has converted to permanent financing, as discussed below.
Residential Projects. Any credit facility that finances one- to four-family	**Residential Projects.** Any credit facility that finances the ADC of one- to four-family residential property.	• No change.

Current Capital Rules – Defining HVCRE Exposure	Bipartisan Banking Bill – Defining HVCRE ADC Loan	Analysis of Difference
residential property.		
Community Development. Any credit facility that finances real property that: • Would qualify as an investment in community development, under the provision of law that authorizes state member banks to make certain public welfare and community development investments, or as a qualified investment, under the rules implementing the Community Reinvestment Act; and • Is not an ADC loan to certain	**Community Development.** Any credit facility that finances the ADC of real property that would qualify as an investment in community development.	• Although the bill's definition of an "investment in community development" is less specific than that contained in the current U.S. Basel III capital rules, this change is likely immaterial, as the U.S. banking agencies would have the authority to interpret the broader statutory exemption in any implementing rule.

Current Capital Rules – Defining HVCRE Exposure	Bipartisan Banking Bill – Defining HVCRE ADC Loan	Analysis of Difference
small businesses or farms.		
Agricultural. Any credit facility that finances the purchase or development of agricultural land, which includes all land known to be used or usable for agricultural purposes (such as crop and livestock production), provided that: • The valuation of the agricultural land is based on its value for agricultural purposes; and • The valuation does not take into consideration any potential use of the land for nonagricultural commercial	**Agricultural.** Any credit facility that finances the ADC of agricultural land.	• As with the community development exemption, the HVCRE ADC loan definition would remove the specific requirements for the agricultural land exemption. It remains to be seen, however, how the U.S. banking agencies would interpret this broader statutory definition in any implementing rule.

Current Capital Rules – Defining HVCRE Exposure	Bipartisan Banking Bill – Defining HVCRE ADC Loan	Analysis of Difference
development or residential development		
Qualifying Commercial Projects. Any credit facility that finances commercial real estate projects in which:	**Qualifying Commercial Projects.** Any credit facility that finances commercial real property projects in which:	• The Bipartisan Banking Bill version of this exemption would allow the promoter or sponsor of a qualifying project to extract internally generated capital from the project prior to the project's reclassification as a non-HVCRE ADC loan. • In a potentially significant modification, the bill version would apparently allow the promoter or sponsor to
• The loan-to-value ratio is less than or equal to the applicable maximum supervisory loan-to-value ratio as determined by the relevant U.S. banking agency;	• The loan-to-value ratio is less than or equal to the applicable maximum supervisory loan-to-value ratio as determined by the relevant U.S. banking agency;	
• The borrower has contributed capital to the project in the form of cash or unencumbered readily	• The borrower has contributed capital of at least 15 percent of the real property's appraised "as completed" value to the project in the form of:	

Current Capital Rules – Defining HVCRE Exposure	Bipartisan Banking Bill – Defining HVCRE ADC Loan	Analysis of Difference
marketable assets (or has paid development expenses out-of-pocket) of at least 15 percent of the real estate's appraised “as completed” value;	○ Cash; ○ Unencumbered readily marketable assets; ○ Paid development expenses out-of-pocket; or ○ Contributed real property or improvements;	count the value of contributed real property or improvements at the time of the contribution (i.e., inclusive of any change in value since acquisition) towards the 15% contribution threshold, whereas under the existing rules and the U.S. banking agencies’ FAQs regarding these rules (see **this FDIC FAQ, Federal Reserve SR Letter 15-06** and **this OCC FAQ**) contributed real property counts towards the 15% threshold only to the extent it was
• The borrower contributed the minimum amount of capital before the banking organization advances funds under the credit facility; and	• The borrower contributed the minimum amount of capital before the banking organization advances funds (other than the advance of a nominal sum made in order to secure the depository institution’s lien against the real property) under the credit facility; and	
• The contributed capital and any capital internally generated by the project is contractually required to remain in the	• The contributed capital is contractually required to remain in the project until the credit facility has been reclassified as a non-HVCRE ADC loan, as described below.	

Current Capital Rules – Defining HVCRE Exposure	Bipartisan Banking Bill – Defining HVCRE ADC Loan	Analysis of Difference
project until the credit facility is converted to permanent financing, as described below.		purchased with cash. Under these FAQs, real estate subject to a mortgage does not qualify as value contributed to a project.
No comparable provision.	The value of any real property contributed by a borrower must be the appraised value of the property as determined under standards prescribed pursuant to FIRREA.	
Conversion to Permanent Financing		
A credit facility ceases to be an HVCRE exposure if it is converted to permanent financing. Permanent financing may be provided by the banking organization that provided the ADC facility as long as the permanent financing is subject to the Board-regulated institution's underwriting criteria for long-term	A banking organization may reclassify a credit facility as a non-HVCRE ADC loan – at which point it no longer may be subject to heightened risk-based capital requirements – upon: • The substantial completion of the development or construction of the underlying property; and • Cash flow being generated by the property is sufficient to support the debt service and expenses of the property, in accordance with the banking organization's applicable loan	• The non-HVCRE ADC loan definition provides more guidance as to when an ADC loan transitions to permanent financing, but it would not seem to meaningfully change the existing rules.

Current Capital Rules – Defining HVCRE Exposure	Bipartisan Banking Bill – Defining HVCRE ADC Loan	Analysis of Difference
mortgage loans.	underwriting criteria for permanent financings.	

This provision of the Bipartisan Banking Bill would effectively prevent the U.S. banking agencies from amending the capital treatment of commercial real estate exposures for non-advanced approaches banking organizations – which they proposed to do in September 2017, as discussed in a prior post **here**. The bill also clarifies that the U.S. banking agencies would retain their authority to scrutinize all commercial real estate lending in exercising their supervisory functions.

Law Clerk Greg Swanson contributed to this post.