The Unintended Consequences of Basel III for Community Banks in the United States
Contents

Introduction 2

Consequences of Changing Status of AFS Portfolios 3

Consequences of the Capital Conservation Buffer 3

Consequences of the New Risk Weights on Residential Mortgage Loans 4

Conclusion 5
Introduction
The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (the Fed) and the Federal Deposit Insurance Corporation (FDIC) all jointly requested comments on three Notices of Proposed Rulemaking (NPR) in April of 2012. These NPRs are all a reaction to the American banking crisis that began in 2008. Because the genesis of these NPRs came from the international banking community and the Basel III guidelines, they are most often referred to as Basel III. The NPRs do not mirror Basel III exactly. The U.S. regulators have made adjustments to them so as to make them consistent with the Dodd-Frank Wall Street Reform & Consumer Protection Act (DFA). For most purposes, the two different pronouncements are similar enough to be referred to as “Basel III.”

The comment period for these NPRs was kept open through October 22, 2012. After this date, the three banking agencies will consider all of the comments received and make determinations on which of these standards (if any) to adopt. Currently, the prevailing opinion of buy side bank analysts and the regulatory community is that these NPRs will have significant impacts only on the nation’s largest banks. The most complex and onerous parts of the proposal are saved for institutions greater than $50 billion in assets (approximately the top 35 banks in the U.S. by asset size) since they apply to credit derivatives and trading activity.

More than 950 individuals have provided comments regarding the proposed NPRs, most of whom certainly are community banks. Upon studying the responses, it is very clear that there will be significant consequences to the smaller U.S. banks than intended if these proposals are adopted. There are three components in particular that appear to be overly restrictive and will disproportionately create negative impacts on shareholder returns for community banks and actually will serve to increase balance sheet risks:

- Including unrealized gain/loss on available-for-sale (AFS) securities in Tier 1 Capital
- Capital conservation buffer will limit access to capital
- The new reporting requirements and risk-based capital (RBC) weightings of residential mortgages will cause community banks to reduce/abandon their residential mortgage lending
Consequences of Changing Status of AFS Portfolios – Balance Sheet Liquidity
Risk Will Increase
The first NPR of the three proposed rules is referred to as the “Basel III NPR.” In 2010, the Basel Committee
proposed a comprehensive reform package that was intended to increase the quality and quantity of regulatory
capital. Currently, the unrealized gains/losses on a bank’s AFS portfolio are excluded from Tier 1 capital. The
Basel III NPR would include this adjustment to capital. Regulators and investors promote this change because
it increases transparency of the balance sheet. However, from a practical bank management standpoint, it also
increases the volatility of the balance sheet. Consider the current balance sheet trends banks faced in November
of 2012:

- Loans to assets ratio down to 59% from 65% in 2009 (source 9/30/12 UBPR)
- AFS securities to assets ratio up to 18% from 15% in 2009 (source 9/30/12 UBPR)
- Net non-core funding dependency ratio down to -1.20% from 19% in 2009 (source 9/30/2012 UBPR)
- Loan growth in Q3 2012 was positive (barely) for the first time in 4 quarters

By any measurement, loan growth is down. Maturing loans have been reinvested into securities. Banks have a very
narrow set of allowable investment options which have low credit risk and consequently very low yields. With few
exceptions, banks classify these securities as AFS for liquidity management reasons. When rates rise (eventually),
these securities will lose value and capital will be impacted. From a practical standpoint, bank managers cannot
mitigate this from happening:

- To classify all securities as HTM instead of AFS limits liquidity options (i.e. adds more unseen risk to the
  balance sheet)
- Bank managers cannot artificially stimulate loan demand without increasing the risk of their portfolio (i.e.
  lower underwriting standards)
- Bank managers cannot control benchmark interest rates from rising

Because the securities typically held by community banks are low risk/risk free, a loss in market value is almost
always the result of a rising rate environment and nothing else. A loss in value in the AFS portfolio does not imply
improper management. Also, all of these securities are held to maturity in practice anyway. The AFS designation
simply gives the bank the ability to sell prior to maturity, it does not require it.

Because of the growing proportion of these portfolios to the overall balance sheet and because of their very low
yields, banks will necessarily have to designate them as HTM to protect Tier 1 Capital. When this occurs, bank
liquidity will suffer and the risk that they will not survive a liquidity crisis will increase. This is counter-productive to
most of the systemic risk that Dodd-Frank intended to fix.

Consequences of the Capital Conservation Buffer
Also part of the Basel III NPR is the addition of the capital conservation buffer. Minimum regulatory capital
requirements will increase from the current 4% to 6% (phased in by 2015). In addition to this minimum, banks with
less than an additional 2.5% buffer (phased in by 2015 also) above and beyond the minimum 6% will be restricted
from declaring any capital distributions. Capital distributions include:

- Dividends
- Discretionary bonuses to officers
- Paying off debt

Consider a bank that is struggling to raise capital. Restricting dividends would discourage current shareholders
from contributing more capital, not encourage it. Community financial institutions do not have access to the
credit markets that large banks do. Most equity is raised through private equity in closed offerings. Again, what outside investor would contribute capital to an institution that could not pay dividends?

Consider the case of a struggling bank that is attempting a turnaround in management. Recruiting top managers to an institution that cannot pay discretionary bonuses would be extremely difficult.

Basel III NPR would also phase out Trust Preferred Securities (TPS) from Tier 1 Capital. TPS and s-corporations are a very common form of ownership in small banks. But, neither type of owner would be able to receive distributions on their investment unless the buffer is exceeded.

All of these changes combine to have the overall effect of discouraging capital investment in these undercapitalized banks. The intention here is to raise capital, but the execution of the new regulations would actually drive capital out of community banks. Banks will have to face the choices of:

- Raise capital
- Shrink
- Sell

Raising capital will prove too difficult and we will experience further consolidation in these entities.

**Consequences of the New Risk Weights on Residential Mortgage Loans**

Of all the proposed changes, the changing of risk weights for residential mortgages could be the factor that will most negatively affect community banks. The change in risk weights for assets is included in the second NPR, referred to as the “Standardized Approach NPR.” The current risk weight for any loan backed by a first mortgage lien is 50% (currently, no asset has a weighting above 100%). The proposed standards would divide all mortgage loans into Category 1 and Category 2 loans. Category 1 loans must meet all items below:

- Must be first lien, final term must not be > 30 years, no negative amortization features
- No balloon payment at maturity
- Must meet conforming secondary market underwriting guidelines
- ARMS cannot have caps greater than 2% annually / 6% lifetime
- Cannot be >90 days delinquent, cannot be in non-accrual status

If it does not qualify for Category 1, it must fall into Category 2. Risk weights are then designated by Loan to Value (LTV) ratio as follows:

**Category 1**

- 35% risk weight for LTV < 60%
- 50% risk weight for LTV < 80%
- 75% risk weight for LTV <90%
- 100% for all else
Category 2

- 100% risk weight for LTV < 80%
- 150% risk weight for LTV < 90%
- 200% for all else

The first difficulty in complying with this new regulation will be tracking of the loan statistics required to accurately calculate risk-based capital. Banks have already built their accounting systems without these guidelines in mind. It will require investment in new systems or possibly restructuring current systems to comply. Banks typically do not track LTV of a loan after origination. Real estate markets change continually as do amortizing loan balances. Periodic appraisals through the life of a 30-year loan will completely wipe out any profitability in the product. Maintaining the LTV data needed to properly categorize the loans will prove too expensive to implement.

The larger difficulty is the risk weights themselves. The change in risk weights will certainly cause community banks to stop offering mortgages. A conforming mortgage loan is one of the lowest spread products on the balance sheet of a bank. If the bank is forced to hold four times the amount of capital that they used to, they will price themselves out of the market where other market participants (credit unions, mortgage companies) are not subject to the same requirements.

The inclusion of balloon products in Category 2 also reduces the competitiveness of community banks. They will be discouraged from offering them because of the high capital charge. Balloon products have been a very effective tool in mitigating interest rate risk. The borrower desires a fixed payment amortized over a long enough period as to keep the payments low. The bank desires an asset with a shorter duration to manage earnings when rates rise. The balloon product is advantageous to both parties. This is another example of where the bank will not be able to compete on cost with the other market entrants not subject to the regulation. They will simply cease the offering.

It is easy to understand why regulators wish to reconsider the relative riskiness of residential mortgage lending. However, these changes will actually increase the level of risk on bank balance sheets by taking away an available asset class and denying the bank the ability to further diversify its holdings.

Conclusion
The public outcry for bank reform and the regulatory response to do something are understandable. However, the regulatory actions as proposed do not manage the risk in the banking sector. The manner in which these new guidelines will be executed does not consider some of the most obvious practical operations of a community bank. The proposal actually increases the level of risk in the system:

- Liquidity risk increases
- Ability to raise capital via private equity decreases
- Balance sheet diversification will be reduced because an asset class will no longer be offered (residential mortgage loans will become the domain of a smaller set of institutions, in fact concentrating the risk that the regulators hoped to disperse)