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OVERVIEW OF BASEL III IMPACT ON AND IMPLEMENTATION TIPS FOR COMMUNITY BANKS

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In the wake of the global financial crisis, regulatory agencies were prompted to take a much harder look at existing capital, lending and risk management frameworks used by banks and bank holding companies. This led the Basel Committee on Banking Supervision, a working group of central banks and regulators from 27 countries, to propose new rules that increased minimum capital ratios, narrowed definitions for what qualifies as capital, and amplified risk weighting for certain volatile assets that could expose an institution to greater on-balance sheet risk.

The final rules, commonly referred to as "Basel III," were approved in 2013 by the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve (FED) and the Office of the Comptroller of the Currency (OCC). While the final rules did aggressively retain a focus on higher capital reserve standards for major banks, some accommodations were made for community banks with limited risk profiles and less-complex balance sheets. In addition, the new Basel III standard also incorporated aspects of the Dodd-Frank Act, particularly in the areas of consumer protection and mortgage finance reform. In this paper, we'll take a closer look at the primary Basel III capital and risk weighting requirements, how these rules affect year-end reporting and decision-making for community banks, and what steps executives should take to prepare for the first implementation deadline of January 1, 2015. We will also provide insight on the future impact of the new capital conservation buffer requirements, which will gradually phase to full implementation by 2019.

BASEL III: HIGHER RATIOS AND QUALITY OF CAPITAL COMPONENTS

A core element of the Basel III framework was not only requiring banks to carry higher capital reserves to navigate challenging economic circumstances, but also improving the quality of those reserve capital assets. Beginning this year, so-called "advanced approaches" banks and holding companies with $250 billion or more in consolidated assets or $10 billion or more in foreign asset exposure were required to begin compliance with Basel III's new capital rules. A summary of those requirements[1] included:

- Holding a capital conservation buffer of 2.5 percent, calculated on risk-weighted assets and funded completely through common equity holdings. This buffer was designed by regulators to give banks added insulation against unexpected market or financial swings. Institutions that fail to comply with the required buffer levels could face restrictions on dividend payouts or bonus compensation. Additionally, the Basel III rules require large banks to potentially fund a countercyclical capital buffer up to another 2.5 percent, depending on a formula that calculates the nation's level of credit growth.
- Establishing a new common equity Tier 1 (CET1) capital ratio of 4.5 percent. These common equity holdings are limited to common stock and related surplus, retained earnings or qualifying minority interests—all of which are considered lower-risk assets by regulatory agencies. Certain deferred tax and mortgage servicing assets can be deducted in the calculation of the CET1 capital ratio.
- Increasing overall Tier 1 capital ratio (as measured against an institution's total risk-weighted assets) from 4 percent in the old regime to a new level of 6 percent. These assets can include trust preferred securities, non-cumulative perpetual preferred stock or cumulative perpetual preferred stock.
- Enforcing a minimum Tier 1 leverage ratio of 4 percent for all banks. For very large banks and bank holding companies required to use "advanced approaches" to determine capital rules, a 3 percent supplementary leverage ratio also applies.

COMMUNITY BANKS GAINED KEY CONCESSIONS IN FINAL BASEL III RULES

When proposed rules for Basel III were first presented for public comment in 2012, advocates for banks of all sizes pushed back on the higher capital requirements, changes to risk weightings for certain loans, and exclusion of certain assets from the new CET1 capital definition. Community banks, in particular, argued that the "one size fits all" reform was inappropriate, particularly since the majority of those institutions were already well-capitalized and not engaged in excessively risky lending activities. In fact, recent Federal Reserve data showed that 95 percent of banks

1 http://www.federalreserve.gov/aboutthefed/boardmeetings/20130702__Basel__III_Board__Memo.pdf

with less than $10 billion of assets already meet the minimum CET1 ratio of 4.5 percent, and 90 percent meet the 7 percent threshold of minimum CET1 capital plus the conservation buffer.[2]

In its capital rule guide for community banks, the OCC noted three significant changes from Basel III's original proposals that benefit community banks. These include:

Residential mortgage exposure. In early proposals, eight weighting categories from 35 to 200 percent were considered, based on a variety of underwriting factors. But community bank lobbyists successfully argued that the higher weightings may restrict the flow of available mortgage funding.[3] In the final rules, most residential mortgage risk-based capital weightings remained unchanged, including 50 percent for performing first mortgages and 100 percent for other residential mortgages.

Accumulated Other Comprehensive Income (AOCI) filter. The final Basel III rules removed this AOCI filter for large banking institutions, while providing a one-time opportunity for community banks to opt-out (thus permanently retaining the filter). This choice was considered an important win for community banks, since the loss of an AOCI filter would result in unrealized gains and losses on available-for-sale securities to be counted as CET1 capital. This could greatly increase year-to-year volatility in a bank's capital ratios.

Trust Preferred Securities (TRuPS). The final Basel III rules allow banks or bank holding companies with assets of $15 billion or less (as of December 31, 2009) to grandfather trust preferred securities (TRuPS) into Tier 1 capital, provided that these securities were issued prior to May 19, 2010. Under the new rules, securities that qualify for the grandfathering clause can account for up to 25 percent of overall Tier 1 capital. That was seen as a win for community banks, since they typically do not have access to the range of other qualifying Tier 1 capital sources as larger competitors.[4]

In addition to these concessions, community banks were allowed to delay compliance with the new Basel III rules until January 1, 2015. That's one full year longer than the schedule regulators imposed on large banks.

CONSIDERATIONS TO HELP PREPARE FOR BASEL III IMPLEMENTATION

For purposes of the final Basel III rules, community banks are generally viewed as less complex and not subject to the market risk rule or the advanced approaches risk-based capital rule. However, that doesn't mean those institutions should ignore the opportunity to prepare for their upcoming Basel III requirements. As the final months of 2014 approach, community bank leaders can take several steps to help efficiently implement the new rules. These include:

Establishing the CET1 equity ratio in capital reports. Under Basel III's focus on retaining more high-quality capital, regulators have excluded a number of adjustments and deductions that existed in past regimes. As previously noted, Basel III's rules limit holdings in this tier to common stock and related surplus, retained earnings or qualifying minority interests. However, primary deductions that are still allowed include goodwill and intangibles (excluding mortgage servicing rights), as well as deferred tax assets generated by operating losses or tax credit carryforwards. Both of these deductions are net of deferred tax liabilities. The Basel III rules also provide limited deductibility for mortgage servicing rights and deferred tax assets generated by temporary differences, net of any valuation allowance or deferred tax liabilities. For that reason, it's critical for community bank leaders to take a close look at their current capital structure and projected CET1 ratio and holdings.

2,4 http://www.banknews.com/Single-News-Page.51.0.html?&no_cache=1&tx_ttnews%5Btt_news%5D=19936&tx_ttnews%5BbackPid%5D=1003&cHash=4aaf501537
3 http://blog.thomsonreuters.com/index.php/u-s-regulators-basel-iii-rules-package-signals-intent-to-maintainmomentum-in-big-bank-reforms/

Making a decision on the Accumulated Other Comprehensive Income (AOCI) filter. In past regulatory regimes, all unrealized gains and losses in available-for-sale securities were excluded from regulatory capital. Beginning in 2015, community banks must decide by their first quarterly call report if they wish to “opt-out” (or keep) this AOCI filter, which would continue excluding those unrealized gains and losses. With that in mind, bank leaders should first review their portfolios, since sizable unrealized losses not excluded by the AOCI filter would have a negative effect on capital ratio calculations. In addition, executives should consider how any planned acquisitions or mergers may affect the initial AOCI filter election. For example, if a community bank acquires a target institution with the same filter election, that choice remains valid after the deal closes. However, if the bank merges with or acquires an institution that has made a different AOCI selection, the acquiring bank is required to make a new election when filing the first combined call report. The need for a new AOCI election may also arise if the acquiring bank does not secure a substantial majority of assets or voting stock in the transaction.

Once all of these factors have been weighed in an executive review, it’s a good idea to brief the bank’s board of directors, which will ensure clear understanding of management’s analysis and recommended course of action.

Reviewing risk weightings assigned to certain assets. While most community bank residential and commercial mortgage risk weightings were not changed by the new Basel III rules, there are still two key issues for community bank leaders to consider during the implementation process. For example, the new rules place a 20 percent risk weighting on unfunded commitments that are not unconditionally cancellable by the bank within one year. In addition, regulators added a 150 percent risk weighting on “high volatility” commercial real estate, excluding one to four family acquisition, development and construction (ADC) loans, agricultural properties and other loans that qualify as community development investments. To accommodate these changes, it’s wise for community bank leaders to clearly identify unfunded commitments that fall under the new weighting definition. This may include analyzing the ADC portfolio to determine what loans may require the new risk rating, since banks have the option to assess the impact of those ratings and establish meaningful risk limits for each type of loan. Bank leaders also should work with their boards to determine if they will continue originating credits within either category. Finally, management and board leaders should discuss the bank’s forward-looking approach to commercial real estate lending, with an eye toward how the new risk weighting may affect approvals, loan pricing and overall capital costs.

Planning phase-in of capital conservation buffer. The capital conservation buffer is measured using three ratios: CET 1 risk-based capital, Tier 1 risk-based capital and total risk-based capital. As part of the new regulations, community banks face a graduated schedule to fund this buffer, ranging from 0.625 percent by January 1, 2016 to 2.5 percent of risk-weighted assets by January 1, 2019. If the required minimum buffer requirement (in effect at the measurement date) is not met for each of these ratios, a bank will face restrictions on certain types of payments, including dividends, share repurchases, discretionary payments on Tier 1 instruments and discretionary bonus payments to executive officers. If a bank’s internal review indicates it cannot fund the buffer to required levels, management and board leaders should collaborate on how to communicate limited dividend or bonus payments to affected stakeholders.

On the other hand, if the bank’s capital conservation buffer is above the ratio required to be considered “wellcapitalized”— but below the conservation buffer target—the institution may pay out a percentage of eligible retained earnings without prior regulatory consent. As outlined in the Basel III framework, eligible retained earnings are defined as the most recent four quarters of net income (excluding capital distributions and certain discretionary bonus payments). Consider the following example, where a community bank calculates the percentage of eligible retained earnings available for restricted payments based upon the buffer amount as of January 2019:

Key Guidelines

Capital conservation buffer example

RISK WEIGHTED ASSET RATIO	BANK'S RATIO	REQUIRED CAPITAL	CAPITAL CONSERVATION BUFFER
CET 1 risk-based capital	7.25%	4.50%	2.75%
Tier 1 risk-based capital	8.50%	6.00%	2.50%
Total risk-based capital	9.00%	8.00%	1.00%

As reflected in the table above, total risk-based capital does not meet the 2.5 percent buffer ratio, achieving only 9 percent instead of the required 10.5 percent. In this scenario certain dividend, share repurchase or discretionary bonus payments are limited to 20 percent of eligible retained earnings. For these reasons, it's wise for community bank leaders to incorporate the capital conversation buffer requirements and CET1 measures into all capital plans, capital stress tests and strategic plans.

FINAL THOUGHTS ON BASEL III COMPLIANCE

Since the new Basel III capital standards are a significant shift from recent regulatory policies, executives and board leaders should keep several key points in mind. First, understand that regulatory capital measurements and requirements under the Basel III regime will be seen through three lenses: risk profile, capital adequacy plus buffers and prompt corrective action. During any regulatory procedure, risk identification, measurement and management will be evaluated, stressed loss and revenue estimation will be assessed, and governance and control practices will be reviewed. For those reasons, it's essential for community banks to have a topquality enterprise risk management program, since that system will play a vital role in assessing overall capital adequacy[5].

While community banks are viewed under a generally-accepted description by regulatory agencies, we understand that the capital implications of Basel III can vary greatly from one institution to another.

5 Summary content adapted from Bob Browne article in 11-18-2013 edition of McGladrey Financial Institutions Insights (http://mcgladrey.com/content/mcgladrey/en_US/our-insights/newsletters/financial-institutions-insights/final-rulesissued-for-basel-iii-capital-rules.html)

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