

BASEL III DEBATE: Community bankers don't like it

Industry wins more
time to comment on
proposals

By Steve Cocheo,
executive editor and digital content manager. This article is based on the
Community Banking department in the August ABA Banking Journal magazine.

Art Johnson doesn't like surprises--at least not the kind
that Washington sent him and other community banks this summer: proposed
regulations implementing the international Basel III accords that would apply
to smaller banks in many important regards.

"It's a lot more than what I expected, for us, and I'm a
little confused," says Johnson, chairman and CEO at \$451.3 million-assets
United Bank of Michigan, Grand Rapids. Johnson says he can understand coming
down hard on megabanks with restrictive and complex capital rules. But he can't
figure out how community banks came to get a very challenging series of
proposed capital-rules changes themselves.

"I'm not convinced that the proposal will solve the problems
it is purported to solve," Johnson says.

Winning extension, bankers have until Oct. 22 to comment
on risk-based proposals

Efforts by ABA, bankers, and others helped convince federal regulators to extend the comment period deadline on the proposed risk-based capital standards discussed in the main article to Oct. 22, from Sept. 7.

ABA President and CEO Frank Keating commented: "At more than 1,000 pages, the rules are enormously complex--they will affect the entire economy and all of us in it. Our industry needs to take the time to fully understand their potential impact and let regulators know what the rules will mean for bank customers, farms and communities across the country. This extra time will help us achieve that goal."

- Read the Federal Reserve's extension notice

- Read ABA's full statement on the extension

- Read the regulators' proposals in full

- Visit ABA's Basel III page

Federal regulators released a mammoth package of proposals on capital, plus extensive summaries, in early June, in compliance with the Basel process and the Dodd-Frank Act. ABA and others succeeded in pushing back the original comment due date, as described in the green box accompanying this article.

Not that there is a lack of opinion right now. Bankers interviewed after the proposals' publication had little good to say about the rule. There is a feeling, for instance, that smaller banks already have been paying for the financial crisis through FDIC insurance, and that piling on extensive changes to risk-based capital standards isn't fair.

"The proposed standards would apply to the companies that did not fail, and which made it

through the downturn," says Johnson. "There ends up being a fairly punitive element to it."

What makes the proposals so surprising is that many in the industry did not expect the regulators to concentrate so directly on community banks.

"Applying this to all banks in the country was not expected," notes Sanford Brown, now a partner with Bracewell & Giuliani LLP, who worked on the Basel I risk-based standards' development while serving at the Comptroller's Office in the 1980s. In retrospect, adds Brown, it is not surprising that federal regulators decided against any community bank carveout. "In the current environment," he explains, "bank regulators are not taking any risk for anybody."

Consultant and bank director Jay Brew comes down hard on the proposals. "This is ludicrous!" says Brew, of Seifried and Brew LLC. "We've just gone through a horrific number of bank failures. This whole proposal is so far from the reality of what's going on with community banks, it strikes me we have a regulatory burden imposed on an international basis on local institutions, with no clue."

ABA has pointed out that the rules are being proposed at a time when the industry has historically high capital levels. Consultants point out that regulators have been pushing community banks to increase their capital levels for some time, where they weren't already heavily capitalized. The association worries that the proposed rules could result in more expensive ongoing capital calculations, to justify levels that are already sufficient, and cause some banks to raise more.

Overview of objections

Putting the three interconnected proposals' effect on community banks in a nutshell, they: add to, amend, or increase minimum capital ratios; change the risk-weighting rules significantly, regarding residential mortgage lending; increase the capital burden on certain high-volatility commercial real estate loans; impose higher capital burdens on certain past-due exposures; and amend the treatment of available-for-sale securities for capital purposes. Thrift holding companies would also receive formal capital rules, which they currently don't have.

One of the more troubling elements of the proposals, for Georgia banker Dan Blanton, is that the ability to address regulators' concerns already exists. Blanton believes that elements of what regulators want to accomplish through increased risk weightings and tougher categorization of loans by perceived risk should be addressed when establishing the proper level of loan loss reserve.

"You're seeing regulators, here, overreacting to acquisition, development, and construction lending by the industry," says Blanton, president and CEO at \$1.6 billion-assets Georgia Bank & Trust Company of Augusta. "But that ought to be handled through the reserve."

If a bank is, appropriately, addressing troubled credit through reserve setting, Blanton explains, then simultaneously applying a new risk-capital weighting to the same loans "amounts to 'double taxation,' in a sense."

William Isaac, former FDIC chairman and longtime industry consultant, agrees with Blanton's logic. "You don't hit capital twice," says Isaac, senior managing director and global head of financial institutions for FTI Consulting.

Blanton admits to some philosophical aggravation. "We've always been held to a higher standard than the megabanks," the veteran community banker explains.

Michigan banker Art Johnson reflects that, overall, "leverage would be going down-but shareholders aren't going to lose their expectations." This puts additional pressures on community bankers who already face continuing evolution in the ownership profile and attitude.

Opinions on the impact on capital levels and on leverage, in fact, vary. For example, Barak Sanford, managing director at Promontory Financial Group, LLC, says it's wrong to think that the Basel III capital requirements will be a non-event for community banks. "These are complex rules, and it will require individualized analysis to determine how each bank is affected," says Sanford. However, for the industry as a whole, including bank holding companies above \$500 million and even smaller thrift holding companies, these rules represent a significant change in the capital regime.

On the other hand, Joshua Siegel, managing principal at StoneCastle Partners LLC, says that for community banks "there will be a lot of noise and light, but not a lot of heat."

However, the influence will be more widespread yet, in that the proposals, if adopted, will change how some banks do business as well as the business mix that others opt for. There's broad agreement that the new standards will bring many new calculations and new, continuous monitoring and evaluation.

"I'm starting to get my mind around quite a bit of these proposals," says Texas community banker Ken Burgess, "and I can see this is so much more complex than what we've had in the past." Burgess, chairman of \$643.2 million-assets FirstCapital Bank, N.A., Midland, believes the data-gathering alone that banks will have to go

through, in order to properly address the proposed standards, will add significantly to the burden.

Residential lending impact

No longer will a mortgage be a mortgage, if the proposal goes through as written, with all being held on the books at a 50% capital weighting. Loans would fall into two categories—"traditional first-lien, prudently underwritten mortgage loans" and then junior liens and nontraditional mortgage products. Within those two broad categories, banks would adjust risk weightings by loan-to-value ratio. Some clean loans could see weightings below the current rule-but others could see weightings quadruple to 200%.

This, and the commercial real estate segment of the proposals, are among sections that especially bother community bankers interviewed.

Consultant Jay Brew points out that community banks typically didn't experience the mortgage issues that larger lenders did, but they will now pay the price.

Maryland's William Grant objects to the proposals' structure, wherein the revamped weightings system would apply not only to new lending, but to the existing portfolio of mortgage loans. "That's a retroactive application on the current balance sheet," says Grant, chairman and CEO at First United Bank & Trust, Oakland, Md. He finds such after-the-fact application unfair, as portfolios come together under current regulatory views, not based on what regulators might do in the future.

Another concern is how private mortgage insurance is ignored. Promontory's B.J. Sanford points out that the private mortgage insurance currently enables banks to make higher loan-to-value mortgages. Taking that tool out of the box, at least as far as capital standards is concerned, may affect who banks can serve in home lending.

Banker Art Johnson wonders how banks, being asked to put folks of moderate means into homes, are supposed to do that if they lose the assistance of insurance.

Commercial real estate impact

Bankers expressed concerns about the negative view on commercial real estate that the proposals take. Johnson notes that there is little recognition evident in the proposals that many community banks turned to such lending because so many other, traditional areas of credit became unprofitable for them.

Dan Blanton objects to the proposals in that they are numbers driven, rather than performance driven. If a borrower has the cash flow to keep a loan current, why should other factors push it into a higher-cost capital weighting, he asks?

More skeptical yet, Maryland's Bill Grant says, "it's just another ding on your capital."

Texan Ken Burgess says most of his bank's commercial real estate lending has consisted of owner-occupied projects. But now and then, the bank has gone into the types of projects that the proposals would weight more heavily.

Burgess wonders what this will mean for credit availability: "I promise you, once we understand the rules, at my bank, we will want to stay in the lowest-risk categories."

Attorney Sanford Brown wonders if the long-term may see community banks thus lose the commercial real estate market to larger banks.

Outlook for the issue

While bankers remain skeptical, some consultants think the proposals won't turn out so badly for community banks in actual practice. Josh Siegel, for instance, thinks that in the field, examiners will tend to not be as stringent as the rules are. He compares this to the idea of a 55-mph limit-how many people consistently push that envelope?

While some interviewed agree with Siegel, others say they never saw a regulation that an examiner didn't like to enforce to the letter.

"Directors and managers ought to be sending their letters to the government on this proposal," says consultant Jay Brew. "It not only doesn't address the cause of bank failures, but it adds cost to the price to comply."

[This article was posted on August 10, 2012, on the website of ABA Banking Journal, www.ababj.com.]