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Community Banks and Basel III: What to Know

Kamal Mustafa

Don't celebrate too much over the revised Basel III standards for community banks. While the new proposal substantially reduces or delays some of the highly restrictive rules initially suggested, it also has profound implications for most community banks.

The mitigation of the guidelines was only possible under the umbrella of a substantially increased minimum capital adequacy requirement.

In an inadvertent sleight-of-hand, regulators have exchanged a series of easily attacked rules and complex calculations for a larger and more encompassing regulatory capital ratio. The new capital requirement will ultimately have a greater negative impact on the sustainability and profitability of community banks.

The **Basel III** fine print suggests that the higher capital requirements will make even the so-called victories hard to take. Gains/losses on AFS securities are a good example. The one-time decision to opt out may not even be a win for community banks, as detailed on page 166:

"Notwithstanding the availability of the AOCI opt-out election under the final rule, the agencies have reserved the authority to require banking organizations to recognize all or some components of AOCI in regulatory capital if an agency determines it would be appropriate given a banking organization's risks under the agency's general reservation of authority under the final rule. The agencies will continue to expect each banking organization to maintain capital appropriate for its actual risk profile, regardless of whether it has made an AOCI opt-out election."

This shows that by increasing the overall capital ratios, regulators have and will, indirectly, impose operating and financial restrictions on community banks. Cumulatively, these restricions – combined with regulatory flexibiliy to boost capital requirements – may be greater than the orignal Basel III proposal. Unlike the CCAR and Dodd-Frank banks that will have their individual capital ratios determined by mandated stress tests, community banks will be subject to "thumb rule" regulatory capital ratios. As these rules are moved to higher and higher levels, community banks will lose FreeCapital/financial leverage. In a declining loan and NIM environment, they will face extreme ROI pressures.

One way to fight the application of higher thumb rules is by integrating stress testing into strategic planning. Invictus Consulting Group's community bank clients have had great success convincing regulators to establish regulatory levels consistent with their unique portfolio mix and historical experience. ▪

Higher Capital for Community Banks

Regulators can require the bank "to hold a greater amount of regulatory capital than otherwise is required under the final rule, if the supervisor determines that the regulatory capital held by the banking organization is not commensurate with its credit, market, operational, or other risks," according to p. 51 of the Basel III proposal which goes into effect for community banks in 2015. In reality, examiners are already demanding higher thumb rules – as much as 12 percent leverage – for community banks.

Community Bank Restrictions Removed

The final Basel III rule gets rid of onerous restrictions initially proposed, such as:

- Complicated risk weights for residential mortgages
- Eliminating the grandfathered community bank exception for including TruPS in Tier 1 capital

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How You Identify and Measure Risk Can Be Key to CAMELS

The OCC wants community bank CEOs and directors to know that risk management is crucial to how it examines a bank. The latest indication:The OCC has updated its eight risk categories in the Comptroller's Handbook and several key sections that discuss risk.The revisions are in a booklet called **"Community Bank Supervision."**

The main message the national bank regulator is sending: Your bank's earnings, capital or enterprise value can be affected by unforeseen events. How you manage and measure those risks will be key factors in how well your bank does in its next exam.

Capital Stress Testing and Strategic Planning

Decisions ranging from dividend policy to loan pricing cannot be made without implementation of an ongoing stress testing program that is incorporated into a bank's strategic planning process, according to Invictus Consulting Group CEO Kamal Mustafa. Any strategic action taken by senior management has capital implications. Stress testing is the only way to evaluate, quantify, define and defend management actions relating to capital adequacy – and have them approved by examiners.

The OCC points out that its eight risk categories –credit, interest rate, liquidity, price, operational, compliance, strategic and reputation – "are not mutually exclusive," and that any product or service may expose a bank to multiple risks. It instructs its examiners to also "be alert to concentrations" across products, business lines, geographic areas and legal entities that can increase risk.

"The presence of risk is not necessarily reason for supervisory concern. Examiners determine whether the risks a bank assumes are warranted by assessing whether the risks are effectively managed, consistent with safe and sound banking practices," the handbook notes in one of its revised sections. "Generally, a risk is effectively managed when it is identified, understood, measured, monitored, and controlled as part of a deliberate risk/reward strategy, known as risk appetite. A bank should have the capacity to readily withstand the financial distress that such a risk, in isolation or in combination with other risks, could cause."

When examiners find that there is not enough capital to support a bank's risk taking activities, they will tell the bank management and the board of directions to mitigate or eliminate the excessive risk by reducing exposures, increasing capital or strengthening risk management practices.

Community banks must tailor their risk management systems to their own needs.The OCC suggests that no matter the risk management design, each system should:

- **IDENTIFY** risk.This should be a continuing process, taking into account new business initiatives. Risks need to be identified at the transaction and portfolio levels.
- **MEASURE** risk in an accurate and timely way. "A bank that does not have risk measurement tools has limited ability to control or monitor risk levels," the OCC warns. Banks that offer complex products must have more sophisticated risk measurement tools. Test your tools periodically to make sure they are on the mark.
- **MONITOR** risk levels "to ensure timely review of risk positions and exceptions." Make sure you distribute "informative" reports to the "appropriate individual to ensure action."
- **CONTROL** exposures to risk limits through the right policies, standards and procedures. Bank management should be able to adjust limits when conditions or risk tolerances change. Make sure you authorize and document changes to your risk limits and review your policies if your objectives or standards change.

The handbook stresses that bank management must keep the board informed of risk-taking activities.The board of directors is responsible for implementing the bank's strategy, developing policies that define risk tolerance that "are compatible with strategic goals" and ensuring that the bank's strategic direction and risk tolerances are known and followed throughout the bank. The board should also be in charge of developing a management information system to make sure that the risk reports are timely, relevant and accurate. ▪

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Troubled Banks Need to Explore TruPS Cliff Options

Jim Hannon

Hundreds of troubled community bank holding companies that deferred interest payments on trust preferred securities (TruPS) will soon be facing a deadline to pay up. That so-called TruPS "cliff" poses significant capital questions for their boards.

Of the 271 banks that went into deferral on their TruPS payments in 2009, 115 have failed, according to SNL data. In 2014 and 2015, more than 200 banks will reach the 5-year anniversary of their deferral status: 109 banks in 2014, and 105 banks in 2015.

High transaction costs prevented most community banks from issuing TruPS in stand-alone transactions. However, investment bankers devised a strategy of pooled trust preferred transactions with little expense to the participating banks. The hybrid securities had elements of both debt and equity and the proceeds from their sale could account for up to 25% of Tier 1 capital. The interest payments on the debt were tax-deductible and deferrable for up to 20 consecutive quarters without the debt going into default.

Many community banks that struggled in the financial crisis stopped paying dividends to their BHCs, which then put their TruPS into deferral. To the extent that there is franchise value in the underlying bank, the TruPS holders may now seek to enforce their rights, which could include a bank takeover. Hedge funds have been buying TruPS in deferral for pennies on the dollar in anticipation of defaults.

Here are three strategies that bank boards should discuss before the deferral period ends:

1. Contemplate a capital raise. If the bank can raise capital, part of the raise should address bringing the deferred interest due under the TruPS current. It should also allocate funds into a reserve to service the interest payments until the bank can generate earnings to pay dividends to the BHC to service this debt.
2. Consider approaching the TruPS owners, though this may be impossible in a pooled deal. If it is a stand-alone transaction, the bank should try to initiate talks to settle the outstanding balance. These discussions should include the possibility of exchanging the TruPS security for an equity position in the holding company (common or preferred stock). Given that some hedge funds and investors have bought the TrUPS for such a low amount, they may be inclined to discuss this.
3. If all else fails, think about a 363 bankruptcy sale of stock. A sale of the bank stock under Section 363 of the Bankruptcy Code conveys the stock to the purchaser free and clear of any liens and encumbrances. The liens and encumbrances attach to the net proceeds of the sale which are then paid as ordered by the Bankruptcy Court. In a 363 sale, the holding company equity holders typically lose their investment in the bank, but an FDIC failure is avoided. For a 363 sale to be successful, the prospective purchaser must believe that there is value in the underlying bank. ▪

What Happens When the Five-Year Deferral Ends

- If the BHC hasn't made an interest payment, the debenture that issued the TruPS will go into default..
- The entire amount of principal and interest will become due.
- Upon default, the holder of the TruPS has the right to initiate legal action to collect the balance due.

EDITOR'S NOTE: *Hannon discussed this issue at the Bank Executive Conference in Chicago on June 17. This article reflects his opinions. The conference was co-sponsored by Invictus. For information on conference opportunities, contact Charlie Perry at cperry@invictusgrp.com*

About the Expert

Jim Hannon is Of Counsel to the law firm of Gozdecki, Del Giudice, Americus & Farkas in Chicago, where he specializes in banking, loan work-outs, liability defense for bank officers and directors, business advisory, corporate and real estate. From 1999 to May 2006, he was Executive Chairman of Hinsbrook Bank & Trust, a community bank in Illinois. Hinsbrook was sold to Wintrust Financial in May, 2006. Jim stayed on as a managing director of Wintrust Financial into 2007. Prior to that, Jim practiced law and organized seven community banks. He has a B.S.C degree in Accounting from DePaul University, a J.D. from DePaul College of Law, and was a licensed C.P.A.

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Read Between the Lines: What Regulators Are Highlighting

Each month Bank Insights will review enforcement orders, publications, speeches and other news from regulators to give perspective on regulatory challenges and initiatives.

Making Rules Easier to Understand

The Federal Deposit Insurance Corp. wants community banks to understand Basel III and new capital requirements without having to pay a high-priced consultant to translate the complicated rulemakings, FDIC executives said at a July 25 meeting of the advisory committee on community banking. To foster understanding, the FDIC has created a **regulatory capital web page** with a 41-minute video tailored just for community banks and an easy-to-understand **presentation** with emails and contact numbers.

Publications

The OCC's **semi-annual risk perspective** offers some insights into what examiners are focusing on in 2013. The report says that community banks should expect scrutiny of strategic planning, risk management of new products or services, operational risk related to changes in business models, commercial credit underwriting, interest rate risk, CRE exposures and ALLL levels. The report also notes that small banks' investment portfolios are concentrated in agency-backed mortgage securities, which will make these banks more vulnerable to interest-rate risk.

Speeches

Comptroller of the Currency Thomas J. Curry told a congressional hearing in July that the OCC is "taking steps to reduce the burden and expense smaller institutions bear in reviewing and implementing new regulatory requirements." The lending limit rule, for example, included a "simple look-up table" for banks to calculate exposures, and the Basel III proposal featured a community bank guide when it was released. Future rulemakings and proposals will also be accompanied by guides, which should help banks decide which rules are worthy of comment, Curry said.

Community Banks and TARP

The special inspector for the Troubled Asset Relief Program disclosed in its July report to Congress that 142 community banks still had investments in the program as of June 30, and 96 had missed dividend and interest payments. Community banks involved in the program will see their dividend payment rates increase to 9 percent (from 5 percent) in the next year. Treasury has the right to appoint board members to banks that miss six dividend or interest payments and has done so at 15 institutions. It has appointed observers at 33 of the 88 banks that have missed at least five payments, and 12 more banks have refused to allow Treasury observers at their meetings, the report notes.

Student Loan Workouts Urged

All three bank regulatory **agencies** are encouraging banks to work "constructively" with private student loan borrowers who may have trouble repaying their loans. The statement from the Federal Reserve, OCC and FDIC noted that "prudent workout arrangements are consistent with safe and sound lending practices and are generally in the long-term best interest of both the financial institution and the borrower. Under the "Uniform Retail Credit Classification and Account Management Policy," which covers student loans, banks are allowed to grant extensions, deferrals, renewals and rewrites to student loan borrowers in temporary financial difficulty.

The Consumer Financial Protection Bureau says there are more than $1 trillion in **outstanding student loans**, a number that is growing "at a steady clip." ■

About Invictus

Invictus Consulting Group's bank analytics, strategic consulting and capital adequacy planning services are used by banks, regulators, investors and D&O insurers. Invictus runs a stress test on every U.S. bank each quarter with its patent-pending Invictus Capital Assessment Model™ (ICAM). Bank clients have excellent results when using Invictus reports to defend their strategic plans and capital levels to regulators.

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Next in *Bank Insights*: Troubled Banks and Stress Testing