What Does a Community Bank in Dickson Have in Common with Deutsche Bank and JPMorgan Chase? Basel III

By Kathryn Edge on Sat, 12/01/2012 - 12:00am

Coming soon may be an answer to this question.

Ask any banker what she thinks of Basel III, and then prepare yourself for a tirade. Ask Greg Gonzales, the Commissioner of the Tennessee Department of Financial Institutions, and he'll be more dignified in his criticism, but he won't disagree that Basel III is a bad idea. Ask the Conference of State Bank Supervisors (CSBS), the professional association for the heads of the state banking agencies, and it will say that "…we are opposed to the proposed approach put forth by the federal banking agencies to implement the Basel III capital accord and to incorporate a standardized approach for risk-weighted assets."[1]

What's "Basel III" and Why Is Everyone So Upset?

Basel, Switzerland, is the site of the Bank for International Settlements (BIS). The Basel Committee on Banking Supervision, whose Secretariat is located at the BIS, provides a forum for discussions and cooperation on banking supervisory matters. The stated objective of the Basel Committee is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide. Committee members exchange information on national supervisory issues and make recommendations about how to achieve a common, international understanding about supervisory standards, including international standards on capital adequacy. Committee members come from all across the globe, from Argentina to Luxembourg, from India to the United Kingdom. And the United States. However: the CEO of the Sevier County Bank is not on the committee. Neither is Commissioner Greg Gonzales, who is also chairman of CSBS. Community banks are not at the table at the most important and potentially destructive policy-making confab in recent financial services history.

Basel III's ideas about how banking supervisors should decide how much capital is enough for all banks, regardless of size and sophistication, are extremely complex and, frankly, over the heads of most of us. It builds upon the regulatory frameworks already in place in some countries that were adopted as a result of Basel II and Basel 2.5. Basel II dealt primarily with market risk, and Basel 2.5 enhanced the measurements of risks related to securitization and trading book exposures.[2]

Basel III would require banks to hold 4.5 percent of common equity (up from 2 percent in Basel II) and 6 percent Tier 1 capital (up from 4 percent in Basel II) of risk-weighted assets. In addition, Basel III adds something called a "mandatory capital conservation buffer" to all ratios, effectively raising each minimum ratio an additional 2.5 percent, and a "discretionary counter-cyclical buffer" that allow federal banking regulators to require up to another 2.5 percent of capital during periods in which the bank is growing its loan portfolio (i.e., making loans to people and businesses). Basel III also adds a minimum 3 percent leverage ratio and two new required liquidity ratios. The "liquidity coverage ratio" requires a bank to hold enough high-quality liquid assets (investments it can quickly turn into cash) to cover its total net cash outflows for a 30-day period. The second liquidity ratio, called the "net stable funding ratio," requires the available amount of stable funding to exceed the required amount of stable funding over a one-year period of extended stress. (Pay attention – there'll be a test on this later.) Even though Greece is not represented on the Basel Committee, all these ratios are probably Greek to you.

What's the Big Deal?

Today, banks in the United States already have strict capital standards built into the federal banking regulations that are adopted by all of the states. In addition, banks that are under informal or formal supervisory actions are required to have even more capital in order to cushion any potential losses. All U.S. banks are required to set aside reserves in a separate account, called an Allowance for Loan and Lease Losses, that does not count toward its required core capital-to-assets ratio. Extra money sitting around "just in case."

Current capital ratios are set out into three different tiers:

Tier 1 Leverage Capital Ratio
Tier 1 Risk-Based Capital Ratio
Total Risk-Based Capital Ratio.

Journal Links

About the Journal
Advertising Info
Submit an Article
Send a Letter to the Editor
Journal Archive

Table of Contents

For a bank to be well-capitalized, its Tier 1 Leverage Capital Ratio must be at least 5.00 percent and its Total Risk-Based Capital Ratio, at least 10.00 percent. However, banking regulators can require higher capital levels under existing regulations. It is typical for a bank operating under a formal supervisory action to be required to maintain at least an 8.00 percent Tier 1 Leverage Capital Ratio, and a 12 percent -13 percent Total Risk-Based Capital Ratio. In addition, most banks who are not operating under a supervisory mandate for higher capital typically maintain 8.00-9.00 percent Tier 1 capital and 12.00-15.00 percent total risk-based capital. Why? Because prudent bankers who have the luxury would rather have more capital than less.

Why, then, are bankers and state bank supervisors so exorcized about new capital standards?

It's About the Risk, Stupid

The amount of capital a bank will be required to have under Basel III is all about how much risk the bank has in its portfolio. Risk is in the eye of the beholder, it seems. Most community bankers would prefer to have a large portfolio of 1-4 family residential mortgages over riskier loans. People who might default on a loan to develop a parcel of raw land will fight to the bitter end to save their homes. Nevertheless, under Basel III, most of these home mortgages will have the same “risk-weighting” for capital purposes as the defaulted debt to a foreign country. Our friend Ron DeBerry, president and CEO of Commerce Union Bank in Springfield, would never loan money to Greece, but he'll shake your hand and be able to tell whether you will honor your home mortgage.

For our community bank clients, increasing the risk-weighting assigned to residential and commercial loans will have a significant impact on both the banks and on the communities they serve. These loans are the bread and butter of a community bank's balance sheet, and Basel III will require banks to keep more capital on-hand when they make many common home mortgage and small business loans. The practical effect of this change will be to push banks away from making home loans and into lower risk investments, like bonds. In essence, Basel III will push community banks' investments away from Main Street and into Wall Street.

When asked at a recent banking conference what impact the new capital requirements of Basel III would have on the First Community Bank of Bedford County, CEO Scott Cocanougher joked, “I'll let you know when we figure it out.” Understanding how each asset in the bank will be risk-weighted takes a village. On Sept. 24, the federal banking regulators released a Basel III “calculator” designed to help banks estimate the impact of the proposed capital rules on banks, but in a joint statement have said that these calculations “should not be relied on as an indicator of a bank's actual regulatory capital ratios.”

Here's the Bottom Line

If the federal banking agencies in this country adopt the capital and liquidity requirements of Basel III with the current risk-weighting that an international committee adopted while drinking hot chocolate and eating fine Swiss cheese, some banks will fail because they cannot meet the requirements. Other banks will be forced to merge into larger companies for the same reason, perhaps creating more banks that are too big to manage, too big to regulate, and too big to fail.

There will be fewer dollars to lend in Memphis, Jackson, Union City, Byrdstown, Chattanooga, Pigeon Forge and Humboldt. If the small businesses in those cities and towns can't find loans, they will also wither. They won't have deposits to put into banks, and that will further exacerbate banks' liquidity problems.

Experts predict that banks will have to abandon home mortgage lending because the capital requirements providing a cushion for those types of loans will be just too high. At a time when our national government has not developed a long-term solution to housing finance, Basel III, according to the CSBS, would “further stifle mortgage lending by traditional depository institutions.”[3]

A few years ago, a very young staffer for the United States Treasury was delivering a lecture to a group of Tennessee bankers, a few of us lawyers, and the commissioner on the efficacy of having only one regulator for all banks. Think of the efficiencies. Think of the consistency of regulation. As we were filing out of the room at Treasury in Washington, I shook hands with the lad, apologized in advance for my comment, but said, “Son, I have shoes older than you are. This might have been a fine term paper, but in our world, the thought of having one all-powerful regulator with no checks and balances is worse than scary — I trust that Congress won't be that irresponsible.” He smiled, called me ma'am, and continued his Ivy League of Your Own discourse. One of these days, maybe this young man will be a member of the Basel XIV Committee.

Notes

1. Oct. 3, 2012 Statement on Federal Banking Agencies' Proposed Capital Rules, Conference of State Bank Supervisors.
2. International Convergence of Capital Measurement and Capital Standards — revised, June 2006 and Enhancements to the Basel II framework, Revisions to the Basel II market risk framework and Guidelines for computing capital for incremental risk in the trading book, July 2009.
3. Oct. 3, 2012 Statement on Federal Banking Agencies' Proposed Capital Rules, Conference of State Bank Supervisors.

Katie Edge

KATHRYN REED EDGE is a member in the Nashville office of Butler, Snow, O'Mara, Stevens & Cannada PLLC, with offices in Tennessee, Mississippi, Alabama, Pennsylvania, and Louisiana. She is co-chair of the firm's Banking Subgroup and concentrates her practice in representing regulated financial services companies. She is a past president of the Tennessee Bar Association and a former member of the editorial board for the *Tennessee Bar Journal*.

ELIZABETH WILEE SIMS is an associate in the Nashville office of Butler, Snow, O'Mara, Stevens & Cannada PLLC. She focuses her practice in the areas of financial services, mergers and acquisitions, public and private securities and corporate finance. She is a graduate of the University of Tennessee College of Law (2006) where she was a member of the Tennessee Law Review and Order of the Coif. Sims is also the former Access to Justice Coordinator of the Tennessee Bar Association.