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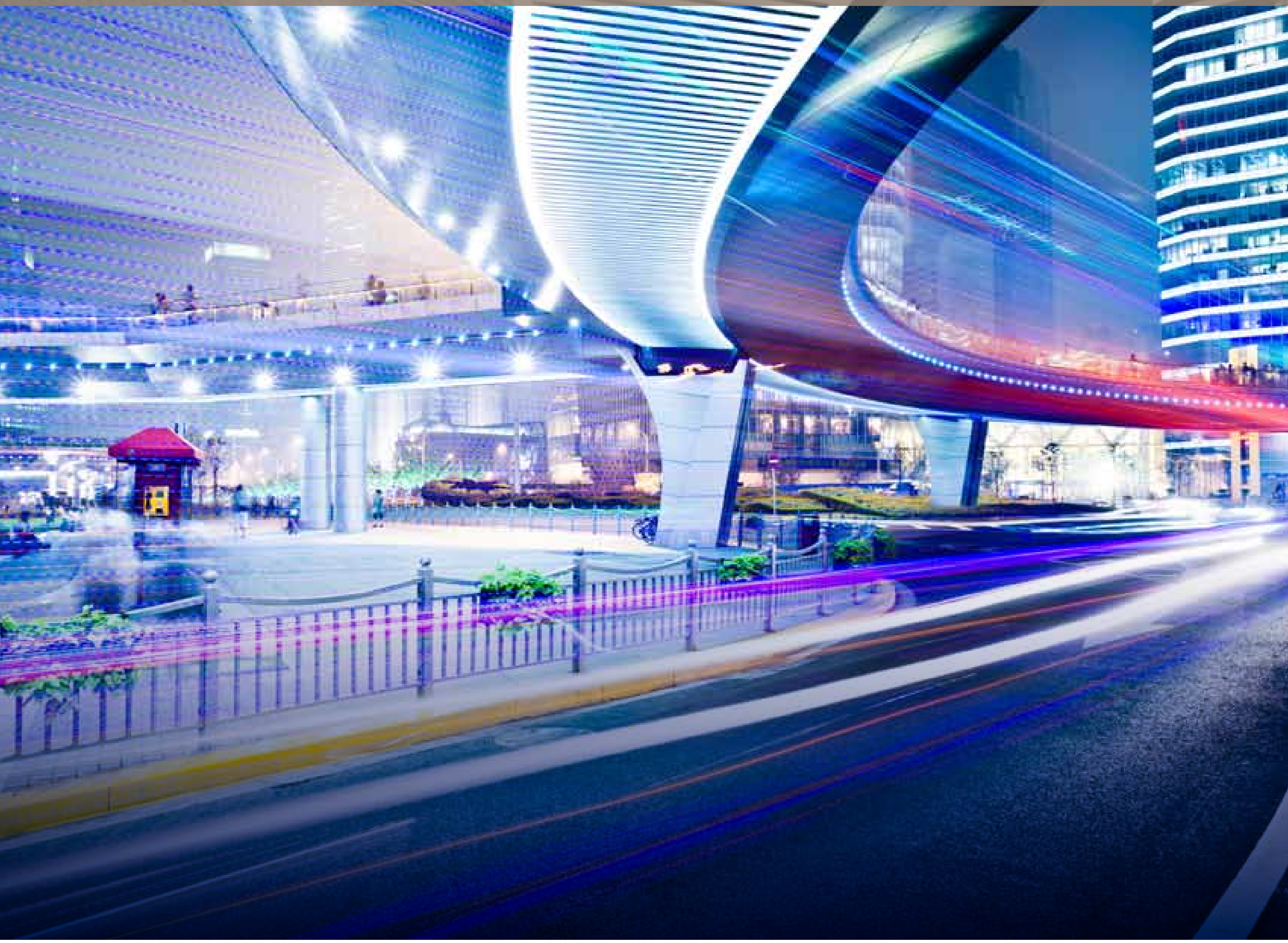
EQUIAS INSIGHTS

IMPACT OF BASEL III ON COMMUNITY BANKS



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EQUIAS ALLIANCE
BOLI AND BENEFIT ADVISORS

EQUIAS INSIGHTS

IMPACT OF BASEL III ON COMMUNITY BANKS

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About this document

This edition of Equias Alliance INSIGHTS has been prepared in support of Equias Alliance's commitment to provide ongoing technical assistance to our clients and associates. The following information provides general insights into the Notices of Proposed Rulemaking (NPRs) recently issued which propose significant changes to the U.S. regulatory capital framework. Equias Alliance, LLC cannot and does not engage in the practice of law or accounting. Accordingly, nothing in this document should be construed as legal or accounting advice, or as a solicitation to provide legal or accounting advice. You are urged to seek independent tax and legal counsel for advice in applying this information to your particular facts and circumstances. If you have any questions regarding your Bank-Owned Life Insurance (BOLI) program, please contact the Equias Alliance Service Center at (612)326-4996.

EQUIAS INSIGHTS

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INTRODUCTION

On June 12, 2012, the Federal agencies (OCC, Federal Reserve Board and FDIC) proposed three significant changes to the U.S. regulatory capital framework:

- The Basel III Proposal revises the definition of regulatory capital for virtually all U.S. banking organizations and affects the numerator of risk-based capital ratios.
- The Standardized Approach Proposal would modify the calculation of risk-weighted assets of virtually all U.S. banking organizations and affects the denominator of risk-based capital ratios.
- The Advanced Approach Proposal, applicable only to the very largest of banks, would revise the advanced approaches risk-based capital rules.

The new rules, if adopted, will phase in over a period of years with full implementation expected by 2019. The purpose of these proposals is to help ensure that banks maintain strong capital positions even after unforeseen losses and severe economic downturns. It is important to keep in mind that these are only proposals, but some provisions may become effective as early as January 1, 2013 if the new rules are approved as currently drafted.

BANKS SUBJECT TO NEW RULES

The Basel III Proposal and the Standardized Approach Proposal would apply to:

- All insured banks and savings associations
- Bank holding companies with more than $500 million in assets
- Savings and loan holding companies domiciled in the U.S.

The Advanced Approach Proposal would generally apply only to the largest banks in the U.S. (e.g., banks with over $250 billion in assets or over $10 billion in foreign exposures), but some provisions, such as the new market risk rules, would apply to banks with $1 billion or more in assets.

This summary will focus only on the Basel III Proposal and the Standardized Approach Proposal that primarily affect community banks.

I. BASEL III PROPOSAL

NEW CAPITAL REQUIREMENTS

According to the Board of Governors of the Federal Reserve System, the intent of the new capital requirements is to:

- Increase the quantity and quality of capital
- Revise the definition of capital
- Establish limitations on capital distributions
- Introduce a supplementary leverage ratio for internationally active organizations

The specific areas of change are outlined below.

Overview

According to the FDIC, Basel III would revise the definition of regulatory capital components; add a new common equity tier 1 risk-based capital level; incorporate the revised capital requirements into the Prompt Corrective Action framework; implement a new capital conservation buffer; and provide a transition period for several aspects of the proposed rule.

Briefly, the new common equity tier 1 to risk-based capital ratio would be 4.5%; the additional tier 1 capital to risk-weighted assets would be 6%; the overall capital ratio would be 8%; the new capital conservation ratio would be 2.5%; and the tier 1 leverage ratio would remain at 4%.

Proposed Definition of Capital

The definition of capital is revised to include common equity tier 1 capital as well as additional tier 1 (T1) capital; and tier 2 (T2) capital. Common equity tier 1 (CET1) capital is a new concept. It includes common stock instruments, retained earnings, accumulated other comprehensive income (AOCI), and common equity minority interest less certain adjustments and deductions described below.*

In addition to this added element of CET1, the proposals introduce a new ratio utilizing CET1 and raise other minimum capital ratios as illustrated in the following summary table:

SUMMARY OF CURRENT CAPITAL RATIOS VS. PROPOSED CAPITAL RATIOS

Capital Ratio	Current	Proposed	Proposed Capital Conservation	Total Proposed	Increase
Common Equity Tier 1*	N/A	4.5%	2.5%	7.0%	7.0%
Tier 1	4.0%	6.0%	2.5%	8.5%	4.5%
Total Capital Ratio	8.0%	8.0%	2.5%	10.5%	2.5%
Tier 1 Leverage Ratio	4.0%	4.0%	N/A	4.0%	0%

* Accumulated other comprehensive income (AOCI) will flow through to CET1. This includes all unrealized gains and losses on AFS securities; unrealized gains and losses on cash flow hedges; and adjustments to the funded status of defined benefit pension plans. However, there will be deductions like goodwill, deferred tax assets from operating loss and tax carryforward provisions, and after-tax gain-on-sale associated with securitization exposures and adjustments like unrealized gains and losses resulting from changes in banking organization creditworthiness or unrealized gain/loss on cash flow hedges.

PROPOSED CAPITAL RATIOS PHASE-IN SCHEDULE

As noted above, the proposals, as currently drafted, provide for the phase-in beginning from January 1, 2013 through January 1, 2019. The full phase-in schedule is detailed below:

	1/1/13	1/1/14	1/1/15	1/1/16	1/1/17	1/1/18	1/1/19
Minimum Common Equity %	3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital Conservation Buffer %				0.625%	1.25%	1.875%	2.5%
Common Equity with Capital Conservation Buffer %	3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
Minimum Tier 1 Capital %	4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum Tier 1 Capital with Capital Conservation Buffer %				6.625%	7.25%	7.875%	8.5%
Minimum Total Capital %	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum Total Capital with Capital Conservation Buffer %	8.0%	8.0%	8.0%	8.625%	9.25%	9.875%	10.5%

Source: Office of the Comptroller of the Currency (July 19, 2012)

CHANGES TO PROMPT CORRECTIVE ACTION (PCA) RULES

The changes to the PCA rules are summarized below:

Proposed New Prompt Corrective Action Requirements (effective 1/1/15)

Requirement	Total Risk-Based Capital %	Tier 1 Risk-Based Capital %	Common Equity Tier 1 %	Standard Leverage %
Well Capitalized	≥10%	≥8%	≥6.5%	≥5%
Adequately Capitalized	≥8%	≥6%	≥4.5%	≥4%
Undercapitalized	<8%	<6%	<4.5%	<4%
Significantly Undercapitalized	<6%	<4%	<3%	<3%
Critically Undercapitalized	Tangible equity to total assets ≤2.0%			

Source: Office of the Comptroller of the Currency (July 19, 2012)

II. STANDARDIZED APPROACH PROPOSAL

NEW ASSET RISK WEIGHT REQUIREMENTS (EFFECTIVE 1/1/15)

The intent of the Standardized Approach Proposal is to replace the current Basel I rules on risk weighting and provide enhanced risk sensitivity because of the shortcomings that became apparent in the recent financial crisis. The proposed rule would:

- Revise certain methodologies for calculating risk-weighted assets such as residential mortgages
- Increase capital requirements for past-due loans, high-volatility commercial real estate exposures, and certain short-term loan commitments
- Expand the recognition of collateral and guarantors in determining risk-weighted assets
- Remove references to credit ratings and propose alternatives for calculating risk-weighted assets
- Establish due diligence requirements for securitization purposes

RESIDENTIAL MORTGAGES

The risk weighting for category 1 and category 2 residential mortgages has changed.

- Category 1 generally includes traditional, first lien, prudently underwritten mortgage loans
- Category 2 generally includes junior liens and nontraditional mortgage products

OTHER CHANGES

Examples of other changes in this proposal include:

- Updated definition of securitization to include a wider range of exposures
- The simplified supervisory formula approach is now used instead of ratings
- An alternative to the simplified supervisory formula approach is available
- Expanded recognition of guarantors
- Expanded recognition of collateral

III. BASEL III IMPACT ON BANK-OWNED LIFE INSURANCE (BOLI) VS. OCC 2004-56

CURRENT GUIDANCE

The Interagency Statement on the Purchase and Risk Management of Bank-Owned Insurance (OCC 2004-56) provides “If an institution owns a general account insurance product, it should apply a 100 percent risk weight to its claim on the insurance company for risk-based capital purposes.” OCC 2004-56 also provides that a BOLI investment in a separate account insurance product, meeting certain criteria, may qualify for a “look-through” approach to the underlying assets to determine the risk weight. In no circumstances, however, may the assigned risk weight on a separate account BOLI be less than 20 percent, and any elements of a separate account insurance policy subject to general account claims on the insurer and/or any stable value provider, should be risk weighted at 100 percent. The result is that Separate Account BOLI products, including Hybrid Separate Account, generally have risk weightings ranging from 20% to 100% – again, based on the nature of the underlying investments.

A POTENTIAL SOURCE OF CURRENT MARKET CONFUSION

We understand there may be some question in the marketplace currently regarding the impact of the Standardized Approach Proposal on the risk weighting of BOLI. The problem may lie in a provision of the proposal which would allow banking organizations to substitute the risk weighting of an eligible guarantor for the risk weighting assigned to a guaranteed exposure. This substitution would apply only to **eligible guarantors*** and **eligible credit derivatives that meet certain criteria**.

**Eligible guarantors would include several entities. The most relevant for this summary are a depositary institution, a bank holding company, a savings and loan holding company, securities firms, corporations, insurance companies (other than monoline carriers) and any other entity that has investment grade debt whose creditworthiness is not positively correlated with the credit risk of the exposures for which it provides guarantees.*

With the publication of these proposed rules, a question was raised as to whether the provisions of the proposal relating to the expanded recognition of guarantors would allow for a lower risk weighting to be applied to General Account BOLI policies held with insurance carriers with the highest of credit ratings and, possibly, their Hybrid Separate Accounts as the investor could substitute the risk weight of the eligible guarantor for the risk weight applicable to the investment itself, if certain conditions were met.

In addition, some have also asked whether it would be possible under the new proposal to apply a lower risk weighting than 20% for a Separate Account BOLI investment. None of the proposals directly address BOLI and since it was not clear whether it was the intent of the Agencies to change some or all of the risk weight classifications currently found in OCC 2004-56, we contacted the OCC for clarification. Based on a written response from an attorney for the OCC, it is our understanding that:

- Currently, General Account BOLI is 100% risk weighted in accordance with the specific guidance in OCC 2004-56 as that is the governing guidance at this time as the Notice of Proposed Rulemakings (NPRs) are only proposed rules and are not final.
- Under the NPR on the Standardized Approach for Risk weighted Assets, General Account BOLI would **continue** to be risk weighted at **100%** as BOLI would be treated as a corporate exposure. Corporate exposures are addressed in Section 32 of the NPR Standardized Approach. Specifically, Section 32(f), reads:

  > *(f)"Corporate exposures. A [BANK] must assign a 100 percent risk weight to all its corporate exposures."*

- OCC 2004-56 currently allows a bank to utilize a look-through approach for their separate account BOLI and utilize the risk weightings of the underlying assets in the separate account, but does not allow a risk weighting lower than 20%.
- The NPR – Standardized Approach, if adopted, may actually allow a lower risk weighting than 20% – if the underlying assets in the separate account have a risk weighting, as calculated in accordance with the NPR, of less than 20%. Any portion of a separate account BOLI policy's contractual values subject to the insurance carriers' general account, such as a claims stabilization reserve, would continue to be risk weighted at 100%.
- Based on the attorney's comments, the section of the NPR – Standardized Approach on Guarantees (Section 36) does not apply to BOLI as the insurance policy contract is a corporate exposure to the insurance company, and there is no mitigating other guarantee as contemplated by Section 36.
- It is unclear whether the very largest of banks, those potentially subject to the Advanced Approaches Risk-Weighting NPR, will be able to assess a lower risk weighting to General Account BOLI via application of approved internal models to assign risk weightings to corporate exposures – as no such banks have been approved for the use of internal models on corporate exposures at this time. It is not likely that any such models, if and when approved, would result in an allowable risk weighting of 0% for general account BOLI.
- A number of questions regarding the impact on the risk weighting of BOLI have been received by the OCC and, although not a top priority currently, there may be clarifying guidance and/or communication on the topic forthcoming.
- It is important to note that the responses we received from the OCC, described above, represent staff level opinion and do not represent an official position of the OCC. Only the agencies can provide an official position on this issue.

IV. OVERALL IMPACT OF BASEL III ON COMMUNITY BANKS

The new proposals will **narrow** the elements that can be considered capital; require the maintenance of **higher** capital ratios; and establish **higher** risk-weighted asset requirements.

The measured impact to any particular bank will depend on the composition of each entity's balance sheet, as the various deductions and adjustments to common equity will impact the numerator of the capital ratio while the revised risk-weighting requirements will affect the denominator.

Banking trade organizations like the American Bankers Association and Independent Community Bankers Association as well as many community bankers have expressed very strongly in Washington their concerns that these new and complicated capital requirements will pose an excessive financial and administrative burden on community banks. Many community banks feel very strongly that the community bank sector was not the cause of the recent financial crisis, but yet is paying a heavy price for it in terms of additional regulations.

In analyzing the impact of the new proposals, the ABA has pointed out that more pressure will be placed on a bank's profitability; weaker banks may find it harder to raise capital; there will be reduced lending capacity; banks will need to raise additional capital; and, even for well-capitalized banks, the new rules will change the mix in assets. The ICBA has expressed concern that the proposals redefine the components of core regulatory capital; that risk weights for residential mortgages will deplete capital levels; and that complex rules regarding mortgage disclosures will take time to review.

Some have stated that the new rules would require banks to hold more capital at the same time they are subject to more stringent risk weightings. The higher risk weightings would affect pre-sold construction loans, mortgages (higher loan-to-values), and past-due loans. The changes in the new rules related to residential mortgages are a special concern to many bankers.

Although the new rules will be implemented in phases with full implementation not due until 2019, there seems little doubt these proposals, if adopted as drafted, will create significant administrative burdens and, for many banks, very heavy financial burdens to comply with the new requirements as well.

V. COMMENT PERIOD

The FDIC and OCC have been holding informational meetings and webinars for the past few months to inform bankers about the new proposals and have asked the banking industry and the public to comment on the proposals.

Originally, the Agencies asked for comments to be submitted to the OCC by September 7, 2012. However, due to the complexity of the new proposals and the impact these proposals could have on community banks, particularly the regulations affecting capital, Federal banking regulators announced on August 8, 2012 that they would extend the comment period on Basel III until October 22, 2012.

Sources: Federal Register; Office of the Comptroller of the Currency; Federal Deposit Insurance Corporation; American Bankers Association; Independent Community Bankers Association; Board of Directors of the Federal Reserve System; Morrison & Foerster LLP; Sandler O'Neill; Wachtell, Lipton, Rosen & Katz

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