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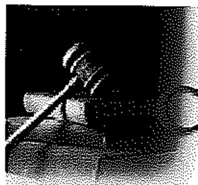
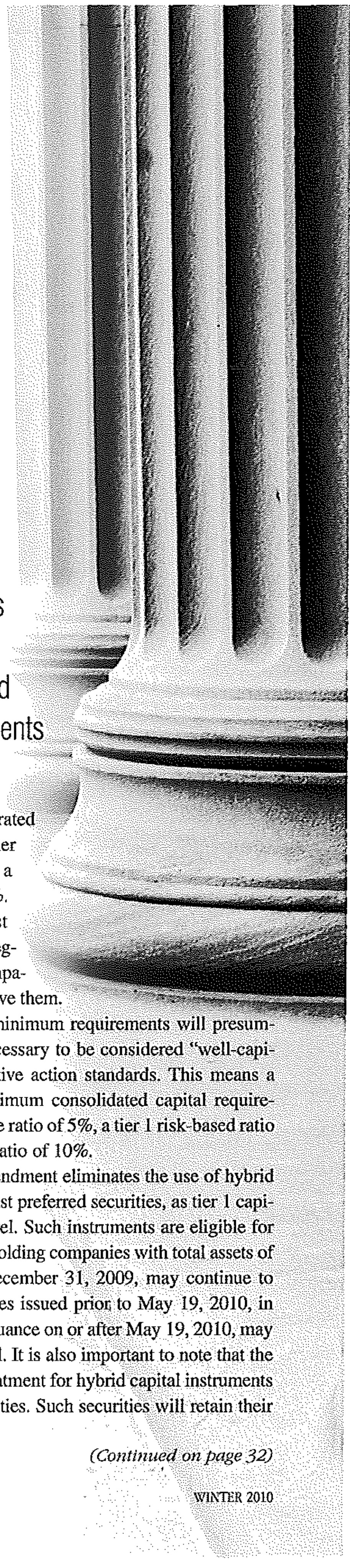


Dodd-Frank & Basel III:

How Do They Impact Capital at Your Bank

By Michael D. Waters and Rob Carothers



Perhaps the most discussed and provocative topic that arises in the community bank arena is capital. Recently, there have been two key developments that will have an impact on regulatory capital requirements for community banks: (1) the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act, and (2) the release of the proposed Basel III capital standards. This article discusses each of these developments and offers commentary on the potential impact on your bank.

Dodd-Frank

The Dodd-Frank Act was signed by President Obama on July 21, 2010. This Act, which represents the most extensive financial reform since The Great Depression, is more than 2300 pages in length and requires more than 200 regulatory initiatives before it will be fully implemented. The provision of the Act that has the most significant impact on capital is the Collins Amendment (Section 171 of the Act).

Before getting into the details of the Collins Amendment, it is important to point out that the Collins Amendment does not apply to bank holding companies that are subject to the Federal Reserve's Small Bank Holding Company Policy Statement. This means it does not apply to bank holding companies with total assets of less than $500 million that (i) are not engaged in significant non-banking activities, (ii) do not conduct significant off-balance sheet activities, and (iii) do not have a material amount of debt or equity securities registered with the SEC.

Now, for those bank holding companies that are subject to the Collins Amendment, the Dodd-Frank Act imposes important changes for Alabama's banks. First, it calls for the Federal Reserve to apply to bank holding companies the same minimum leverage and risk-based capital standards that apply to banks under the Federal Deposit Insurance Act's prompt corrective action standards. Prior to Dodd-Frank, bank holding companies (with $500 million or more in total assets) were subject to a minimum leverage ratio of 4% (3% for the highest-rated bank holding companies), a tier 1 risk-based ratio of 4% and a total risk-based ratio of 8%. These, of course, were just minimum requirements and regulators expected holding companies to maintain a cushion above them.

Under Dodd-Frank, these minimum requirements will presumably increase to the levels necessary to be considered "well-capitalized" under prompt corrective action standards. This means a bank holding company's minimum consolidated capital requirements will consist of a leverage ratio of 5%, a tier 1 risk-based ratio of 6%, and a total risk-based ratio of 10%.

In addition, the Collins Amendment eliminates the use of hybrid capital instruments, such as trust preferred securities, as tier 1 capital at the holding company level. Such instruments are eligible for tier 2 capital treatment. Bank holding companies with total assets of less than $15 billion as of December 31, 2009, may continue to include trust preferred securities issued prior to May 19, 2010, in tier 1 capital. However, any issuance on or after May 19, 2010, may not be included in tier 1 capital. It is also important to note that the elimination of tier 1 capital treatment for hybrid capital instruments does not apply to TARP securities. Such securities will retain their tier 1 capital treatment.

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A separate provision of Dodd-Frank that is applicable to all banks directs the banking agencies to make capital requirements countercyclical so that the amount of capital required to be maintained increases in times of economic expansion and decreases in times of economic contraction.

Basel III

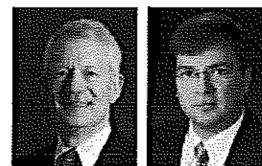
The Basel Committee on Banking Supervision announced on September 12, 2010, that it had reached agreement on new capital standards. These new standards will increase minimum regulatory capital requirements and place an important emphasis on common equity. U.S. Federal banking regulators are expected to apply the new Basel III standards to all banks. The following highlights the more important provisions of Basel III:

- The tier 1 common equity ratio (tier 1 common equity to total risk-weighted assets) will be increased from a minimum of 2% to 4.5%. The increase will be phased in beginning January 1, 2013.
- Basel III imposes a new "capital conservation buffer" that is meant to increase a bank's ability to withstand losses during financial downturns. Under this requirement, banks must maintain an additional 2.5% ratio of common equity to total risk-weighted assets. This will result in banks having to maintain common equity equal to at least 7% of their risk-weighted assets (4.5% common equity ratio plus the 2.5% capital conservation buffer). The new capital conservation buffer will be phased in between January 1, 2016, and January 1, 2019. Failure to satisfy the capital conservation buffer will result in restrictions on dividends and other earnings distributions.
- The minimum tier 1 risk-based capital ratio (tier 1 capital to total risk-weighted assets) will increase from 4% to 6% and will be phased in beginning January 1, 2013. How U.S. regulators may alter the definition of "adequately capitalized" and "well capitalized" for prompt corrective action purposes, if at all, remains unclear. It seems likely that the tier 1 risk-based capital ratio could increase from 4% to 6% for the "adequately capitalized" category, which likely means a higher ratio for the "well capitalized" category would also be imposed. The capital conservation buffer would be added on to the minimum tier 1 risk-based capital ratio resulting in a minimum ratio of 8.5%; however the capital conservation buffer is not expected to affect the PCA definitions.
- Basel III also introduces a "countercyclical buffer" that could require banks to hold up to an additional 2.5% of common equity. This requirement is expected to be imposed under rare circumstances, perhaps only occurring once every 10-20 years. This additional buffer will be imposed during periods of excessive credit growth that results in a system-wide build-up of risk.
- Basel III does not alter the minimum total risk-based capital ratio (sum of tier 1 and tier 2 capital to risk-weighted assets), which remains at 8%. However, with the addition of the capital conservation buffer, the minimum total risk-based capital ratio will increase to 10.5%.
- Basel III will also phase in a 3% minimum leverage ratio between 2013 and 2017. This is the first time Basel has included a minimum leverage ratio (although U.S. regulators already impose a minimum leverage ratio).
- At this point, it is unclear how Basel III and the capital provisions of Dodd-Frank will interact.

What does all of this mean for Alabama community banks?

We have the following thoughts with respect to the impact Dodd-Frank and Basel III will have on Alabama community banks:

- For bank holding companies with less than $500 million in total assets, Dodd-Frank will have less of a direct impact with respect to capital since the provisions of the Collins Amendment do not apply.
- For bank holding companies with $500 million or more in total assets, the most significant impact of Dodd-Frank will be the inability to issue new trust preferred securities and receive tier 1 capital treatment. As a result, bank holding companies will require more common equity raises, which are more dilutive to existing shareholders and more difficult in the current economic climate. These holding companies will also be subject to higher minimum consolidated capital requirements, however, most should already be operating above these minimums.
- For community banks of all sizes, Basel III will increase minimum regulatory capital ratios; however, most community banks should already be operating above the increased minimum requirements.
- Maybe most importantly, Basel III and Dodd-Frank indicate a trend towards a regulatory expectation of higher capital requirements regardless of a bank's financial condition and the strength of the economy. Therefore, it can be expected that going forward regulators will require higher capital ratios than banks are used to seeing, even after things get back to normal. Evidence of this can be seen in today's enforcement actions. In 2004, the FDIC and Alabama State Banking Department issued enforcement actions requiring a tier 1 leverage ratio of 7%. Lately, almost every order requires a tier 1 leverage ratio of 9% and a total risk-based capital ratio of 12%. If, or when, the economy improves these higher capital standards will likely remain in place. Thus, banks which seek to expand into new areas, make acquisitions, open new branches and undertake other activities will be required to insure first that they have plenty of capital.



Michael D. Waters Rob Carothers

Mike Waters is a partner in Jones Walker's Birmingham office. His practice focuses on securities and regulatory matters for financial institutions. Rob Carothers is a partner in Jones Walker's Mobile office. His practice focuses on regulatory matters for financial institutions.