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# Blindsided by Basel III

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In the fall of 2010, the Basel Committee on Banking Supervision introduced the Basel III international capital standards. These measures were aimed at improving risk management so that, ultimately, the bank industry could better withstand future economic crises. When these reforms were first established it was generally thought that they would apply to international "too-big-to-fail" banks or "systemically important financial institutions." It is doubtful community banks expected to be totally exempt or immune from the new standards, since most regulations trickle downstream, despite original intent. However, when the federal bank regulatory agencies rubber stamped approval of the international version for U.S. institutions in June, the industry appeared to be caught flat-footed as to the all-inclusive nature of the proposal. The weight and complexity of these reforms, coupled with current and other proposed new regulations, poses a real threat to the community banking industry.

M Benefit Solutions - Bank Strategies provides Executive benefits consulting and assists community banks in investing in bank-owned life insurance ("BOLI") as a financing or cost-recovery vehicle for employee benefits. This article examines new banking regulations in two ways: how the regulations will impact the community bank marketplace in general (a macro view) and how the regulations will impact the products and services to banks (a micro view).

From a macro point of view, the federal bank regulatory agencies proposals create new capital standards with underlying changes in how regulatory capital is calculated as well as significant changes to asset risk weights, particularly residential loans. These proposals would most likely impede lending and, due to the implementation timeline, hinder smaller banks ability to raise new capital, when necessary. Imposing complex rules and regulations originally intended for the largest international banks on small, traditional community banks makes little sense. The overall outcome, if these standards are implemented, could very well be massive bank consolidation as many smaller, private banks will be forced into distressed sales or assisted mergers due to an inability to raise capital quickly.

From a micro point of view, one area stands out—the inclusion of accumulated other comprehensive income (AOCI) in regulatory capital. Currently, unrealized gains and losses from available-for-sale (AFS) securities, which fall under AOCI, are excluded in the calculation of regulatory capital. This change adds extra volatility and will totally alter the investment strategies of banks. This could positively impact capital in some instances; however, given the

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current rate environment and the inevitable rise in interest rates, this could have a devastating effect. The rule will discourage holding long-term debt and push banks towards holding shorter durations or many may just move assets from AFS into the held-to-maturity (HTM) securities category. This could potentially weaken the market for typical bank held securities such as municipal bonds and agency mortgage-backed securities.

Bank-Owned Life Insurance (BOLI) can potentially be a partial solution to this problem. A bank worried about the capital risk of their securities portfolio could move these funds into the tax favorable environment of BOLI, which has always been accounted for as an "other asset." The bank could choose to invest in the general account of the life insurer or potentially fulfill their investment mandate by diversifying their funds in underlying sub-accounts of certain types of BOLI products. While BOLI is not a complete solution to the volatility and other issues that will emerge if unrealized gains/losses from AFS securities flow through regulatory capital, BOLI could provide a useful option for banks.

When federal regulators presented these proposed regulations, it does not appear they anticipated the extent of the opposition. Regulators minimized the impact pointing to the fact that most U.S. banks already met or exceeded the ratio thresholds. However, this underestimated the massive cost and complexity that these standards will impose on community banks, not to mention the myriad of unintended adverse consequences. While the regulators had two years to review these proposals prior to implementing, the banking industry has a few months to state their case and banks and trade organizations are actively pointing out the flaws in the current proposals.

To provide comments on these regulations you can find resources at:

http://www.icba.org/advocacy/index.cfm?ItemNumber=130925

http://www.fdic.gov/regulations/capital/rulemaking.html

http://www.occ.treas.gov/news-issuances/bulletins/2012/bulletin-2012-24.html

http://www.federalreserve.gov/newsevents/press/bcreg/20120607a.htm

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