The Changing Capital Landscape for Community Banks

Sweeping Capital Regulations Proposed

Federal bank regulatory agencies recently jointly proposed sweeping new capital regulations that would, if adopted as proposed:

- Increase minimum bank regulatory capital ratios and require that unrealized gains and losses on all debt securities (including cash flow hedges) flow through to regulatory capital.

- Introduce a new common equity tier 1 capital minimum ratio and require that banks maintain a "capital conservation buffer." If a bank fails to hold enough capital to maintain the buffer at minimum levels, then the regulations would impose restrictions on bank dividends and executive bonuses.

- Increase the complexity of how regulatory capital is calculated, requiring a series of complex deductions and adjustments.

- Change how bank assets are risk-weighted, with many significant changes being proposed to the risk-weighting of real estate loans and new increases to risk-weights for loans that are 90 days or more past due or on nonaccrual (but excluding past due or nonaccrual loans to the U.S. government or 1-4 family loans). These changes in risk weighted assets also affect the risk-based capital ratios because once the value of a banking organization's total risk weighted assets is determined, that number is used as the denominator to calculate the banking organization's risk-based capital ratios.

These sweeping new regulations, if adopted in the form proposed, would apply to all federally-insured depository institutions, all savings and loan holding companies no matter what their size and all bank holding companies (other than bank holding companies with less than $500 million in assets, although the regulations would still apply to their subsidiary banks). Banks and their directors would be well advised to evaluate the proposed changes and calculate pro forma risk-based capital ratios "as if in effect today" to determine how the increasing capital ratios will impact their institution and to begin considering strategies in response.

Practical Considerations

Some of the practical considerations in the details of the new capital regimen particularly relate to external factors that are outside the control of management.

- In light of the fluctuations that may occur in the amount of capital available as a result of the flow through of unrealized gains and losses to regulatory capital, banks seeking to maintain compliance with all capital requirements will, as a practical matter, need to maintain a "cushion" on top of the capital conservation buffer to ensure they maintain high enough levels of capital despite these fluctuations to comply with the buffer and avoid the restrictions on dividends and executive bonuses that might otherwise be triggered.

- As a result of changes in risk-weighting that can occur when an otherwise well-underwritten loan (such as a commercial real estate loan or a loan on multifamily property) goes delinquent, the denominator of the capital ratio calculation (as well as the pricing of loan products and the level of ALLL) can significantly increase, which could materially affect the bank's capital requirements, including calculation of the capital conservation buffer. The practical consequence is that a bank may be wise to maintain capital at well above the projected ratios across all capital categories.

- Notwithstanding the increases in the risk-based capital ratios as proposed under the new rules, we would expect that if the proposals are adopted the regulatory agencies would still require that banks maintain capital in excess of the minimum ratios from a safety and soundness perspective. In the proposed rules, the banking regulatory agencies state that the risk-based capital ratios do not explicitly take account of the quality of individual asset portfolios or the range of other types of risks to which banking organizations may be exposed, such as interest rate, liquidity, market, or operational risks. A supervisory assessment of capital adequacy must take account of these internal processes, the risks and other factors that can affect a banking organization's financial condition. In the proposals, the regulators state that in light of these considerations, as a prudential matter, a banking organization is generally expected to operate with capital positions well above the minimum risk-based ratios and to hold capital commensurate with the level and nature of the risks to which it is exposed.

Raising Additional Capital

Community banks that maintain capital near current regulatory minimum thresholds would need to strategically plan to comply with the proposed regulatory capital increases. For community banks that already maintain high levels of capital, the proposed capital regulations may be treated as simply codifying standards these banks already maintain, although these banks may feel the need to raise additional capital to maintain a capital cushion as the minimum thresholds rise.

In light of these new regulatory changes, we expect an increase in capital-raising activities by banks over the next several years.

- Banks should be proactive in reviewing their capital levels and cushions in order to determine whether a capital raise in the near term would be prudent rather than waiting for final implementation of the rules.

- Recent disclosures by some banks of the pro forma impact of the new capital rules have put downward pressure on their stock. We expect to see a similar effect for many institutions on a going-forward basis.

- With so many community banks now being so well capitalized, if not significantly overcapitalized, some industry associations are suggesting a safe harbor as a proposed exemption from the proposals that would relieve many community banks from yet further new operational and compliance regulations that distract them from lending.

Banks Affected by the Regulations

These new rules would apply to all insured depository institutions, all savings and loan holding companies and all bank holding companies (other than small bank holding companies with $500 million or less in total assets, although the rules would apply to the subsidiary banks of these small holding companies). Additionally, certain aspects of the proposed new regulations, not addressed here, apply to thrift, savings and loan holding companies and large complex banking organizations.

International Basel Committee Lays Groundwork for New Rules

The proposed rules are detailed in a series of notices of proposed rulemaking (the "NPRs") by the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Board of Governors of the Federal Reserve System (collectively, the "agencies"). The groundwork for the new rules is embedded in the Basel II and Basel III Accords, which were issued by the Basel Committee on Banking Supervision in 2004 and 2010, respectively, and were intended to provide regulatory guidance for large and complex international banks about uniform and best practices for liquidity risk and capital measurements.

As the NPRs are consistent with the Basel II and Basel III Accords, the NPRs greatly expand the pool of subject financial institutions that were originally targeted by those Accords. This trickle-down effect in regulatory oversight appears to be a new trend, with large complex banking organizations acting as the testing ground for regulations that are then applied to more and more subsets of institutions within the financial system.

Capital Rules

In one of the NPRs implementing Basel III capital measures (the "Basel NPR"), the agencies propose to modify various regulatory capital ratios applicable to most banking organizations, introducing a new Common Equity Tier 1 capital ratio of 4.5%, increasing the Tier 1 capital ratio from 4% to 6%, and maintaining the total capital ratio at 8%. Key features of the Basel NPR include adjustments to the manner in which banks calculate capital, the phase-out of certain nonqualifying capital instruments, including trust preferred securities and restrictions on capital distributions and executive bonus compensation if capital falls below certain levels.

To allow banks to adjust to the new required framework, these capital requirements would be implemented in stages over a seven-year period beginning in 2013, with full phase-in by 2019. The NPR implementing risk-based capital requirements (the "Risk-Weight NPR") will not be phased in but would become effective on January 1, 2015.

Risk-Weight Rules

Under the Risk-Weight NPR the agencies have proposed to revise the risk-weighting of certain asset categories. Significant changes are made to the risk-weighting of real estate loans in reaction to the unprecedented levels of mortgage loan defaults and home foreclosures during the financial crisis. The current rules risk weight real estate loans at 50% to 100%, but the Risk-Weight NPR introduces risk-weights ranging from 35% to 200% for both residential and commercial real estate loans. For commercial real estate loans the actual risk-weight assigned would depend on the terms of the loan. For 1-4 family loans, the risk-weight assigned would depend on various terms, including the loan-to-value ratio of the loan at the time of origination. These proposed changes are intended to enhance the risk sensitivity to risk-based capital ratios for financial institutions.

Additionally, if a loan is 90 days or more past due, the current rules generally do not require a change in the assigned risk-weight. The proposed new rules require that the unguaranteed or unsecured portion of loans that are 90 days or more past due or on nonaccrual (other than loans to the U.S. government or 1-4 family loans) would require a 150% risk-weight. For 1-4 family loans, if the loan-to-value ratio is not updated at the time of a modification or restructure, then the loan would be assigned a risk weight of 100% or 200%, depending on the category of the loan. However, if the loan-to-value ratio is updated at the time of the modification or restructure, then the loan would be eligible for risk weights ranging from 35% to 200%.