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Small Banks Brace for Basel III Implementation

By Jackie Stewart

Community banks seem well-prepared for Basel III, but they aren't happy about the efforts required to get there.

Basel III will be phased in for smaller banks starting in January. While most of those institutions are ready to meet the new capital standards, some uncertainty remains over the ultimate impact of those requirements. Banks will likely endure rising regulatory costs, and industry observers said Basel-related pressure could help push some to sell.

"Since the proposal of Basel III, it has become a daily discussion point for us," said John Buhrmaster, president and chief executive of First National Bank of Scotia in New York and chairman of the Independent Community Bankers of America. "It has been difficult to sort through."

Among banks with less than $15 billion in assets, fewer than 200 would currently fail to meet Basel III standards under a conservative scenario, according to SNL Financial. That would equate to 3% of the roughly 6,600 banks of that size, based on data from the Federal Deposit Insurance Corp. (SNL's capital cutoffs included 10.5% total risk-based capital, 8.5% Tier 1 capital, and a 5% leverage ratio.)

Such a relatively small number of noncompliant banks "systematically is not a significant problem," said Shaheen Dil, managing director of risk and compliance at Protiviti.

Regulators noted in recent testimony before the Senate committee on banking, housing and urban affairs that they tried to be fair by implementing regulation that took into account the business models and resources of community banks. Overall, regulators were "doing what they could to lighten the burden" on smaller institutions, said William Shirley, a lawyer at Sidley Austin.

Many bankers still believe that it was unfair to apply Basel III standards to smaller institutions, even if those banks were largely ready for the new requirements. Having enough capital has remained a concern for many bankers.

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"The problem is the amount of capital required by Basel III, including the capital conservation buffer," said James Kaplan, a partner at Quarles & Brady. "That means the total amount of capital banks are expected to hold, including community banks, is significantly greater. So for that reason this is still a concern."

Many bankers find it particularly difficult to raise common equity, said Evan Tomaskovic, a partner at Carl Marks Advisory Group. Smaller banks often struggle to attract investors because "the rules are reducing potential returns to shareholders," and there are potential restrictions on paying dividends if a bank's capital falls below the conservation buffer, he said.

"Profits will be depressed still going forward," Tomaskovic said. "It will be harder and harder to access the common equity these guys need."

The $421 million-asset First National Bank, a unit of Glenville Bank Holding, has been growing rapidly. Though this would normally be cause for celebration, the bank's management has been keeping a close eye on its balance sheet, Buhrmaster said. Executives were concerned about its assets outpacing capital levels.

"It's a vicious cycle," Buhrmaster said. "The more growth we have the tighter we get on capital."

Others remained concerned about different aspects of Basel III, including the treatment of mortgage-servicing assets, said Chris Cole, senior regulatory counsel at the ICBA. Previously, banks could count such assets as capital, but that will be limited under Basel III.

Management at First State Bank in Barboursville, W. Va., is considering a corporate restructuring so it can continue its mortgage-servicing business despite the Basel III changes, said President and Chief Executive Sam Vallandingham. Still, this change would create additional costs and make the bank less efficient.

The $253 million-asset bank, a unit of First Bankshares, is also an S Corporation, meaning shareholders usually count on dividends to pay taxes on the company's earnings. If the bank were to fall below the common equity Tier 1 capital ratio of 4.5% plus the capital conservation buffer of 2.5% then it could have its ability to pay dividends diminished.

"First State operates in West Virginia so we shouldn't be subjected to international regulations," Vallandingham said. "It is impacting us. We're spending unnecessary dollars. We have a large servicing portfolio so that impacts our capital, and that is pretty scary."

Many banks have seen costs rise after hiring outside experts to help them prepare for Basel III, industry observers said. Basel III has also put a strain on bank employees who have taken on added responsibilities, Dil said.

These factors could prompt increased consolidation, industry experts said. Some management teams may decide that they can get a better premium by selling, rather than raising more capital, said Craig Miller, co-chair of the financial services and banking practice at Manatt, Phelps & Phillips. It is much harder for community banks to earn a healthy profit compared to a decade earlier, as margins remain tight and competition for the best loans is fierce.

Basel III will not force M&A on its own, but "it is one of many components that will lead to the long awaited increase in consolidation," Miller said.