

“What’s Basel *Got to Do with* Me?”

A Community Bank Perspective

Basel II’s emphasis on more risk-sensitive measures has been echoed by U.S. banking regulators, and that emphasis will change how community banks go about their business.

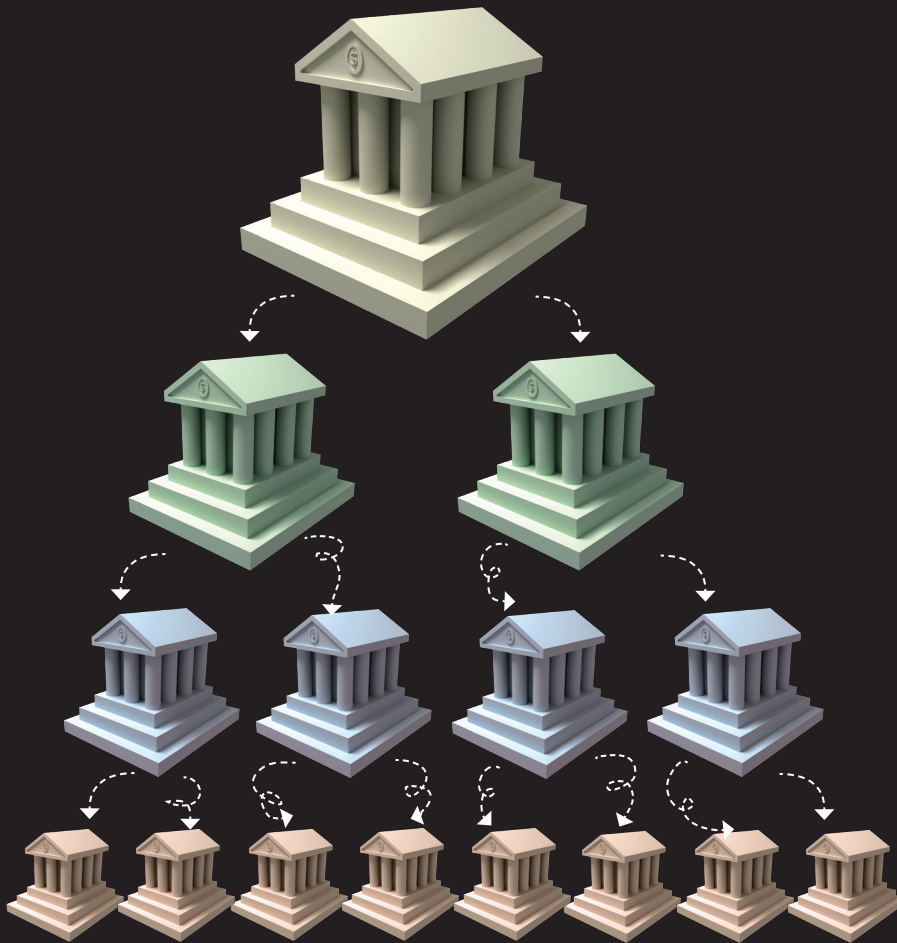
BY JEREMY D. TAYLOR

WHAT DOES BASEL have to do with you if you’re a community banker? Today, not a lot. Basel II, the successor to the 1988 Basel Accord, is aimed at the largest and most international of banks. Only a dozen or so U.S. institutions (those with more than \$250 billion in total assets and/or \$10 billion in foreign assets) will be required to comply, and only a handful more are expected to opt in.

That’s a very small fraction of the nearly 8,000 commercial banks in this country. Most banks choose to operate well above current regulatory minimum-capital levels; FDIC data shows total risk-based capital (at March 31, 2008) averaging 19.9% for banks with fewer than \$100 million in assets, falling to 11.9% for those with greater than \$10 billion. Compare 19.9% with the 8% regulatory minimum (or 10% to be “well capitalized”). Smaller banks need additional capital to cover start-up losses,

more volatile earnings, lower diversification in their loan book, and more limited options for funding growth. Given these realities, incentives to lower minimum required capital don’t mean so much—especially given the costs of full Basel II compliance.

From a broader and longer-term perspective, however, Basel can’t be ignored. Most fundamentally, it is where the industry is heading. Basel II’s emphasis on more risk-sensitive measures represents a continuation of a trend that becomes clearer with every new pronouncement from U.S. banking regulators. What they’re expecting of larger institutions today will percolate down to smaller players over time. Improved collection of internal loss data, more sophisticated measurement tools, more active risk management practices, greater organizational prominence to the risk management function—all are in their infancy in the



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community bank arena, but expect more. As examiners come to look for more, so will investors and directors.

More imminently, efforts continue in the U.S. to bridge the gap between the status quo, Basel I, and the brave new world of Basel II. Basel IA was floated, then recently (June 20, 2008) supplanted by a proposal to allow small and midsized U.S. institutions to use Basel II's standardized approaches rather than the advanced approaches required of large banks (see <http://www.fdic.gov/news/news/press/2008/pr08050a.pdf>). The most notable features would be 1) to add more risk buckets to the current four, and 2) to give more recognition to credit risk mitigants like collateral and guarantees. Residential mortgages could be differentiated according to loan-to-value ratios. But the proposal also would introduce an explicit capital charge for operational risk, using Basel II's Basic Indicator

Approach (which calculates capital as a multiple of three-year average gross income).

Again, the impact of this proposal on small-bank capital management won't be significant in the short term, and not just because it's intended to be optional. (The proposal has been approved recently by the FDIC, OCC, OTS, and Federal Reserve. It is open for comment through October, and regulators aim to issue a final rule by mid-2009.) In fact, the increased granularity on the credit side may not mean much at all to community banks, given that buckets are defined according to agency ratings; most small-bank portfolios have few rated borrowers.

This U.S. attempt to build a bridge from Basel I to Basel II for institutions that have not needed to pay attention to Basel until now reinforces the trend of rising expectations for risk management. Look down the road, for instance,

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and you'll see Basel II's Internal Ratings Based approach, which requires a two-part risk-grading system, with separate ratings for borrower (default risk) and facility (loss given default).

Very few community banks have done much in this regard. Meanwhile, the Advanced Measurement Approach to operational risk requires collection and analysis of internal operating loss data, another example of best practices that all banks will be expected to migrate toward as time goes by. Asset/liability management and liquidity risk are both Pillar 2 issues, meaning they're governed by supervisory review rather than by (Pillar 1) minimum capital requirements. But Basel documentation provides quite detailed guidance on best practices in these areas to assist supervisors as well as bankers.

Much has been made in recent years of the competitive implications of allowing large banks to shave their required capital by adopting Basel II's more sophisticated approaches, but this concern can be overblown. Smaller banks will always need higher capital ratios than their larger competitors for the kind of reasons indicated above. Further, the (non-risk-adjusted) leverage ratio is expected to remain in the regulators' arsenal, providing a floor to capital requirements. And at least some of the benefit of lower capital costs will be dissipated by the up-front investment and ongoing costs to comply with Basel II's advanced approaches.

Some advice for community bankers: Focus instead on what Basel II means for the practice of risk management. To the extent that Basel II methodologies (even if just the standardized variety) can enhance understanding of risk across the bank, they represent an important step forward. They also are a competitive differentiator from your local-market peers. Managing your credit, market, and operational risks in a more disciplined and, yes, quantitative manner can pay off in lots of ways—stronger and more stable margins, lower losses over time, more focused marketing, enhanced market reputation, and so on.

Take a look at the recent interagency proposal mentioned earlier, even if not all of its 323 pages are relevant to your business. Start thinking about its recommendations and implications now before competitors, and examiners, force them on you. ❖



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