

EQUIAS INSIGHTS

IMPACT OF THE BASEL III NEW CAPITAL RULE ON COMMUNITY BANKS



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About Equias Alliance

Equias Alliance helps banks achieve their key financial goals, manage benefit liabilities and enhance shareholder value through market-leading knowledge, tailored executive benefit plan design, BOLI expertise and administration solutions.

Equias Alliance is a trusted partner to America's banking institutions. Our strategies and practices enable clients to meet key financial goals, manage benefit liabilities and enhance shareholder value. Equias Alliance consultants are known for their market-leading knowledge, use of advanced financial products and solutions, and skillful development of well-administered benefit programs.



INTRODUCTION

During the first two weeks of July 2013, the Federal agencies (OCC, Federal Reserve Board and FDIC) adopted significant changes to the US regulatory capital framework. It is being referred to as the “New Capital Rule” or “new rule”.

The new rule is effective January 1, 2015 for financial institutions with total consolidated assets of less than \$250 billion. Many of the provisions will phase in over a period of years with full implementation required by January 1, 2019. According to the federal agencies, the purpose of the new rule is to improve the quality and increase the quantity of capital for all banking organizations as well as to set higher standards for large, internationally active banking organizations. The new rule is also expected to result in capital requirements that better reflect a banking organization’s risk profile and thereby increasing the overall resilience of the banking system.

BANKS SUBJECT TO NEW RULES

The New Capital Rule will apply to:

- All insured banks and savings associations
- Bank holding companies with more than \$500 million in assets
- Savings and loan holding companies domiciled in the U.S.

The banks impacted are the same institutions identified in the June 2012 proposals.

KEY CHANGES FROM THE JUNE 2012 PROPOSALS

Although the banking industry was not able to obtain an overall exemption from the requirements for community banks, some key changes were made in the final rule.

- Community banks may continue to use the current risk weights for mortgages instead of the more complex and burdensome rules laid out in the June 2012 proposals.
- Financial institutions with consolidated assets of less than \$250 billion are allowed a one-time irrevocable option to permanently exclude accumulated other comprehensive income (AOCI) from inclusion in regulatory capital. Under the June 2012 proposal, AOCI would have been included in the regulatory capital calculations for all banks.

- Trust preferred securities (TruPS) can now be permanently included in Tier 1 capital, if certain conditions are met. Specifically, the TruPS must have been issued prior to May 19, 2010 by a banking organization with less than \$15 billion in assets as of December 31, 2009 or the banking organization must have been in mutual form as of May 19, 2010. Under the June 2012 proposals, TruPS would have been phased out over time.

Many of the provisions, however, in the June 2012 proposals did become part of the final rule.

KEY PROVISIONS OF THE NEW CAPITAL RULE

OVERVIEW

The New Capital Rule:

- 1 Revises the definition of regulatory capital components;
- 2 Adds a new common equity tier 1 risk-based capital level;
- 3 Incorporates the revised capital requirements into the Prompt Corrective Action framework;
- 4 Implements a new capital conservation buffer; and
- 5 Provides a transition period for several aspects of the proposed rule.

Briefly, the new common equity tier 1 to risk-based capital ratio would be 4.5%; the additional tier 1 capital to risk-weighted assets would be 6%; the overall capital ratio would be 8%; the new capital conservation ratio would be 2.5%; and the tier 1 leverage ratio would remain at 4%.

NEW DEFINITION OF CAPITAL

The definition of capital is revised to include common equity tier 1 capital as well as additional tier 1 capital (T1); and tier 2 (T2) capital. Common equity tier 1 (CET1) capital is a new concept. It includes common stock (plus related surplus) and retained earnings plus limited amounts of minority interest in the form of common stock, less the majority of the regulatory deductions and adjustments described below.*

In addition to this added element of CET1, the new rule introduces a new ratio utilizing CET1 and raises other minimum capital ratios as illustrated in the following summary table:

SUMMARY OF CURRENT CAPITAL RATIOS VS. NEW CAPITAL RATIOS

Capital Ratio	Current	New	Capital Conservation Buffer	New Total	Increase
Common Equity Tier 1*	N/A	4.5%	2.5%	7.0%	7.0%
Minimum Tier 1 Capital	4.0%	6.0%	2.5%	8.5%	4.5%
Total Capital Ratio	8.0%	8.0%	2.5%	10.5%	2.5%
Tier 1 Leverage Ratio	4.0%	4.0%	N/A	4.0%	0%

*Deductions will include goodwill and other intangibles, deferred tax assets (DTAS) that arise from net operating loss and tax credit carryforwards (above a certain level), gains -on-sale in connection with a securitization, any defined benefit pension fund net asset (for banking organizations that are not insured depository institutions), investments in a banking organization's own capital instruments, mortgage servicing assets (MSAs), DTAs arising from temporary differences that the banking organization could not realize through net operating loss carrybacks, and certain investments in financial institutions, are each limited to 10% of common equity tier 1 and in combination are limited to 15% of common equity tier 1. For banking organizations that make a one-time, irrevocable AOCI opt-out election, adjustments include the neutralization of unrealized gains and losses on AFS debt securities for regulatory capital purposes.

CAPITAL CONSERVATION BUFFER

Under the new rule, banks must hold a capital conservation buffer composed of common equity tier 1 capital above its minimum risk-based capital requirements in order to avoid limitations on capital distributions, including dividend payments and certain discretionary bonus payments to bank executives.

According to the federal agencies, this buffer will ensure that banking organizations conserve capital when it is most needed, allowing them to better weather periods of economic stress.

A banking organization with a buffer of less than 2.5% would be subject to increasingly stringent limitations as the buffer approaches zero. For example, if the capital conservation buffer as a percentage of risk-weighted assets was less than or equal to 1.875%, but greater than 1.25%, then the maximum payout percentage of eligible retained income, as defined in the rule, would be 40%.

NEW CAPITAL RATIOS PHASE-IN SCHEDULE

As noted above, the new rule provides for the phase-in of certain requirements beginning January 1, 2015, with full implementation required by January 1, 2019. The full phase-in schedule is detailed below:)

	January 1, 2015	January 1, 2016	January 1, 2017	January 1, 2018	January 1, 2019
Minimum Common Equity %	4.5%	4.5%	4.5%	4.5%	4.5%
Capital Conservation Buffer %	—	0.625%	1.25%	1.875%	2.5%
Common Equity with Capital Conservation Buffer %	4.5%	5.125%	5.75%	6.375%	7.0%
Minimum Tier 1 Capital %	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum Tier 1 Capital with Capital Conservation Buffer %	—	6.625%	7.25%	7.875%	8.5%
Minimum Total Capital %	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum Total Capital with Capital Conservation Buffer %	8.0%	8.625%	9.25%	9.875%	10.5%

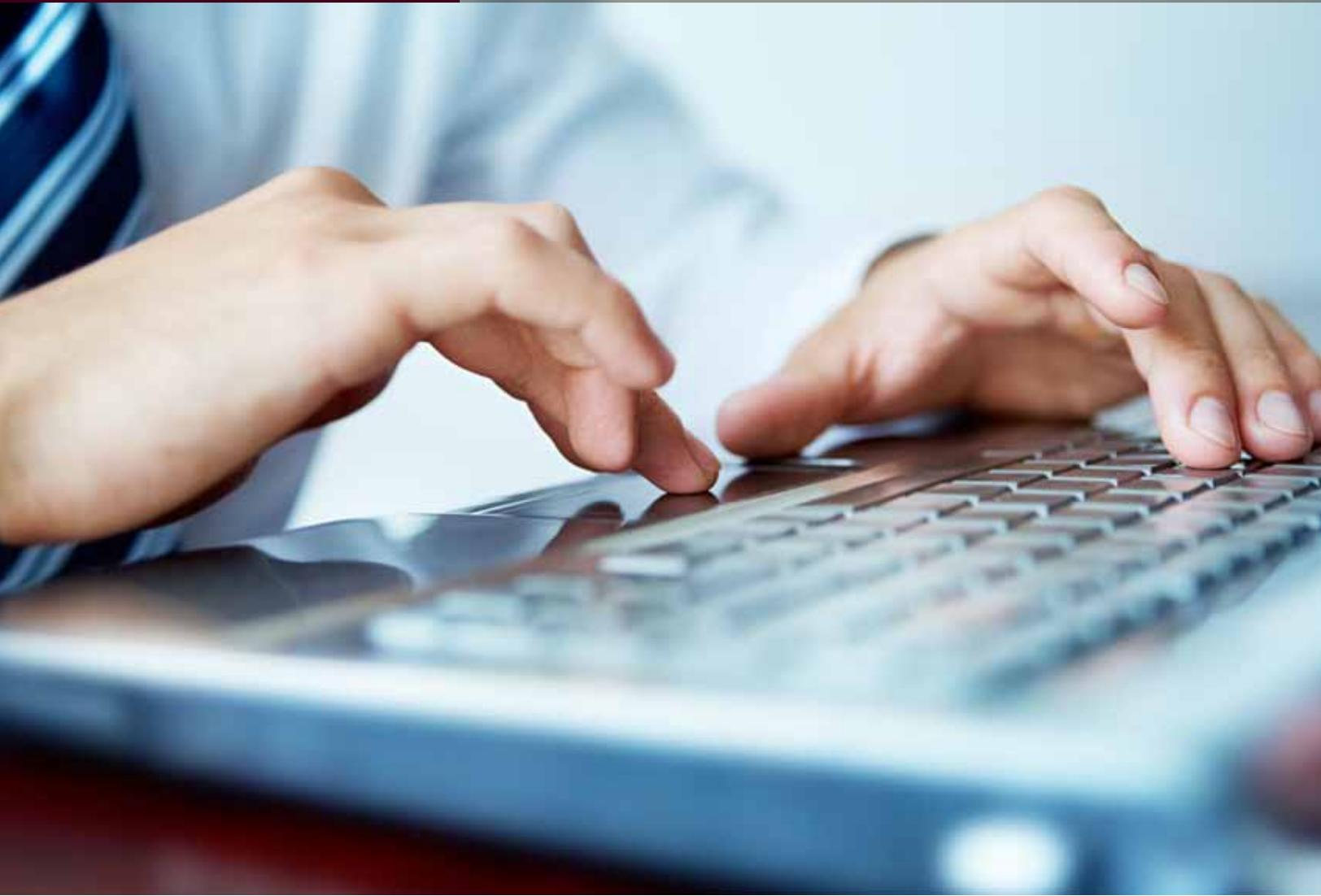
Source: Office of the Comptroller of the Currency (July 2013)

NEW PROMPT CORRECTIVE ACTION REQUIREMENTS (EFFECTIVE 1/1/15)

The changes to the PCA rules are summarized below:

Requirement	Total Risk-Based Capital %	Tier 1 Risk-Based Capital %	Common Equity Tier 1 %	Leverage %
Well Capitalized	≥10%	≥8%	≥6.5%	≥5%
Adequately Capitalized	≥8%	≥6%	≥4.5%	≥4%
Undercapitalized	<8%	<6%	<4.5%	<4%
Significantly Undercapitalized	<6%	<4%	<3%	<3%
Critically Undercapitalized	Tangible equity to total assets ≤2.0%			

Source: Office of the Comptroller of the Currency (July 2013)



NEW ASSET RISK WEIGHT REQUIREMENTS (EFFECTIVE 1/1/15)

The new rule increases the risk-weights for past due loans, certain commercial real estate loans, and some equity exposures. More specifically:

- Claims on qualifying securities firms are now 100%.
- Certain high volatility commercial real estate (HVCRE) exposures are now 150%
- Past due exposures are now 150% for the portion that is not secured
- For mortgage-backed securities, asset-backed securities and structured securities, there are two general approaches: 1) the gross-up approach and 2) the simple supervisory formula approach which has a new default percentage of 1,250% with respect to private label securities.
- Equity exposures will now range from 0 to 600% depending on the entity and whether the entity is publicly traded

Other key risk-weightings have remained unchanged:

- Conditional and unconditional claims on the US government
- Claims on US public sector entities
- Industrial development bonds
- One to four family loans
- Cash

Although there have been some changes, the banking industry overall has been particularly pleased that no change was made in one to four family loans.

IMPACT OF THE NEW CAPITAL RULE ON BANK-OWNED LIFE INSURANCE (BOLI)

As a national firm that provides BOLI consulting and administrative services for over 800 banking organizations, the effect of BASEL III on BOLI in community banks was of special interest to Equias Alliance. We have summarized our understanding of how the New Capital Rule impacts BOLI below.

Under the new rule, General Account BOLI will continue to be risk-weighted at 100% as General Account BOLI will continue to be treated as a corporate exposure.

In the past, Hybrid Separate Account BOLI followed the guidelines set out under OCC 2004-56 which allowed a bank to utilize a full look-through approach to determine the risk weighting for its Hybrid Separate Account BOLI. This approach allowed banks to apply the risk weightings of the underlying assets in the separate account, which typically ranged from 20% - 100%. Under the BASEL III New Capital Rule, in order to qualify as a separate account, and therefore be eligible for look-through treatment, one of the requirements is that investment performance, net of contract fees and assessments, must be passed through directly to the policy owner. In the case of Hybrid Separate Account BOLI, because some carriers assess a default charge and assume the investment risk themselves rather than pass through the actual investment losses, under the new rule, there is now a question as to whether such carriers' Hybrid Separate Account portfolios will continue to qualify as a "separate account" and, thus, be eligible for the full look-through process. If they are not considered "separate accounts" for risk weighting purposes under the new rule, some suggest they would then be considered "general account" and have a risk-weighting of 100%, regardless of the actual risk weightings for the underlying investments.



If, on the other hand, the Hybrid Separate Account meets the definition of "separate account" for risk weighting purposes, then the bank can continue to utilize the full look-through approach to each investment in the portfolio to determine the risk-weighting of the overall portfolio. However, since the Dodd Frank Act and the new rule do not allow banks to rely solely on the credit rating assigned to an exposure by a major rating agency, a bank will need to do its own internal research or obtain help from a third party regarding the risk-weighting of an asset. We hope that carriers/fund managers will provide the appropriate risk-weighting information with regard to their portfolios to help banks in their analysis of the portfolios. Assistance from services such as Bloomberg or BlackRock may also be available to help identify the risk-weighting of assets within a portfolio, but the costs may be higher than most community banks will feel comfortable paying.

If for whatever reason the bank cannot, or elects not to, determine the risk-weighting of each investment in the Hybrid Separate Account portfolio, then the bank can use either the simple modified look-through or the alternative modified look-through approach. Under the alternative modified look-through approach, the bank references the portfolio's investment guidelines. We expect that some, or possibly, many carriers will be revising their investment guidelines either to eliminate the possibility of including assets with high risk-weightings or to severely restrict the amount that may be invested in higher risk-weighted assets to allow the carrier to offer an account with a lower (below 100%) overall risk-weighting.

Although most community banks use General Account and/or Hybrid Separate Account BOLI products, there are some community banks that also utilize a Variable Separate Account BOLI product. The full look-through and modified look-through approaches are still available to Variable Separate Account products.

Although the rules are still not clear, it appears that Variable Separate Accounts would be handled in the same fashion as Hybrid Separate Accounts. However, with their more complex investment strategies, there may be additional wrinkles.

We hope that the regulatory agencies will provide some guidance in the next few months of the new risk weighting requirements. In the meantime, we suggest you contact your BOLI advisor if you have concerns.



OVERALL IMPACT OF BASEL III ON COMMUNITY BANKS

Banking trade organizations like the American Bankers Association and Independent Community Bankers Association as well as many community bankers fought very hard to have community banks exempted from the requirements of the New Capital Rule because of the financial and administrative burden it would place on them. Although not successful in this endeavor, the industry can take solace as three key changes were made in the June 2012 proposals relating to 1) the risk-weighting of mortgages ; 2) having the ability to opt-out of AOCI; and 3) having the ability to continue to include trust preferred securities as part of Tier 1 capital, if certain conditions are met.

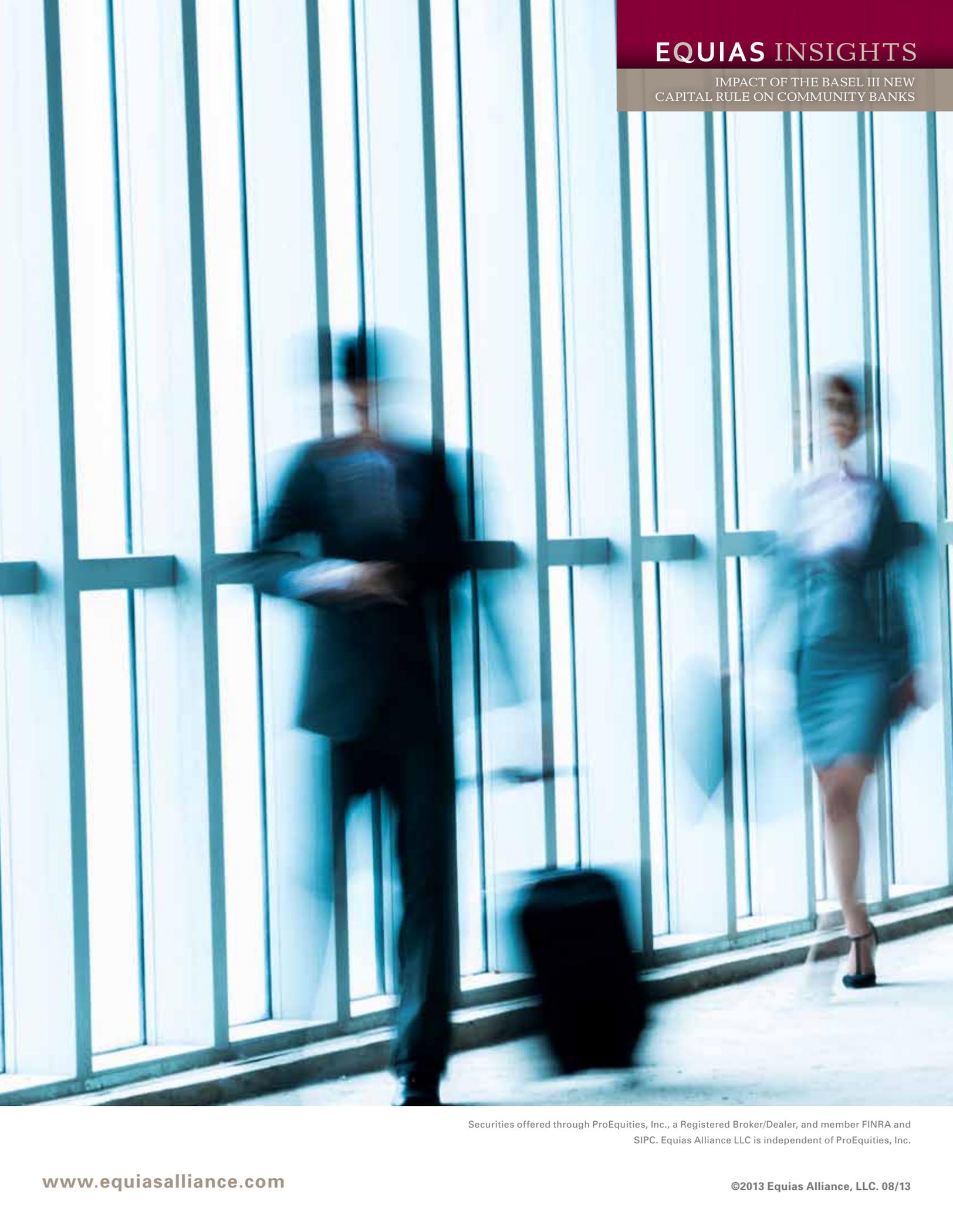
The new rule does impose stricter capital requirements; risk-weighting requirements; and other changes for community banks which will have an adverse impact on some banks. However, since the new rule will not be effective until January 1, 2015, and fully implemented until January 1, 2019, community banks will have some additional time to position themselves for the changes.

The key now for bankers will be analyzing the New Capital Rule to understand more fully precisely how it will impact their own community bank.

Finally, no attempt has been made in this analysis to assess the impact of the new rule on large banks as large banks are subject to somewhat different requirements than community banks.

Sources: Office of the Comptroller of the Currency; Federal Deposit Insurance Corporation; American Bankers Association; Independent Community Bankers Association; Alston & Byrd, LLP; and First Principles Capital Management, LLC.

The information contained in this report has been obtained from third-party sources and is believed to be reliable; however, its accuracy and completeness cannot be guaranteed.

A blurred photograph of two business professionals, a man and a woman, walking in a modern office hallway. The man is in the foreground, wearing a dark suit, and the woman is in the background, wearing a light blue dress. They are walking past large windows with vertical frames. The overall color palette is cool, dominated by blues and greys.

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