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BANKING AND FINANCE

Mississippi bankers brace for change as Basel III's New World Order nears

>> New rules seen making it much more expensive for community banks to lend on mortgages, other loans

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Europe's financial crisis has given U.S. bankers non-stop jitters for more than a year now. Now, a new export from Europe — the Basel III Accords — is keeping bank executives awake at night, especially the heads of America's community banks.

As now framed, Basel III starting in January gradually forces banks of all sizes to greatly increase their levels of regulatory capital and to apply a complex risk weighting system to loans on home mortgages, commercial enterprises and other types of lending. Bankers expect to have to set aside two to three times as much reserve capital on many types of loans than is now required.

The proposals are the work of an international group of bank regulatory experts who made up the Basel Committee on Banking Supervision. As its name implies, Basel III follows two earlier versions of accords going back to 1992. The latest version has received the endorsement of the Group of 20, an organization of industrialized nations, including the United States, that represent 85 percent of the worldwide economy.

When the Group of 20 approved the accords, few expected the rules to apply to any but the largest U.S. banks that were active in international markets, according to the Mississippi Bankers Association.

Basel III 's capital requirements and other provisions have received preliminary nods of approval from the nation's three bank regulatory entities: the Federal Reserve, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency. They would incorporate the provisions into an integrated framework that includes new requirements and regulatory changes contained in the Dodd-Frank banking reform law and the Consumer Financial Protection Bureau that grew out of Dodd-Frank.

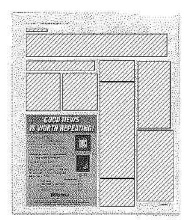
Federal Reserve Chairman Ben Bernanke describes the Basel III provisions as an important element of the framework that addresses shortcomings in regulatory capital requirements so apparent during the recent banking crisis. "With these proposed revisions, banking organizations' capital requirements should better reflect their risk profiles, improving the resilience of the U.S. banking system in times of stress," Bernanke said in announcing the Fed's intention to adopt the rules.

As proposed, banks with assets of $500 million up to $2 trillion must maintain a tier 1 capital ratio of 7 percent, of which 4.5 percent would be derived from risk-weighted assets and the remainder from a common equity tier 1 capital conservation buffer of 2.5 percent of risk-weighed assets.

Community bankers in Mississippi and elsewhere are not overly concerned about the 7 percent capital requirement. Most small banks already keep that level of regulatory capital. The worries lie with the risk weighting and the complexities of the one-size-fits-all regulations, they say.

Here's what they see ahead: Even tighter lending in an already-stingy lending climate and a fierce competition for capital among banks.

In a June *Forbes* magazine report, bank analyst Richard Bove of Rochdale Securities predicted the increased cost of lending and the struggle for reserve capital could drive 2,000 small banks around the



country out of business.

And put the housing rebound on hold, Bove told *Forbes*. The new rules "will increase the cost of borrowing on a home and reduce the number of mortgages being made, hampering a housing recovery."

Ken Cyree, dean of the University of Mississippi College of Business and director of the Mississippi Bankers Association School of Banking, said he expects all but the most conventional mortgage lending could dry up.

"The biggest impact," he said in an email, "will likely be in new risk weights for different types of loans. For example, mortgage loans on low-cost housing that are adjustable or a balloon loan in some proposed scenarios will have twice as much weighting and therefore require twice as much capital."

Many banks will abandon the non-conventional markets, he predicted, "harming the most vulnerable customers that regulation is supposed to protect.

"A good way to think about this is that the owners of the firm have to put in even more money while earning the same amount, thus their return is lowered as they invest more, so they resist adding more capital."

In rural parts of Mississippi, a sizable portion of the home-lending market is in "non-conforming loans" that are held by an individual bank instead of sold on the secondary market. The new risk weighting is going to make this sort of lending much more expensive for community banks, said Mac Deaver, president of the Mississippi Bankers Association.

"Under the new formula, they are going to be considered more risky than before," he said, though he added: "It's not like the banks are losing money on these (non-conforming) loans."

Deducting the cost of the loan from a bank's bottom line could eventually reach a point that "banks just can't do that," Deaver said.

In much of the state what has been the standard "everyday mortgage business" is going to require 200 percent capital reserve, he predicted. "That's just not doable."

BancorpSouth CFO William L. Prater said borrowers will have to be willing to pay more. And if they are unwilling, banks will have to endure the loss of business. "Since banks, like any other business, must obtain a return on invested capital, the cost of these mortgages will go up," he said in an email. "With an effective doubling of the capital requirement, the amount of mortgage loans a bank could lend would also be halved. This would result in less business for banks, and more costly and difficult to obtain loans for consumers."

The top executive at Regions Bank, Grayson Hall, said at the bank's second quarter earnings conference one immediate effect of Basel III will be an end to lowball pricing on bank loans.

"With the Basel III rules coming out... the entire industry is going to have to revisit our pricing models with those capital allocations, and certainly will alter pricing on a number of different lending products."

Ed Wilmesherr, a Butler Snow attorney who specializes in banking compliance, said the kind of bank loans the new regulations are likely to put in vogue hardly fit the profile of the average borrower in the state. "Mississippi's typical borrower may not be the blue-chip borrower many around the country would think of as their typical customer," he said.

Last week, Deaver and about 30 Mississippi banking executives traveled to Washington, D.C., to push for changes in the proposed provisions. Regulators did not indicate what changes they would consider, "but they are certainly willing to consider all the things that we're saying," he said.

Deaver expects Mississippi bankers will have plenty to say during a comment period on the proposed rules that runs through Oct. 22.

"We're going to have a series of meetings, probably by conference call and probably until the deadline for comments," he said. "We're trying to help our bankers compare notes and use some models to see how this will affect them."

The Mississippi Bankers Association board will be submitting comments to federal regulators as well, according to Deaver. "We do get the sense from several regulators they are sincerely wanting to look at the comments."

Meanwhile, Mississippi's banking lawyers can expect to be busy in coming months helping clients sort through compliance issues. It's not just the Basel III rules; Dodd-Frank and other new regulations have led bankers to put law firms on their speed dials, said Jeff Stancill, a banking attorney in Butler Snow's Ridgeland office. "Banks, particularly small banks, have a tremendous burden to comply with all the regulations that have been implemented lately."

With Basel III coming to U.S. shores in the near future, banks are going to have a lot more "to sift through and sort out," Stancill said.

Fortunately, they will have some time to get their bearings, said Alan Deer, a banking attorney and partner in the Birmingham office of Balch & Bingham.

While it is uncertain just what and when the U.S. regulators will put in place from Basel III, the phase-in schedule currently calls for initiating the capital risk-weighting rules in January 2015. "It's not as if it's coming down the pike next week," Deer said. "But it's coming."

KEY DATES FOR IMPLEMENTING BASEL III CAPITAL REQUIREMENTS

2013 — Milestone: Capital Requirement: Start of the gradual phasing-in of the higher minimum capital requirements.

2015 — Minimum capital requirements: Higher minimum capital requirements are fully implemented.

2016 - Conservation buffer: Start of the gradual phasing-in of the conservation buffer.

2019 - Conservation buffer: The conservation buffer is fully implemented.

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