

Small banks eschew a simple solution

Regulators had planned to exclude small banks from the revised Basle Accord, instead offering them a simplified framework but some are refusing to be left out. **Duncan Wood reports**

When the proposed changes to the Basle Capital Accord were unveiled in January, they seemed to offer improvements for everyone, but community banks and thrifts may be feeling a little excluded from the current debate.

It's unlikely to stay that way for long – smaller banks are standing squarely at a regulatory crossroads. Unlike other banks, which are encouraged to make individual choices under the new proposals, smaller institutions will need to choose their path as a group, and the range of opinions within the industry suggests that won't be easy.

The proposals' main innovation is a radical overhaul of bank capital standards, which would allow some banks to have a say in setting their own capital requirements – the so-called internal ratings-based (IRB) approach. The advanced IRB is clearly aimed at the most sophisticated banks. The foundation IRB is open to a mixed audience of first and second-tier banks. By default, the standardised approach, which builds upon the current risk-based system, is for everyone else.

But as the Basle proposals took shape last year, US federal regulators evidently decided that the new Accord was unlikely to offer much for smaller institutions, and began planning for a bifurcated approach to bank capital, which would include a simplified option for "non-complex" institutions.

The result is that now, as banks all over

the world begin puzzling over the impact of the proposals, the smallest US banks are facing a choice between the federal regulators' simplified approach, the Basle Committee's new proposals or the existing system. Further options could yet emerge, raising questions about the Committee's chances of signing everyone up to a new Accord within the year.

The US regulators – including the principal community bank regulator, the Federal Deposit Insurance Commission (FDIC) – were first to the table last November, when they suggested three simplified approaches to calculating capital for non-complex institutions, which all shared the common aim of reducing the regulatory burden on small banks.

"We asked people to think about regulatory capital in light of how the Accord was shaping up," says Mark Schmidt, Washington-based associate director with the FDIC's division of supervision. "We

thought the timing was good to go out to our banks and tell them that, although the last Accord applied to everybody, it may not apply to everybody this time."

The regulators suggested that, separately from the new Accord, so-called non-complex institutions could be hived off and given their own capital framework, which would be a simpler version of the existing risk-based system, or a variant on a crude leverage ratio, where capital is driven primarily by bank assets. In addition, the regulators proposed a \$5 billion asset cut-off point, below which institutions would be regulated by the putative simplified rules, rather than the new Accord.

Broadly speaking, the response has been unenthusiastic, but it has also pointed to deep divisions. Even the most apparently unambiguous benefit of a simplified approach – a lower regulatory burden – has generated debate.

"In discussions with US regulators, everyone has just thrown their hands up about the complexity of the issue when you get down to the small bank level," notes William Longbrake, vice chairman and chief financial officer of Washington Mutual, the largest US thrift. "There has been a determined effort to keep regulatory burdens to a minimum so I think the simplified approach was something of a knee-jerk reaction."

That doesn't mean it's the wrong reaction, though, says Karen Thomas, director of regulatory affairs with the Independent Community Bankers of America (ICBA) in

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Washington. "Community bankers are generally happy with the suggestion that they're just different animals. To them, it's much more important that capital calculations are not a burden," she says.

The ICBA's response to the simplified capital plan echoes this line. While it isn't entirely happy with aspects of the plan, it applauds the regulators' attempts to reduce the regulatory burden, and urges further efforts to draw up a simplified approach to regulatory capital. "Excessive regulatory requirements impose a disproportionate burden on community banks which, in turn, diminishes their ability to serve their communities," says the ICBA's comment letter.

But if the cost of light regulation is a heavier-than-necessary capital burden, this could also restrict a bank's ability to serve. "If regulators impose an unnecessarily high capital ratio – in the sense that it exceeds what is warranted by the risk profile of the bank – an avoidable cost is imposed on society through a high cost of financial intermediation," says David Llewellyn, a professor in finance at the University of Loughborough.

Paperwork vs capital

It's not clear that cutting down on penpushing, form-filling and calculator-tapping should be the top priority of regulators when it comes to capital standards. The ICBA is clearly right to suggest that burying bank executives beneath a mountain of paperwork will prevent them from serving their communities, but it's equally clear that burying banks beneath a mountain of capital isn't an acceptable alternative.

Kathy Marinangel, president of the \$120 million-asset McHenry Savings Bank, is worried a simplified approach to capital will inevitably mean higher-than-necessary capital for many banks.

"If you look in general at the proposal – simplified capital rules for all banks under \$5 billion in assets – you know regulators aren't going to be comfortable unless it results in higher capital," she says.

And Michael Briggs, regulatory counsel at industry body America's Community Bankers (ACB), concurs. "While we support all efforts to reduce regulatory burdens on community banks, we don't believe that the November proposals would achieve this," he says. "Rather, it suggests that the current capital structure might be revised to result in higher-than-necessary capital requirements for many community banks."

Marinangel says it would be infinitely

"If you look at the IRB approach, there's absolutely no way to achieve that," argues the ICBA's Thomas, pointing to the lack of data and the small portfolios at most community banks. "Even if you apply the standardised approach, you'll end up with the same regulatory minimum – mortgages won't change, consumer loans won't change, small business loans won't change."

The lack of consensus on a simplified approach and the lack of enthusiasm for Basle's new proposals seem to indicate that community banks would be happy to retain the current system, which they know and are comfortable with.

The ICBA's comment letter, despite arguing for a dialogue on simplified standards, notes: "Most community banks do not view the current risk-based standards as posing undue burden for small institutions. While the current standards are more burdensome than the previous leverage-only calculation, community banks have adjusted to the risk-based standards. They understand them, have been complying with them for a number of years, and can calculate them relatively simply."

Regulators are in a holding pattern at the moment, awaiting the May 31 end of the Basle consultative period, but based on comments received so far, the FDIC's Schmidt says: "It's not premature to say that small banks are ready to opt for the existing system."

The end of consultation on the Basle proposals may not bring a neat resolution to the issue, though – some bankers, Marinangel among them, are determined to see a new capital framework for small banks which adheres to the principle of risk sensitivity adopted by Basle's proposals. "I feel very strongly about this," she says combatively. "I'll keep fighting."

She has had the chance to put her view-

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better to go in the opposite direction – a more complex capital framework for all banks that is also fairer. "For 15 years, I've been a proponent of more risk buckets, so banks can link capital to risk more effectively," she says.

The second alternative open to community banks is the Basle Committee's new proposal, which offers more opportunity to weight assets according to their risk, with the result that capital better reflects an institution's risk profile.

But while the philosophy underpinning the proposals ought to deliver greater risk sensitivity for the industry as a whole, many small bankers feel that the IRB approach is out of their reach, while the changes made to the standardised approach – more risk buckets for top-rated corporates, for example – do nothing for community banks.

point across at the very highest level, at hearings attended by Federal Reserve Board chairman Alan Greenspan and Fed governor Laurence Meyer. The implicit assumption at these meetings, she says, was that small banks would not share the concerns of their larger counterparts. When Marinangel and her peers came out in favour of enhanced risk-based capital rules for even the smallest banks, the Fed was "very surprised to hear what we had to say, and we were all in concurrence", she says.

Significantly, if bankers such as Marinangel decide to force the issue, a parallel debate on capital standards for thrifts offers them some high-profile allies. The "non-complex" tag adopted by regulators for the simplified capital framework could be extended under certain interpretations of the Basle proposals to include many other, larger companies.

Washington Mutual's Longbrake warns that the Fed's Meyer has suggested that only institutions with international business should be allowed to operate under the terms of the new Accord. Other firms – even those such as Washington Mutual, which has assets of \$220 billion, but only does business in the US – could be stuck with the existing standards, or simplified rules. "Other regulators may be more circumspect about it, but yes, international activity is one of the ways they are considering drawing a line between complex and non-complex firms," he says.

This could mean that Washington Mutual is barred from using the Accord's advanced IRB approach – the option Longbrake favours, although he notes: "Even that is relatively crude."

So, despite their very different asset bases, Washington Mutual and McHenry Savings Bank find themselves fighting for the same fundamental principles: that capital and risk should be linked, and should be linked in as close and dynamic a way as possible, for all institutions. "We

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want our risk measured appropriately, not arbitrarily," says Longbrake. At the very least, he says, institutions should have a choice.

"If there are smaller institutions who want to work on their own systems and are ready to put in the effort required, then they should be able to do so. They should also be able to opt out, have capital rules imposed on them and accept whatever consequences come with that," he says.

Possible consequences

McHenry's Marinangel is pretty clear about what those consequences could be. "For the many public banks, unnecessarily high capital will make it more difficult to hit key performance measures, like return on capital and return on equity. Higher capital without any risk determination is not a good standard," she argues.

Regulators were clearly wrong to assume that small banks weren't interested in making capital sensitive to credit risk, and the pendulum looks poised to swing back the other way – it could come to rest at the point where it all began, leaving banks with the existing risk-based standard or, with enough impetus, it could move further out, towards a more flexible standard.

Marinangel argues in favour of more risk-weighting buckets, which would see assets

risk-weighted according to their loan-to-value ratio. The ACB's comments on the simplified proposal argue the same points, but Marinangel also holds out hope that small banks could be allowed to build their own internal risk rating systems, and benefit from an IRB scheme like the one proposed by the Basle Committee. It sounds like quite a stretch, given the traditional antipathy of community banks for quantitative tools. "It could take some time to develop," she says. "Given time though, I believe most banks would move towards that kind of system."

The ICBA's Thomas is less enthusiastic. "You need to recognise that, even now, community banks hold higher capital than bigger banks – they don't have Wall Street and investors pressuring them to hold less. Community banks feel comfortable holding relatively high capital, because they can't raise capital quickly in the markets like larger banks can."

Regulators now have to build a framework within which the industry's divergent opinions can be reconciled – and even using the existing Accord as a fall-back position may not be wholly safe. Small banks may be comfortable with it now, but if they see the rest of the industry choosing from a menu of enticing new alternatives, it may lose a lot of its appeal, as the FDIC's Schmidt acknowledges. "Community banks may be tempted to stay with the existing standard, but not if they see other banks getting better treatment." And why not?

Any kind of blanket treatment will look unappealing to those it covers if their larger peers are allowed to choose the system that suits them best. Not only is there the issue of where and how to draw the line, but there's also the risk that homogeneous capital rules could undermine bank diversity.

On the other hand, if regulators want to develop some kind of opt-in system, time is running out. ■