PARLIMENT
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At the Margin

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Are You Ready for BASEL III?

Like it or not, Basel III is coming. So, in an effort to help banks grasp what's about to happen...

Janet Frankl-Lockwood sits down with Dr. Tom Parliment and Dave Giesen, Director, Navigant Capital Advisors, to explore this far reaching capital regulation.

Janet Frankl-Lockwood:

Basel III is coming and promises some of the most profound changes in bank capital regulation in more than 20 years. We think the changes will affect virtually every insured institution. You need to start thinking about them now!

Some of the more pronounced changes we see are:

1. Phasing out the use of debt and capital hybrids in Tier 1 and risk-based capital measurements (making common equity THE source of capital for banks).
2. Changes in risk weights on loan portfolios that will affect strategic business focus and loan concentrations. For you residential mortgage lenders, your 50% risk-weighting will now range from 33% to 66% depending on loan-to-value ratios -- rather than the current 50% across the board weighting.

[Since these items together take some of the most popular "efficiency" measures out of capital calculations, count on higher effective capital ratios because the numerator in the capital requirement (qualifying capital) will be decreasing while the denominator in the captial ratio (risk weighted assets) will be increasing.]

Therefore:

3. Shareholder returns could well be crushed for many institutions.

Dave Giesen, Director
Navigant Capital Advisors

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Because interest margins are being squeezed to less than 1% on most investments that are qualified for bank liquidity and less than 3% on many types of loan products, it will be critical for banks to have strong sources of fee income to complement margin income.

Regulators have exempted holding companies with less than $500 million in assets and have offered a phase-in period to adjust to the coming reality. This may seemingly ease the pain, but every bank needs to ask whether strategically, they are positioned for how Basel III and the enabling regulation will change its banking landscape.

Dr. Tom has been very forthcoming in client discussions regarding his concerns that financial institutions think through the strategic implications of Basel III to take advantage of opportunities arising from chaos. Most of you know Dr. Tom was raised in Hell's Kitchen where he learned "When you get a good man down, you kick him!" His attitude hasn't changed!

We have worked closely with our strategic partner, Navigant Capital Advisors (investment banking, restructuring and valuation services), regarding the Basel III issues and how we can best help to prepare clients. I sat down with Dr. Tom and Dave Giesen, Director of Navigant Capital Advisors, to get their thoughts.

Janet: How would you characterize the impact of Basel III and the pending U.S. regulations on the banking industry?

Dr. Tom: We're in those alluring final few hours that fall before a hurricane strikes. The skies are ominous and the impact stark, but I'm not sure every banks grasps what's about to happen. It's as if too many banks are out on their surfboards taking in the last big waves before the storm!

"...Basel III will present the likelihood that capital markets will be glutted by banks seeking capital in the next 3 to 5 years. It will be critical to be first in the capital queue. "

I'm all for surfboards, but I'm also for taking care to make sure the hurricane doesn't knock your bank down. The banking equivalent of "battening down" the hatches, gathering provisions and maybe even leaving town, is... raising capital, shrinking or selling. What you do may be a function of where your bank is in the years ahead. I see three categories for every community bank. They are:

1. **Threatened:** These are the institutions threatened by the phasing in of Basel III and who must raise capital, shrink or sell. Regulators know which institutions fall into this category and believe me, they're looking for consolidation. *Threatened* banks are marginally well-capitalized or only adequately capitalized which includes many family owned and "S" Corp banks. Some of these may even be somewhat healthy banks that have used a highly efficient capital structure to leverage their banks and now must unwind large amounts of trust preferred or subordinated debt. Regulators have already expected the consolidation of approximately 1,000 institutions in the near future.

2. **Challenged:** These are the institutions that have marginally comfortable "qualified capital" and whose risk weighted assets fall inside of "zone of comfort." But how will these institutions carve out a strategic financial plan that delivers an adequate shareholder return in the short- and long term?

3. **Well Positioned:** These are the institutions that currently have capital and capital ratios not threatened by Basel III. They should be building a

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Identify where your institution stands (red, yellow or green). Honest evaluation followed by strategic preparation is key as we move toward the phase-in stages of BASEL III

Threatened Challenged Well Positioned

war chest to capitalize on the inevitable consolidation. These banks need to forget about my often-told warnings about shareholder dilution and look carefully at how much growth capital they'll need. If you need more, think about going to market SOON, because Basel III's fallout is likely to be a near-term flooded capital market. It will be critical to be first in the capital queue. You have a story to tell investors!

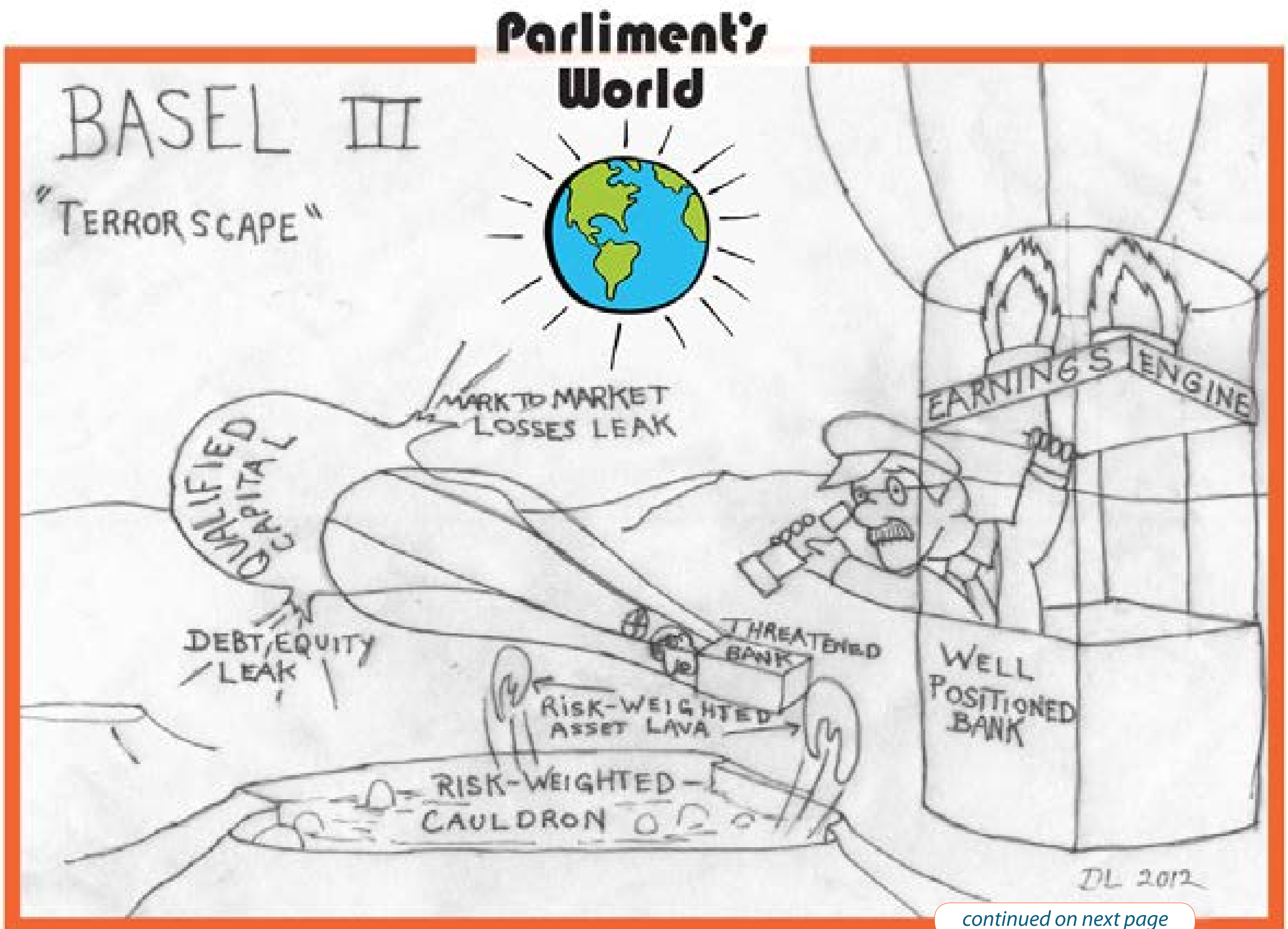
Dave Giesen: Dr. Tom has it right. The challenge is to conduct a reasonable self-assessment of a financial institution that looks at capital, operations and investor return to identify the underlying strength of a banking franchise. At issue is what's the real value of your bank and how do you monetize it?

Do you raise capital? Do you shrink into compliance, change operational focus or sell? One of these may have a higher value to your shareholders and should be considered carefully.

Janet: **How can an institution determine which of Dr. Tom's three categories they fall into? What factors should they be looking at besides capital?**

Dave: The most obvious measure is tangible capital less hybrid capital instruments, divided by tangible assets. Also, look at core earnings. You're not *Well Positioned* if there is significant doubt your bank can generate a market-based return on equity from an existing or contemplated franchise. Also, look closely at asset quality. If your Texas Ratio is still over 100 and non-performing assets are 8% or more, you are a ***Threatened*** institution. In effect, you may need to look at your existing capital and ask, "How will it be used?" If capital is used to cover losses or your return is inadequate, then your bank may be *Challenged*.

I'm especially concerned about what Dr. Tom used to call the "savings and keeps" and those banks that may shrink their way into prospective capital compliance. They'll look like *Well Positioned* institutions, but they won't be. The reason is because they either don't have a core franchise or



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they're eating their young by chasing loans and deposits off the books. The savings and keeps are essentially bond funds with limited lending capability, no material market presence and no desire to change.

In either case, the basic mission of a community bank is called into question and, importantly, an exit strategy may be severely limited. If a bank doesn't have a story, it will be root canal work to get a transaction finished.

Dr. Tom: You're right on, Dave. We also have to consider that some geographic areas of the country are no growth or minimal growth areas. Incredibly, one might even see some banks convert to credit union status from mutual status. In that event, since they will not pay taxes, they will have more retained earnings. But this solution is merely seeking shelter from the storm, not a true long-term strategic response.

Dave: Dr. Tom, we're already seeing a careful review of credit union conversion by some mutually chartered savings banks. I would note that we have many very successful clients in no-growth parts of the country, but their secret is the way they position their products and banking franchise. They are smart, cautiously aggressive and bottom-line focused!

Janet: Dave, the full implementation of Basel III in the United States is 8 to 10 years into the future. Why not take an Alfred E. Neumann strategy, as in, "What, me worry?" We already know Dr. Tom's "Git 'R Done" attitude… he has no patience!

Dave: Because it's doubtful the regulators will let institutions ignore the position that the full phase-in of Basel III will put them. I would expect in examinations during the next few years that the FDIC, OCC and state banking commissioners will be looking for capital plans that deal with the phase-outs of trust preferred and limitations on allowance for loan loss in Tier II capital. Also, expect that regulators are going to be very realistic about your future prospects, even if your management team and Board are not. Why? Because they wrote this change!

"We think you have to strike while the iron is hot. A bank that waits until the eleventh hour exposes itself to a boatload of unknowns that could complicate the capital crunch. "

Sure, if your bank is less than $500 million in assets, you technically may duck some of the Basel III regulations. But don't go toast your luck quite so fast! The full phase-in of Basel III is expected to take 10 years. And, if your bank is a $350 million bank and asset growth is about 4% a year, you'll be at $500 million when Basel III is fully implemented.

We think you have to strike while the iron is hot. A bank that waits until the eleventh hour exposes itself to a boatload of unknowns that could complicate the capital crunch. Does your Board really want to be out there seven or more years from now facing sanction for not meeting capital requirements that were known way back in 2012? I don't think so.

Finally, markets ebb and flow over time. If you flow with the markets, the benefit will be achieved at a lower all-in cost (in the form of dilution) than it you wait. If sale is your goal, waiting hurts shareholders.

Dr. Tom: If I'm a regulator, there's no way I'm waiting. I want to know what you're going to do, how long it's going to take and what's the sensitivity around major assumptions. You don't do it? Well, there's always MOU-land! As a bank regulator, I can't afford to run the risk to the insurance fund and to the payments system of a meltdown, and Basel III notwithstanding, I want people to know I've whipped my banks into shape sooner rather than later.

Janet: What's the impact on a bank's return in the years ahead?

Dave: I'll defer to Dr. Tom on this one. But I am concerned about community development and bank willingness to take risk. The fact is that return requirements will go up because capital costs will be higher after Basel III is implemented. In turn, that means the margin for error is tighter. Credit will be priced higher and debt service ratios will be looked at far more carefully. The result: fewer "lower grade" credits will be taken into the portfolio.

OK, maybe that's what the regulators

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want! But the result may be that you can't do all the things with all the customers that you're doing today. You may want to think carefully about SBA 504 and 7A lending programs, as well as USDA guarantees, for example, as part of your response to Basel III (lower risk weights through insuring the loans). The hope would be that your bank can cast as wide a net as possible to your customer base with lower capital consequences.

Secondly, make sure you're looking very carefully at your loan underwriting standards. Make sure the standards and expectations of your bank conform to your new reality. Also, periodic file review and loan maintenance will become very critical so that you can identify, address and resolve problems as fast as you can. Make sure regular loan review is part of your go-forward plan!

Thirdly, if you need capital, look carefully at possibly repositioning your investment portfolio into lower risk securities. There's a yield give-up, of course, but lower yield needs to be balanced against the opportunity arising from a potentially expanded lending effort caused by freeing up capital used for your investment portfolio.

Finally, don't overlook off-balance sheet risk either. Make sure the contingencies you have are reasonable and prudent business risks. Keep in mind possible hidden recourse back to your bank, the circumstances under which recourse is implemented and the possible impact. This is especially a concern if you have participated loans out or sell and service loans for others. Also, look carefully at your construction and development loans to make sure the contract is well-written. You'll need to double check benchmarks for follow-up funding and make sure there are takeout commitments in place.

More than 20 years ago, Dr. Tom and I were on a platform together where we explored the response to risk-based capital requirements that were then coming into vogue. We had a linear regression equation that attempted to optimize risk weightings. That's an exercise that may be more important than ever today.

Our experience has been that local investors often are tolerant investors. They are either dividend sensitive or they invest for reasons other than just financial return.

Dr. Tom: Sorry, Charlie, as the fisherman said to the Tuna. (Boy does that date me!) The impact of greater risk weights on certain business activity will have the inevitable, inescapable consequence of higher rates on loans for these activities. Markets work. The impact of requiring more capital to back up certain activities MUST have the consequence of higher prices to fund these activities.

What is truly unfortunate is the unintended consequence of de-leveraging, that is, the pro-cyclical macro economic impact of decreasing flows of credit to economic sectors that are collateral dependent for their ability to qualify for loans. (See Parliment Consulting's "The Pain of De-leveraging" article.)

Janet: The capital markets are saying that internal rates of return need to be 20% to raise capital. Is that a reasonable goal for an institution?

Dave: Reasonable? Yes. Attainable? Maybe. Much depends on who your shareholders are, what their expectations are of your bank and why they are investing. If you're owned locally, you may have a different requirement than those banks with large national shareholder bases.

Our experience has been that local investors often are tolerant investors. They are either dividend sensitive or they invest for reasons other than just financial return. Their motive may be community betterment, social or something we can't measure or manage. These are the same folks that brought you the savings and loan conversion wave in the 1990s. Their rewards may be years into the future. We've seen some of these investors who invested for a chicken dinner hosted by a bank as part of its annual shareholder meeting.

The reality is that very few, if any, banks can build an investment thesis on chicken dinners. More sophisticated local investors may well be interested in your bank – and we think they should be part of any

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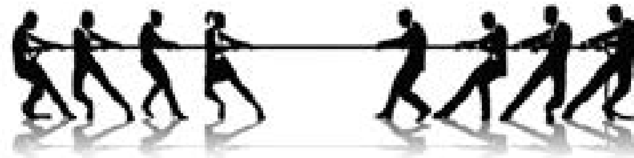
capital planning. But be forewarned! These are pretty smart investors who expect an investment return – and a bank seeking capital had best show it to them. Be prepared to be asked for Board seats as well.

For many banks, private equity probably will be part of the equation. Private equity often invests if <u>you have a story</u> and if their models can show a 20%-plus internal rate of return. How do get there? Think acquisition, for one. Can you acquire and do you have a history of acquisition? The other is sale or IPO years into the future. If private equity is interested, they will work the pricing of your offering down until they can feel reasonably confident they'll reach 20%-plus.

Dr. Tom: Be careful there Dave! We were very good with the conversion business in the 1990s because there was a big IPO pop in the stock and because those investors hadn't been previously tapped to any large scale. You're right in that *Well Positioned* banks should be looking locally. I think you would agree that local money sends a good sign if a bank is seeking private equity as well.

But I'm just not convinced that local money is going to be the answer for many banks. Your hero, Al McGuire, once said, "it's taps city… that's all she wrote" when the game was over. I think that may be the case for this source of financing for more institutions than you might think.

Dave: Yeah, but I'd still look. One place may be your borrowers and long-term savers/depositors. Approach them as an investment tool but don't even hint at any relationship between investment and other banking relationships. Those tying rules are pretty onerous and rightfully so! Also, be darn sure your equity issue is priced right. You don't want one price for local investors and then later find out the price for private equity is materially different! You may want to get some real help in pricing to make sure it's right.



If I'm *Challenged*, I need to know what I need to do to get out of the De-Militarized Zone. Get your senior management team together, make a reasonable assessment of your bank and then ask what that means as the markets change.

Janet: What should banks be doing now in light of the three categories Dr. Tom has put out there?

Dave: If I'm ***Well Positioned***, I need to be thinking corporate development. I want to be the great white shark of my region, looking at franchises, establishing whether I want them based on what I know (and can learn) about them and what I'm willing to pay for them. That doesn't mean everything, but there are some *Challenged* and *Threatened* that would fit well with a *Well Positioned* style of banking.

If you're ***Well Positioned*** and you set the corporate development process in place – with counsel, financial advisors, accounting advisors and due diligence experts available as necessary -- you're halfway home. You know what you can afford to pay, who you are interested in and what you need to do. You also may want to shore up your own policies, practices and procedures to recognize you may soon be seeing something you may not be used to.

Make sure you understand that there's no shame in saying "no," if a franchise doesn't fit, so long as the "no" is in good faith and well researched.

If I'm ***Challenged***, I need to know what I need to do to get out of the De-Militarized Zone. Get your senior management team together, make a reasonable assessment of your bank and then ask what that means as the markets change. Set a plan in place to meet the challenge – whether it is asset quality, capital or operational change – and hold your Management and operations to the fire. Create incentives to get folks to meet what you want them to do and then measure them against the benchmark every quarter.

Threatened institutions probably will need every minute of the phase-in period to transition to ***Well Positioned*** if they can. Some of these banks can and probably will prosper, but like the savings institution crisis of the 1980s, the success is in the nuts and bolts of transition. One need only look at

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the 3,500 savings institutions in 1979 and the 800 or so today to realize what capital, regulation and economic upheaval do to a not-so-favored financial institution class. The savings institutions that prosper today either stuck to their knitting, knew what they did best and developed a core series of relationships with customers and service providers in their markets or they diversified their product bases carefully so that they became a dynamic financial institution. Either way, they found a means to be well capitalized.

My general fear is that America's bankers are, quite frankly, too numerous in many places. Overbanked is a way of life in some states, like my home state of Illinois. And yet, until 2007 we were issuing new bank charters like candy in a July 4th parade. Do we need so many banks in Illinois? Time will tell but this year there are 5,533 bank branches reported in Illinois. Of this group, 2,363 are outside the Chicago MSA serving a disparate population of 3.4 million persons. That's an awful lot of banking.

There are not a lot of banks that will begin by questioning their markets and *raison d'etat*. But, if your bank is having problems with excessive purchased participations, has no lending franchise and a limited core deposit base, it may be time to ask simply, "why?"

If there's a bright spot, it is the 10 years full phase-in. Savings institutions got 5 years back in the 1980s.

Dr. Tom: Ahhhh, Dave, you give up too easy… I spent my childhood running from Bigger Bullies. All I had to do was run faster than the kid next to me. Even ***Threatened*** banks may have some strategic choices if they react quickly enough.

Janet: This seems to be about capital. But, do you see operational changes that will be necessary as a result of the Basel III changes? What should banks be thinking about to position themselves for the future?

"What can you do with what you have to grow the franchise – to build revenue from loans, ancillary services and fee income? How good is your bank at cross-sales... really?"

Dave: One of the big problems facing banks as they move forward is to break the "Wal-Mart" mode of pinching pennies into profitability. The question that's hidden by cost containment is how well a bank has built its franchise. Quite frankly, holding the line on costs has its limits. Growing revenue is limited only by the energy a bank brings to its markets and the opportunity found within those markets.

Lots of merger and acquisition transactions have been sold based on cost-based accretion. But the issue for ***Challenged*** and ***Threatened*** banks is to move beyond costs and into how to grow a franchise. What can you do with what you have to grow the franchise – to build revenue from loans, ancillary services and fee income? How good is your bank at cross-sales… really?

One valuation measure we consider in transactions is the presence of customer relationship intangibles ("CRIs"). A CRI measures the value of an existing customer base over a period of time, based on net revenue and decay assumptions. Whether it's formal or informal, banks need to be thinking clearly about the value of their relationships, what they're producing and what customers or groups of customers are generating profits and losses. Comparatively few banks do this well.

The same can be said for products. Which ones make money and why? Can you get along without them?

Janet: You've raised some interesting issues regarding how a bank will build its franchise value. Dr. Tom and I work with our clients to "tailor make" their products and services. Since all financial institutions' products are to some degree commodities, management must effectively differentiate products and segment their markets and customer base.

Specifically, banks need to <u>start</u> with a net income target and grow organic loans to achieve the income required. They need to meet the market demand for types of loans… which include longer term fixed rate products. It is essential that they price <u>duration</u> of cash

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flows… not contractual term. Banks should originate loans for portfolio as well as for sale in the secondary market which can significantly increase non-interest income.

Organic deposit growth is essential to fund the majority of loan growth. A Tiered pricing approach for certificates of deposits as well as non-maturity deposits will help to save interest expense, especially in a rising rate environment. Wholesale funding such as FHLB advances should be used strategically.

And, relationship pricing builds franchise value as banks will achieve greater share of wallet.

Bankers need to ask themselves: "What retail strategies enhance the investors' perceptions of the value of our retail franchise?" That is, what are the kinds of things that management can do to increase the "appeal" of a bank's franchise and thereby enable them to attract capital. Hmmm. This is definitely an entrée to a subsequent article!

Dr. Tom and Dave, thank you for a very spirited discussion regarding the impact of Basel III. What jumps out at me is that all banks need to start thinking strategically about their response to this capital regulation. No one can afford to wait just because there is a 10 year phase-in period.

Please join us at one of our **two FREE Webinars**, hosted by Parliment Consulting and Navigant Capital, where you will have the opportunity to learn more about the strategic considerations of Basel III.

register at:
http://basel3webinar.surveyanalytics.com

Tuesday, December 4, 2012
2:00 p.m. EST – 3:15 p.m. EST

Wednesday, December 5, 2012
11:00 a.m. EST – 12:15 p.m. EST

Janet Frankl-Lockwood, *President of Parliment Consulting Services, works with community financial institutions to help them include a "best practices" approach to execute and implement organic retail strategies and to embed them into the asset/liability management process. She works with clients to segment and differentiate deposit products in order to help lower average costs, manage marginal cost of funds, segment rate sensitive from non-rate sensitive customers, and to increase the personal household balances of commercial customers.*

Dr. Thomas Parliment, Chairman & CEO *of Parliment Consulting Services, has spent the better part of the last four decades working with financial institutions helping them develop solutions for their business challenges. He has served as a director of several financial institutions, and as a financial expert, has chaired ALCO, Audit, and Investment Committees. Dr. Parliment is currently Interim Chief Operating Officer of a $300 million threatened institution in Illinois.*

David Giesen is a Director *in the Valuation and Financial Risk Management group at Navigant Capital Advisors, Chicago. Dave has worked with financial institutions for about 30 years in valuation, financial advisory, risk management and capital markets .He also has worked as a magazine editor and, for about four years, was Director of Financial Analysis for Amtrak's Intercity Strategic Business Unit.*

Parliment Consulting Services focuses on Strategic Financial Planning and Asset/Liability Management to help community financial institutions gain and maintain superior earnings growth.
We specialize in retail loan and deposit strategies.

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