New Rules, Fewer Choices

Basel III capital proposals limit community banks’ investment options

By Jim Reber

It would be my preference to discuss a new investment product or a timely strategy in this month’s column, because such pieces hopefully enable ICBA members to create a more profitable bond portfolio for the everlasting benefit of their organization—and community banking in general. But instead, this month I’d like to bring to your attention to a possible career-altering event for investment portfolio managers.

What the rules are

Back in 1993, the Financial Accounting Standards Board (FASB) issued Standard 115, which required the available-for-sale (AFS) and held-to-maturity (HTM) classifications for debt securities. The banking regulators subsequently decided that unrealized gains and losses on either portion would not be an element of Tier 1 capital. This allowed community bank portfolio managers to happily manage their AFS securities when necessary.

Banks henceforth have been able to take advantage of market opportunities, reposition their bonds to limit risk and generally act in their institution’s best interest, without causing wild swings in their capital ratios. This of course has been of utmost importance to the community banking industry since 2008, when capital became hard to come by.

One of the elements of the Basel III proposals is to include the unrealized gain or loss from the AFS portion in the calculation of Tier 1 capital. ICBA’s stance is this will unnecessarily cause capital ratios to ebb and flow based on the vagaries of market rates. It also points out that only the AFS debt securities are made to be treated this way; no other parts of the balance sheet are mentioned in the proposals.

Proposals’ impacts

Using the Vining Sparks bond accounting population as a proxy for community banks nationally, the current unrealized gain in the AFS portions of the bond portfolio is right about 2 percent of face value, or $2 million for every $100 million invested. Assuming that bonds compose about one-third of the balance sheet, which is about the national average, this would result in a positive Tier 1 impact of about 50 basis points. Back in 2000, it would have had a negative effect of about 100 basis points.

These proposals present a number of issues for community bank portfolio management. One is that bonds make up a much greater part of the balance sheet now compared to other points in recent history. Another is that debt securities provide the quickest and most efficient means of fixing ICBA Securities’ president and CEO, Jim Reber, and its director of investment strategies, Mark Evans, will be keynote speakers at ICBA’s 12th Annual Directors Conference to be held Oct. 18-21 in Williamsburg, Va.

Details are available at www.icba.org/education.
a problem on the bank’s balance sheet. Still another is the asymmetrical risk the proposals would create; rates can of course rise much more than they can fall.

And don’t think that classifying bonds as HTM will give you a safe harbor. FASB may move to eliminate the AFS/HTM distinction in the next several years, with the vast majority of securities then being subject to the treatment in the Basel III proposals.

If the proposals become regulations as currently written, it can be expected that community bankers would manage the portfolio with a whole new set of objectives. This could mean much shorter effective duration bonds, either through floating rate features or short stated maturities. Other strategies may need to be employed, including the use of interest rate swaps, the election to value liabilities at fair value or wide-scale reweighting of the loan portfolio. At a very minimum, banks will need to have a very precise measurement of their interest rate risk and economic value of equity exposures.

**Control your destiny**
The comment period on the Basel III proposals ends Oct. 22. ICBA has created a Basel III resource center on [www.icba.org](http://www.icba.org) under “Top ICBA Advocacy Issues,” where you can review summaries of the proposals, read up on ICBA’s positions and statements and find a kit to help you write a comment to your regulator.

We recommend you write a letter, and that you make it personal. You should provide specific examples of how these regulations would impact your bank. There are, of course, several other elements of Basel III that present challenges for community banks, and you can include comments on those as well.

Keep in mind that ICBA and ICBA Securities personnel stand ready to help you respond to these proposed regulations. Your fellow community bankers thank you for your involvement. With enough grassroots commentary from the ICBA membership, portfolio management may continue to play by traditional ground rules.

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**Bond Portfolio Statistics**
If you would like to see statistical information regarding community bank investment portfolios extending back to 2002, contact your ICBA Securities sales rep or visit [www.icbasecurities.com](http://www.icbasecurities.com).

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