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SMALL BANKS SHOULD BRACE FOR DOD-FRANK FALLOUT

American Banker article December 6, 2012

The Federal Reserve's package of proposed Dodd-Frank rules, released just before Christmas, targets the largest domestic financial firms. But smaller banks may eventually find themselves in the crosshairs, too.

The 173-page proposal, released on Dec. 20, spells out the rules that would apply to bank holding companies with more than \$50 billion of assets as well as nonbank financial firms deemed systemically important. None of the central bank's proposed rules appear to have an immediate effect on community banks. But there are elements of the proposal that should at least be on the radar of community bankers, analysts and lawyers say.

For one, the Fed's proposal on the early remediation of troubled banks is likely to eventually apply to community banks, said Margaret Tahyar, a banking attorney with Davis Polk & Wardwell LLP.

"It doesn't apply to the \$10 billion-asset [banks] and lower right now, but it is the grandson of prompt corrective action and that applies to everyone," Tahyar said. "Over time, either by regulation or supervisory practice, you could see early remediation move out to the community bank space to become a best practice."

Under the Fed's proposed requirements for early remediation, regulators would be given power to intervene on the detection of certain triggers, including capital levels, the results of stress tests and risk management weakness.

"They're explicitly geared toward large banks, but nothing says those triggers cannot be applied to small institutions," said Brian Gardner, an analyst at KBW Inc.'s Keefe, Bruyette & Woods. "That's something that bears watching, especially for publicly traded (banks)."

Another possibility that community banks should consider is new definitions for Tier 1 capital and prompt corrective action. Once the details of the Basel III process are implemented, regulators will need to decide if a new definition of Tier 1 should apply to everyone, said John Dugan, a banking attorney with Covington & Burling LLP.

"It's definitely in play," said Dugan, the former head of the Office of the Comptroller of the Currency. Whether the Basel Committee on Banking Supervision's tougher new capital requirements apply to smaller banks "was not made clear or decided by the (Fed's) proposed rules."

The Basel III liquidity rules have not yet been finalized by global regulators.

Smaller banks may also be required to establish separate risk committees. That proposal has already been expanded to include banks with assets between \$10 billion and \$50 billion, Tahyar said.

"The statute contemplates it going lower," she said. "So it might be something to watch for the future."

The requirement for stress tests could also trickle down to the midsize banks, and later smaller banks, Tahyar said. In November, the Fed issued guidelines on capital planning, which require banking companies to conduct stress tests and maintain adequate capital, including a Tier 1 risk-based ratio of greater than 5%, under both expected conditions and stress conditions.

Kevin Kabat, the president and chief executive of Fifth Third Bancorp. agreed. "Originally it was the top 19 of us" that faced stress tests, he said in an interview Tuesday.

"Now the stress tests are for banks with \$50 billion [or more] in assets," Kabat says. "Trust me, [the regulators] like it because it gives them insight, and that will spread back to anybody over \$10 [billion of assets] and maybe even \$5 [billion]. There may be different layers of discipline, but at the end of the day the entire industry will be affected."

Finally, it's possible that community banks could be affected by the proposed rule that limits credit exposure to a single counterparty as a percentage of the firm's regulatory capital. But it's highly unlikely that any community bank would meet that threshold, Gardner said.

Chris Cole, senior regulatory counsel for the Independent Community Bankers of America, says regulators will want to first see how early intervention and stress testing work for larger banks before applying them across the board. The ICBA was disappointed the Fed did not issue specifics on capital surcharges on systemically important financial institutions, as the industry group believes it will level the playing field for community banks, Cole said.

The Fed's proposed rules implement Section 165 of the regulatory reform law, and are considered by some observers as the core of Dodd-Frank. The proposal would apply to more than 30 U.S. banks, each of which has total assets of at least \$50 billion.

That group includes the largest U.S. bank by assets, the \$2.3 trillion-asset JPMorgan Chase & Co., and regional banks like Huntington Bancshares Inc. of Columbus, Ohio, which has about \$55 billion of assets.