

# **The Impact of Standardized Basel II on Minnesota Banks**

**Prepared for Minnesota Bankers Association**



# Executive Summary

- Basel II bank capital regulations are in the news ...



- We estimate that Standardized Basel II compliance will improve the regulatory capital ratios of 74.8% of 403 Minnesota banks and thrifts
  - Aggregate potential capital savings for all 403 banks of \$623 million
  - The median Minnesota bank would save \$0.5 million or 4.1% of their existing Tier 1 capital requirement
- Implementation is not without its challenges
  - Pillar II reporting can be complex and costly
  - Compliance requires demonstrated capital management capabilities
- Are your members aware of and prepared for these changes?
  - Second Pillar Consulting is uniquely positioned to help banks comply with Pillar II and obtain the capital relief they deserve

# Minnesota Banks can save up to \$623 million in required capital under Standardized Basel II and improve risk management

## Capital savings estimate and asset category contribution

Regulatory Capital Requirement



Source: 2008Q3 Call Reports; SPC estimates

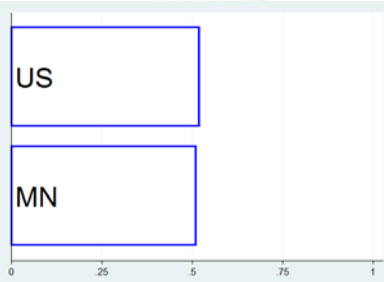
# For Merchants Financial Group, Inc., a representative Minnesota bank, Basel II regulatory capital savings can be stockpiled or deployed

Capital Savings: \$4.5 million or 4.4%

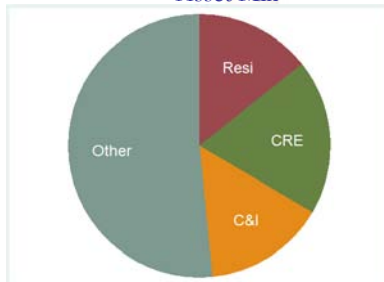
Regulatory Capital Requirement



Capital Savings Percentile



Asset Mix



Capital Metrics and Management

Total Assets (millions)	\$978	
Gross Income Margin	4.0%	
Tangible Common Equity	6.1%	
Leverage Ratio	9.2%	
Capital Estimates		
	Current	Basel II
Tier 1 RBC	10.3%	10.7%
Total RBC	13.1%	13.7%
Potential Use of Basel II Capital Savings		
Special Dividend (\$/share)	\$1.62	
Share Repurchase (7/29/2008 price)		
Number of Shares	161,040	
Change in EPS	\$N/A	
Organic Asset Growth (millions)	\$40	

## Merchants Financial Group, Inc. Winona, MN Highlights

- *Stockpile.* Under Basel II, total RBC increases from 13.1% to 13.7%, an amount equal to \$4.5 million or 4.4% of the existing capital base.
- *Deploy.* Incremental capital can be deployed with a variety of balance sheet actions that preserve the current 13.1% total RBC ratio:
  - Issue a special dividend of \$1.62 per share
  - Repurchase shares (number of shares and impact on EPS unavailable for private entity)
  - Organically grow assets by \$40 million

Upon request, Second Pillar Consulting can provide similar information for all 403 Minnesota banks free of charge

# Minnesota banks with the highest percentage changes in regulatory capital under Standardized Basel II

Name	City	Asset Size (\$000's)	Basel II Capital Impact	
			Dollar Change (\$000)	Percent Change
Crown Bank	Edina	\$ 255,729	\$ 4,980	24.5%
Riverland Bank	Jordan	\$ 45,007	\$ 978	24.0%
Think Mutual Bank	Rochester	\$ 1,351,832	\$ 34,580	24.0%
Pinehurst Bank	Saint Paul	\$ 58,295	\$ 1,391	23.6%
Red River State Bank	Halstad	\$ 43,719	\$ 768	21.7%
EastBank	Minneapolis	\$ 19,335	\$ 447	21.5%
First National Bank of Buhl	Buhl	\$ 26,073	\$ 377	19.5%
St James Federal Savings and Loan Association	Saint James	\$ 23,549	\$ 328	17.5%
Falcon National Bank	Foley	\$ 101,882	\$ 1,375	17.4%
VisionBank	Saint Louis Park	\$ 31,680	\$ 746	16.3%
First Advantage Bank	Coon Rapids	\$ 43,776	\$ 741	16.3%
First Resource Bank	Savage	\$ 26,277	\$ 431	16.2%
Lakewood Bank, National Association	Baxter	\$ 133,738	\$ 1,684	15.9%
Republic Bank, Incorporated	Duluth	\$ 284,026	\$ 3,840	15.7%
Citizens State Bank of Olivia	Olivia	\$ 25,508	\$ 400	15.7%
Farmers State Bank of Darwin	Darwin	\$ 25,428	\$ 357	15.6%
Signature Bank	Minnetonka	\$ 177,102	\$ 2,397	15.5%
Park State Bank	Duluth	\$ 32,890	\$ 338	15.5%
Fidelity Holding Company	Minnetonka	\$ 310,702	\$ 5,250	15.2%
First State Bank of Alexandria	Alexandria	\$ 109,300	\$ 1,236	14.8%
<b>Averages</b>		<b>\$ 156,292.40</b>	<b>\$ 3,132.19</b>	<b>18.3%</b>

Source: 2008Q3 Call Reports; SPC estimates

# Minnesota banks with the lowest or negative percentage changes in regulatory capital under Standardized Basel II

Name	City	Asset Size (\$000's)	Basel II Capital Impact	
			Dollar Change (\$000)	Percent Change
State Bank of Marietta	Marietta	\$ 9,712	\$ (42)	-4.9%
Gary State Bank	Gary	\$ 8,725	\$ (65)	-4.9%
Wanda State Bank	Wanda	\$ 88,652	\$ (863)	-5.0%
Farmers State Bank of Trimont, Trimont, M	Trimont	\$ 44,775	\$ (371)	-5.3%
State Bank of Danvers	Danvers	\$ 37,341	\$ (263)	-5.3%
Northern State Bank of Gonvick	Gonvick	\$ 31,197	\$ (391)	-5.4%
United Farmers & Merchants State Bank	Morris	\$ 30,400	\$ (153)	-5.4%
Farmers and Merchants State Bank of Appleton	Appleton	\$ 38,627	\$ (314)	-5.5%
Citizens State Bank of Shakopee	Shakopee	\$ 24,133	\$ (168)	-6.0%
Odin State Bank	Odin	\$ 36,989	\$ (290)	-6.2%
Security State Bank of Oklee	Oklee	\$ 26,892	\$ (349)	-6.5%
State Bank of Bricelyn	Bricelyn	\$ 22,056	\$ (245)	-6.8%
American Investors Bank and Mortgage	Eden Prairie	\$ 52,579	\$ (346)	-7.2%
Farmers & Merchants State Bank of Clarkfield	Clarkfield	\$ 36,534	\$ (299)	-7.9%
Rosemount National Bank	Rosemount	\$ 45,544	\$ (461)	-8.0%
United Southwest Bank	Cottonwood	\$ 40,047	\$ (403)	-9.5%
First State Bank of Okabena (Incorporated)	Okabena	\$ 19,681	\$ (478)	-11.3%
Stearns Financial Services, Inc.	Saint Cloud	\$ 1,107,693	\$ (38,814)	-13.3%
Community National Bank	North Branch	\$ 81,232	\$ (1,902)	-14.2%
Union Bank and Trust Company	Minneapolis	\$ 70,830	\$ (1,819)	-14.6%
<b>Averages</b>		<b>\$ 92,682</b>	<b>\$ (2,402)</b>	<b>-7.7%</b>

Source: 2008Q3 Call Reports; SPC estimates

## But banks must be prepared to answer the tough risk management questions posed by Basel II compliance

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- Do you have a well-functioning risk oversight structure?
- Do you have clear risk management policies and procedures?
- Have you identified the important risks faced by your institution?
- Have you articulated an institutional appetite for risk-taking?
- Do you have accessible data on the risk characteristics of your existing portfolio?
- Do you have accessible data on the past performance of your portfolio?
- Do you have personnel that can fill critical risk assessment gaps?
- Do you actively manage and plan your capital position?
- Are you committed to enhancing your overall risk and capital management?

# Second Pillar Consulting can help banks prepare for Basel II compliance

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- Our principals have over thirty years of experience in enterprise risk management, regulatory capital compliance, and regulatory relations
  - Supported International Basel II compliance at a top-ten bank
    - Developed analytical and reporting capabilities
    - Created governance structure and supporting policies
    - Led regulatory exams for approval
  - Managed risk in retail banking, commercial banking, and insurance
  - Focused on building strong regulatory relationships
    - Active participants in several Basel II industry and regulatory forums that facilitated drafting the new rules
    - Frequent speakers at industry and regulatory conferences on Basel
    - Several Basel II academic papers written jointly with regulators

## Summary

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- Second Pillar Consulting is uniquely positioned to help banks comply with Basel II and get the capital relief they deserve
  - Services
    - Detailed Capital Savings Estimate
    - Gap Analysis
    - The Internal Capital Adequacy Assessment Process or ICAAP
  - Education
    - We conduct seminars for institutions and organizations on topics including Basel II compliance, Enterprise Risk Management, Capital Management, and Balance Sheet Strategy
  - Facilitation
    - We are currently coordinating the NPR response for the Risk Management Association and can help organizations and institutions with their response

## Contact Information

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