SWISS CHEESE AND BANK CAPITAL

by Steve Brown

Switzerland is known for watch making, mountains, cheese with holes in it and of course global banking supervision. The Basel Accords, originated in Switzerland, sets international banking regulations that U.S. banks are required to follow. Whether it is the neutrality the country has exhibited over the years, or simply a fun place for banking regulators to hang out, Switzerland has become the center of the universe for global banking regulation. As with most significant changes that occur in banking, Basel has its roots in a loan deal gone bad. The group was formed in response to a loan and foreign exchange mess made worse by a government takeover of a German bank. Many international banks on other time zones were left holding the bag and promptly called their government officials to complain and to set about standardizing global banking principles. The result of these meetings brought about the first set of proposals, called Basel I. This was released in 1988 and focused on the definition of bank capital and the structure of risk weights. Basel I delivered banks the concepts of Tier I and Tier II capital, along with risk weightings (20% for Agency securities, 100% for single-family residential loans, etc.) to various assets. This is where bankers found out they would have to hold capital equal to 8% of risk-weighted assets. In all, there have been 5 amendments to Basel I, the last of which introduced capital requirements for market risk. Basel I was pretty much the backbone of regulatory capital over the years until 2004 when Basel II was finalized. After years of debate, Basel II was released with the grand design of moving banks toward better risk management. Basel II shifts capital allocation to risk sensitivity, separates operational risk from credit risk and align economic and regulatory capital. Basel II, globalization and extreme competition has forced independent banks to better understand these concepts in an effort to hang onto their loan business. After all, if a national bank like JPMorgan can prove to banking regulators they only need to hold 25 cents for every $100 of commercial real estate loans, while an independent bank still needs to hold $1. Think of how uncompetitive this makes independent banks. At a minimum, since Basel II has already affected loan pricing, independent banks are urged to educate themselves more actively about this pending industry shift. International banks have already begun adopting Basel II, however because the U.S. banking industry has thousands of independent banks, our regulators are attempting to provide an interim step (to prevent dislocation). They proposed rules on December 26th of last year, called Basel 1A, which gives banks who do not adopt Basel II more flexibility. Under Basel 1A, banks would continue to use Basel I risk based capital rules Â– with some twists. Basel 1A would allow banks to increase the number of risk weight categories they use, incorporate external credit ratings and assign them to risk weight exposures, expand the range of recognized collateral and eligible guarantors, use LTV ratios to risk weight most residential mortgages, increase the credit conversion factor for commitments with an original maturity of 1Y or less and remove the 50% limit for certain derivative transactions. While not perfect in any way, Basel 1A gives independent banks a method to stay competitive with larger banks. Basel II rolls out in the U.S. in 2008, so independent banks should start to climb this Matterhorn.

BANK NEWS

M&A

First Keystone Bank ($518mm, PA) will acquire Pocono Community Bank ($134mm, PA) for approximately $33.6mm or about 2.3x book.

Expanding

International Bancshares ($11B, TX) continues to expand its branch network, announcing plans to add 40 branches this year in TX.

CRE Growth

A new study finds investing in commercial real estate hit a record $307B in 2006, an 11% increase over the prior year. This flood of new money into the sector is also a significant contributor to an increase in competition.

Competitor Expansion

First Horizon National Corp. (the old First Tennessee) announced it has acquired Republic Mortgage LLC (NV) for an undisclosed sum. Republic originated $1B in mortgage loans last year. First Horizon now has branches in 46 states.

Low Income Risk

A Brookings Institute study concludes that 30% of lower income debtors fall behind in payments at some point during any given year and that debt service consumes more than 40% of their household budget. The study also finds that the rise defaults as of late has a direct correlation to financial firm's decreasing credit standards and increasing credit availability.