# INNOVATION TIME FOR ALLL IN BANKING

by Steve Brown

One area that you wouldn't expect to be pro-business cycle is intellectual property. However, patent filings have fallen for the first time in 13Ys. That has scientists, investors and the government worried, because innovation is the future growth engine for the country.

To do our part, we wondered what would happen to community banks if regulators made a small but important innovation to change Tier 2 capital limitations with regard to loan loss reserves. To understand the impact, it is important to first clarify the capital treatment difference between Tier 1 capital and Tier 2. To do that, we need to make a stop in Basel, Switzerland.

Basel is Switzerland's 3rd most populous city and is located in the northwest on the Rhine River, bordering both Germany and France. What is even more interesting to bankers is that Basel is also the meeting place for the Basel Committee, which sets global standards for banking laws and regulations. The Basel Committee is made up of representatives from major central banks and regulatory authorities of major countries.

Back in 1988, the Committee came up with Basel I and published a set of minimal capital requirements for banks. These rules were enforced in countries worldwide by 1992 and this is where we get our 20%, 50% and 100% risk-based capital calculations (among other things). As we all know today, Basel I was a decent start, but it was also pretty blunt, so the Committee immediately began work on Basel II. This set of recommendations, which was initially published in June 2004, is now being completely reworked, given what the world knows now following the most recent global credit crisis. The goal, however, remains the same - to have an international standard that banking regulators can use when creating regulations about how much capital banks need to put aside to guard against financial and operational risks.

Let's get back on the plane and fly back from Switzerland to the United States to review the concepts of Tier 1 and Tier 2 capital. For supervisory purposes, regulators define capital in these two tiers because they want banks to have at least 50% of capital in core equity capital, with the remaining 50% allowed as Tier 2.

Tier 1 capital is considered by regulators to be the most reliable form of capital as it provides a measure of core strength of a bank's capital position. Tier 1 capital is equity capital and some reserves (where the equity cannot be redeemed at the option of the holder). Tier 2 capital, on the other hand, is considered more supplementary in nature. This capital includes general loan loss provisions, hybrid instruments and subordinated term debt (ranking lower than bank depositors). Since these instruments take losses without triggering bank liquidation, regulatory rules allow this tier to be counted as capital.

The problem of determining the quality of capital comes when trying to classify loan loss reserves. Here, regulators were trying to address general reserves set aside against the possibility of loan losses that have not yet been identified. Since potential losses do not reflect a known deterioration in the valuation of particular assets, these reserves are dumped into Tier 2 capital. However, if losses are based on a specific asset or due to an identified deterioration in that asset's value, reserves are not available to meet unidentified losses elsewhere in the loan portfolio (as such it is reasoned that these reserves do not have essential characteristics of capital and should not be included in a bank's capital base). To solve this issue, regulators limited general loan loss reserves that qualify for inclusion in Tier 2 to a limit of 125% of risk-weighted assets.

Since this isn't 1988 and since banks are piling up loan loss reserves, one key innovation regulators could make that would have an immediate and profound impact would be to increase or eliminate the 125% maximum limitation on reserves eligible for inclusion in Tier 2 capital. In the alternative, it could be easier to eliminate the concept of Tier 2 entirely by just increasing the percentage holding of Tier 1 and adjusting the risk-based asset percentages for loss volatility and likelihood. The good news - because the Basel Accords are global in structure, each country's banking regulator has some discretion over how differing financial instruments may count in a capital calculation to address different legal systems in different countries.

# BANK NEWS

### Bank Shuttered (133 YTD)

On Friday, the FDIC closed: [1] Republic Federal Bank, NA ($433mm, FL). 1st United Bank ($669mm, FL) will assume all deposits paying a 1.2% premium and purchase $267mm in assets (79% under a loss-share agreement). [2] Valley Capital Bank ($40mm, AZ) with Enterprise Bank & Trust ($2.49B, MO) paying a 2% premium for all deposits and acquiring essentially all assets (74% under a loss-share). [3] SolutionsBank ($511mm, KS) and sold to Arvest bank ($10.5B, AR). Arvest will assume all deposits and purchase essentially all assets (80% under a loss-share). These closures are estimated to cost the DIF $252mm.

### Citi

Citigroup, the last of the large banks to not have a plan to repay the Gov't's "exceptional financial assistance," announced it will repay the $20B through an equity raise.

### Cash On Hand

Analysis by JPMorgan finds cash holdings are sitting at about 9% of total assets at the largest US banks, a 28% increase quarter over quarter.

### Businesses

US airlines are reporting business demand is slowly recovering as they boost outlooks for 2010.