BASEL COMMITTEE PAPER - CAPITAL

by Steve Brown

Late last year we talked about the Basel Committee. This group made up of banking regulators worldwide has been meeting off and on since the banking crisis erupted. Toward the end of last year, the Committee came out with consultative papers updating their views on both liquidity and capital. The goal of these documents was to toughen bank capital and liquidity rules with a focus on implementation globally no later than 2012. Since community bankers are not directly impacted by Basel, they are indirectly impacted as many proclamations that the Basel committee suggests end up being best practices in the US and many guidance points make it into regulation.

The proposal shifts the focus of capital to common and retained earnings (Tier 1). It emphasizes that this must be the predominant form of capital for banks. It does not allow for an adjustment for unrealized gains or losses and it deducts goodwill (net of deferred tax liability), deferred tax assets reliant on future bank profitability and investments in financial firms (in excess of 10% of the bank's common equity). In addition, it requires full recognition of defined benefit pension liabilities in common equity. Finally, it phases out hybrid capital instruments such as TRUPs and ensures remaining Tier 1 capital must be subordinated instruments with fully discretionary noncumulative payments without a maturity date and no incentive to redeem. This sends a clear message global regulators are going to ensure capital moves back to its purest form and will also serve to reduce leverage in the system even further, if adopted as-is.

The next key area of the proposal relates to Tier 2 capital. Here, regulators propose such capital be subordinated (to depositors and general creditors) and carry a maximum maturity of 5Ys. Additional comments are being sought by the Committee to incorporate additional safeguards to prohibit redemption when a bank becomes stressed, so more changes here are likely.

The third area of focus relates to counterparty risk. In order to safeguard the banking system, capital requirements for counterparties are proposed to be stressed to account for potential credit deterioration. The proposal suggests using a 1Y time horizon and maintaining margin when larger or illiquid collateral is used. The capital charge increases when a counterparty is highly leveraged (such as Lehman was) and requires higher standards for counterparty risk management. External credit rating agency reliance is also reduced under the proposal.

Another area of focus is the leverage ratio. Here the proposal focuses on exposures net of specific provisions or valuation adjustments and moves to ensure consistency between deductions from capital. It no longer allows netting and consideration is still underway to exclude high quality liquid assets from exposure measures. The proposal moves to include all commitments, letters of credit, failed transactions, unsettled securities and liquidity facilities in the risk analysis.

In a very interesting twist, the proposal introduces the concept of a "capital buffer." Here, the proposal bases the buffer on Tier 1 capital levels, then applies the highest average probability of default to each loan type based on bank history and the average to estimate each one as well. The buffer is designed to shift when signs appear that credit in the economy has grown to an excessive level and distributions will be constrained when capital falls below the buffer range.

Finally, the new proposal takes a close look at loan loss provisioning. It deducts provisioning shortfalls from common equity and reviews treatment of excess loan loss provisions as part of Tier 2 capital.

While much of this proposal remains under discussion by regulatory agencies worldwide, it is clear the move is underway to tighten up regulation so a repeat of the global credit crisis does not reoccur.

BANK NEWS

Card Rules

It's final. Effective 2/22, banks are not allowed to raise rates within the first year of the account and customers must sign an agreement permitting transactions to go through that would surpass ones credit limit and incur a charge. In addition, double cycle billing will be prohibited.

Mortgages

The MBA expects volume of loan originations to fall 40% to $1.28T with refinances dropping 60% to $502B this year.

FRB Speakers

Over the past few days the FRB parade of speakers has delivered the following quotable messages: Fed Governor Duke said she "expects to see a continued moderate economic recovery in economic activity in 2010;" FRB Boston President Rosengren said "It appears the recovery will likely experience only a slow improvement in the employment picture;" and FRB Kansas City President Hoenig said "While there is considerable uncertainty about the outlook, the balance of evidence suggests that the recovery is gaining momentum."