ROYAL BANKING CAPITAL

by Steve Brown

You may not have heard it yet this morning, but the 2Q GDP number was released in the United Kingdom. Sure it was interesting to us that it came in at a very weak 0.2%, but what was even more interesting was that it was adjusted down by "nought point five oh percent" due in part to the extra bank holiday at the end of April for the royal wedding. Who knew the Royals could impact the economy that much? We guess as Americans trying to dig out of an economic malaise of our own, we can be happy we don't have a king or queen. Maybe the cranky kid in the corner of the picture is onto something? No matter your opinion on this issue, we know that as a community banker, there are plenty of issues you already face in our crazy industry, so as you wait for US GDP to be released on Friday, we will just say pip, pip, cheerio.

In their own speeches, regulatory higher-ups indicate capital is a shock absorber to protect non-equity stakeholders. The credit crisis pointed out that too much leverage and too little capital were critical components that strained our financial system. That is why the Basel Committee (group of global banking regulators) has been toiling away to develop formalized and standardized capital rules for banks across the world under Basel III. In fact, as if community bankers didn't already have enough on their plates to deal with under Dodd-Frank, more work will need to be done to deal with Basel III (which is scheduled to be phased-in starting in 2013 over a 5Y period). More importantly, the structure of capital has changed since the crisis and regulators are more focused on what sorts of capital your bank holds and how it is being used.

By definition, equity is the portion of funding/capital supplied by owners of the bank. Since those same owners are entitled only to what is left over after the creditors are paid, their shares are riskier in nature compared to other forms of capital. That is one reason why equity is nearly always more expensive than debt to the issuer (not to mention that debt interest expense is deductible, while dividends are not). Issuing stock is not something most banks want to do, unless they have a good use for it and can earn a respectable return over a longer term period.

From a regulatory perspective, it is also important to note that capital requirements naturally limit the size of a given bank's balance sheet. The more capital you have, the more you can grow, while the reverse is also true. On a systemic basis worldwide, what comes out of Basel III ultimately matters to community banks because it will have an impact on how large you can grow (given changing regulatory requirements for capitalization). Leverage has become a dirty word, despite the fact that it is a basic component of the banking system, because of the excessive leverage that was allowed in the heady days prior to the crisis. Capital will be limited under Basel III, so the only question is how much and the ultimate impact.

Another offshoot of any discussion around capital has to include loan loss reserves (which are yet another cushion against potential loss). Here, examiners are discomforted by things they see in the use of market data and a bank's own credit risk indicators. Significantly reducing Q factors in a short period of time, for instance, when the economy is moving more slowly is likely to get additional scrutiny. If your bank's own credit risk indicators (volume of loans past due, nonaccrual, classified, etc.) are not stabilizing or improving; reducing Q factors is likely to be met with healthy skepticism, so be prepared.

Finally, it is important for directors to understand that the critical role of capital means regulators expect directors and senior management to credibly estimate sources and uses of capital for a given planning period - before any dividends are paid. Suffice it to say that managing capital has become a royal pain to many bankers, but a necessary one nonetheless. Hang in there and perhaps over time you might even be knighted for your efforts.

BANK NEWS

Cards

According to an AP-GfK poll, 43% of the consumer population owe $1k or more and 10% owe $10kor more. The average consumer credit card debt in June was $3,200, down from $3,800 6 month ago.

Fannie Freddie Small Business Loans

Rumors were circulating that the Treasury is working with FNMA and FHLMC to rollout a new loan-guarantee program, designed to assist small businesses in poor communities. The program, if true, might offer a guarantee on qualifying loans made by Community Development Financial Institutions.

Negative Equity

While NY holds the distinction of the state with the largest amount of average negative equity in its home loans at -$120k, upside down mortgages only compose 6.2% of the population. NV has 63% of its homes underwater followed by AZ at 49%. Both states average a negative equity amount of -$63k.

FHA

One story that has yet to be written is major accounting and provisioning problems at the FHA. We look for some sort of bailout needed to save the troubled agency.

CIBC

In order to boost its wealth management business, the Canadian bank will pay $848mm for 41% of American Century Investments, a major U.S. asset management company with $112 billion under management.

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