BASEL III, DODD FRANK & BANK CAPITAL - PART 1 of 3

by Steve Brown

As you can see a little bit from the map at the left, Basel Switzerland is smashed right between Germany and France where the Rhine River flows into Switzerland. Believe it or not, this is where all the regulatory agencies and political muckety- mucks worldwide meet periodically to have major discussions about bank capital rules for all banks. Well, those folks have released the Basel III Accord, which was followed about a month ago by a series of three separate by related proposals by U.S. banking regulators. All of these proposals and Basel III significantly change the way banks calculate and hold capital. All of them completely revise the structure of capital adequacy rules and are designed to bolster the quality and quantity of capital banks must hold. As a group, the changes incorporate requirements imposed by Dodd Frank, upgrade the world's banks from current Basel II requirements and implement international agreements on capital. This subject is critically important to community banks as it is the most comprehensive overhaul of capital standards since 1989. To begin, the changes modify regulatory risk weights, potentially sharply reducing earnings potential and changing existing business models. As such, we are going to do a series for you over the next few days on the subject, so you can keep them handy for your future review. Since we have already consumed hundreds of pages on this subject, we will do our best to get it down to something more bite-sized for you as we go. The first thing to know is that comments on the 3 proposals are due Sept. 7, 2012. If you think that still gives you plenty of time, we would caution that there are literally hundreds of pages of regulatory information flowing here that might change the very capital structure of banking, so you need time to absorb it, sit in on calls with regulatory agencies, get help from industry law firms, review with accountants and consult with advisors to fully understand the impact on your bank. After gathering information, then you need to decide your best strategic path, so the sooner you start, the better we would say. Basel III is the global viewpoint, so we cover it first to help tee up our discussion. In short, Basel III builds on the regulatory framework adopted by Basel II and Basel 2.5 (now absorbed into Basel III). As you will recall, Basel II improved the measurement of credit risk and included capture of operational risk over Basel I. Basel II was released in 2004 and was due to be implemented by year end 2006. As you will further recall, Basel 2.5 was agreed to in mid-2009. It enhanced risk measurement around securitization and trading book exposures, so for the most part it bypassed community banks. Basel 2.5 was to be implemented no later than Dec. 31, 2011. Deep into the credit crisis in Dec. 2010, Basel III was released. This first version set higher levels for capital requirements and introduced a new global liquidity framework. After a few cycles around the world, regulators worldwide agreed to implement it beginning Jan. 1, 2013 with final phase-in due by Jan. 1, 2019. Basel III is important for community bankers because it sets the methodology worldwide for how banks calculate their Risk Weighted Assets and capital ratios. Now that the high-level around Basel III is at least reasonably understood, it is important to know that the proposals would require all banks, savings associations, SLHCs and bank holding companies (BHCs) that are subject to minimum capital requirements other than "small bank holding companies" (generally a BHC with consolidated assets less than $500mm). Banks must begin complying with Basel III minimum risk-based capital requirements as of Jan. 1, 2013. So as not to fry your brain too much this morning, let's end there. We will pick things up again tomorrow however, as we continue to explore this significant event.

BANK NEWS

US Rating

Fitch affirmed the US's "AAA" rating, but kept America on negative credit watch.

TARP

The Treasury announced another individual bank TARP auction for 12 community banks. The last auction generated discounts of about 6% on a weighted average.

LIBOR Scandal

As users (borrowers, Wall Street, etc.) assess the potential impact of the manipulation, talk is increasing about switching over to an index that has observable and tradable prices. Considerations include repo, Fed Funds & T-Bills.

Cloud IT

The FFIEC warns banks that regulators consider cloud computing to be another form of outsourcing, with the same basic risk characteristics and risk management requirements as traditional forms of outsourcing. Banks are instructed to perform thorough due diligence and risk assessment , incorporate vendor management, information security, audits, legal, regulatory compliance, business continuity planning and have risk mitigation controls.

Prepaids

Comerica becomes the latest major bank to launch a prepaid card in an effort to migrate their free checking customers over to a cheaper and more profitable product line. Of note, the Bank will charge $3.95 a month for the account, the lowest so far among major banks.

Muni BK

The city council for San Bernardino approved a bankruptcy filing. If they go through with it, they will become the 3rd major CA city to do so and the 2nd in 2 weeks.

Swaps

The CFTC has approved final rules on derivatives that exclude community banks with less than $10B in assets from clearinghouse requirements.

Beneficial Holders

FINCEN meets today to discuss rules and risk around customer due diligence. At particular issue for banks is the potential requirement to identify beneficial ownership of accountholders.