BASEL III, DODD FRANK & BANK CAPITAL - PART 2 of 3

by Steve Brown

Today we continue our series on the new capital structure rolling out across the banking landscape, but we shift our focus back to the U.S. Here, regulators have issued 3 notices of proposed rulemaking (NPR), all designed to increase the quality and quantity of regulatory capital, enhance risk sensitivity, address identified weaknesses and deal with requirements under Dodd Frank. The first NPR is dubbed "Basel III" and it is primarily focused on improving the quality and quantity of bank capital. It applies to all institutions with consolidated assets > $500mm. It also revises risk-based and leverage capital requirements, introduces a new Common Equity Tier 1 (CET1) ratio, increases the minimum Tier 1 capital ratio, incorporates a Capital Conservation Buffer (CCB) and modifies the Prompt Corrective Action (PCA) framework. Minimum risk-based capital ratios would be CET1 capital to total Risk Weighted Assets (RWA) of 4.5% (new), Tier 1 capital to total RWA of 6% (up from 4%) and total capital to RWA of 8% (same as it is today). These capital ratios would begin in 2013 and be fully phased in by 2015. It is important to understand CET1 capital, since it is a new requirement. It is clear that regulators view common equity as the highest quality form of capital and that concept is picked up here. CET1 capital would be composed of common stock and retained earnings and would include regulatory capital deductions or adjustments (such as goodwill, deferred tax assets from operating losses and tax credit carry-forwards, certain defined benefit pension fund assets, investments in own shares). In addition, there are also threshold deductions from CET1 capital (such as mortgage servicing or deferred tax assets arising from temporary differences and significant investments in the capital of unconsolidated institutions that exceed certain thresholds). As things stand right now, unrealized gains and losses on all available for sale securities would flow through CET1 capital. Tier 1 capital revisions would not allow trust preferreds or cumulative preferred instruments (phased out by 2016 for institutions with $15B in assets and 2022 for everyone else). Meanwhile, the Leverage Ratio stays at 4% minimum under the revised definition of Tier 1 capital. The Capital Conservation Buffer is designed to ensure institutions remain above regulatory capital minimums during a systemic stress event. Here, banks would need to hold a buffer of 2.5% CET1, in addition to minimum risk-based capital requirements, in order to avoid restrictions on dividends and discretionary bonus payments to executives. The transition period for the CCB would begin in 2016 and be done by 2019. The math for CET1 Capital to RWA would be the 4.5% minimum level plus a potential 2.5% CCB for a total of 7.0%. Tier 1 Capital to RWA would be a 6% minimum plus a potential 2.5% CCB for a total of 8.5%. Finally, Total Capital to RWA would be a minimum 8.0% plus a potential 2.5% CCB for a total of 10.5%. The second NPR is called the Standardized Approach and it applies to all institutions with consolidated assets > $500mm. It provides a more risk sensitive view of RWA and takes effect by 2015 (but can be adopted earlier). This NPR also removes references to credit ratings. While much of the current risk weighting approach remains intact, the NPR also makes some interesting changes. It shifts exposures more than 90 days past due or in nonaccrual to a 150% risk weight; assigns risk weightings of between 35% and 200% to residential mortgage exposures based on LTV, performance and certain product features; and it changes CRE exposures related to acquisition, construction and development financing to 150% risk weight. There are a lot of nuances and other risk weighting changes that are too numerous to mention today, so we will cover that tomorrow as we wrap up this series.

BANK NEWS

FOMC Minutes

The June minutes show the Fed is on high alert, as officials sent signals they are seriously considering taking more action to boost the economy if it loses momentum or their growth and employment forecasts are reduced.

ECB Reserves

The ECB's decision to stop paying interest on overnight deposits has driven banks to cut the amount of cash left there by 60%.

Branch Closures

The parent company of FirstBank ($12.1B, CO) said it will close 12 branches inside grocery stores, as it seeks to cut expenses and modifies its footprint due to increased popularity of online banking.

M&A Recap

SNL reports bank transactions grew 15% in the fist half of 2012 vs. the same period last year, but volume fell 12% from 1Q. Of the 50 deals announced, the median price-to- tangible book was 1.11x in 2Q, compared to 1.16x in 1Q.

M&A Change

In a set of deals being closely monitored, First California ($1.9B, CA) cut the number of shares it would pay to acquire Premier Service Bank ($138mm, CA) by 38%, due to a run up in First California's stock price. First California itself is in the middle of a hostile takeover bid by PacWest ($5.4B, CA).

No M&A

By mutual agreement, Vintage Bancorp ($14mm, KS) canceled its merger with CornerBank ($270mm, KS) after neither bank could reach terms and/or Vintage could not complete its planned capital raise.

Competition

Navy Federal CU ($49B, VA) launched a business loan initiative to actively purchase commercial loans from other credit unions that may be at or near their regulatory business loan asset cap.