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

by Steve Brown

Today marks the final part of our series on comprehensive capital reform and its impact on banks. We have discussed many aspects of the changes already, but there are so many things to talk about, you will certainly see this surface again in a future issue.

We begin today on the 3rd notice of proposed rulemaking (NPR), called Advanced Approaches and Market Risk. This two-part NPR only applies to institutions with assets of at least $250B (Advanced Approaches) or those with trading assets and liabilities that are equal to at least 10% of total assets or $1B in exposure (Market Risk). Since neither are applicable to you as a community bank (except for how your competition will behave), we end discussion on these now.

Switching gears, it is critical to know that the Risk Weighted Assets calculation forms a critical piece of these new capital calculations. As such, here are some things to know:

0% Risk Weight: To begin, the regulators indicate the following assets would carry a 0% risk weight under the proposal: cash owned and held in all of an institution's offices or in transit; gold bullion; exposures to and claims directly and unconditionally guaranteed by the U. S. government (Treasuries) or agencies that where the obligation is fully and explicitly guaranteed by the full faith and credit of the U.S. government (GNMA, VA, FHA); the portion of a deposit insured by the FDIC or the NCUA (note here that loss-sharing agreements entered into by the FDIC are considered conditional guarantees for risk-based capital purposes due to contractual conditions that acquirers must meet and as such are 20% risk weighted); residential mortgage exposures that are unconditionally guaranteed by the U.S. government or a U.S. agency; exposures to the BIS, ECB, EC and IMF; the exposure amount of an off-balance sheet item such as commitments, contingent items, guarantees, certain repo-style transactions, financial standby letters of credit and forward agreements (usually the notional amount) multiplied by a 0% credit conversion factor for the unused portion of commitments that are unconditionally cancelable by the institution. While this list is not comprehensive, it hopefully gives you a good start.

20% Risk Weight: Under the proposal, the following items are assigned a 20% risk weight: cash items in the process of collection; exposures conditionally guaranteed by the U.S. government, its central bank or a U.S. government agency; claims on government sponsored entities like FNMA, FHLMC, FHLB and Farmer Mac (note that a 100% risk weight is applied to preferred stock issued by a GSE); exposures to U.S. depository institutions, NCUA-insured credit unions and foreign banks incorporated in an OECD country; general obligation claims on, and claims guaranteed by the full faith and credit of state and local governments and other defined public sector entities (note that exposures that rely on repayment from specific projects like muni revenue bonds carry a risk weight of 50%); self-liquidating, trade-related contingent items that arise from the movement of goods and that have a maturity of 3 months or less; residential mortgage exposures that are conditionally guaranteed by the U.S. government (such as GSE); the absolute minimum risk weight for any securitization; and certain collateralized off balance sheet exposures (with a maturity of 1Y or less). Another thing to know about using collateral for anything is that the risk weight cannot go below 20%, regardless of the risk weight of the underlying collateral on a stand-alone basis (would discourage using cash, GNMA's, Treasuries, etc. for collateral).

While we have done our best to explore and identify key issues for you over the past 3 days in this series, we cannot emphasize enough that we have only just begun this process and it is also critical for you to do more. We urge you to review the proposals thoroughly for yourself, get expert help to understand nuances if you need it and begin to review the impact on your own bank.

One clarification point of note that leads to a lot of confusion but is critical to know - The proposals apply to all U.S. banks that are subject to minimum capital requirements, including thrifts. They also apply to all BHCs except those categorized as "small bank holding companies" (generally, assets of < $500mm).

No one yet knows for sure the impact on the industry, but projections include a reduction in bank activity in the economy by some $600B; some banks being forced to sell assets or merge; decreased profitability and return on equity; and a more difficult capital raising environment. We will all get through this and hopefully will end up with an even stronger banking system worldwide once everything settles down. Until then, if you have questions or want to discuss these significant changes, contact us directly or your relationship manager and we will assist.

BANK NEWS

Earnings

2Q Earnings kicks off with JPMorgan Chase reporting a 9% drop (5% drop from the same period last year) in net income. The "Whale Trading Loss" came to $4.4B, which was offset by $1B in gains in securities sales and a 6x earnings increase in retail banking (driven my mortgage refi fees). JP also restated 1Q earnings, due to unreliable marks on some trading positions. NIM fell to 2.5% from 2.7%. Wells Fargo posted a 17% increase in 2Q earnings (a new record) due to lower expenses and strong mortgage production.

Wells Out

Wells Fargo follows other major banks and exits the 3rd party broker wholesale lending business today. Wells will still fund through correspondents, just not independent brokers. The move is a result of increased compliance risk (as well as a business that is seen to be decreasing in profitability over time). Provident Funding and Flagstar Bank are now the largest providers of mortgage liquidity to mortgage brokers.