THE BLUEPRINT OF BASEL AND CAPITAL

by Steve Brown

We have written before about Basel, the Swiss city on the Rhine River where the borders of Germany, France and Switzerland come together. This city is the 3rd most populous in Switzerland and its name comes from an ancient

Greek work for "kingship" (it has nothing to do with the fresh basil we like on our pizza, but we like that one also).

In banking, Basel is home of the Basel Accords, which are issued by the Basel Committee on Banking Supervision. That is a mouthful, but it all has to do with capital and the most recent standard, Basel III, was unveiled in 2010-2011. It was originally scheduled to be introduced as early as 2013; however recent revisions have pushed the implementation to as far as 2019. This third installment was developed to address deficiencies in regulations that were revealed in the recent financial crisis and all of the global banking regulators have been working together to set forth a new blueprint for capital that can be used globally.

Specifically, Basel III updates international banking standards having to do with capital adequacy, stress testing and liquidity. Although it is still a ways off, banks need to be prepared because changes are already in motion and they will impact community banks. Of particular interest are the new capital standards because they will require more capital than previously expected (and will entirely remove Tier 3 capital).

Basel III also establishes more conservative standards for including an instrument in Tier 1 capital. The good news is that the Fed estimates 90% of community banks already have sufficient capital to meet or exceed the proposed buffer around this, but the bad news is that since that is the case, regulators are likely to make everyone comply. Certainly the new regulations are likely to affect the very large banks the most, but they will also have a big impact on community banks. At the highest level, Basel III as it stands now will incentivize banks to reduce risk-weighted assets in order to attract investment capital.

As these higher and more defined capital requirements loom down the road, banks should be certain their strategic planning takes this into account. For community banks, this means understanding that as rates rise, the negative mark to market on the investment portfolio will reduce capital and that capital sitting in Trust Preferred Securities and Holding Company Loans pushed down to the bank won't be treated kindly (a transition period is expected, so you will have time to adjust, but it appears the die is cast and these will not count as Tier 1 capital once Basel III is finalized).

Banks should consider all sides of the risk equation when considering these or any capital strategies and be sure to incorporate the analysis into your strategic planning. One of the things regulators look for when assessing capital strategies is whether an instrument is stable and of a structure that supports the safety and soundness of the bank. Revolvers or short maturity lines have not been shown in regulatory circles to provide much stability or strength, so these kinds of structures should be avoided if possible and replaced with core capital.

Under Basel III, core capital is limited to common equity, retained earnings, accumulated other comprehensive income, other perpetual equity (cannot have step ups or other incentive to redeem), the bank does nothing to create an expectation at issuance that the instrument will be bought back, redeemed or cancelled (nor do statutory or contractual terms provide any feature which might give rise to such expectation) and the structure allows discretionary repurchases by the issuer.

For now, the capital rules remain the same, but change is in the wind, so it makes sense to start work designing your ideal capital structure so you are ready well in advance.

BANK NEWS

1 Closure (14 YTD)

Regulators closed Banks of Wisconsin doing business as Bank of Kenosha ($134mm, WI) and sold it to North Shore Bank, FSB ($1.74B, WI). North Shore gets 2 branches, assumed all deposits except brokered and $97.4mm of assets.

M&A

Bank of North Carolina ($2.9B, NC) will acquire Randolph Bank & Trust ($302mm, NC) for $10.4mm in cash and stock.

M&A Off

Oxford Bank ($266mm, MI) said it has terminated its agreement to be acquired by Level One Bank ($519mm, MI) due to an improving financial picture and regulatory delays in the process.

Out

Investment management company T. Rowe Price Group is selling its banking unit T. Rowe Price Savings Bank ($175mm, MD) to investor Jacob Safra for book value. T. Rowe said a heavy regulatory burden and a shift in regulations drove it to take the action and get completely out of banking.

Great Sector

Jim Cramer said on CBNC that banks are the market's most "undervalued" group and that once the Fed begins to taper QE, the rising economy and rising yields will lead banks to " make fortunes, and that's why the net interest margin is going up and the banks are the place to be."

Customer Retention

A report by Capgemini finds 10% of customers say they will likely leave their bank within the next 6 months and another 41% aren't sure.