The Explosion of Basel III - Part 1 of 2

by Steve Brown

Just before everyone took off for the 4th of July to grill hot dogs and blow up fireworks, the Fed set off some fireworks of their own by approving its final rule implementing the Basel III capital framework. For bankers, this marks the most significant revision to regulatory capital in more than 2 decades. To get a better understanding, it is important to note that Basel III arose from the post-crisis landscape, replacing Basel I which had become outdated and completely bypassing Basel II which never really got legs. As with most landscape-changing regulation, it's not clear whether Basel III will perfectly fit the needed response to the crisis. However, one thing is crystal clear: the primary objective of Basel III is to ensure banks have larger amounts of higher quality capital.

The rule weighs in at a whopping 972 pages long it will take some time to digest entirely. We have been working on this for some time and our two part article running today and tomorrow on the subject should help community bankers.

Since the introduction of the proposed rules last summer, the banking industry has fired back more than 2,600 comment letters to the regulators. Suggestions to improve the proposed rules have run the gamut, but it appears that in turning out the final rules, the Fed heard the collective community bank voice. Basel III makes key concessions that will help community banks including: keeping the same risk weighting for residential mortgages; eliminating the phase-out of capital instruments such as trust preferred securities; and allowing an opt out of Accumulated Other Comprehensive Income. This is all good news, but there is nuance that needs to be understood.

To begin, under the new rules, regulatory analysis indicates the overwhelming majority of banking organizations already have sufficient capital to comply with the rule if immediately implemented. In fact, an estimated 95% of insured depository institutions would be in compliance with the minimum ratios and buffers established by Basel III. That is good, but many bankers would likely argue having record amounts of capital on the books and weak loan demand isn't the ideal mix for performance, so you have to dig even deeper to get the full picture. Overall, the rule is designed to ensure that banking organizations maintain their capacity to absorb losses in the future - period.

The next key thing to know is that community banks will not need to implement the standardized approach until Jan. 1, 2015, so your bank has some time to get a handle on things. Capital drives all else, so the deadline itself is a "win" for community banks (the original requirement was Jan 1, 2014). However, we know it is not easy to turn a bank on a dime, so the new rules should be quickly reviewed and considered by your bank, with a particular focus on setting up a capital planning committee.

In our last piece of discussion today, we note Basel III sets up a brand new capital ratio, called Common Equity Tier 1 (CET1). CET1 must be 4.5% of Risk Weighted Assets (RWA) and is made up of common stock (plus related surplus) and retained earnings, less the majority of regulatory deductions (including items like goodwill, gain-on-sale associated with a securitization exposure or defined benefit pension fund net assets). This new category is designed to ensure banks hold sufficient high quality regulatory capital to absorb losses on an ongoing basis. We will pick up tomorrow, with more fireworks and discuss the new capital buffer and other important elements.

BANK NEWS

Q2 Earnings

Wells Fargo reported Q2 net income of $5.5B, up 19% vs. Q2 2012. Over the same period, the efficiency ratio fell to 57.3%, ROAA reached 1.55%, ROE was 14.02%, the ALLL fell 14% to 2.07%, average loans grew 4.2%, $500mm was released from loan reserves and NIM declined 12% to 3.46%. **JP Morgan** reported Q2 net income of $3.1B, a decrease of 6% vs. prior year period (lower net revenue and higher noninterest expense, partially offset by lower provision). Over the same period, active mobile customers jumped 32% (to 14mm), mortgage originations grew 12% and average business banking loans grew 4%. **Comerica** reported Q2 profit of $141mm, flat vs. the year-earlier period. Net interest income fell 4.8% to $414mm and noninterest income fell 1.4% to $208mm. Loans increased 1% from Q1, securities fell 6%, loan loss provisions were $13mm vs. $19mm and NIM came in at 2.83%. **Bank of America** reported a stronger-than-expected 70% increase in Q2 profit, driven by a 17% jump in sales and trading revenue and lower expenses. From Q2 2012, net income climbed to $3.6B, operating expenses declined 6%, investment banking fees climbed 24%, asset management fees climbed 10%, NIM climbed 10% to 2.44%.

Ugly Projections

Bankers should note Wall Street analysts have cut Q2 GDP forecasts to less than 1% after weakness surfaced in retail sales and business activity.

Crackdown Coming

Fed Governor Daniel Tarullo said regulators should crack down on wholesale short-term funding used by banks prior to the crisis, as it leaves them exposed. Tarullo said regulators are working on a plan to address short- term funding risks.

High Cash

The Fed reports the amount of cash held at banks has reached a 5Y high.