# Basel III - Part 2 of 2

by Steve Brown

Yesterday, we began picking apart the new Basel III capital rules, so today we continue where we left off (describing the new capital buffer, different definitions of Tier 1). We will then move on to the new risk weightings, as we close the discussion.

??To begin, the Capital Conservation Buffer is composed of Common Equity Tier 1 (CET1) capital and should be at least 2.5% of risk weighted assets (RWA). This buffer is in addition to the minimum CET1, Tier 1 capital and total capital ratios and was created by regulators in response to the actions of financial institutions during the financial crisis that continued to pay dividends and substantial discretionary bonuses - even as their financial condition deteriorated. Regulators viewed those actions as a significant contributor to the crisis, so a buffer was added. If a bank's buffer is short of the 2.5% level, regulatory limitations kick-in on capital distributions and discretionary bonuses.

As we noted yesterday, the main purpose of Basel III is to drive more and better capital into the banking system. In response to this objective, regulators have increased the Tier 1 capital requirements from 4% to 6%. In addition, fewer items now qualify under Tier 1. This shift has resulted in a new definition of Tier 1 capital: CET1 plus non-cumulative perpetual preferred stock.

On the higher quality capital side of things, community banks dodged a bullet when regulators grandfathered in trust-preferred and other securities, but larger banks are excluded from this carve out, so regulators appear determined they do not want to see this market come back to life. There is no change to the Total Capital Ratio requirement of 8% or the leverage ratio of 4%.

The Basel III rules also make regulatory capital measurements more risk-sensitive, as the final rule increases the risk weighting requirements for certain assets. Regulations currently require 100% risk weighting for all commercial real estate (CRE) loans and for most loans that will remain the same. However, for the newly-created CRE subset of high-volatility CRE (HVCRE), the requirement will increase to 150%. Under the rule, HVCRE loans are made for the acquisition, development or construction of real property, prior to the conversion to permanent financing. While regulators have made some exceptions here (i.e. 1-4 family residential, agricultural, etc.), it is clear they are discouraging banks from certain behaviors and loan asset classes.

Finally, Basel III zeros in on 90 day past due exposures. Past due loans had previously not required any change in risk weighting, but now will require 150% risk weighting. Non-accrual loans will also require 150% risk weighting. In scanning community bank numbers for the 5,887 institutions under $1B, 90 day past due loans are not a huge number anymore and have declined over the past 5Ys from an average of $330k to $232K, but non-accruals are significant. While non-accruals have declined from an average of $3.5mm at the end of Q1 2013, they stand at an average of $2.9mm still, so this piece of the rule would have a significant impact and would chew up regulatory capital when recessions or downturns occur.

These are some key items to know for now about the new rule and we will write more on this subject soon as we continue to dig in. Implementation is still a ways off, so that is good, but it will be here before you know it so it is something to ponder over your summer vacation as you try to construct this new capital puzzle.

## BANK NEWS

**M&A**

Grand Bank & Trust ($246mm, FL) will sell its trust and asset management business to Reliance Trust Co. for an undisclosed sum. Grand Bank took the action to boost capital ratios, as it was adequately capitalized as of Mar. Reliance is a leading provider of financial and trust services with more than $121B in assets under management.

**Competition**

HSBC Bank USA ($184B, VA) has launched a $1B loan program focused on small to medium sized businesses interested in exporting.

**Customers**

A recent survey by Novantas found 70% of consumers who opened deposit accounts at banks preferred to shop online for the product, but 62% then went into a branch to actually open the account.

**Construction Spending**

Small builders that have historically borrowed from community banks have been quietly selling themselves to larger builders over the past few years, as they have been unable to buy land and develop it given a lack of bank funding due to regulatory pressures in this sector. Since 2008 in fact, the FDIC reports the dollar value of outstanding construction and development loans has declined 68%.

**Fined**

British bank Barclays Plc and four of its former traders have been fined a combined $487.9mm related to alleged manipulation of California energy markets and will have to surrender $34.9mm in profits, according to the Federal Energy Regulatory Commission (FERC).

**Risk Management**

A survey of CFOs (80% at companies with $1B+ in annual revenue) by Deloitte finds the top 5 changes these financial executives have seen in risk management over the past 5Ys are: elevating risk visibility to the board or executive level (80%); improved the assessment of risk probability or impact (70%); improved risk response through contingency planning, etc. (50%); clarified responsibility for key risks (46%); and increased staff training to raise awareness, mitigation and responsiveness (42%).

**Comparison**

FactSet reports S&P 500 companies paid shareholders a yield of 5.1% in 2012 from a combination of dividends (2.0%) and stock buybacks (3.1%).