Basel III and Sub S Banks

by Steve Brown

It's that time of year again - harvest season. It's a dangerous time in many areas where farmers prowl about neighborhoods searching for cars with unlocked doors. They stuff the front seat with bags of tomatoes and baseball bat-sized zucchini squash and then flee into the night. Vegetables tend to ripen at the same moment, so the oversupply must be dealt with as gracefully as possible. This was a great year for tomatoes in many places so watch your car closely. If you happen to get tagged, one favorite recipe for fresh tomatoes is caprese salad - sliced tomatoes with fresh mozzarella and most importantly, fresh basil and olive oil - tasty.

For bankers, in spite of the abundance of tomatoes this year Basel means something else. The third chapter has been released and it is quickly moving to the front burner for many banks. Basel III is not the same for everyone though and is much tougher on the big banks (as it should be). Another group closer to home that is negatively impacted though is Sub S banks.

There are a lot of Sub S banks in the US: 2,239 in all or about 33% of the industry as of 2Q 2013. Sub S corps were created in 1958 as a way to help small businesses with a single layer of tax and the liability protection of a corporation. The number of shareholders was limited to be sure it was used as intended (for small business) and income and losses were passed through to shareholders. The number of S corps has grown from 2.7mm to 4.5mm from 2000 to 2010.

As for Sub S banks and Basel III, the key to note is that the primary emphasis of Basel III is to ensure more and better capital for the industry at large. Regulators have also pointed out that the vast majority of community banks already have enough capital to meet these new requirements. The question is what happens to Sub S banks?

Banks that are a bit closer to the required levels of Tier 1 capital of 4.5% plus the capital buffer of 2.5% could have difficulty. That is because a bank that falls below this 7.0% threshold will have their ability to pay dividends compromised. Even profitable banks can't pay dividends because of this new rule. If there are no dividend distributions shareholders will be required to pay taxes out of their own pockets. This can be especially onerous, as there are severe consequences if a Sub S bank fails to follow strict rules for maintaining the tax structure since the entity will be subject to tax at the highest corporate rate.

If you don't think this could happen, consider the need for shareholders to pay taxes out-of-pocket has already arisen in cases where enforcement actions kept banks from paying dividends. It is not a ground-breaking revelation, but it is important to keep in mind.

Keep in mind that unlike the Sub S, C corp shareholders would not be subject to tax on the bank's undistributed income and would not be required to make tax payments from personal sources. This is because the bank pays tax on income at the corporate level so shareholders have no tax due (because no distributions have been made). Sub S shareholders are not as lucky, though and would be subject to tax on their allocable share of the undistributed income because of the tax rules, so must pay the tax using their own individual funds due to the rules.

As a result of Basel III, community banks may ultimately decide that the Sub S designation is not as attractive as it once was. To be sure, top personal tax brackets have risen and that seems unlikely to change.

We note that the capital conservation buffer does not take effect until Jan 2019, but Sub S banks should carefully consider the implications of Basel as you decide whether to throw tomatoes at the ruling or not.

BANK NEWS

M&A

Huntington National Bank ($56B, OH) will buy Advantage Bank ($756mm, OH) for $97mm in cash (20%) and stock (80%). Huntington picks up 22 branches.

3Q Earnings: Wells Fargo

beat expectations as its 3Q earnings climbed 13% YOY to a new record. Wells said loans and deposits grew strongly as credit quality also improved. By the numbers: ROA 1.53%, ROE 14.07%, efficiency 59.1%, loan growth +4% YOY (core loans up $13.8B, 62% organic and 38% acquired), mortgage originations -29% in the Q, revenue -3.5%; mortgage banking fees -43% YOY, provisions -89%, reserve release $900mm, NIM -8bps to 3.38%, announced two rounds of job cuts for 4,800 employees, primary business checking accounts +3.6% YOY.

3Q Earnings: JP Morgan

reported a loss of $380mm after taking a $9.2B pretax charge for legal expenses and reserves for litigation and regulatory proceedings (related to Bear Stearns and Wamu home loan issues). By the numbers: loans +0.9% YOY, deposits +12% YOY, headcount -2% YOY, net revenue -8% YOY (mostly due to lower loan yields due to competition), mortgage originations -14% YOY and active mobile customers +30% YOY.

DC Idiot Show

Citigroup research points out the DC fight over the budget and debt has already negatively impacted 4Q GDP and could push it as low as 1% even if a deal gets done soon.

Social

A study by Pew finds 67% of adults who use the internet on a regular basis rely on social networks to learn about things going on in their community.