You Decide - Half Empty Glass Or Half Full

by Steve Brown

Bankers know that just before the holidays, regulatory agencies approved the adoption of Section 619 of the Dodd Frank Act, better known as the Volcker Rule. While most bankers may have some familiarity with what it entails, given the noise in the press we thought we would offer our take on the subject.

Post-financial meltdown, regulators have looked at the elements that could have/should have been in place to prevent such an event. There have been calls to bring back The Glass Steagall Banking Act of 1933 or at least the provisions that separated commercial banks and their depositors from Wall Street trading. Glass Steagall was repealed in 1999 and whether that timing was causal or coincident, a buildup of risk in the banking system followed.

The Volcker Rule, for its part, was designed to restrict proprietary trading of securities and derivatives. It prohibits certain kinds of relationships with hedge funds or private equity funds. As such, many community banks yawned when it was announced and moved on to bigger and better things. Unfortunately for community bankers, Volker harkens back in some areas to Glass Steagall, so it's kind of a half-Glass. The question of whether it is a glass half-full or half-empty for community banks is all the discussion as of late.

To begin, banks with assets less than $10B have exemptions from many parts of the rule. These include trading in Treasuries, agencies and municipal bonds, which make up the vast majority of community bank portfolios. Community banks are also exempt from the requirement that the CEO of the bank attests that the bank's compliance program is sufficient. Both exemptions are good for community banks.

One problem that has occurred relates to community banks that own trust preferred collateralized debt obligations (CDOs), because Volker disallows these investments and banks have until July 2015 to get rid of them. Given year-end timing of the regulation and potential accounting issues, Zions Bank (UT) was the first bank to announce it was taking a 4Q OTTI charge of $629mm related to its CDO portfolio. Since then, community and regional banks have followed suit and regulators have been slammed by banking associations for creating the issue. Given the enormous uproar, regulators have said they will review whether it would be "appropriate and consistent" with the Volcker Rule to allow exemption of such CDOs and will address the issue by Jan 15.

The CDO issue aside, Volker also puts an end to portfolio hedging. This applies to portfolio hedging activities and not one-by-one loan or other asset hedging, however. Regulators made the change in particular because they saw large banks using portfolio hedges to speculate. Gone are the days when large banks placed big bets on the overall direction of rates or prices or other indicators.

So, as we peer through the looking glass and try to discern whether it is half full or half empty, there is much to think about. Like most regulations, the effectiveness of Volker will depend largely on how regulators enforce it. Overall, the design of the rule is to prohibit banks from playing speculative games with customer deposits backed by the FDIC and supported by taxpayers. That makes sense at a high level, but as with most regulations that roll out, it is common for unintended consequences to surface soon thereafter. Our hope is that regulators will focus on the intent of the rule and go upstream to the larger banks, while leaving community banks to do what they do best - supporting their community. Much remains to be sorted out here, so be careful not to spill the glass as the regulatory wheels slowly turn.

BANK NEWS

M&A

AIMBank ($434mm, TX) will acquire First State Bank of Miami ($39mm, TX) for an undisclosed sum.

Regulatory Warning

Recent Fed communications warn bankers regulators are worried about the increasing level of interest rate risk and the risk bankers are taking to supplement weak loan demand. Regulators tell bankers to review risk model capabilities and assumptions to be sure they can handle evolving market conditions.

Settlement

Flagstar Bank FSB ($11.8B, MI) will pay $10.8mm to resolve claims on loans it originated and sold to FHLMC between 2000 and 2008.

Settlements

The Federal Housing Finance Agency (FHFA) reports FNMA and FHLMC collected a total of $7.9B in settlements with large financial institutions in 2013 to resolve mortgage lawsuits.

Social Competition

Bankrate.com reports Wells Fargo's director of social media says the bank's social media efforts now include eight blogs, four Twitter handles, two Facebook pages, two LinkedIn pages and a YouTube channel. We thought you would like to know in case you are moving further into this area or still considering it.

Stronger Economy

JPMorgan predicts the US economy will expand 2.8% in 2014, up from the 2.5% level it predicted just one month ago.