Tainting The Portfolio

by Steve Brown

Banks everywhere are considering the implications of Basel III which takes effect on Jan 1, 2015. On a high level, we know that the rule will require more and better capital. There have been projections that most community banks already have sufficient capital for Basel III, but the rule changes how capital levels are calculated. Risk weightings for a number of asset classes will change, the rule narrows the definition of what qualifies as capital, and with the later implementation of the capital conservation buffer (beginning in 2016) a shortfall in the buffer could have a major impact on a bank's ability to pay dividends and bonuses, or to repurchase shares. There is no question that Basel III will affect community banks.

One area of interest for banks is the "Opt Out" provision that gives banks a one-time opportunity to permanently retain the accumulated other comprehensive income (AOCI) filter for the securities portfolio. The AOCI filter allows banks to avoid having unrealized gains and losses in the securities portfolio flow through to Common Equity Tier 1 Capital (CET 1). This is a good thing, as otherwise there would be far more volatility in a bank's capital levels, which could be especially problematic in a rising interest rate environment. In fact, we would argue it is hard to find a reason a community bank would NOT elect to opt out in order to retain the filter. Banks need to make the election to opt out in the first call report filed after Jan 2015. For the largest banks, Basel III permanently removes the filter for those considered to be "Advanced Approach Banking Organizations" (primarily larger than $250B in assets).

Banks also have the ability to classify their securities as Held to Maturity (HTM) and not mark them to market, but this has been something primarily used for long term municipal bonds or other investments that a bank never intends to sell. Typically, a bank uses its investment portfolio as a source of liquidity and therefore holds almost everything in the Available for Sale (AFS) portfolio. But with the increase in the size of the investment portfolio as a percent of assets, some banks have put significant portions of their securities portfolio in HTM in order to avoid market volatility. Given some pickup in demand for loans, would it make sense for a bank to look to the HTM portfolio as a source of liquidity?

If a bank wants to sell securities in the HTM portfolio, except for in a few unusual cases, such action would taint the entire portfolio. That means all other securities would then need to move to the AFS portfolio for at least 2Ys, with all securities then marked to market and all subsequent purchases also going into the AFS portfolio. The problem here is that the HTM portfolio is not supposed to be a source of liquidity for the bank. There are exceptions, so called "safe harbors," which allow the sale of securities, like a significant deterioration in an issuer's creditworthiness, or a modification in regulatory requirements which change what is considered a permissible investment.

The implementation of Basel III raises an interesting question though, as there is a safe harbor allowing a sale from the HTM portfolio in the case of "a significant increase in industry-wide regulatory capital requirements that would cause the bank to downsize." One would hope with all the discussion surrounding Basel III that no bank would have to resort to shrinking the bank by selling securities in the HTM portfolio in order to have enough capital, but it's not out of the question. Banks should be carefully assessing what the new capital levels require based on the assets they hold and those they intend to buy in coming years.

BANK NEWS

Cyber Attacks

A survey by CDW finds the primary causes of cyber attacks included: unauthorized access (51%), malware (43%) and identity theft (38%).

Cash Hoarding

A study by State Street finds the average investor is now holding 36% in cash vs. 26% from 2Ys ago - nearly a 40% increase. Baby Boomers reportedly hold 41%.

Stronger Banks

A new report from S&P predicts rising rates will help industry NIM improve 4bps in 2015 and 2 more in 2016.

NII Pressure

Research by the Chicago Fed finds that C&I loan balances in the district grew at an 11.1% annual basis in Q1 but actual interest income generated grew 0.0%. Furthermore, CRE loan balances grew at a 5.1% pace in Q1 but actual interest income declined 0.6%. Bankers are putting new loans on the books, but low interest rates are continuing to put pressure on net interest income.

Bank Talent

An RMA survey finds banks rate the following as the most difficult positions to find qualified talent: commercial lender (67%), chief risk officer (63%), compliance (48%), risk manager (48%), chief executive officer (44%), data protection manager (33%) and directors (33%).

Economic Strength

A Wall Street Journal survey of 46 major economists finds most expect the combination of stronger job growth, rising consumer confidence and lower energy prices as providing solid economic support in 2015. The group predicted that the economy would grow at a 3.2% pace in Q3 and then by 2.8% in 2015.

Healthcare

A survey by Towers Watson finds 75% of companies say they plan to offer a high deductible health savings account as an option in 2015 vs. 63% in 2014. Meanwhile, 23% of companies say it will be the only option they offer.

Dodd Frank

A recent analysis by law firm Davis Polk & Wardell, finds that only 52% of the Dodd Frank requirements have actually been finalized.

Virtual Tellers

Celent reports about 150 banks in North America currently use virtual tellers.