A Little Basel With Your Meal

by Steve Brown

We mostly think of basil in terms of Italian recipes and the fresh flavor it gives to caprese salad, pesto and other fragrant dishes. Basil does indeed keep things fresh and you may find it interesting to know that it was historically used as an embalming and preserving herb in the processing of Egyptian mummies. Gross, who wants to eat that.

While perhaps not as tasty on dishes, the banking form of basil, known as Basel III, must be implemented on Jan 1 2015. This restructure of bank capital incorporates so many changes, many bankers may well be screaming for their mummies before all is said and done. Consider that the overriding objective of Basel III is to require banks to have more and better quality capital. The devil is in the details of course and Basel III applies to nearly all US financial institutions (although those with >$250B in assets have much more stringent requirements).

Discussion by various sources and in various publications have hypothesized that community banks will not be that affected by Basel III, and that most community banks already hold adequate capital. We beg to differ, think the ramifications will be broad-based and that community banks will indeed be affected.

Given that Basel III is right around the corner, we are dedicating two issues of the BID to outline important takeaways community bankers need to know to better prepare. The BIDs will run today and next Wednesday. We do this because Basel III is complicated, so even after you read the information, we suggest you also consult your accountants and other advisors on how your bank should address the new rules.

The implementation of Basel III will come in two phases with new capital requirements, changes in risk weightings, the grandfathering of eligible non-qualifies instruments and the AOCI election effective 1/1/2015. The second part of the law, the phase-in of the capital conservation buffer, begins on 1/1/2016.

To focus on the immediate concerns, the new definitions of regulatory capital and compliance with new minimum risk-based capital ratios require some new thinking (primarily because there are new risk weightings for some instruments). Risk Based Capital is calculated by dividing total regulatory capital by risk-weighted assets, so changes to risk weightings under Basel III take on great importance.

For risk weightings, note there will be no changes for many categories of loans and securities and that is good. But, to highlight some changes, note there will be a 150% risk weighting for CRE that is identified as high volatility, or HVCRE. This category is defined as all acquisition, development and construction (ADC) commercial real estate loans, with some exceptions. The exceptions are: 1-4 family residential ADC loans or CRE ADC loans that meet applicable regulatory LTV requirements and loans where the borrower has contributed cash of at least 15% of the real estate's "appraised as completed" value (and the borrower's capital remains in place until the project converts to permanent financing, is sold, or is paid in full). Everything else that falls under HVCRE will be risk weighted at 150%, where under current rules those loans would be risk-weighted at 100%.

Another risk weighting adjustment to 150% is applied to past due exposures and non-accruals. This applies to revenue bonds, single issuer trust preferreds, commercial (real estate, C&I, and ag) and consumer loans. Currently, the maximum risk weighting here is 100% and most important, risk weightings generally do not change if the loan becomes past-due.

Since credit quality is pretty clean in most banks right now, many are not really focused on this, but it is important. Consider the drag on capital if NPAs increase to more stressed levels and how that could impact your capital and flexibility. A tougher economic cycle down the road and the subsequent deterioration of credit quality will definitely be more impactful and more negative. This is important because difficult economic times are typically also not easy times for a bank to raise capital.

Basel III's emphasis on risk weighting is a regulatory expression of a desire for banks to operate with capital positions well above minimum risk-based levels. The goal is to have "cleaner" capital and for banks to hold capital commensurate with the level and nature of the risks to which that bank is exposed. Next week we will dig a little deeper into our helping of Basel and more implications for community banks.

BANK NEWS

M&A

Bay Commercial Bank ($510mm, CA) will acquire Valley Community Bank ($135mm, CA) for $4.15 per share in stock.

M&A

The holding company for Central State Bank ($436mm, IA) and Farmers & Mechanics Bank ($279mm, IL) will acquire Buffalo Prairie State Bank ($72mm, IL) for an undisclosed sum.

Cyber Risk

Home Depot now indicates hackers that got into its systems in Apr stole 53mm email addresses in addition to 56mm credit card accounts.

Vendor Risk

USA Today reports it now appears hackers used a vendor's stolen log-on credentials to get inside Home Depot's computer network and install custom-built malware that stole customer payment-card data and e-mail addresses.

Volatility Warning

FOMC Chair Yellen said in a speech she expects the normalization of monetary policy could lead to heightened financial volatility. She said the FOMC will communicate actively to try and reduce surprises, but that market turbulence might occur.

Job Cuts

HR firm Challenger, Gray & Christmas reports US employers now plan 51k+ job cuts this month, the 2nd highest reading this year and a 70% increase vs. the prior month.