Another Piece Of Basel

by Steve Brown

We ended last week's exploration of Basel III considering the ramifications of increased risk weightings for past due or non-accrual loans and the possible consequences in an economic downturn. The OCC in its stress testing guidance indicates expectations that a bank should assess its capital adequacy in relation to its overall risks and have a plan for maintaining appropriate capital levels. Therefore, a bank should understand what effect an economic downturn could cause related to credit problems and capital. This implies that a stress test of some sort is required and that stress testing should include the ramifications of Basel III.

In addition, the OCC indicates that a bank's board and management should be prepared to take appropriate steps to protect the bank if the results of a stress test indicate that capital ratios could fall below the levels needed to support the bank's risk profile. In the end, the implementation of Basel III points to the need for banks to update their contingency capital plans to reflect the ramifications of the new law.

In terms of immediate ramifications of the implementation of Basel III on Jan 1, an important deadline is the accumulated other comprehensive income (AOCI) opt-out election. We wrote about the ramifications of the AOCI election in a previous BID (Oct 15, 2014), but it is very important for banks to make a permanent election to opt-out in the first Call Report the bank files after Jan 1, 2015 or you will automatically stay in.

One other consideration will not affect every bank, but could be important for certain banks. Deferred tax assets (DTAs) and liabilities (DTLs) occur when there is a difference between tax and accounting (GAAP) treatment. In general there are two types of deferred tax assets. One relates to temporary differences where an expense is deductible for book purposes immediately, but may not be deductible for tax purposes until a later date or vice versa for DTLs. The other difference relates to the future tax benefit related to net operating losses (NOL) or other unused tax credits. For GAAP purposes a valuation allowance (VA) is booked when DTAs are considered non realizable.

New Basel rules eliminate the inclusion of all NOLs and credit carry forward DTAs (net of allocated DTLs) from Common Equity Tier 1 (CET1), regardless of projected future taxable income. The remaining DTAs are included in CET1 to the extent they can hypothetically be carried back against taxes previously paid and do not exceed the 10% individual threshold or 15% combined threshold of CET1 (mortgage servicing assets, significant investments in the common stock of other financial institutions, and certain deferred tax assets).

Finally, the capital conservation buffer begins during the second phase of Basel III on Jan 1, 2016. In addition to the minimum risk-based capital requirements, all banks must hold CET1 capital in an amount greater than 2.5% of total risk-weighted assets. The buffer phases up to 2.5% over adequately capitalized minimums from the inception date of the buffer through Jan 1, 2019. Institutions that fail to maintain the buffer will have restrictions on their dividends, their ability to retire capital and on discretionary management bonuses.

Once all is said and done, many of the effects of Basel III will be felt down the road more than immediately, especially when the capital conservation buffer comes into force. Clearly the ramifications will be much more serious in an economic downturn if borrowers and collateral values become more stressed.

To prepare, banks should be certain to measure and analyze risk with Basel III in mind and to alter policies to reflect the requirements as needed. Once that is done, our piece of advice is to do what is needed to get through this next regulatory test, and as you enjoy a tasty meal, don't forget to add a little basil.

BANK NEWS

Worries increase

Fed officials are concerned weakness overseas could hurt the US recovery, leading some to say they may consider delaying the rate hike expected in Q2 2015 if conditions warrant.

Higher Capital

In an effort to address TBTF, global regulators have released new rules (would take effect in 2019 or so) that would require the top 30 largest banks in the world to set aside loss absorbing capital of 16% to 20% of risk weighted assets for a whopping all-in total combined capital buffer of 21% to 25% of risk weighted assets. The rule next goes out for public comment, so let the fireworks and unintended consequences begin shortly.

Less Regulation

Fed governor Tarullo is calling on Congress to make legislative changes to help ease the regulatory burden on community banks. Suggestions include: raising the asset threshold that allows bank holding companies to issue debt to finance an acquisition from $500mm or less to $1B or less and simplifying rules that do not make sense when applied to community banks with simple business models.

Interesting Difference

A survey by brokerage firm UBS finds Millennials still hold more than 50% of their assets in cash. It appears the financial meltdown, drop in housing prices and sharp decline in stocks during the crisis severely rattled many and ingrained this experience on their investing psyche.

Shadow Banking

The Financial Stability Board says it expects to begin to focus on the shadow banking system (composed of an extremely diversified subset of institutions, including broker-dealers, money market mutual funds, structured finance vehicles, financial companies and investment funds, among many others) in 2015.