Guaranteed Or Secured

by Steve Brown

We are certain that during discussions last week over your Thanksgiving meal with family and friends, that the most scintillating topic of conversation was the implications of Basel III and its imminent implementation coming up in Jan. We have written a couple of previous issues on various aspects of Basel III and we thought we would offer another with some discussion of a confusing point regarding the increase in risk weightings for past due loans.

The new rules under Basel III increase the risk weights on past due loans > 90 days to 150% for the portions that are not guaranteed or secured, except for residential mortgages which will be risk-weighted at 100%. The question is what counts as guaranteed and what is considered secured.

In most cases, non-accrual non-residential non-government guaranteed loans will be weighted at 150%. The rules do, however, include credit risk mitigation benefits if certain criteria are met. Without specific information regarding the secured instrument, it is impossible to give specific answers, but here are some general guidelines:

What equates to "guaranteed" under the new rule is expanded some. The definition of eligible guarantor includes a sovereign, the BIS, the IMF, the ECB, the European Commission, FHLB, Federal Agricultural Mortgage Corporation (Farmer Mac), a multilateral development bank (MDB), a depository institution, a bank holding company, a savings and loan holding company, a credit union, a foreign bank and a qualifying central counterparty.

The definition of eligible guarantor also includes entities that at the time the guarantee is issued (or anytime thereafter), have issued and have outstanding an unsecured debt security that is investment grade, whose creditworthiness is not positively correlated with the credit risk of the exposures for which it has provided guarantees and that is not an insurance company primarily engaged in the business of providing credit protection.

For loans to be considered secured there must be collateral, and a bank can reduce the risk based capital requirements so long as collateral is eligible and meets the following requirements: the collateral must be subject to a collateral agreement for at least the life of the exposure, it must be revalued at least every 6 mos. and collateral other than gold must be denominated in the same currency as the exposure.

Eligible collateral includes: cash on deposit with the banking organization or held for the banking organization by a third-party custodian or trustee, gold bullion, short-term debt instruments that are not resecuritization exposures and are investment grade, publicly traded equity securities, publicly traded convertible bonds, money market and other mutual fund shares so long as a price for the shares is publicly quoted daily. In general, banks can use the "simple approach" for the underlying risk weight (minimum 20%) for the secured portion of the loan.

In the end, the Basel III rules take an approach of assigning risk weightings appropriate and commensurate with the level of risk an asset adds to a bank's balance sheet. There is a lot of detail in the regulation and while most banks mostly hold assets of a traditional nature, anything unusual should be carefully researched so you give it the correct treatment.

Sources for more information include publications and the web sites of the FDIC, OCC and other regulatory agencies, but be sure to ask your regulator if you are in doubt. Everyone will have to become more educated about the details and nuances of the rules but with any luck, we will not be talking turkey about Basel III next Thanksgiving.

BANK NEWS

Paying More

Deloitte reports whole bank buyers in M&A transactions paid a premium of 38% over tangible common equity in 2Q 2014 vs. 30% in 2Q 2013 and 14% in 2Q 2012.

Higher IT Costs

Research by Forrester finds bank IT costs equal 7.3% of revenues vs. an average of 3.7% for other industries. Meanwhile, McKinsey estimates bank IT costs equal 4.7% to 9.4% of operating income.

IT Budget

Research by Deutsche Bank finds that US banks allocate their IT budget in the following way: staff (26%), software (19%), telecommunications services (18%), outsourcing and hardware maintenance (16%), consulting and systems integrations services (9%), computer equipment (8%) and communications equipment (3%).

Do More

The Organization for Economic Cooperation and Development (OECD) is urging the ECB to do more to support growth in the region and avoid deflation. The OECD projects the global economy will grow 3.3% this year and 3.7% in 2015.

Narrower Definition

FNMA and FHLMC have announced changes to life of loan exclusions in an effort to give loan originators more predictability as to whether they would be forced to buy back a loan.

Liquidity Compliance

Fed Governor Tarullo said in a speech that banks that fall out of compliance with liquid asset requirements under Basel III during a period of general stress should be given an opportunity to come back into compliance in a way that does not expose the firm or the banking system to greater stress.

Higher Fees

FNMA and FHLMC reported guarantee fees on single family residential loans they charged lenders climbed to 51bps in 2013 vs. 36bps in 2012 and 22bps in 2009.

Key Staff

A Bank Director survey finds 67% of banks say tying pay to performance is a top challenge, followed by retaining key talent and managing compensation and benefits costs.