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Basel III and Its Implications: A Closer Look

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Highlights

Near-Term Implications:	Long-Term Implications:
• Uncertainty until Rules Finalized	• Increased After-Tax Cost of Capital
• Cautious Capital Management by Banks	• Altered Market for Debt-Like Bank Capital
• Conservative Capital Ratio Determinations	• Pressure on Bank Profitability
• Continued Pressure on Troubled Banks	• Opportunities in Shadow Banking System

Following the announcement of global capital standards by the Basel Committee on Banking Supervision on Sunday, September 12th, we now have the broad framework for capital requirements that the banking industry will be subject to for the coming years.[1] These standards were approved by the Group of 20 Nations, including the United States, and are expected to be formally adopted in November. The new standards call for capital ratios of 7% common equity, 8.5% Tier 1 capital, and 10.5% total capital – all as a percentage of risk-weighted assets. There is also a requirement for at least a 3% Tier 1 leverage ratio that is not tied to risk-weighted assets. These requirements will be phased-in beginning in 2013 and must be fully implemented by 2019.

On the surface, these thresholds, combined with the long phase-in period, appear to provide capital levels that can easily be met by most U.S. banks. This likely contributed to the initial positive equity market reaction of U.S. bank investors following the September 12th announcement. But if one looks more deeply at the near-term and long-term implications of Basel III on the U.S. banking sector, it is clear that the current banking model could be fundamentally changed, with a real impact on bank profitability and financial returns. Prudent

[1] The comments herein refer to the package of reforms developed by the Basel Committee in the December 2009 Consultative Document, Strengthening the Resilience of the Banking Sector; the July 26, 2010 consensus Annex; the August 2010 Consultative Document, Proposal to Ensure the Loss Absorbency of Regulatory Capital at the Point of Non-Viability; and the September 12th press release and announcement by the Group of Governors and Heads of Supervision of the higher global minimum standards. All documents are available at www.bis.org. Our understanding is that all proposals contained in the December 2009 consultative document remain in full force and effect except to the extent explicitly modified by subsequent documents.

bank managers are now assessing these near-term and long-term implications to determine how they can best adapt their business models and capital planning to perform optimally within these new rules.

There are four near-term implications of the Basel III requirements that bear attention: (1) ***uncertainty until the rules are finalized***, (2) ***cautious capital management by banks***, (3) ***conservative capital ratio determinations by regulators***, and (4) ***continued pressure on troubled banks***. Longer term, we think there are also four key implications for U.S. banks: (1) ***increased after-tax cost of capital***, (2) ***altered market for debt-like bank capital***, (3) ***pressure on bank profitability***, and (4) ***opportunities in the shadow banking system***.

Near-Term Implications:

1. *Uncertainty until Rules Finalized* – Developing actionable rules to be implemented by U.S. regulators from the broad outlines of Basel III will likely take at least 6 to 12 months of detailed work. During this time, bank managers will have to operate their institutions without certainty on several critical matters. We expect to see intense debate among the Federal Reserve, other federal banking agencies and the banking industry as the real world implications of these proposals are evaluated and practical implementation guidelines developed. This rulemaking activity will likely focus on four areas – the required deductions from equity capital, risk weighting calculations, the level of the "countercyclical buffer" required to be set on a national basis, and the impact of gone-concern capital on non-common Tier 1 and Tier 2 regulatory capital:

    (a) Deductions from capital: As we understand the Basel release, the amount of common equity to be used for capital calculations is not based on a GAAP determination of common equity. Rather, it is tangible common equity reduced by a myriad of deductions that have largely not previously impacted U.S. banks. Most significant among these deductions are: (i) deferred tax assets (net of any associated deferred tax liability); (ii) mortgage servicing rights ("MSRs"); (iii) equity investment in unconsolidated subsidiaries; (iv) the extent to which reserves do not reflect forward-looking loan loss provisioning[2]; and (v) investments in other banks, financial institutions and insurance entities that fall outside the regulatory scope of consolidation.

    By our calculations, almost 60 U.S. banks holding approximately $1.5 trillion in assets have MSRs equal to or greater than 10% of their common equity and 160 banks with $5.2 trillion in assets have deferred tax assets equal to or greater than 10% of their common equity. For these banks, and others with higher levels of MSRs or deferred tax assets, the deduction of these assets

[2] In the December 2009 Consultative Document, the Basel Committee required banks to deduct from capital the amount by which loan loss reserves do not reflect forward-looking, life of loan losses. The July 2010 Annex discusses only changes from the December 2009 Consultative Document, as does the September 12, 2010 release. Based on this, we understand that other aspects of the December 2009 Consultative Document, namely the requirements related to forward-looking loan loss provisioning, to be a part of what was agreed to and announced on September 12th.

from the amount of common equity could significantly reduce their calculated capital ratios.

The impact of the forward-looking loan loss provision requirement is hard to quantify and is inconsistent with current U.S. GAAP, which requires that loan loss provisions be tied to historical loss experience. The Basel proposal would also exacerbate the DTA deduction from common equity as an increase in loan loss provision without an increase in charge-offs will increase the GAAP/tax differential and inflate the DTA. As such, the deduction from bank equity of a larger DTA amount will amplify the impact. Hopefully, this "double-counting" impact will be evaluated and addressed through the rulemaking process.

Banks have been active investors in other bank subordinated debt and trust preferred securities since the time trust preferred securities were first approved as Tier 1 capital by the Fed in 1996. Since that time, banks have issued over $325 billion of trust preferred securities and subordinated debt. While the exact level of participation of banks in this market is not tracked, U.S. banks may currently own a significant amount of bank and insurance company Tier 1 and Tier 2 capital securities.

Although the Basel language is unclear, such holders could be required to deduct their excess investments in the capital instruments of unconsolidated financial institutions using a "corresponding deduction approach." The "corresponding deduction approach" would require the deduction of excess investment from the component of capital of the investor bank for which the capital would qualify if issued by the investor bank. Thresholds are specified for common stock investments only, the more relevant of which is aggregate investment in the common equity of other financial institutions. A similar 10% threshold may apply to holdings of other non-common capital instruments. When the threshold level of aggregate investment in non-common capital instruments is clarified, banks holding excess investments may decide to sell some of those securities. In addition, the prospect of this capital deduction may result in the withdrawal of banks as buyers from the market for new issue bank and insurance company capital securities. If so, there may be an impact on market liquidity and pricing for such issues. We would expect to see the impact of this deduction evaluated and addressed in the rulemaking process.

(b) Risk weighting calculations: The framework for risk weighting from Basel III is largely based on the current Basel II requirements, but with significant refinements to the counterparty credit risk components largely due to credit valuation adjustments. The Basel Committee also felt that central counterparties were not widely used, resulting in greater counterparty risk. As a result, a sophisticated protocol of revised risk weightings is proposed in

Basel III that will likely increase the risk weightings on trading, derivatives and securitization activities. Complicating this process is the Dodd-Frank requirement that banks no longer rely on published debt ratings for purposes of determining appropriate risk weightings of investments in debt securities. This has created a scenario where banks cannot be sure how they will determine the creditworthiness of securities that will then drive risk weightings. We expect to see rulemaking settle uncertainties such as whether each bank will have to prepare its own analysis of risks to determine the appropriate risk weighting or whether banks may rely on a report by a third party other than a "nationally recognized statistical rating organization," or rating agency.

(c) Countercyclical buffer: Basel III mandates that banks carry a countercyclical buffer of 0% to 2.5% of risk-weighted assets, in common or other "fully loss absorbing capital" to protect the banking sector from periods of excess aggregate credit growth. The level of capital required for this buffer will be set and implemented according to national circumstances. While it will be left to the U.S. regulatory authorities to set the level of this countercyclical buffer, at the upper end it represents a 35% increase in capital over the common equity required. In addition, what constitutes "fully loss-absorbing capital" will be the subject of the rulemaking process and is discussed further below.

(d) Gone-concern capital proposal: The Basel Committee has proposed in its August 2010 Consultative Document that all non-common Tier 1 and Tier 2 qualifying regulatory capital be required to convert into common stock upon a "triggering event" as determined by the relevant regulatory authority.[3] These provisions will require a significant reevaluation of capital structures and qualifying securities. The impact will be felt not only with respect to new issuances of non-common capital securities, but could also require banks and investors to amend existing securities to include this conversion feature.[4] Until rulemaking guidance is provided on these gone-concern

[3] Comments from interested parties must be submitted to the Basel Committee by October 1st and there will likely be a period during which these comments are incorporated into final rulemaking. Sandler O'Neill provided a comment letter regarding this issue on September 10th in which we proposed three recommendations: (i) limit the requirement of the conversion/write-off provision to systemically important banks using a defined criteria such as asset size or deposit market share; (ii) include an objective triggering mechanism to provide transparency for conversion/write-off thus enabling market discipline as the bank moves closer to a triggering event, and (iii) establish an industry task force to examine the ramifications of the proposed elimination of an event of default upon a triggering event. The letter is available at:
http://www.sandleroneill.com/Collateral/Documents/English-US/Gone%20Concern%20Capital%20Ltr-9-10-10.pdf

[4] The Basel Committee believes that banks which do not fall into the category of systemically important already utilize capital that absorbs losses because when these banks fail, depositors are protected at the expense of subordinated security holders. The Basel Committee fears the explicit identification of systemically important banks versus other banks creates a moral hazard risk. For this reason the Basel Committee has proposed that gone-concern capital absorbency explicitly apply to all banks.

capital issues, the market for non-common Tier 1 and Tier 2 regulatory capital will likely be dormant for both buyers and sellers.

2. *Cautious Capital Management by Banks* – Uncertainty regarding the final rules and regulations outlined above, and their impact, will likely lead bank managements to take a very cautious approach to capital management, including dividend policy, stock buybacks and subordinated debt or trust preferred repurchases and issuances. Once the rulemaking activity is completed and banks have a clearer view on specific capital requirements for their institutions, there will likely be a period of active capital management in the next 12 to 18 months as bankers realign their capital structures for their retained business lines. Of broader concern may be willingness to lend. It remains to be seen whether prospective and uncertain changes in capital ratios will lead bankers to become increasingly cautious in making loans for fear of taxing their capital bases.

3. *Conservative Capital Ratio Determinations by Regulators* – As currently proposed, the home-country regulator has discretion to impose on domestic banks a countercyclical buffer of common equity or other fully loss-absorbing capital in a range of 0% to 2.5% of risk-weighted assets as needed to control excess credit growth within that country resulting in an elevation of international, system-wide risk. Systemically important banks may have an additional capital buffer added atop these levels. While the minimum capital levels of 4.5% common equity, 6.0% Tier 1 capital and 8.0% total capital as of 2015 all appear to be well within reach for most U.S. banks, bankers should assume they will have to comply with the more conservative levels of 7% common equity, 8.5% Tier 1 capital and 10.5% total capital as of 2019. These higher effective levels include the mandatory conservation buffer of common equity in an amount equal to 2.5% of risk-weighted assets. Dodd-Frank imposes a three-year phase-out of the Tier 1 capital qualification of trust preferred capital for banks with assets of $15 billion or greater. This is much more conservative than the 10 year phase-out beginning in 2013 for trust preferred securities as required under Basel III. The Basel III provision, however, will have an impact on banks with less than $15 billion of assets, even though the Tier 1 treatment of trust preferred securities was otherwise permanently grandfathered under Dodd-Frank. These inconsistencies between Dodd-Frank and Basel III may be resolved in rulemaking rather than legislation.

4. *Continued Pressure on Troubled Banks* – Notwithstanding the important rulemaking process that will take place over the next year, with the passage of Dodd-Frank and the announcement of the Basel III rules, U.S. regulators can now turn their attention more fully to the U.S. banks with high levels of asset quality risk and low levels of tangible equity. As of June 30, 2010, we observed that there were more than 700 banks, holding over $1 trillion in assets, which either had a Texas ratio greater than 50% or a tangible equity/tangible assets ratio less than 6%. The FDIC recently announced that there were over 800 banks on its troubled bank list. These banks will be under intense scrutiny and pressure to find a solution either by raising capital, de-risking their balance sheets or selling.

Long-Term Implications:

1. ***Increased After-Tax Cost of Capital*** – Prior to the Basel III requirements, common equity had to be the "dominant" (>50%) component of the Tier 1 capital of U.S. banks. The balance could consist of qualifying Tier 1 components such as trust preferred securities (up to 25%) and non-cumulative perpetual preferred stock. By optimally structuring their capital with this combination of securities, U.S. banks reduced their after-tax cost of capital, improved returns on common equity and earnings per share and enhanced their franchise values. The new Basel III requirements will increase the common equity component of Tier 1 capital from at least 51% to approximately 82% (7% common equity relative to 8.5% Tier 1 capital). Similarly, common equity will increase as a percentage of total capital from a minimum of 51% to approximately 67% (7% common equity relative to 10.5% total capital). By requiring far greater amounts of common equity relative to non-dilutive, tax-deductible forms of capital, the cost of capital for U.S. banks will increase. The impact on the after-tax cost of Tier 1 capital is illustrated below:

Illustrative Cost Under Current Rules

	Pre-Tax Cost	After-Tax Cost	Percentage of Tier 1	Weighted Average Cost of Capital
Common Equity	15.00%	15.00%	51%	7.65%
Trust Preferred Securities	8.00%	5.20%	25%	1.30%
Non-Cumulative Perpetual Preferred	10.00%	10.00%	24%	2.40%
			100%	11.35%

Illustrative Cost of Capital Under Basel III

	Pre-Tax Cost	After-Tax Cost	Percentage of Tier 1	Weighted Average Cost of Capital
Common Equity	15.00%	15.00%	82%	12.30%
Trust Preferred Securities	8.00%	5.20%	0%	0.00%
Non-Cumulative Perpetual Preferred	10.00%	10.00%	18%	1.80%
			100%	14.10%

Note: Assumes: 35% tax rate
Actual cost of trust preferred securities and non-cumulative perpetual preferred will vary according to institution and market conditions.

As shown above, the after-tax cost of Tier 1 capital increases almost 25% as a result of (i) the increase in the required common equity component and (ii) the phase-out of tax deductible Tier 1 capital. While the exact costs will vary for each bank, the increase in common equity required will in all cases dramatically raise the cost of capital for the banking industry. This change will also lessen the importance and value of subordinated debt, trust preferred and other non-common components of capital, which will comprise a smaller percentage of regulatory capital. A higher cost of capital in the banking industry would be expected to ultimately impact returns on equity for banks and the valuation and trading of bank stocks, and may be passed along to bank customers.

2. ***Altered Market for Debt-Like Bank Capital*** – The market for bank debt that is treated as capital may be reduced as a result of (i) the potential limit of 10% of equity for total purchases of other banks' capital securities by banks and (ii) the gone-concern requirement of converting bank debt into common stock upon a triggering event. While these requirements may be modified in the rulemaking process, the first of these may reduce the participation of banks in the market as buyers of these securities, and the second could remove from the market some traditional bank debt investors, who may be unwilling to risk becoming subordinated/common stock investors following a triggering event. These changes could therefore lead to less demand, higher cost and less liquidity in the bank debt capital markets.

3. ***Pressure on Bank Profitability*** – The higher common equity requirements of Basel III could be expected to reduce bank profitability as expressed by return on common equity, put pressure on earnings per share and lower growth potential. As a result, we expect to see prudent bankers consider the following:

   (a) Carefully evaluate each business line, loan pricing and investment strategies to determine whether each is meeting the thresholds required for appropriate returns.

   (b) Analyze marginal lending, including non-relationship business and commercial mortgage lending, which represent high risk-weighted, credit intensive activities with limited cross-sell potential and lower risk-adjusted returns.

   (c) Pursue business line M&A activity either to generate scale-based returns or exit non-core businesses.

   (d) Reduce cost structure and generate non-credit intensive fee income to achieve financial returns. *Cost savings from in-market M&A activity can generate attractive returns with reduced risk.*

4. *Opportunities in Shadow Banking System* – Reduced or substantially re-priced credit availability from banks could push more lending activity to the "shadow banking system." The securitization markets, finance companies, REITs, private equity funds and business development companies will have the opportunity to pick up the slack in lending activity, particularly as the economy recovers. Among these, REITs and BDCs have significant tax advantages, as they can pass through income to investors without paying corporate level taxes. There are currently 170 publicly-traded REITs with a total market capitalization of $354.0 billion and there are 24 publicly-traded BDCs with a total market capitalization of $13.7 billion. If and when the financing markets return for these non-bank lenders, these types of businesses could be among the biggest beneficiaries of the shift of credit from the banking system to the "shadow banking system."

Conclusion:

We are very focused on the implications for the U.S. banking industry of the Basel III requirements in combination with Dodd-Frank. In addition, we continue to watch, and argue against, the proposed implementation of fair value accounting rules.[5] These matters require all bank management teams and their Boards to remain fully informed and engaged about the status of these rules as the rulemaking process continues and develop long-term business and capital plans that account for alternative scenarios.

Nonetheless, the U.S. banking system and capital markets have a history of innovation in responding to challenges. With forward planning, banks can be well-positioned to deploy capital to earn attractive returns on the core business lines and build their franchises. Those banks with strong regulatory capital, strong regulatory ratings, manageable credit risk and a clear vision for their franchise will no doubt emerge from this difficult period stronger than ever.

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[5] In a comment letter to the Financial Accounting Standards Board, Sandler O'Neill urged the Board to withdraw its proposal to expand fair value accounting for financial instruments because it is not justified by failure wrongly blamed on historical cost accounting; it would degrade rather than improve the transparency and utility of financial reporting; it would unnecessarily penalize banks (the entities most affected) and could place the U.S. banking system and economy at risk; and it lacks broad-based support by banks, investors, and bank supervisors. The letter is available at: http://www.sandleroneill.com/Collateral/Documents/English-US/SOP%20Comment%201810-100%20s.pdf