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## COVER STORY

# Basel Proposal Watchers Predict a Blow to Profits

■ BY STEVEN SLOAN

WASHINGTON — While much of the industry's attention is centered on congressional efforts to revamp financial services, a proposal from the Basel Committee on Banking Supervision also could significantly rewrite the rules of banking.

The Basel Committee is accepting comment through April 16 on a proposal that would, among other things, restrict an institution's ability to pay dividends, force it to raise more common equity and broaden the leverage ratio to include off-balance-sheet assets. If finalized, the changes would be tacked on to Basel II, the complicated capital framework that caused bankers so many headaches before the financial crisis.

Before American regulators finalized Basel II in 2007, the industry was able to beat back some of the provisions it found most troubling, even winning a carve-out that allowed smaller institutions to avoid the rule entirely. But observers do not expect the industry to be so successful this time and say bankers should begin forming plans to raise large sums of capital in the coming years.

"Get ready," said Susan Krause Bell, a partner at Promontory Financial Group who frequently worked with the Basel Committee during a two-decade career at the Office of the Comptroller of the Currency. "The bar is rising. The capital requirements are going up and banks will need more common equity. They need to act accordingly."

Central bank leaders from the U.S. and other nations met in Switzerland over the weekend of Jan. 9 to reaffirm their commitment to these plans, and said they hoped to have them finalized by yearend.

The committee also pledged to review compensation standards being introduced around the globe and propose rules later this year to rein in systemic risk. In the past year the Basel Committee has already proposed higher capital requirements for trading book activities and certain securitization transactions.

The ideas the Basel Committee is considering pose a serious threat to bank profits, said Karen Shaw Petrou, the managing director of Federal Financial Analytics Inc.

"Depending on how it's calibrated, bank profitability would go anywhere from down a bit to wholly evaporated," she said.

The committee's actions are especially important, Petrou said, considering Congress continues to debate regulatory reform. Lawmakers return to Washington this week and the Senate Banking



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Committee is expected to focus its attention on reform legislation.

"They're moving pieces of the same puzzle," Petrou said. "If you look at one piece of the cube, you could miss another one about to fall on your head."

Many questions surround the proposal, which was released on Dec. 17. It does not address whether the changes would apply to all institutions or just the largest, internationally active firms, and there appears to be some disagreement on that question among American supervisors. The proposal contains few numbers, making it impossible for bankers to predict how high their capital requirements would rise.

Though the Basel Committee strongly suggested it would not impose capital hikes while the global economy is still finding its footing, the proposal says nothing about whether supervisors would phase the rule in over several years or whether some institutions would be grandfathered.

Still, there is plenty in the proposal that has industry representatives worried, including the broader leverage ratio.

U.S. banks have operated under the equity-to-assets ratio for decades and argue it requires them to hold too much capital. The international version of Basel II did not include a leverage ratio, but

## Basel Proposal Could Prove To Be Double Dose of Reform

regulators folded the calculation into the version of the Basel rule adopted here in 2007.

Regulators, particularly at the Federal Deposit Insurance Corp., contend that the leverage ratio acts as a floor preventing capital from dropping too much, even if a bank's models show it is not taking on much risk. They feel vindicated that the Basel Committee's latest proposal would impose a leverage ratio on institutions around the globe.

"To us, that is a huge step forward that the Basel Committee has been willing to endorse this concept which they had not for many years," said George French, the deputy director for policy in the FDIC's division of supervision and consumer protection. "We've come a long way since 2006, when the FDIC first advanced the concept, and have worked hard since then to overcome the concerns of some of our international colleagues."

The leverage ratio articulated by the Basel Committee would go even further than the American version by including off-balance-sheet assets. Some in the industry were disappointed that the Basel Committee's proposal made no effort to require less capital for off-balance-sheet holdings that involve minimal risk, such as highly liquid government securities.

"Including off-balance-sheet items is particularly troublesome," said Mary Frances Monroe, the American Bankers Association's vice president of regulatory policy. "Some off-balance-sheet exposures really do reflect exposures where the risks have been transferred, so this doesn't seem appropriate."

Since American banks went into the financial crisis with generally higher capital levels than their European counterparts, there is broad consensus among regulators here to keep the leverage ratio and introduce it in other countries. But there is a fear in some supervisory corners in the U.S. that the Basel Committee may have overreached with the ratio by not offering discounts for low-risk securities and including items such as the unused portions of consumer credit card lines in the calculation.

These are issues, they say, that will certainly be subject to negotiation as global regulators work toward finalizing the proposal.

Another provision likely to arouse concern focuses on the quality of capital held by banks. Intangible assets, such as deferred taxes, are typically deducted from a bank's Tier 1 capital. The Basel Committee is effectively creating a more conservative standard by requiring the deductions to come from common equity instead.

For most banks, the change means their capital ratio will likely be lower under the new standard than when deductions were taken from Tier 1. If the more conservative ratio places a bank below the target established by regulators — which has yet to be defined

— the bank would be forced to issue more common stock to bring it above the threshold.

Even in a good economy, that could cause trouble if many banks are forced to sell stock at the same time, Monroe said.

"There will be a crowding issue," she said. "The crowding issue is particularly an issue for the mid- to smaller-sized banks. They don't have the access to the capital markets that the large banks do."

A representative of the Independent Community Bankers of America said the proposal would likely hurt large banks more because their capital calculations are more complex.

"Most of Tier 1 among community banks is common stock and retained earnings," said Chris Cole, a senior regulatory counsel at the ICBA. "I don't foresee at this point that these changes will be tough for community banks. They'll be much harder on the larger banks."

Regulators themselves privately expressed some worries about the proposal. Though some see it as a way to raise capital levels — as the stress tests successfully accomplished last year — others question whether such provisions do enough to tackle the problems exposed by the financial crisis. These officials say there should be less focus on how much capital banks hold and more on making sure that Basel II is capturing the right risks and that banks cannot arbitrage their capital requirements.

The Basel Committee's proposal is loaded with other provisions, including plans to encourage banks to move derivatives exposures to central counterparties and limit an institution's ability to pay dividends if its capital slips beneath an as-yet-undetermined level.

American regulators will begin collecting data next month for a study to be released by the end of June on the proposal's likely impact on companies.

Meanwhile, the big test facing international policymakers is coming up with rules that satisfy the demands of regulators in the U.S., Europe and parts of Asia. American regulators acknowledge the importance of harmonizing Basel II across the globe and are preparing for what are sure to be challenging negotiations with their international counterparts.

"We're gratified that the committee is moving ahead in this direction. But having said that, we remain concerned that certain aspects of the process ahead are uncertain," the FDIC's French said. "For example, there are still a lot of questions surrounding what the minimum leverage capital ratio will be. It could take time, and it's not certain what the outcome will be."

In most instances, that ratio is currently 4%. ■