

The Basel consultative proposal: What counts as capital

By Nick Gorski
March 31, 2010

The Basel Committee on Banking Supervision has proposed fundamental changes to the bank regulatory framework that could force at least some banks to hold additional core capital, and the period for banks to comment is rapidly coming to a close.

The proposals are still in a draft phase. The consultative document was released in December 2009, and the committee is conducting an impact assessment, with an eye towards releasing a comprehensive proposal by the end of this year. The committee aims to implement the proposals by the end of 2012.

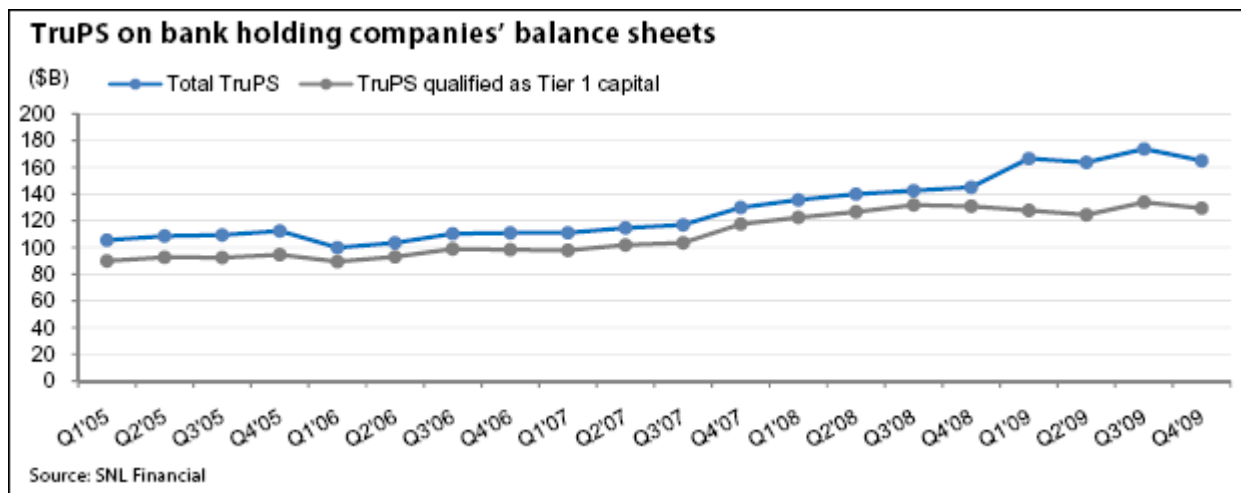
One of the primary focuses of the document is to modify regulatory capital standards to place greater emphasis on common equity. The committee has proposed that Tier 1 capital comprise primarily common equity, including retained earnings, with tight restrictions on the other types of securities that can be included.

According to the document, securities that are intended to count as Tier 1 capital must have discretionary payments and must be able to bear losses while the bank is still a going concern. The change is part of a realignment of the capital tiers. Tier 1 will be explicitly for capital available on a going-concern basis, while Tier 2 capital will be used as "gone-concern capital," available after a bank has failed.

"It is a post-failure cushion to the deposit fund," Sandler O'Neill principal Thomas Killian told SNL. Subordinated debt, for example, would be subordinated to depositor claims.

Currently, Tier 2 capital is limited and cannot be greater than Tier 1 capital; that restriction is eliminated under the consultative document.

One of the primary results of the change is that hybrid securities, such as trust preferred securities, will no longer be considered Tier 1 capital. The original inclusion of trust preferred securities as regulatory capital was initially controversial, FinPro executive managing director Nicholas Ketcha Jr. told SNL. "When the Fed first allowed that, there was a lot of disagreement among the agencies as to whether it was real capital or not," he said. "Then I think it just got to be such a huge part of the structure."



Trust preferred securities, which have composed a growing portion of capital at U.S. banks over the past several years, would be grandfathered in under the new rules. Not all of the securities are accepted as Tier 1 capital under current limits. Also, the addition of [Goldman Sachs Group Inc.](#) and [Morgan Stanley](#) as bank holding companies decreased the amount of qualified Tier 1 capital in 2009 to 78% of outstanding trust preferreds in the U.S., from 82%.

However, the size of the TruPS capital pool, at \$129.35 billion in the fourth quarter of 2009, means that the proposals will eventually lead to a significant shift in capital structure.

"Just from my experience of looking at how big that market grew, if it is disallowed it's going to have a big impact on a lot of institutions," Ketcha said.

Killian noted that the terms of the grandfathering will determine the effect on the banking sector. "The question is not whether you're going to disallow it completely," he said. "It's really more, how are you going to grandfather it, or how would you phase it out over time."

The documents also propose creating two new regulatory capital ratios. The first is a common equity to risk-weighted assets ratio, which includes common shares, retained earnings and other comprehensive income net of regulatory adjustments. In an initial [report](#) on the document, released in December 2009, Calyon Securities analyst Michael Mayo noted that the new ratio "appears to approach the Tier 1 common measure as introduced in the SCAP report in [May 2009](#)."

The leverage ratio has not yet been defined, though the document states that the committee is planning "to consider both Tier 1 capital and the predominant form of Tier 1 capital" as the definition for capital in the ratio.

The definition of total exposure is also in flux. Currently, the proposal uses accounting treatments to measure exposure, so that exposure would be net of provisioning and other valuation adjustments. Certain off-balance sheet items will be included at a 100% credit conversion factor, and written credit protection will be included at the notional value.

Accounting for derivatives could have significant effects, however. For derivatives other than credit derivatives, the proposal considers two methods of determining exposure. The first uses the sum of on-balance sheet positive fair values; the second also includes the potential exposure using the current Basel II rules.

FBR Capital Markets analyst Paul Miller Jr. told SNL that the leverage ratio requirement will likely have a larger effect on European banks because U.S. banks already have a leverage ratio requirement. "Now, we've got to bring everything on the balance sheet, and we've got to have simpler leverage ratios," he said. "That's the new rules."

As noted earlier, the proposals are not yet set in stone, but the trend is a push towards stricter capital requirements. Additionally, there are several types of assets that must be deducted from Tier 1 capital. (These will be addressed in a subsequent article.)

"Regardless of the ultimate outcome, we remain convinced that, at best, overall capital levels will migrate higher and returns (ROA/ROE) will migrate lower for the global banking industry," Brad Smith, an analyst Macquarie Private Wealth Corp., said in a December [report](#).

Comments on the proposals are due April 16, and banks should copy their comments to their primary federal regulator. Comments may be sent to baselcommittee@bis.org.