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Final Basel 3 Rules Largely Benign

Lower mortgage risk weights benefit FHN, STI, and BBT; Proposed changes to supplementary leverage ratio still to come

- **Final Basel 3 rules largely in line for advanced banks…** Today regulators published final Basel 3 rules for U.S. banks. Our best assessment is that the final rules were relatively in line with investor expectations for the "advanced" banks (BK, BAC, GS, JPM, MS, NTRS, PNC, STT, USB and WFC in our large cap coverage universes).

- **….But provide some relief for non-advanced banks** – We did find the rules modestly exceeded investor expectations for the non-advanced banks (BBT, FITB, MTB, CMA, FHN, FNFG, HBAN, KEY, NYCB, RF, SIVB, STI and ZION in our regional coverage universes). More specifically, non-advanced banks should benefit from (1) the opt-in provision for unrealized gains/losses on AFS securities which will lead to smaller buffers for interest rate risk above minimum capital ratios due to reduced volatility, (2) residential mortgage risk weights remain unchanged from current rules (50% for most first-liens, 100% for other residential mortgage exposures) and (3) grandfather of trust preferreds for banks under $15 billion of assets as of Dec 31, 2009.

- **Supplementary leverage ratio stays at 3% for now…but looks like will be addressed at July 9th FDIC meeting** – Although the regulators elected to leave the minimum supplementary leverage ratio that applies to advanced approach banks unchanged for now at 3%, that lack of change will only be temporary. Today, Fed Governor Daniel Tarullo publicly commented that the "the Basel III leverage ratio seems to have been set too low" and that regulators are "very close" to a proposal to raise the limit. The FDIC has added the leverage ratio discussion to the agenda for their meeting on July 9th. We observe that the supplementary leverage ratio as a potential capital constraint is gaining traction with regulators faster than we and most investors anticipated. For more on this topic, please see Potential New Capital Constraint Emerges and Supplementary Leverage Ratio Update.

- **Rule changes imply concern for housing recovery, smaller banks** – When we compare and contrast the final rules with the original NPR, two themes emerge. First, it appears that regulators did not want to make changes which might adversely impact the housing market recovery (shift back to the Basel 1 risk-weightings for mortgages), suggesting that regulators are focused on not derailing the housing recovery. Second, it appears that regulators endeavored not to unduly harm small banks and took those banks' comment letters to heart.

- **We see FHN, STI, and BBT benefiting the most from changes to mortgage risk-weightings** – Under the final rules, the risk-weightings on mortgage portfolios move from an LTV-based risk-weighting approach to an approach based mostly on lien positions. We see those banks with the largest mortgage portfolios, especially portfolios with higher LTV's at origination, benefiting the most from the reversion back to the Basel 1 risk-weighting methodology. Those banks include FHN, STI and BBT.

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1) Changes/Clarifications Affecting Tier 1 Common capital (the "numerator")

- **There was one major change…** Based on our initial read of the document, there was one major change to the calculation of Tier 1 common capital under the final rules for unrealized gains and losses on AFS securities.
  - **AFS gains/losses in OCI to affect advanced approach banks, but others can opt out** – One key change between the proposed and final rules allows standard approach banks to opt out of including unrealized gains/losses from AFS securities in Tier 1 Capital. Industry proponents had argued that including the unrealized gains and losses in capital would create excess volatility in capital levels and ratios, and the agencies responded by allowing standard approach banks to opt-out of this requirement on a one-time basis. Advanced approach banks (over $250 bil in assets) will still be required to include gains and losses on AFS securities in their calculation, but the availability of an opt-out for standard approach banks is a modest positive for the industry.
- **…While there was no change to restrictions on DTA, MSR, and financial institution investments** – The final rules also left unchanged the limits on deferred tax assets, mortgage servicing rights, and investments in financial institutions. Under the rules, DTAs, MSRs, and financial institution investments cannot make up more than 10% of risk-weighted assets individually, and in aggregate cannot exceed 15% of risk-weighted assets.
  - **No additional clarity on PNC's BlackRock stake, which is currently weighing on its B3 T1C ratio by an estimated ~50bp** – The finalized B3 rules were essentially unchanged with regards to minority interests and we did not get more clarity on the definition of "financial institution." As such, it remains unclear whether PNC's ~$5.6 bil stake in BlackRock will be subject to the 10% individual/15% aggregate cap. We estimate that the current impact to B3 T1C is ~50bp, declining to ~30bp by 4Q14 as PNC's capital base grows.

2) …And some Changes/Clarifications Affecting Risk-Weighted Assets

On the whole, there do not seem to be any significant changes to RWA calculations in the finalized documents when compared to the 2012 NPR. The marginal differences are centered around treatment of mortgage risk weights.

- **Treatment of residential mortgages returns to Basel 1 methodology; biggest incremental positive for FHN, STI, and BBT** – Under finalized B3 rules, residential mortgage exposures receive either 50% or 100% risk weighting. First lien exposures that are not 90+ days past due and that have not been restructured or re-modified would receive 50% risk weighting and all other residential mortgage exposures would receive 100% risk weighting. Previously under the proposed rules, risk weightings on residential mortgages were based on the LTVs of the underlying loans – loans with LTVs >80% received risk weights of 75-200%. Mortgages guaranteed by the FHA or VA generally receive a 20% risk weight under the finalized rules.
  - **Our estimate of ~2% inflation from mortgage risk-weightings under the NPR no longer holds** – Under the proposed rules issued in June of last year, we estimated that the more stringent proposed risk-weightings on mortgage portfolios would account for a ~2% increase from Basel 1 RWA to Basel 3 RWA. Given that under the final rules risk-weightings on mortgage portfolios revert back to the methodology used under Basel 1, we see FHN, STI, BBT as

benefiting the most. WFC is an advanced bank and given that these changes impact only the standard banks, WFC should not be impacted.

Figure 1. Although we had previously estimated ~2.2% of RWA inflation due to risk-weightings on mortgages, the final rules effectively eliminate that inflation

		C estimated RWA inflation to B1 RWA under NPR proposed Risk Weights		
$ in billions	Basel 1 RWA	1st Mortgage	HELOC	Total Mortgage
FHN	19.8	1.2%	2.4%	3.6%
STI	134.1	2.2%	1.3%	3.5%
WFC	996.8	2.3%	1.1%	3.4%
BBT	119.0	2.7%	0.6%	3.2%
RF	92.6	1.6%	1.3%	3.0%
HBAN	46.7	1.6%	1.4%	2.9%
USB	274.8	1.7%	0.7%	2.3%
FITB	105.5	1.3%	1.0%	2.2%
MTB	71.9	1.1%	0.9%	2.0%
PNC	250.8	0.7%	1.1%	1.8%
NYB	26.8	1.4%	0.3%	1.7%
ZION	42.7	1.0%	0.6%	1.6%
KEY	77.0	0.4%	1.1%	1.5%
CMA	64.7	0.3%	0.3%	0.5%
SIVB	12.1	0.3%	0.1%	0.4%
Average		**1.3%**	**0.9%**	**2.2%**
Median		**1.3%**	**1.0%**	**2.2%**

Source: Citi Research, SNL Financial

Note: Based on 1Q12

- **Treatment of high volatility CRE left mostly unchanged** – The finalized B3 rules retain the 150% risk weighting of high volatility CRE that was previously proposed. HV CRE is a subset of acquisition, development, and construction loans that regulators consider to be high risk. The finalized rules amended the HV CRE definition to exclude community development investments.

- **Treatment of delinquent loans unchanged** – Loans 90+ days past due retain a 150% risk weighting.

- **Treatment of unfunded commitments under 1 year and other off-balance sheet exposures unchanged** – As under the proposed rules, unfunded commitments under 1 year receive a 20% credit conversion factor and off-balance sheet guarantees, repo agreements, sec lending/borrowing transactions, and other similar exposures receive a 100% risk weighting. These exposures are treated as actual on-balance sheet exposures and are converted at their credit conversion factors to be included in RWA.

3) Collins Amendment may impact stated Tier 1 common numbers, but at end of the day does not seem likely to be a major issue – The Collins Amendment requires advanced approach banks to calculate their three risk-based capital ratios using both the standardized and advanced approach methods. The lower ratio of the two methods will be used to determine the bank's compliance with the minimum capital requirements.

- **Collins is not binding until the banks are out of the parallel run, so will not see any restatements of Basel 3 Tier 1 Common ratios…** In its 2Q12 earnings call, JPM provided a comparison of its B3 ratios under both the advanced and standardized approach. While the reported B3 Tier 1 common number was 7.9% under the advanced approach, it was 7.6% under the standardized approach largely due to increased weightings for mortgage. Since JPM is under parallel run, they were not required to report the 7.6%...but it was a good proxy to see what the hit would be under the proposed rules.

- **…But while there will likely be some impact to stated B3 ratios, it will be less than initially thought due to changes in residential mortgage risk weights…** One of the main drivers of the 30 bp difference was the elevated mortgage risk weights, but with the change back to the old Basel 1 rules, this should minimize the difference, and may even move the standardized approach higher than the advanced. JP Morgan also showed an additional 60bp (120bp under advanced vs 60bp under standardized) benefit from mitigation under advanced approach, which will likely be limited with the Collins floor.

- **…And ultimately might not really end up mattering since CCAR is the ultimate governor of capital.** While the stated Tier 1 common ratio will likely be lower due to the Collins amendment, we are not sure how much it really matters at the end of the day since the real constraint on capital is the stress test for CCAR. And we believe here that the advanced approach is hit much harder in the stress test, so at the end of the day we think the amount of capital the banks return will not be impacted all that much.

Appendix A-1

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