WINTHROP Capital Management

As a result of the Financial Crisis of 2008, the global banking system is in the process of implementing a series of regulatory proposals for higher minimum regulatory capital standards under what is known as Basel III. Financial regulatory reform is a complex process which requires coordination between international bank regulators in order to maintain a consistent and stable financial system to support international finance activities. The recently passed Dodd-Frank Act addressed regulatory reform of US banks and included new rules and regulations for the financial services industry. The Basel III rules are in addition to the reforms required by Dodd-Frank and provide an international standard for capital requirements.

What is Basel III?

Basel III is the third of the Basel accords, which are recommendations on international banking laws and regulations issued by the Basel Committee on Banking Supervision. Named after Basel, Switzerland where the Committee meets, the purpose of Basel III is to improve upon the existing international standards that banking regulators use for measuring capital adequacy for participating banks. In the absence of a supreme regulator for international banking, the Basel Committee is a self-governing body that consists of representatives from 27 participating countries.

Basel II, which was implemented in 2004, was the first coordinated initiative at setting a consistent international standard for banks with respect to three major issues: capital requirements, supervisory oversight and market risk assessment. Generally speaking, the minimum capital requirements outlined in Basel II direct that the greater risk to which the bank is exposed, the greater the amount of capital the bank needs to hold to safeguard its solvency. If one country's banks are under-capitalized relative to another's, the stronger bank will require higher rates and more collateral to lend to the under-capitalized bank.

Initially, Basel II set an international minimum capital standard of 4.0% of a bank's assets to cover its risks. However, the push into riskier businesses and the polluting of capital markets with toxic forms of securities throughout the last ten years eventually put pressure on bank capital. By the time Basel II was fully implemented in 2007, the required minimum capital of 4.0% proved inadequate in the face of the coming global financial panic.

With the new rules promulgated under Basel III, this mandatory reserve, which is known as Tier 1 capital, would increase to 4.5% by 2013 and reach 6.0% in 2019. In addition, banks would be required to maintain an emergency reserve known as a "conservation buffer" of 2.5%. As a result of the new rules, the amount of capital reserves each bank is expected to have by the end of the decade will be 8.5% of its assets. In addition, the new capital requirements will restrict how much and what types of hybrid securities will count toward Tier 1 capital.

What is the Impact on the US Economy and Financial System?

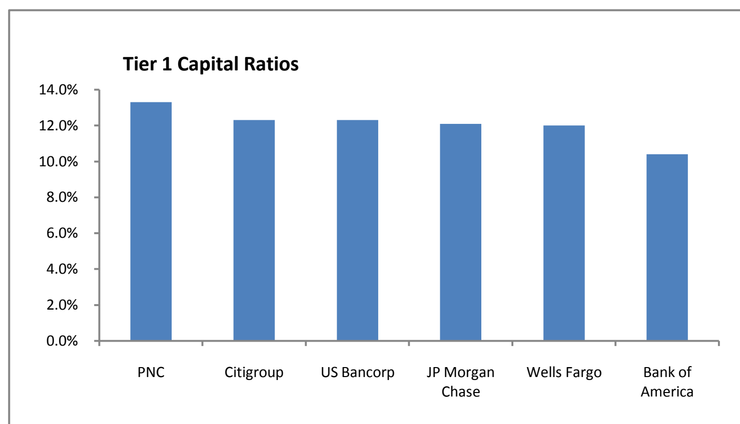
As a result of Basel III, banks will be required to increase their minimum capital reserves with the aim to strengthen the global financial system and hopefully prevent another financial collapse without impeding the fragile economic recovery. To have sustained economic growth, banks need to make loans in order for business expansion to take place. We need business expansion to create jobs and to grow the economy. And, in order for the banks to make loans, they are required to hold capital in reserve for those loans. While the new banking rules are designed to rein in excessive risk-taking, the consequence of higher

capital could dampen the fragile economic recovery by forcing banks to restrict the lending that fuels economic growth.

As an incentive to garner acceptance of the new minimum capital requirements, the Basel Committee has allowed initial compliance in 2013 and up until 2019 for most banks to come into compliance. Our concern is that there will be further pressure to weaken these minimum capital standards down the road given the long time frame to implement. In our opinion, this long time frame to full implementation ultimately exposes our capital markets to additional risks.

The Basel III rules did not address other major issues including bank liquidity and "too big to fail." As the financial crisis unfolded, the speed at which it overtook financial institutions left bank regulators and management blindsided and lacking necessary liquidity to meet demand. However, it was agreed that the focus needed to be on propping up minimum capital levels and that issues of liquidity and systemic risk would be addressed in 2018 after further study.

Our analysis of the current Tier 1 Capital levels of the major US banks shows that they are well within compliance of the Basel III capital requirements for 2019. We expect that the market will ultimately combine the minimum capital requirement and the buffer capital into one minimum capital requirement. The chart shows six major banks and their Tier 1 Capital levels for the second quarter of 2010.



Where are the Investment Opportunities?

We believe there is good relative value in certain hybrid securities and senior debt of high quality U.S. banks. As the banking industry works to replenish its Tier 1 capital base, we expect the credit quality of the senior debt and hybrid securities of the healthier banks to continue to improve. In addition, with the objective of reducing those hybrid securities which count toward Tier 1 capital, we believe there are select opportunities for income oriented investors to earn dividend yields between 7.5% and 8.5% in the current environment. For example, the JP Morgan Chase non-cumulative preferred stock which has a dividend of 8.625% currently is priced at 28.30 resulting in a yield of 7.62%. In addition, the credit quality of the senior debt of the major banks will improve as Tier 1 capital levels grow and loan losses decline. The five year debt of Morgan Stanley (A2/A) at a spread of +234, Goldman Sachs (A2/A) at +133, and JP Morgan (Aa3/A+) at +117 offers good relative value in today's market.

This report is published solely for informational purposes and is not to be construed as specific tax, legal, or investment advice. Nor is this document intended as a solicitation or an offer to buy or sell securities or related financial instruments. The report should not be regarded by recipients as a substitute for the exercise of their own judgment. The comments are based on current market conditions. Different market conditions and assumptions could have materially different results. Neither Winthrop Capital Management nor any of its affiliates, directors, employees or agents accepts any liability for any loss or damage arising out of the use of all or any part of this report. Winthrop Capital Management owns the securities of PNC, JP Morgan, Bank of America, Citigroup, Goldman Sachs, Morgan Stanley and US Bancorp for its own portfolio or its client portfolios.

© 2010 Winthrop Capital Management