



# The Impact of Standardized Basel II on Delaware Banks

Prepared for Delaware Bankers Association



# Executive Summary

Basel II bank capital regulations are in the news ...



We estimate that Standardized Basel II compliance will improve the regulatory capital ratios of 56.3% of 17 Delaware banks and thrifts

- Aggregate potential capital savings for all 17 banks or \$431 million
- The median Delaware bank would save \$6.6 million or 2.1% of their existing Tier 1 capital requirement

Implementation is not without its challenges

- Pillar II reporting can be complex and costly
- Compliance requires demonstrated capital management capabilities

# Agenda

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## Basel II Implications and Overview

- Basel II background
- Capital savings

## Pillar Two Requirements

- Pillar Two required for lower rates
- Requires development of an ICAAP

# Banks must comply with all three pillars of Basel II to get capital relief from lower risk weights defined in Pillar One

## Pillar One

### Minimum Capital Requirements

- Derives capital requirements through the assessment of “risk weights”
- “Standardized” approach: regulators provide revised (and typically lower) risk-weights for various asset classes
- “Advanced” approach: institutions estimate their own risk-weights, subject to massive internal analysis and regulatory oversight

## Pillar Two

### Supervisory Review

- Requires meaningful introspection of institutional risk and capital management philosophy
- Analyze and report to supervisors’ satisfaction
  - Risk profile
  - Risk appetite
  - Capital strategy

## Pillar Three

### Market Discipline

- Requires public disclosure of risk and capital calculations

**The investment required for lower capital rates**

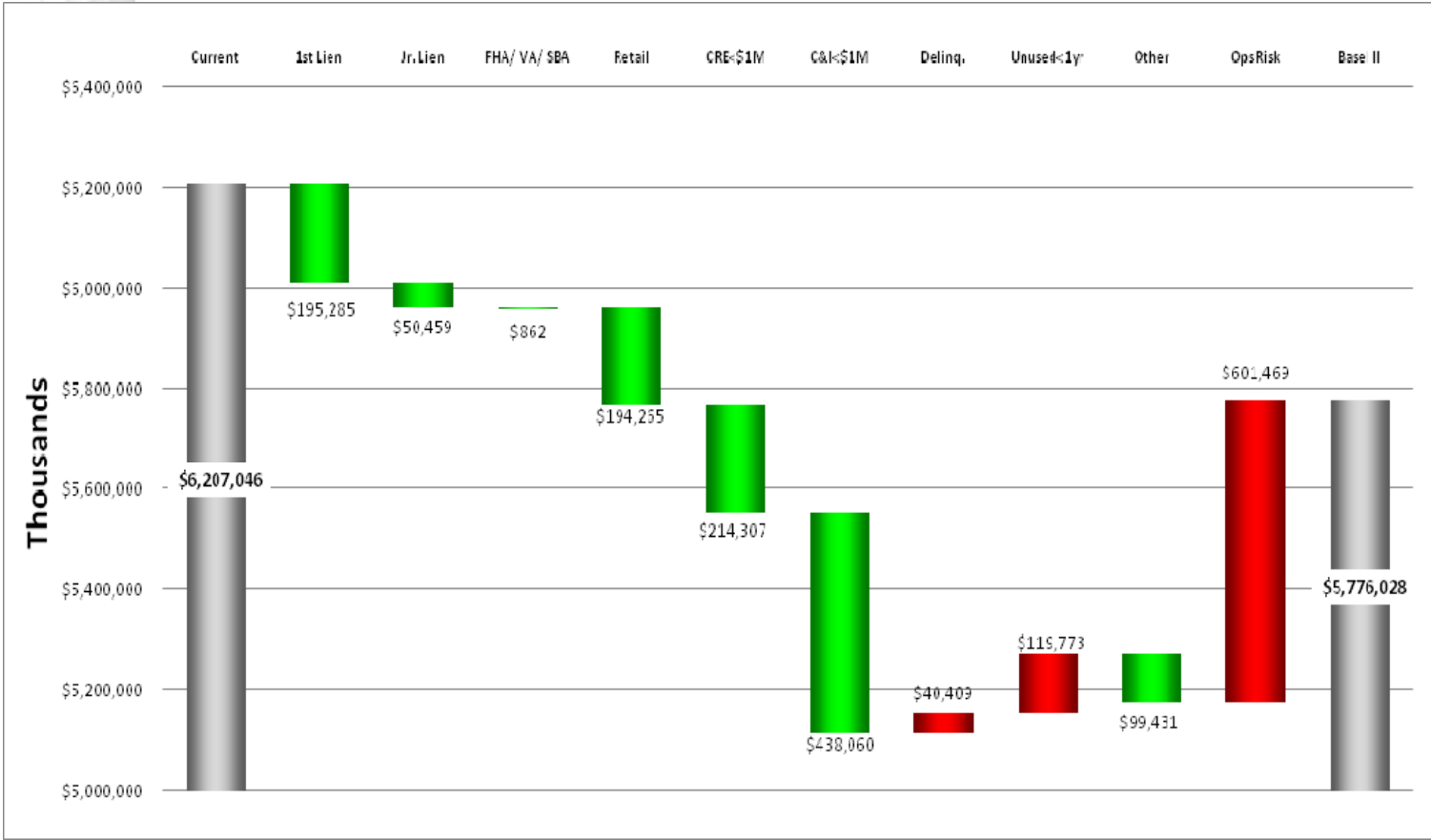
# Standardized Basel II assigns different risk weights to various asset classes

Major asset classes for which risk-weights change under Standardized Basel II		
Asset Class	Basel I risk-weight	Basel II risk-weight
First lien mortgage	50%	varies by LTV (avg ~ 34%)
Junior lien mortgage	100%	varies by LTV (avg ~ 90%)
FHA/VA mortgage and SBA loans	20%	0%
Consumer	100%	75%
C&I/CRE < \$1mm	100%	75%
90+ delinquent / non-accrual assets	100%	150%*
ABCP liquidity facilities	10%	20%
unused short-term commitments	0%	10%**
* delinquent low-LTV mortgages are still risk-weighted at 100% under Basel II		
** credit conversion factor		
<b>Source: Standardized Basel II NPR; Second Pillar Consulting estimates</b>		

# Delaware Banks can save up to \$431 million in required capital under Standardized Basel II

Capital savings estimate and asset category contribution

Regulatory Capital Requirement



Source: 2008q1 Call Reports; SPC estimates



## Capital savings can be immediately stockpiled or deployed

Under Basel II Standardized, the median Delaware Bank would see a reduction in regulatory capital of \$6.6 million or 2.14%

This means that Delaware banks can maintain their existing Tier 1 Risk-Based Capital Ratio and stock pile or deploy the \$431mm of capital savings

- Stockpile as a capital buffer
- Issue a special dividend
- Repurchase shares, generating an increase in annual EPS
- Organically grow the balance sheet without raising additional capital

Banks that choose not to comply with Standardized Basel II might suffer a competitive disadvantage to peer banks that opt-in, as well as the larger banks that comply with Advanced Basel II

# The capital savings that Wilmington Trust Corporation accrues under Basel II can be stockpiled or deployed in a variety of ways

Capital Savings: \$14.0 million or 1.2%

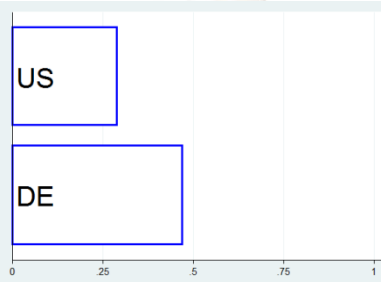
Regulatory Capital Requirement



## Wilmington Trust Corporation Wilmington, DE Highlights

- *Stockpile.* Under Basel II, total RBC increases from 11.2% to 11.3%, an amount equal to \$14.0 million or 1.2% of the existing capital base.
- *Deploy.* Incremental capital can be deployed with a variety of balance sheet actions that preserve the current 11.2% total RBC ratio:
  - Issue a special dividend of \$0.21 per share
  - Repurchase 583,296 shares, increasing EPS \$0.02 or 0.9%
  - Organically grow assets by \$142 million

Capital Savings Percentile



Asset Mix



Capital Metrics and Management

Total Assets (millions)	\$11,847	
Gross Income Margin	6.4%	
Tangible Common Equity	6.8%	
Leverage Ratio	7.2%	
Capital Estimates	Current	Basel II
Tier 1 RBC	7.7%	7.8%
Total RBC	11.2%	11.3%
Potential Use of Basel II Capital Savings		
Special Dividend (\$/share)	\$0.21	
Share Repurchase (7/29/2008 price)	583,296	
Change in EPS	\$0.02	
Organic Asset Growth (millions)	\$142	

Upon request, Second Pillar Consulting can provide similar information for all Delaware banks free of charge



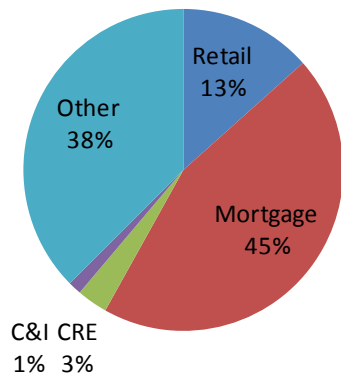
# Standardized Basel II capital savings for a sample of Delaware banks

Name	City	Asset Size (\$000's)	Dollar Change (\$000)	Percent Change
MidCoast Community Bank	Wilmington	\$ 81,978	\$ 2,390	16.8%
Community Bank Delaware	Lewes	\$ 50,429	\$ 1,124	10.6%
Wilmington Savings Fund Society, FSB	Wilmington	\$ 3,173,008	\$ 26,145	9.7%
Bancorp, Inc.	Wilmington	\$ 1,647,454	\$ 11,140	7.5%
Harris Financial Corp.	Wilmington	\$ 69,172,194	\$ 364,840	5.5%
First National Bank of Wyoming	Wyoming	\$ 300,002	\$ 2,442	4.9%
AIG Federal Savings Bank	Wilmington	\$ 1,354,796	\$ 6,587	4.8%
Artisans' Bank	Wilmington	\$ 601,862	\$ 2,002	3.1%
Wilmington Trust Corporation	Wilmington	\$ 11,846,590	\$ 14,349	1.2%
County Bank	Rehoboth Beach	\$ 353,449	\$ (403)	-1.0%
Lehman Brothers Bank, FSB	Wilmington	\$ 12,246,720	\$ (22,100)	-1.1%
First Bank of Delaware	Wilmington	\$ 118,185	\$ (8,411)	-18.3%
Discover Bank	Greenwood	\$ 31,123,609	\$ (935,605)	-19.3%
<b>Averages</b>		<b>\$ 10,159,252.00</b>	<b>\$ (41,192.38)</b>	<b>1.9%</b>

Source: 2008Q1 Call Reports; SPC estimates

# The major difference between highest and lowest percentage change banks is portfolio mix and profitability

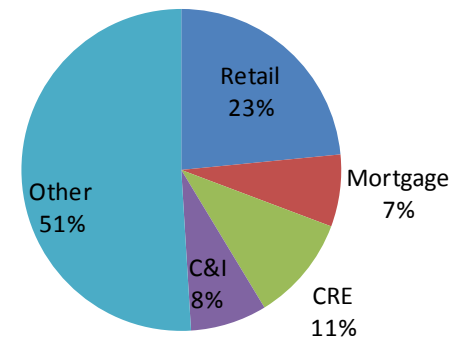
## Asset Mix of Highest Percentage Gain Banks



**Top 5 banks have a significant portfolio concentration in mortgage which under the new rules has the largest change in risk weight**

**Average Gross Income Margin – 2.7%**

## Asset Mix of Lowest Percentage Gain Banks



**Bottom 5 banks have a smaller portfolio concentration in mortgage and larger in CRE, C&I, and other**

**Average Gross Income Margin – 10.5%**

**Operational Risk is calculated using the banks average gross net income over the past 3 years and then multiplying by 15% to arrive at the risk weighted assets. Therefore, highly profitable banks have a higher operational risk charge.**

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# Pillar Two requires meaningful risk management investments

## Enhanced Risk Management

### Analytical documentation

- Articulation and quantification of institutional risk profile and risk appetite
  - Identification of key risks
  - Economic Capital modeling
  - Scenario analysis and stress testing
- Compelling capital contingency plans
- Comprehensive policies and procedures

### Corporate behavior

- Demonstrated governance, oversight, risk management, and controls
  - Senior Management ownership and Board oversight
  - Not a compliance exercise, but a way of life
- Enhanced regulatory dialogue

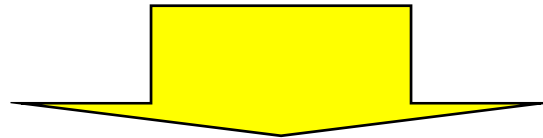
Internal  
Capital  
Adequacy  
Assessment  
Process  
(ICAAP)

# ICAAP memorializes risk culture, risk profile, and capital adequacy

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## Contents Include:

- ✓ Executive Summary
- ✓ Institution background
- ✓ Current and projected financial and capital positions
- ✓ Risk appetite
- ✓ Risk profile
- ✓ Capital requirements
- ✓ Key sensitivities and future scenarios
- ✓ Peer analysis
- ✓ Adoption and use within the firm



**Can be up to 50+ pages in length!**

## Banks must be prepared to answer the tough risk management questions posed by Basel II compliance

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- ✓ Do you have a well-functioning risk oversight structure?
- ✓ Do you have clear risk management policies and procedures?
- ✓ Have you identified the important risks faced by your institution?
- ✓ Have you articulated an institutional appetite for risk-taking?
- ✓ Do you have accessible data on the risk characteristics of your existing portfolio?
- ✓ Do you have accessible data on the past performance of your portfolio?
- ✓ Do you have personnel that can fill critical risk assessment gaps?
- ✓ Do you actively manage and plan your capital position?
- ✓ Are you committed to enhancing your overall risk and capital management?

## Summary

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The current misconception is that Standardized Basel II is only for big banks

- This legislation applies to all banks
- Non-compliance may put you at a competitive disadvantage to peers

Are you aware of and prepared for these changes?

- You may want to think about responding to the NPR by October 27<sup>th</sup>
- You may want to contact the RMA or ABA to find out more

## Contact Information

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