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By Yalman Onaran

July 10 (Bloomberg) -- The biggest U.S. banks, after years of building equity, may continue hoarding profits instead of boosting dividends as they face stricter capital rules than foreign competitors.

The eight largest firms, including JPMorgan Chase & Co. and Morgan Stanley, would need to retain capital equal to at least 5 percent of assets, while their banking units would have to hold a minimum of 6 percent, U.S. regulators proposed yesterday. The international equivalent, ignoring the riskiness of assets, is 3 percent. The banks have until 2018 to fully comply.

The U.S. plan goes beyond rules approved by the Basel Committee on Banking Supervision to prevent a repeat of the 2008 crisis, which almost destroyed the financial system. The changes would make lenders fund more assets with capital that can absorb losses instead of using borrowed money. Bankers say this could trigger asset sales and hurt their ability to lend, hamstringing the nation's economic recovery.

"The higher requirement for bank subsidiaries does have significance for the shareholders of their parent companies,"
said Frederick Cannon, director of research at Keefe, Bruyette & Woods Inc. The units would have to retain earnings at least temporarily to comply, which would prevent holding companies from distributing dividends as most profit comes from those units, he said.

Morgan Stanley and Bank of New York Mellon Corp. currently have the lowest ratio of equity to assets of the eight banks, according to estimates from analysts including Cannon and Autonomous Research LLP's Guy Moszkowski. Investors may get more information when the banks report second-quarter results, beginning July 12.

Joint Proposal

September data from the largest banks show their holding companies fell short of the new leverage requirement by $63 billion, according to the joint proposal by the Federal Deposit Insurance Corp., Federal Reserve and Office of the Comptroller of the Currency. Insured lending units would need $89 billion more capital. The firms can fill the gaps by retaining profits and without selling more stock, the regulators said.

The changes would affect U.S. companies with assets exceeding $700 billion or those with custody of more than $10 trillion of customer assets. Besides JPMorgan, Morgan Stanley and BNY Mellon, the affected lenders include Citigroup Inc., Wells Fargo & Co., Goldman Sachs Group Inc., Bank of America Corp. and Boston-based State Street Corp.

'Prop-Trading'

"They have plenty of time to comply, and they have steady earnings they can hold onto," said Mayra Rodriguez Valladares, managing principal at New York-based MRV Associates, which trains bank examiners and finance executives. "They can also divest more from hedge funds, commodities and other prop-trading bets, which is what the regulators are hoping will happen."

All of the firms except San Francisco-based Wells Fargo advanced yesterday in New York trading as the 81-company Standard & Poor's 500 Financials Index climbed 0.8 percent, outpacing the 0.7 percent gain for the broader S&P 500 Index.
Investors had anticipated the harsher standards, limiting immediate price declines, Rodriguez Valladares said.

"All of these banks are easily going to get there by 2018, the question then is what will the market demand?" said Gerard Cassidy, an analyst at RBC Capital Markets. "That's going to be a determinant. My suspicion is that everyone will be over the 5 percent hurdle by the end of 2014."

Token Dividends

Citigroup and Charlotte, North Carolina-based Bank of America both pay token quarterly dividends of 1 cent a share while Morgan Stanley's is 5 cents. Citigroup's payout was $5.40 a share before the crisis. The banks had to sell new shares to bolster capital at the height of the meltdown, while cutting dividends and buybacks.

Bankers have resisted the stricter capital standards, saying that lending might be curtailed and that the remedies adopted after the financial crisis, such as the 2010 Dodd-Frank Act, should be given time to work.

"The Federal Reserve's stress tests clearly demonstrated that our nation's banks are strong enough to withstand even the most challenging economic circumstances," Frank Keating, chief executive officer of the American Bankers Association, said in a statement. "Doubling the capital requirements adds little protection, and may adversely affect the level and cost of credit that's so vital to continued economic expansion."

The new Basel leverage ratio expands what are counted as assets, intensifying the demand for capital. It includes more of the derivatives contracts that are kept off of banks' balance sheets under accounting rules and recognizes unused credit lines granted to companies and consumers.

The Independent Community Bankers of America, which represents smaller lenders, voiced support for that approach because it targets "risky financial instruments" hidden away.

'Common Sense'

"This will offer a clean, common-sense way to help offset the true level of risk that these megabanks pose to themselves, to consumers, and to our financial system and economy," the Washington-based trade group said in a statement.

The dual ratios in the U.S. plan may help more lenders comply. If both ratios were set at 6 percent, only Wells Fargo would meet that threshold. With the holding company requirement set at 5 percent, most of the biggest banks would come closer, according to KBW estimates. KBW didn't say how the firms would fare under a separate ratio for the banking units.

Derivatives Contracts

JPMorgan Chase NA, the insured depositary arm of New York- based JPMorgan, held $70 trillion of the lender's total $71 trillion notional value derivatives contracts at the end of March, according to OCC data. Citibank NA held all $58 trillion of Citigroup contracts. Bank of America's lending unit held $45 trillion of the firm's $61 trillion.

Morgan Stanley Bank NA had just $3 trillion of the firm's
$47 trillion total. Holding the bulk at the parent, with its lower capital requirement, might help New York-based Morgan Stanley as it has the lowest Basel leverage ratio among the largest U.S. banks, according to six analyst estimates compiled by Bloomberg. Those range from 3.6 percent to 4.6 percent.

"A cap on leverage is in my view a good thing in the banking industry," Royal Bank of Canada CEO Gordon Nixon, 56, said yesterday in a telephone interview. "It would have been far more effective in 2008 than higher capital levels."

Karen Shaw Petrou, managing partner of Washington-based Federal Financial Analytics, said the banks would struggle to raise the necessary capital simply by retaining earnings. Banks may have to discontinue some products, pushing "a lot of complex business into the shadows," she said, referring to less regulated institutions such as hedge funds.

Less Risky

The leverage ratio measures capital as a flat percentage of assets, eschewing formulas that let banks hold less capital for assets deemed less risky.

The traditional Basel capital regime allows larger lenders to calculate the likelihood of losses using their own formulas, and thus how much capital they need. As the models became more complex and harder to understand, regulators such as former FDIC Chairman Sheila Bair questioned their credibility.

Bair, 59, pushed Basel to add the leverage ratio, a more transparent gauge that measures capital as a simple percentage of assets regardless of the risk. FDIC Vice Chairman Thomas Hoenig, who has advocated a 10 percent straight leverage ratio, yesterday reiterated his objection to the complicated formulas used to calculate risk-weighted capital ratios.

The proposed U.S. rules could push banks to shift to riskier assets, according to Jason Goldberg, a Barclays Plc analyst.

'Competitive Disadvantage'

"This new heightened requirement would only impact certain U.S. institutions, potentially resulting in these banks being put at a global competitive disadvantage," Goldberg wrote yesterday in a note. U.S. regulators probably will follow with further capital measures in coming months, he said.

Fed Governor Daniel Tarullo, who's in charge of bank supervision, said last week that new rules would be forthcoming on how much long-term debt the largest firms would need to hold and extra capital charges on short-term funding.

Hitting the new leverage ratio targets would be easier if safer holdings such as cash and government debt were excluded from the tally of assets. Bankers say this would be fair as those holdings aren't likely to sour and have less need for a backstop. Yesterday's proposal doesn't grant such an exclusion.

Without it, Morgan Stanley and BNY Mellon have the lowest ratios of capital to assets, analysts at New York-based Goldman Sachs estimated in a report last month. The industry has been lobbying for the exclusions and may renew efforts to narrow the definition of assets before the rule becomes final.

"The banks will keep fighting until the last moment to soften this proposal," Rodriguez Valladares said. "But there's considerable political backing for tougher rules on big banks, so they probably won't win."

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