Federal Financial Analytics, Inc.

U.S. IN "DAMNED-IF-WE-DO, DAMNED-IF-WE-DON'T" BASEL DILEMMA, FEDFIN MANAGING PARTNER TELLS CONGRESS

> "Current plans for Basel II in the U.S. won't work, but it is at the same time also imperative that our regulatory capital standards change as quickly as possible."

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WASHINGTON, D.C -- In testimony today before Congress, the managing partner of Federal Financial Analytics (FedFin), Karen Shaw Petrou, pointed to the profound market impact the pending rewrite of global risk-based capital rules will have. "Starting January 1, 2007, large, global financial services firms will have sharply lower risk-based capital on mortgages, small-business loans and many other assets," she said, making them potential acquisition "powerhouses" here because the U.S. has delayed implantation of the new standards.

Petrou did not, however, argue for quick action on the pending approach to Basel II. "If the U.S. tells Basel we are in, we will buy into a complex rule with, at last count, a 50-page list of provisions subject to 'national discretion.' Further, we will buy in even as we propose to keep our unique leverage ratio and apply Basel II only to the very largest institutions. …In essence, we will be putting the round-peg of the U.S. financial system through the Basel II square hole."

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Petrou argued for the following next steps to resolve this dilemma:

- There should be quick U.S. implementation of the standardized credit risk-based capital provisions in Basel II. Deferring the standardized options now in hopes of eventually implementing the better advanced options is a classic case of making the perfect the enemy of the good.
- We should pair this with immediate revisions to the leverage rule for banks and savings associations coming under these revised standards so that the leverage standard does not create a perverse incentive to take undue risk. Keeping leverage as is under the Basel II plans will also worsen small-institution competitiveness problems because they will find it harder to game the leverage requirement.
- It is essential that the regulators implement a new supervisory framework for operational risk without a mandatory regulatory capital charge. A regulatory charge for operational risk now will create perverse incentives against readiness for natural and man-made disasters, as well as pose unique and significant competitive problems for U.S. banks.
- We must continue to work quickly to finalize the advanced approaches for credit and operational risk. Importantly, big investment banks in the U.S. can come under the current Basel II advanced options without a leverage requirement at the same time as foreign institutions, putting large U.S. banks in a potentially big competitiveness hole if advanced options are not quickly made available to them as well.

A copy of the testimony is attached.

Federal Financial Analytics, Inc. has for the past twenty years counseled large financial institutions and even their regulators on major legislative, regulatory and policy issues that pose strategic risk. It does not lobby on behalf of clients, but advises them on appropriate responses in light of identified challenges, working on an array of GSE, Basel II, and acquisition-value issues. The firm publishes numerous information and analytical services, including Financial Services Management and GSE Activity Report.

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