Federal Financial Analytics, Inc.

# LEAVE NO BANK BEHIND ON BASEL, PETROU TELLS CONGRESS

"This is not to say that Basel I should be retained – it should not. Rather, it is to argue for a gradual approach to rewriting Basel II so that improvements are well-understood, implemented across the board and tested before additional refinements are made. The current effort to do a global, complete rewrite of the risk-based capital rules that deals with almost every variation of all banking products around the world at one time is a classic instance of the perfect proving to be the enemy of the good."

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WASHINGTON, DC – Testifying before two subcommittees of the House Financial Services Committee today, Karen Shaw Petrou, managing partner of Federal Financial Analytics, argued for quick action on the agreed-upon sections of the new risk-based capital rules. Congress is concerned that the recent U.S. quantitative impact survey showed undue differences in bank capital that will put small banks left out of Basel II at a competitive disadvantage. Petrou noted that risk-based capital should lead to big differences in capital between low- and high-risk institutions, but she argued that these should apply to all banks, not just the very big ones the U.S. now intends to bring under the new standards.

Petrou told Congress that, Basel II "will drive decisions about which banks can offer what types of mortgages, small business loans and other critical financial services at what price where.  Thus, despite the daunting technical nature of these rules, Congressional review and, if necessary, direction is essential."

Petrou's testimony addresses the latest issue in the U.S.:  a delay announced on April 29 of the Basel II rules and the planned Basel I rewrite to evaluate the latest data round.  She said, "Despite the Basel II and Basel I rewrite delays, banks are being told in no uncertain terms to get ready for Basel II and decide if they want to opt in.  Incredibly detailed guidance on even minor Basel II points is being issued although the entire rule remains up in the air.  Frankly, this is the worst of all options – agencies are demanding readiness for a rule not yet written because of an effort to get all its details totally right while all of the market distortions from the current requirements remain unaltered."

Petrou's testimony also argues that the U.S. leverage standard is inconsistent with risk-based capital.  If it is retained, she said, it should be reduced (permissible under current law).  She noted the many problems with the proposed capital charge for operational risk, arguing that regulators should get the qualitative standards for this critical risk right before mandating a capital charge.  A capital charge now for operational risk could well result in "perverse incentives" against effective contingency planning, disaster preparedness and system security, Petrou said.

A copy of the testimony is attached.

Federal Financial Analytics, Inc. has for the past eighteen 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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