Federal Financial Analytics, Inc.

New Capital Rules May Decide Winners, Losers Sooner Than Thought, Report Says

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WASHINGTON, October 16 – The latest version of proposed new capital standards for the world's largest banks could have profound market impact, starting as soon as the first quarter of 2003, concludes the first objective analysis of the Basel rules in their latest version.

The new rules will vary regulatory capital according to risk far more widely than now required, forcing banks that are scored as having high-risk profiles to hold much more capital when the rules become effective. To minimize the profit impact of so big a change, affected banks will start to rebalance their portfolios as early as next year, when the final rules are set, concludes Federal Financial Analytics in a report sent yesterday to clients.

"This rule – even in draft form – will begin to define financial industry winners and losers as early as next year," said FFA Managing Partner Karen Shaw Petrou in releasing the analysis. "Banks can't make sudden adjustments because of the long maturity of many of their assets," she said. "Big banks must start now to adjust their portfolios to avoid massive capital increases when the rules become effective."

Federal Financial Analytics is a research and consulting firm in Washington, D.C. Its clients include major financial institutions in the U.S. and abroad.

The FFA report also notes the potential major impact of these rules in the financial markets. Significant changes in credit availability could well ensue. Bank pricing of high-quality loans will likely improve to match that in the larger capital markets, but interest rates and fees on higher-risk loans could ratchet up to the point that credit availability for emerging markets, subprime borrowers and startup companies is adversely affected.

Among the conclusions of the FFA report:

- Floors on reductions to capital could reduce some of the benefits for low-risk assets, undermining the value of the new internal models-based options.
- A new charge for operational risk could result in higher overall capital costs for most banks, particularly those using the standardized capital

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charges. A new "advanced measurement approach" for operational risk is offered, but overall limits on it may force even large banks to use more costly operational risk capital options.

- The new rules are so complex that taking part in the dry-run quantitative impact survey is a daunting task even for large institutions. The value of the survey is in doubt because of the large amount of discretion provided to national supervisors.
- A new stress test to counter the tendency of the rules to exacerbate economic booms and busts could further reduce the anticipated capital benefits.
- The rules may be difficult to apply outside the G-10 area, which could create some competitive disadvantages for big banks operating in significant markets outside the Basel area.

A copy of the full FFA report is available by contacting Federal Financial Analytics at 202-296-5240 or sending an email to: info@fedfin.com