



Federal Financial Analytics, Inc.

REGULATORS HEAD TO COV-LITE LOANS

“After watching the boat sail on mortgages, bank regulators are deeply worried they may do the same on billions in commercial loans without the usual covenants that protect lenders. Examinations are under way to determine the depth of this risk, but some are urging immediate supervisory action and even new capital rules.”

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WASHINGTON, D. C. – Federal Financial Analytics today released a forecast of what bank regulators, the SEC and the Bush Administration are reviewing following new data on the sharp spike in cov-lite loans. Several are concerned that industry pressure and internecine squabbling led the regulators to intervene too late in the subprime mortgage melt-down and are pushing for quick action now on cov-lite paper. Others fear, however, that intervention now runs the risk of repeating the regulatory crack-down on junk bonds in the late 1980s that actually heightened the risk, led to bank failures and contributed to a nationwide recession.

The FedFin analysis describes these differences of opinion and their respective rationales. It notes that, among other things, the Bush Administration is considering convening the President’s Working Group on Financial Markets to turn out another set of high-level

principles on risk management like those recently released on hedge funds and private-equity firms. Bank regulators are also looking at new guidance and even specific capital standards designed to capture the significant credit risk associated with cov-lite loans.

“Once made, a cov-lite loan is there to stay,” said Karen Shaw Petrou, managing partner of Federal Financial Analytics. “Post-hoc risk management can’t remedy over-favorable terms and lax underwriting,” she continued, “but it can at least limit the damage these loans will do should they later go upside down. Given the increasing worries in commercial and investment bank portfolios related to collateralized debt obligations and other high-risk paper, bank regulators and the SEC may well choose to err on the side of caution,” she noted.

The FedFin analysis 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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