Federal Financial Analytics, Inc.

FINAL BASEL ACCORD TO KICK OFF FINANCIAL SERVICES SHUFFLE, FEDFIN REPORT CONCLUDES

"Capital rules look complex, but they drive who wins and loses in the financial services industry."

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WASHINGTON, D. C. – A report today released by Federal Financial Analytics concludes that the final new international risk-based capital standards will give the biggest, most diversified banks an even greater competitive edge than they now enjoy. In the first of a series of reports to clients on the complex overhaul of these critical standards, FedFin concludes that, even under the variation of the Basel rules planned for the United States, the steep drop in credit risk-based capital will position big, diversified banks powerfully against smaller competitors, especially specialized ones. The FedFin report also concludes that banks in the European Union, Canada and elsewhere will have a competitive edge for two years or more over U.S. ones because of the way the Basel rules will be implemented in these various jurisdictions.

"Some may think that Basel won't matter until 2006 or even later," said FedFin's managing partner, Karen Shaw Petrou, upon releasing the client report. "That's dead wrong," she continued. "Capital is a prime driver of strategic advantage in the financial services industry as a whole and on a line-of-business basis. When ROE is the principal measure of shareholder return, changes in regulatory capital that drive that equation are critical in determining which franchises win and which ones lose out."

Key findings in the FedFin Basel II report include:

- Even the standardized credit risk-based capital approach authorized outside the United States should drop regulatory capital for most banks, and the decision in Basel to permit immediate recognition of standardized model benefits without any floors will thus result in immediate risk-based capital reductions for such institutions. The European Union, Canada and Japan do not have the United States leverage requirement or the "well-capitalized" test, meaning that such banks have no offsetting domestic capital standards that affect their ability to realize these capital reductions. Thus, they should prove formidable competitors at home and acquirers here while this capital advantage lasts.

- In the United States, smaller institutions will not necessarily go under Basel II. Thus, their regulatory capital incentives may stay the same, along with the higher capital charges for low-risk assets like mortgages and small-business loans. These institutions could find themselves forced in essence to become brokers for big banks, originating loans and then selling them to the big banks that then hold the assets on their own books.

- Basel II will result in profound change in the competitive balance between big banks and Fannie Mae and Freddie Mac, massive entities of course already under an array of regulatory stress.

Copies of the FedFin report are available on request. To obtain one, call Arezou Rafikian at 202-296-5240 or e-mail INFO@FEDFIN.COM

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 Basel II policy and implementation issues.

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