Federal Financial Analytics, Inc.

NEXT-TO-FINAL BASEL ACCORD: BIG BENEFIT FOR RETAIL LENDERS

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WASHINGTON, D. C. — Federal Financial Analytics today issued the first summary of the new Basel II Accord released this morning by international bank regulators. The complex proposal will have profound implications on all financial services firms, not just the "internationally-active" banks explicitly subject to them because regulatory capital is a key driver of overall profitability, FedFin concludes.

As anticipated, the new proposal includes significant changes to the regulatory capital for credit risk and a new operational risk capital charge. Regulators have tried to address the major criticisms of the operational risk charge with a new "advanced measurement approach," but this still imposes a regulatory capital charge for a risk the new document states is very hard to measure. Banks using this advanced approach to operational risk and the new internal ratings-based ones for credit risk will only benefit from the new standards over time, as floors for possible reductions in regulatory capital will be imposed. This could minimize the benefits some now anticipate from the drop in regulatory capital for low-risk assets, especially in the U.S. (where only these advanced approaches are now under consideration).

"Although U.S. regulators have said that only the biggest banks will come under Basel II, the new regulatory scheme will have profound implications for all financial services firms, ultimately defining franchise value for a range of winners and losers," said Karen Shaw Petrou, Managing Partner of Federal Financial Analytics. Petrou testified before Congress on the rules last February, and FedFin advises a range of clients on Basel matters. She continued, "Banks focused on retail lending – mortgages, credit cards and small-business loans – will be the big Basel winners, assuming the floors on the benefits of Basel II for sophisticated banks in the U.S. drop fast." On the other side, banks holding higher-risk loans and asset securitizations could see their regulatory capital spike up from day one of Basel II, FedFin concludes.

Although Basel II doesn't go final until 2007, the proposal released today will have immediate market impact. "Banks can't swap their portfolios overnight," Petrou said. "Now that the final shape of Basel II is clearly in sight, banks must begin to restructure their risk to take full advantage of Basel's benefits and minimize its costs," she said. This will have a big impact now on who gets loans for how much and which financial services firms offer them.

A summary of Basel II is attached.

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