Federal Financial Analytics, Inc.

LITTLE GAIN, MUCH PAIN FOUND IN U.S. BASEL PROPOSAL

> "Low-risk banks won't benefit from Basel and high-risk ones might not be penalized – the reverse of what all the regulators wanted at the outset. In fact, much in the rule suggests the U.S. regulators could go back to the drawing board, abandoning the Basel process in favor of a rewrite of the U.S. standards. "

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WASHINGTON, D.C. -- A detailed analysis of the U.S. proposal to implement international risk-based capital rules shows major problems that significantly undermine the initial goals of the capital rewrite, costing big U.S. banks far more in regulatory capital than originally anticipated. Large U.S. banks – especially those focused on mortgages and other retail activities – have hoped for a big drop in regulatory capital that would enhance profitability under Basel II. However, details in the advance notice of proposed rulemaking show that the U.S. proposal would make it very hard for covered banks to get meaningful drops in regulatory capital, a study released yesterday to clients by Federal Financial Analytics (FedFin) finds.

The FedFin analysis reviews the hundreds of pages released on August 4 by U.S. banking agencies for public comment. Although the outlines of the advance notice of proposed rulemaking (ANPR) have been clear since regulators testified to Congress earlier this year, specifics buried in the proposal pose very serious problems for banks hoping to benefit from the complex, costly rewrite. For example, the ANPR states that U.S. banks must make all their credit risk decisions based on the capital models – a requirement that could dramatically shift the cost and availability of credit, especially in higher-risk markets.

"The ANPR reads in spots like a quant's doctoral dissertation," said Karen Shaw Petrou, FedFin's managing partner. "However, the net impact of the new regulatory capital standards will drive how profitable different U.S. bank franchises will be in which lines of business. Numbing details thus will mean a lot not only for banks, but also for their competitors and customers," she continued.

A key finding in the FedFin analysis is the adverse impact from the proposed retention of unique aspects of U.S. capital standards. These will have the effect of making it very hard for low-risk banks to see any reductions in risk-based capital (RBC). In fact, FedFin concludes, these unique features could also mean that high-risk U.S. banks don't have to hold as much capital as their positions would otherwise dictate. "As a result," Petrou said, "low-risk banks won't benefit from Basel and high-risk ones might not be penalized – the reverse of what all the regulators wanted at the outset."

FedFin notes that the ANPR suggests bank regulators themselves have doubts about what is being proposed. Tensions among the regulators have been clear at recent hearings, and details in the text of the proposed rule show how deep these divisions run. Indeed, the ANPR suggests that U.S. bank regulators could well go back to the drawing board and abandon Basel II altogether, with a major revision to all of the U.S. regulatory capital standards then in the offing, FedFin concludes.

Other findings in the FedFin study include:

- Although big U.S. banks overall won't see RBC drop, key lines of business in diversified banks could get a major competitive edge. This will result in consolidation in retail banking and mortgage lending, possibly putting small and mid-size banks at serious strategic risk.

- The proposed new capital charge for operational risk will be particularly costly to specialized U.S. banks because major competitors will remain outside the Basel rules. However, these banks can "de-bank" – resulting in major changes in U.S. financial markets.

- Fannie Mae and Freddie Mac could come under even more market pressure than is now evident. Changes under the proposed rule will force banks to focus on their portfolios, not securitization. As a result, fewer and riskier mortgages will be made available to the GSEs for their purchase.

- The proposal to permit use only of the advanced credit and operational RBC models could put U.S. banks under a further competitive strain. EU and other nations' banks will be allowed to use simpler capital models that go into effect on day one. However, use of the advanced models is not only delayed, but also made conditional in the U.S. Thus, U.S. banks could remain under Basel I for years even as EU banks see their RBC drop.

The FedFin analysis is attached.

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