



Federal Financial Analytics, Inc.

U.S. BASEL PROPOSAL POSES SERIOUS COMPETITIVENESS CHALLENGES, FEDFIN STUDY FINDS

“In general, the NPR is more stringent and thus reduces the anticipated risk-based capital benefits for which many large U.S. banks hoped at the start of the Basel process in the mid-1990s. However, the rules would still make regulatory capital closer to the economic capital allocations that drive strategic decisions.”

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WASHINGTON, D.C. – In the first in-depth study of the new U.S. Basel II proposal, Federal Financial Analytics, Inc. concludes that the numerous differences in the proposal combine with unique features in the U.S. financial system to pose serious long-term challenges to banks. However, perhaps the first problems created by the notice of proposed rulemaking (NPR) is that even it is very much a work in progress, subject to many conditions and even a wholesale rewrite. The FedFin study concludes that these delays compound differences that will put U.S. banks in play for foreign or non-bank acquisition. The study also forecasts the rule’s impact on borrowing costs for small businesses, commercial real-estate, mortgages and other key bank customers.

“To be sure, the Basel II NPR is better than Basel I,” said FedFin managing partner Karen Shaw Petrou. “However, it’s so far from current market realities that we’ll see the U.S. banking system redesign itself in unintended and, perhaps, undesirable ways,” she continued.

The FedFin study points to the various differences between the U.S. NPR and the final Basel II Accord about to go final everywhere else on January 1, 2007. Of particular concern is the unique U.S. leverage requirement, which regulators have decided to retain out of fears of large regulatory-capital reductions resulting from untested models. However, the FedFin analysis notes that the leverage requirement may actually encourage banks to hold more, not less, risky assets, questioning also why the U.S. has decided to impose this standard not only on banks, but also on only some parent holding companies.

The U.S. regulators published the NPR for public comment on September 25, with comments due by January 23, 2007. They will soon publish a companion “Basel IA” proposal outlining a new regulatory-capital regime for smaller banks and savings associations. As noted, the overall Basel II regime is final outside the U.S. with the “standardized” options coming into effect on January 1, 2007. Significant market change outside the U.S. in anticipation of these rules is already evident, demonstrating their far-reaching strategic impact.

The FedFin analysis is available on request.

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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