

**Remarks by
Sheila Bair, Chairman,
Federal Deposit Insurance Corporation;
Before the
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It is a pleasure for me to be here this morning to participate in this biennial meeting of the world's bank supervisors. The subject of today's panel, "Core Principles for Effective Banking Supervision and Governance Issues," is an important one.

I want to start by commending Chairman Wellink for his leadership during our meetings this week. I look forward to his thoughtful and balanced leadership of the Basel Committee. He has been very welcoming to me as a new participant in the process, and I very much appreciate that.

In addition, I particularly want to thank Governor Bies for her remarks. In the short time I have been the Chairman of the FDIC I have developed a strong working relationship with Governor Bies. She and I have worked to achieve consensus on a number of important U.S. supervisory issues, and I look forward to our future work together.

Each of us here today brings our own perspective to the issues. Our countries have important differences in the structure of their financial and banking markets as well as in their national laws and regulations. Across these differences, however, we share a common framework through the Basel Core Principles. The Core Principles are the continuing product of the wisdom and experience of our predecessors as well as those on the Committee today.

Naturally, as the Chairman of the FDIC - the U.S. deposit insurer as well as a supervisor - I bring my own personal and institutional perspective to this discussion. I have personally seen the consequences when key aspects of the Core Principles are not observed or enforced. During the 1980s, U.S. regulators failed to require adequate real capital as a cushion against losses - and, when the losses occurred, more than 2,900 banks and thrifts closed. As Chairman of the FDIC, I must consider the ways that the Core Principles protect the stability and strength of the deposit insurance system - an important part of the U.S. safety net for banking.

Banking systems play an important role in our economies. A well functioning banking system is a necessary catalyst for economic growth and national stability. Problems in the banking sector can be debilitating to an economy. They can also be financially costly - to bankers, their customers, the economy, and to the government safety net. Today, more than ever, weaknesses in the banking system of a single country can threaten financial stability both within that country and in many other countries. The

Core Principles help ensure that both the banking system and the underlying safety net arrangements can remain strong and resilient for future crises.

The Core Principles reflect an international consensus about the broad outlines necessary for sound supervisory practices. The recently released Consultative Document seeking comments on proposed revisions to the Core Principles reflects the need to continuously refresh our thinking in the face of a constantly changing financial services industry. Still, the fundamental practices that underlie the Core Principles remain the same - rigorous risk management, sound supervision, and strong capital.

The Core Principles also reflect how effective risk management, sound supervision and strong capital must complement each other. Supervisory oversight helps ensure that banks apply sound risk management practices to the inherent risks of banking. Effective risk management and supervision, in turn, help ensure that capital will be adequate. However, neither risk management nor supervision can replace a strong capital base. Capital is the cushion that ensures protection of the banking industry and the safety net.

Our experience during the banking crisis of the 1980s taught us some important lessons. First, as the Basel Core Principles confirm, a clear definition of capital is crucial. Flexible versions of so-called regulatory capital did not provide the cushion needed. Second, numerical capital standards are an important brake on supervisory discretion. Our experience confirmed that consistency and certainty is a key part of capital cushions. The Basel Core Principles recognize this as well. Third, an effective capital regime should include a risk-based component. This has been a hallmark of this Committee's ground-breaking work since 1988.

Finally, our experience demonstrated the wisdom of capital-based standards for supervisory intervention and, if required, closure of banks. Our framework, known as Prompt Corrective Action or PCA, prescribes a series of progressively more severe controls as banks pass below various capital tripwires. Ultimately, if the bank falls below a two percent ratio of tangible equity capital to assets, the agencies have 90 days either to close the bank or document why they believe an extension of the deadline is warranted. The Basel Core Principles do not specify that level of detail, but they recognize the importance of prompt supervisory action to address problems in the banking sector.

Where does this experience lead us? As our national and international regulatory systems continue to evolve to keep pace with the changing financial services landscape, we must preserve the strengths that exist today. The work of the Basel Committee on risk-based capital has been groundbreaking. We have already seen significant improvements in banks' approach to risk management and measurement. However, as our efforts to measure risk become more ambitious, we must keep in mind the simple need to maintain a base of capital that will cushion our banks and our economies in bad times.

While much progress has been made, I do not think we are at the end of the road. For example, international supervisors do not share a common approach to defining capital, and in some cases the definition is weakening. I think this is an issue the Committee will need to take up - as it indicated it would in the 2004 accord.

The results of recent Quantitative Impact Studies also point to questions about the potential for extreme and undesirable capital outcomes under the new approaches. How should such outcomes be mitigated? Should this be left to each supervisor on a case by case basis? Or should there be consideration of a more uniform approach to supplement the risk-based requirements?

In the U.S., for example, we have a dual system of capital regulation that includes a straightforward constraint on balance sheet leverage to complement the risk-based capital framework. The leverage ratio - a simple ratio of capital to balance sheet assets - and the more complex risk-based requirements work well together. The leverage requirement provides a baseline level of capital to protect the safety net, while the risk-based requirement can capture additional risks that are not covered by the leverage framework. The more advanced and complex the models become, the greater the need for such a baseline.

I believe the time is right to engage in dialogue about the merits of an international leverage ratio to support our supervisory efforts, maintain the strength of our banks, and prevent erosion of the vital capital cushion.

The leverage ratio is a vital "trip-wire" to ensure that a consistent standard can be applied across all banks for supervisory intervention. While some have criticized the leverage ratio as simplistic, its simplicity is a virtue. A leverage ratio of equity capital to balance sheet assets provides a "hard number" that is easily determined, imposes no costs to calculate, and serves as a backstop constraint on leverage.

The leverage ratio ensures that a capital backstop remains even if model errors or other miscalculations impair the reliability of risk-based capital. This is a crucial consideration - particularly as we work through the implementation of Basel II standard. By restraining balance sheet growth, the leverage ratio promotes stability and resilience during difficult economic periods. A more highly capitalized banking system provides investors with greater comfort and provides banks with greater access to the capital markets for liquidity and funding.

In conclusion, it is absolutely crucial to the long term health of our banking systems that capital regulation not become a tool of international competition. Development of an international leverage baseline would be an important way to ensure that international competitive advantage is obtained through business, not capital, competition.

While no regulatory capital standard provides a perfect solution, the leverage capital cushion would strengthen, not weaken, the risk-based Basel II framework we are seeking to implement.

I look forward to discussing these important issues with the Committee and its members as we continue to support the strong capital base on which the Basel Core Principles rest.

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