Remarks by
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Good morning. It is a pleasure for me to be here to speak to this distinguished group of risk professionals. The Global Association of Risk Professionals has long recognized the importance of providing a forum for risk professionals, practitioners and regulators from around the world to gather and discuss key issues of the day. Clearly, the implementation of Basel II fits that description. I want to thank GARP for inviting me to open up the Basel Forum today and allowing me to provide my assessment of the progress we have made to date, and how to overcome the challenges that lie ahead.

With Basel II, bank regulators are playing for high stakes. Our decisions will determine whether the effort becomes a compliance exercise, or truly improves risk management. Our decisions could affect the severity of the business cycle and the allocation of credit across economic sectors. We risk accelerating the contraction of our community banking sector, and our large banks have expressed concerns about international competitive imbalances. Most fundamentally for any regulator, our decisions will affect the capital strength of the U.S. banking system and its ability to absorb losses without imposing costs on the federal banking safety net.

Getting it done right is going to be difficult. I must say that I am not comfortable with the position we find ourselves in today on Basel II. I do not find the Basel II status quo appealing, and I am very concerned with the tenor of some of the more recent public debate. My hope is we can all bring some fresh thinking to bear on these issues, so we can ensure our decisions in this high-stakes process will be in the public interest.

During my time this morning, I will elaborate a bit on the nature of the FDIC's discomfort. I will conclude with some thoughts on where—at least from my perspective—we might look to address both our concerns, and those of potential Basel II adopters.

First, why our discomfort? From day one, back in 1999 with the first consultative paper, Basel II was supposed to be about improvements in risk management and not about dramatic reductions in capital requirements. This was a sensible guiding principle. If the result of Basel II is much less capital supporting the risks in the banking system, then Basel II may make the banking system more vulnerable to shock—not safer.

In the ongoing debates about Basel II and capital levels, it is important to remember that strong capital has been a recognized strength of the U.S. banking system. U.S. banks have demonstrated over the past ten years that strong bank capital levels are compatible with record profitability. It would be both unnecessary and imprudent to allow

significant reductions in industry capital to occur as a result of Basel II implementation. While providing a cushion for less favorable economic and banking conditions, capital also supports market confidence in the resiliency of our banks.

Another related component of our system's resiliency is prompt corrective action. Prompt corrective action uses a stepped system of capital-based triggers to ensure that potential problems are addressed before they threaten a bank's solvency. PCA and strong capital have served the U.S. banking system well.

To my mind, developments in the financial system since the Basel Committee began its Basel II efforts have only confirmed the wisdom of avoiding a substantial reduction in bank capital requirements. If the current, Basel I capital requirements were too conservative, they could have been expected to constrain the availability of credit. Yet we see the opposite. The global financial system has enjoyed a sustained period of abundant liquidity, and we are aware of no concerns about a shortage of bank credit. If anything, concerns about bank credit tend to point towards the dangers of poorly underwritten and excessive credit.

Some observers of the financial system are expressing concern that unprecedented credit availability is masking the financial stresses on some corporate and household borrowers. Credit availability has gone hand in hand with a buildup of financial leverage in the system. Household savings are negative, debt levels relative to income are high, and we are experiencing some weakness in housing prices, and a near-term shakeout in sub-prime mortgages.

The growth of the hedge fund industry highlights another aspect of growing credit in the marketplace. Hedge funds often employ substantial leverage as a key part of their investment strategies. Some banks are key counterparties to hedge funds, providing loans, margin credit, derivative products, collateral management and clearing, settlement and custodial services. However, hedge funds' lack of transparency makes it more difficult for banks and regulators to accurately determine the potential risks from individual funds.

Business models based on a high degree of financial leverage are not confined to the hedge fund industry. Outside the United States, for example, it is not uncommon for large internationally active banks to operate with liabilities as a multiple of tier 1 capital ranging from thirty to fifty times, or more, compared to less than twenty in the U.S. This is not to compare these banks to hedge funds in any meaningful sense, or to suggest there is an international banking crisis in the making. It is meant to suggest that there is an international component to questions about leverage in the financial system and that some safety nets overseas may shoulder significantly greater risks in any crisis. With globalization, this is a profound concern.

Into this already highly leveraged global banking landscape we have introduced a Basel II regulatory capital regime that appears likely to deliver substantial double digit reductions in minimum bank capital requirements. I emphasize substantial. Half of the

banks participating in the latest U.S. impact survey reported that their minimum risk-based tier 1 capital requirements would be reduced by 31 percent or more. In the U.S., the agencies agreed such results would be unacceptable if produced under an up-and-running capital regulation, and that we could not responsibly proceed without safeguards.

I understand the concerns of our large banks, but as a regulator, I am convinced we need those safeguards. I remain very concerned about what would happen under this proposed regulation when the floors come off. The safety-and-soundness of the U.S. banking system would not be well-served by unconstrained double digit reductions in bank capital requirements. In my judgment, the same could be said of the global banking system.

In fairness, our international regulatory counterparts believe they have adequate safeguards in place. Some countries have indicated that they would consider imposing supplementary capital measures to control potential drops in capital, others have adopted a wait and see approach. All have indicated, however, that they are most likely to rely primarily on the supervisory process to counterbalance any concerns that arise with pillar 1. Without questioning their good intentions, I would offer two observations about the idea that pillar 2 can provide adequate safeguards. First, while effective supervision is crucial to any regulator's ability to promote bank safety-and- soundness, the effectiveness of supervision can be fatally undermined if the regulations do not require an adequate amount of capital.

Second, supervisor-imposed correctives to the pillar 1 formulas have their own costs in terms of regulatory burden, especially if approaches differ from country to country, or change over time. Such differences appear inevitable, as long as financial business is transacted under rules set by sovereign governments.

Banks are frustrated by these safeguards and international differences in supervisory approaches. However, with the advanced approach, all this comes with the territory. In the advanced approach, the Basel Committee has created a capital framework that will be assumption-driven, subjective in its implementation, and holds the potential for large reductions in the capital underpinning bank safety nets. The very softness of the framework virtually forces supervisors to employ safeguards, bells and whistles, suspenders—name your favorite analogy. Those safeguards will come in two flavors, pillar 1 and pillar 2. They will be costly for banks, and by their nature they will stray from relying on banks' own approaches to risk measurement.

It is not surprising that large banks are pushing back on a range of issues across the board, from the U.S. safeguards to the home-host issues they are experiencing. However, I am troubled by the tenor of recent discussions about international competition. For bank capital requirements to become a tool for international competition, creates the potential for a competition in laxity. A race to the bottom in bank capital standards would be a profoundly negative development for the future stability and health of the global financial system. Strong capital is a strength, not a

weakness. Likewise, any weakness in capital standards in foreign markets has the potential to spread instability to the U.S. banking industry. For these and other reasons, it is essential that we work with our foreign counterparts to ensure that capital remains strong overseas as well.

This is not to deny that there is a legitimate place for discussion of international competition. It is one thing to debate small business exceptions to Section 404 of Sarbanes Oxley or further curbs on securities litigation. It is quite another to allow unconstrained double-digit reductions in the capital underpinning the federal banking safety net in the name of international competition.

My concern, at this point, is that differences of views about permissible capital reductions under the advanced approaches are so deeply held, that they could bring this process to an impasse. My preference in any policy debate is always to find the areas of agreement, and as I said at the outset, I believe there is still room for fresh thinking.

For example, I think everyone would, to the extent possible, like to reduce cost and burdens to Basel II adopters. I suspect some of the costly and prescriptive elements can ultimately be traced to a desire to prevent, or compensate for, unacceptable pillar 1 outcomes. From the FDIC's perspective, at least, a framework that provided greater certainty on a bank's bottom line risk- based capital requirement might well be accompanied by a reduction in other prescriptive or costly elements.

More concretely, a Standardized or Basel 1A-type of approach to setting regulatory capital, along with rigorous pillar 2 expectations for internal risk management and measurement processes, would be an example of a less burdensome framework that also reduces uncertainties about capital impact. I am amenable to other suggestions for ways to simplify and reduce differences between US and overseas implementation, while maintaining strong safeguards against capital reductions.

This process is important enough that we should still be willing to consider fundamental changes in direction. Nothing should be off the table (except for the leverage ratio!). I look forward to receiving comments on all these issues, and to the very interesting decision process we have ahead of us.

Before I turn the podium over, I would like to make a few comments about my colleague, Sue Bies, who understands this process well. During her tenure at the Federal Reserve, she has worked extremely hard find the right balance among a difficult set of trade-offs. Her work on important consumer issues like truth-in-lending standards, and the strong guidance she helped craft on Commercial Real Estate and accounting and auditing standards for financial institutions are all commendable. I greatly admire Sue's respect for the industry, her commitment to consumers and her steadfast determination. It has been an honor to work with her. Please join me in a round of applause for this outstanding public servant.

While you may note some differences in our views on Basel II today, it's important to note that Sue and I share the most important belief on this issue – our belief in the importance of not just getting it done, but getting it done right.

Thank you.

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