Remarks
of
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FDIC Conference of State Bank Supervisors
2006 International Dialogue
Day Washington, D.C.
October 26, 2006

Thank you, Diana, for that very kind introduction. I am delighted to be here at the Conference of State Banking Supervisors (CSBS) 2006 International Dialogue Day.

Today I would like to take a few minutes to share with you some thoughts on an issue that holds great consequence for the safety and soundness of the U.S. banking system -- the Basel II international agreement on bank capital. You are probably aware that on September 5, the FDIC Board of Directors, along with the other federal banking regulators voted to publish the Basel II Notice of Proposed Rulemaking for public comment. In conjunction with Basel II, U.S. bank and thrift regulators are also developing a more risk sensitive capital framework for non-Basel II banks, known as Basel IA, which we hope to publish for comment in the near future. As the federal deposit insurance agency for all U.S. banks and thrifts, the FDIC has a keen interest in the capital adequacy of the institutions it insures.

The Historical Context of Basel II – FDICIA and Basel I

I would first like to spend a few minutes discussing the historical basis for our existing capital requirements, starting with the enactment of the Federal Deposit Insurance Corporation Improvement Act of 1991, known as FDICIA. That law established for the first time statutory requirements for both risk-based capital and the so-called leverage ratio, and a system of prompt corrective action to enforce capital requirements. The law was a response to both the thrift crisis and the severe problems encountered by the commercial banking industry in the late 1980s.

It is worth examining the experience of the U.S. bank and thrift industries since the enactment of FDICIA. There has been a steady rise in both the capital levels and the profitability of federally insured banks and thrifts since FDICIA's enactment in 1991. In fact, both bank capital and bank profitability are at or near historic highs today.

There are three conclusions I draw from these facts and recent experience. First, strong bank capital and bank profitability are not incompatible. Second, our banking system right now is in very good shape and stands on a foundation buttressed by this strong capital and enhanced profitability. Third, the current capital position of the U. S. banking system is an important strength that has been built up during an extended period of economic growth and should be preserved as a cushion for when economic conditions are not as favorable as today. I think these are important points to keep in mind as we consider making changes in bank capital requirements.

Like FDICIA, Basel I addressed regulatory concerns regarding capital adequacy. Basel I, which of course was the predecessor to Basel II, was adopted in 1988 in response to the erosion in the capital base of large international banks here and abroad that coincided with the severe emerging market debt crisis of the 1980s. In this context, bank supervisors from the major industrial countries sought to set international standards for the capital increase required to maintain confidence in the international financial system and to support banks' off-balance sheet activities that circumvented simple asset-based measures of capital adequacy. It was also an effort to introduce risk sensitivity to capital regulation. Basel I addressed these issues in fairly simple ways that had the overall effect of raising capital levels internationally and in the U.S.

Basel II

The impetus for Basel II was the view that Basel I, with its four-bucket approach to risk management, was insufficiently risk sensitive and created incentives for banks to engage in capital arbitrage – keeping high-risk assets and selling off low-risk assets, which under Basel I received the same capital treatment. Conceptually, Basel II was based on the premise that regulatory capital for the large, complex, internationally active banks needed to be tied more closely to the internal risk-based models that the institutions were developing to measure their economic capital. The view was that they would more accurately measure the risks to the institutions and improve their safety and soundness.

Developing agreement among the Basel Committee member countries and implementing Basel II has proved to be a daunting task that is now in its seventh year. It is important to recognize that the premise for the agreement from its inception was that it would broadly maintain the aggregate level of risk-based minimum capital requirements. In 2004, the Basel Committee on Banking Supervision summarized its goals regarding capital adequacy as follows: "The Committee believes it is important to reiterate its objectives regarding the overall level of minimum capital requirements. These are to broadly maintain the aggregate level of such requirements, while also providing incentives to adopt the more advanced risk-sensitive approaches of the revised framework."

The purpose of the agreement is to improve risk management by the largest internationally active banks without a significant reduction in aggregate risk-based minimum capital.

It was because of that commitment to preserve capital that the regulatory agencies were so concerned over the results of the most recent U.S. Quantitative Impact Study, known as QIS-4, which was conducted last year with a group of the institutions that are expected to participate in Basel II. The QIS-4 results showed a decline in aggregate minimum risk- based capital of 15.5 percent. The median decline was 26 percent, with one participating institution realizing a decline of nearly 50 percent. Tier 1 capital requirements, of critical importance from a safety and soundness perspective, declined

by 22 percent, with half of the institutions reporting reductions in those capital requirements of more than 31 percent. Almost all of the participants reported minimum Tier 1 capital requirements that would be prohibited under current prompt corrective action requirements.

The results of QIS-4 were viewed by all the U.S. bank regulatory agencies as unacceptable. The QIS-4 numbers resulted in a pause by the agencies in moving forward with the Basel II process. The agencies ultimately announced an agreement on September 30 of last year on a plan that provided for safeguards and a longer transition period, specifically a one-year parallel run for Basel II in 2008 and then a three-year implementation period from 2009-2011. The three-year implementation period provided for certain prudential safeguards including floors on how much risk-based capital could fall for any given participating institution of 5 percent in the first year, 10 percent in the second year, and 15 percent in the third year. The agreement also stated that the agencies anticipated that there will be further revisions to the Basel II-based capital rules prior to the termination of the floors, and that the agencies will retain both the existing prompt corrective action and leverage capital requirements in the proposed domestic implementation of Basel II.

The Capital Objectives of the NPR

With that framework in place, the agencies proceeded to work on reaching agreement on a notice of proposed rulemaking for Basel II. I would briefly like to review the overall capital objectives contained in the NPR with you because, in my view, they lay out the fundamental principles for proceeding with Basel II in the U.S.

First, the NPR states that the agencies remain committed to the objective contained in the underlying Basel II Accord of broad maintenance of the overall level of risk-based capital requirements while allowing some incentives for banks to adopt the advanced approaches. The NPR also states that were the QIS-4 results produced under an up and running risk-based capital regime, "the risk-based capital requirements generated under the framework would ... be considered unacceptable."

Second, the NPR identifies a 10 percent downward limit on aggregate reductions in risk-based capital requirements that if exceeded will trigger regulatory changes. The NPR states:

"If there is a material reduction in aggregate minimum regulatory capital requirements upon the implementation of Basel II-based rules, the agencies will propose regulatory changes or adjustments during the transitional floor periods...In any event, the agencies will view a 10 percent or greater decline in aggregate minimum required risk-based capital...as a material reduction warranting modifications to the supervisory risk functions or other aspects of this framework."

Third, the NPR provides that the agencies will carefully consider during the transitional floor periods whether dispersion in risk-based capital results across banks and portfolios

appropriately reflects differences in risk. In addition to the impact on aggregate minimum risk-based capital, the QIS-4 results indicated unacceptable levels of capital dispersion among the participating institutions for assets with comparable risk. A conclusion by the agencies that dispersion in risk-based capital requirements does not appropriately reflect differences in risk could be another possible basis for proposing regulatory adjustments or refinements during the transitional floor periods.

Fourth, the NPR provides that regulatory changes will be made, including fundamental changes if necessary, to address competitive effects of differential capital requirements between institutions that participate in Basel II and those that do not participate. This is a critically important point, in my view. The purpose of Basel II was to improve the risk-sensitivity of U.S. capital requirements. It was not intended to have a significant impact on the competitive relationship between institutions that participate in Basel II and those that do not participate. Basel II should not tilt the playing field toward either group. The NPR makes clear that the agencies will be prepared to make fundamental changes in the framework, if necessary, to address this issue.

Finally, the NPR reaffirms the commitment of the agencies to preserve the current leverage ratio and the current system of prompt corrective action under Basel II. The NPR states,

"The agencies reiterate that, especially in light of the QIS-4 results, retention of the Tier 1 leverage ratio and other existing prudential safeguards (for example, PCA) is critical for the preservation of a safe and sound regulatory capital framework. In particular, the leverage ratio is a straightforward and tangible measure of solvency and serves as a needed complement to the risk-sensitive Basel II framework based on internal bank inputs."

I believe these are a sound set of objectives on which to proceed with the NPR - broad maintenance of the overall level of risk-based capital requirements; a 10 percent downward limit on aggregate reduction in minimum risk-based capital; comparable capital requirements for similar portfolios to minimize dispersion; a level playing field between institutions that participate in Basel II and those that do not; and retention of the leverage ratio and prompt corrective action.

Requests for Standardized Approach

The banking agencies received requests from virtually all of the U.S. banking industry to utilize a simplified approach such as the standardized approach provided for under the Basel II Accord. The U.S. is the only country proposing to make the advanced approaches mandatory for some banks. These requests have been received from CSBS, the American Bankers Association, America's Community Bankers, CSBS, and the Financial Services Roundtable. In addition, four of the largest Basel II mandatory banks have asked to be allowed to use the Basel standardized approach for calculating their requirements. In response, the banking agencies agreed to seek public comment

in the Basel II NPR on whether the standardized approach should be permitted for all U.S. banks under Basel II.

The standardized approach links risk weights to external ratings and includes a greater array of risk classes than are included in the current rules. It is simpler and less costly to implement than the advanced approach. In addition, because there is a floor for each risk exposure, it does not provide the same potential for dramatic reductions in capital requirements and therefore would not pose the same issues about competitive equity. On the other hand, there is an argument that only the advanced approach provides an adequate incentive for strengthening risk measurement systems at our largest banks. In my view, the banking agencies should have an open mind in regard to allowing the standardized approach for all U.S. banks under Basel II.

Final Thoughts

As we proceed with the Notice of Proposed Rulemaking for Basel II, we should keep in mind that the U.S. has enjoyed an unusual period of sustained economic growth with only a mild recession over the past decade. That growth has contributed to the strong profitability and the strong capital base of the U.S. banking industry. While we all hope that the current high level of economic activity will continue, it would be a mistake, it seems to me, to take for granted that the next 10 years will be equally benign. We should therefore be particularly cautious and prudent in making changes to our system of bank capital.

I would like to extend this point to the global financial system. The Chairman of the FDIC, Sheila Bair, has raised the issue of an international supplementary capital measure such as a leverage ratio. I strongly support her view on this. I believe an international supplemental capital measure, such as a leverage ratio, would ensure a minimum cushion of capital for safety and soundness throughout the global banking system. I hope that the Basel Committee will give careful consideration to this question as it takes stock of the approaches currently used by its member countries to ensure a stable base of capital.

Basel II was intended to bring about technical improvements in the risk-sensitivity of bank capital in the U.S. while broadly maintaining the overall level of risk-based capital requirements and not changing the competitive balance between U.S. institutions that participate in Basel II and those which do not. I think these are each worthy goals, and the achievement of each of these goals, in my view, is essential in the implementation of Basel II in the U.S.

Thank you very much for your attention this afternoon. I look forward to a continued close working relationship between CSBS and the FDIC.

Last Updated 11/13/2006