Remarks of
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FDIC at the OpRisk USA Conference
New York, New York
May 23, 2007

Good morning and thank you for that kind introduction. It is a privilege for me to have been invited to speak here today. Since this is an audience of risk management professionals and we are coming down to the endgame of the rulemaking process for Basel II, I thought I would take this opportunity to share with you some thoughts about Basel II.

As you are no doubt aware, the four federal bank regulatory agencies – FDIC, Federal Reserve, OCC, and OTS - published the Basel II Notice of Proposed Rulemaking (NPR) for public comment last September, and the Basel IA NPR for non-Basel II banks last December. When the agencies released the Basel IA NPR, they extended the comment period for the Basel II NPR and both comment periods ended on March 26th. It was an intentional judgment by the agencies to make the comment periods coterminous so that they would have the opportunity to review the proposed rules and the comment letters in tandem. The agencies received 81 comment letters on the Basel II NPR and 39 comment letters on the Basel IA NPR from a range of institutions and organizations, domestic and international, representing a variety of viewpoints. The agencies are currently in the process of reviewing comments on the proposed rules, and will of course give them careful consideration. Since the agencies are now engaged in this deliberative process, I will be somewhat circumspect in my comments today.

The Historical Context of Basel II – FDICIA and Basel I

I think all would agree that Basel II has been an unusually ambitious and difficult undertaking, and one that holds great consequences for the safety and soundness of the banking system in the United States. For that reason, I would like to discuss briefly the historical basis for our existing capital requirements as a context for considering what we are trying to achieve in Basel II.

I'll start with Basel I. Basel I 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.

In 1991, the Congress enacted the Federal Deposit Insurance Corporation Improvement Act, 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 two conclusions I draw from this experience. First, strong bank capital and bank profitability are not incompatible. Second, the current capital position of the U.S. banking system has been built up during an extended period of economic growth and may be needed as a cushion for when economic conditions are not as favorable as today. In fact, there are clear indications in our mortgage market and potentially elsewhere that we have entered a new phase of the credit cycle and may face more challenging times ahead.

Basel II

The impetus for Basel II was the view that Basel I, with its risk 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.

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 make regulatory capital more risk sensitive thereby improving risk management by the largest, internationally active, most systemically significant 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 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 agreement 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.

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.

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

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 in the United States that participate in Basel II and those that do not participate.

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.

Requests for Standardized Approach

The banking agencies received requests from virtually the entire U.S. banking industry to allow 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 approach mandatory for some banks. These requests have been received from the American Bankers Association, the Independent Community Bankers Association, America's Community Bankers, the Financial Services Roundtable, and the Conference of State Banking Supervisors. In addition, four of the largest Basel II mandatory banks have asked to be allowed to use the Basel II 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. In the Basel IA NPR, the agencies sought more detailed comment on this issue.

The standardized approach links risk weights to external ratings, includes a greater array of risk classes than are included in the current rules, and provides for an operational risk charge. 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 reductions in capital requirements. The advanced approach, on the other hand, should provide for a more precise measurement of risk-based capital. The FDIC has supported consideration of alternative approaches to capital adequacy, including the possibility of making available the standardized approach provided for in the Basel II Accord as an option to all U.S. banks.

International Competition, Foreign Acquisitions, and the Relationship Between the Leverage Ratio and Risk-Based Capital

Concern has been expressed that the U.S. Basel II proposal includes provisions that will give foreign banks a competitive advantage over U.S. banks. In this regard it is worth noting that when comparing the top 10 U.S. banking organizations to the top 10 European banking organizations, U.S. banking organizations today hold over twice the tangible equity capital held by their European counterparts. Despite that, U.S. banking organizations have twice the return on assets of European banking organizations. Further, U.S. institutions are only slightly behind European institutions on a return on

total equity basis despite holding substantially more capital. There is no clear evidence today that U.S. banks are at a competitive disadvantage relative to their foreign counterparts despite holding substantially higher levels of capital. In fact, research by Professor George Kaufman of Loyola University Chicago suggests there may be a positive correlation between strong bank capital and bank profitability across countries.

Some have also cautioned that the U.S. Basel II proposal will cause U.S. banks to become attractive acquisition targets for foreign banks. However, while regulatory capital may be a factor banks look at when analyzing merger opportunities, other strategic factors such as expanding the customer base, entering new and profitable lines of business, and increasing value through operational efficiencies play an equal, if not greater, role. In addition, market capitalization is a far more effective barometer of value than regulatory capital. The dollar amount of excess capital that would be available to foreign banks as a result of Basel II is expected to be substantially less than the current market capitalization of any of the largest U.S. banks, thereby limiting the possibility that Basel II capital reductions will induce foreign acquisitions of U.S. banks. Finally, foreign acquirers of U.S. banking organizations would gain no immediate regulatory capital benefit for the newly formed banking subsidiary in the United States since the subsidiary would remain subject to U.S. capital and prompt corrective action rules, including the leverage ratio. This would reduce, if not eliminate, acquisitions with an economic purpose of capital arbitrage.

Further, it has been suggested that retention of the leverage ratio may allow greater flexibility in regard to risk-based capital levels. That suggestion calls for careful consideration of the relationship between the leverage ratio and risk-based capital. The leverage ratio is a simple capital adequacy measure which provides a base of capital to absorb losses that could arise as a result of interest rate risk, liquidity risk, business risk, and other risks not accounted for by risk-based capital. Risk-based capital, on the other hand, is intended to capture risks not accounted for by the leverage ratio. For example, it measures risks associated with off-balance sheet as well as on-balance sheet exposures, thereby requiring capital holdings for certain complex risks such as derivatives A risk-based capital system, independent of the leverage ratio, that does not generate sufficient capital for these and other risks will fail in its purpose of protecting the safety and soundness of the insured institution.

Final Thoughts

As the agencies proceed with consideration of implementation of 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. We are beginning to see clear warning signals of potential difficulties ahead and it would be a mistake to take for granted that the next 10 years will be as benign as the last. We should therefore be particularly cautious and prudent in making changes to our system of bank 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. In the view of the FDIC, these are both worthy goals, and the achievement of both is essential in the implementation of Basel II in the U.S.

Thank you.

Last Updated 5/23/2007