Press Release

November 02, 2007

Statement by Governor Randall S. Kroszner

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Thank you, Mr. Chairman. Let me begin by saying how delighted I am that the Board of Governors is today considering the final rule implementing the advanced approaches of the Basel II framework for large, complex U.S. banking organizations. Maintaining strong capital levels is essential to safe and sound banking. The Basel II rule will promote improvements in risk-management practices that will enhance the resiliency and stability of the banking and financial system. As the Chairman noted, this is an important step in the process--one that has, at times, seemed like a long time in coming. I have often been reminded of Sisyphus, pushing the stone up the hill but never quite reaching the summit--until now. The draft of the final rule that is being considered today will be issued jointly by the four federal banking agencies--the Federal Reserve, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision--after all agency approval processes are complete. In this regard, I note that the OCC and OTS each approved the final rule yesterday afternoon and the FDIC board will be considering the rule on Monday.

I want to thank the staffs at each of the banking agencies for their efforts in developing this final rule. Staffs from all of the agencies showed remarkable cooperation and dedication--from reading and assessing comments on the proposal, to reaching consensus on the final rule. I believe this commitment has paid off with a final rule that both is responsive to public comment and sets forth a risk-sensitive and robust risk-based capital regime for sophisticated U.S. banking organizations. I want to thank personally Board staff for their hard work in bringing us to this next step in the process. Also, I am deeply grateful to the principals from each of the banking agencies for making this joint rule possible.

While it has taken a number of years get to this point, in my view, it was important to take sufficient time to assess and resolve issues raised through the notice and comment process. Our U.S. rulemaking procedures have proven time and again to be well worth the effort: to ensure that different perspectives are considered and the final product is the best product it can be. One prominent theme commenters raised was a desire for the U.S. agencies to conform our rules to the Basel Committee framework. I have taken this request quite seriously because I believe that international consistency in definitions and in the framework overall helps to avoid unnecessary burdens that can interfere with sound risk-management. Staff has worked with this theme as a key guiding principle in developing the final rule.

I want to take a moment to underscore some of the reasons why I believe finalizing the Basel II rule and moving forward with implementation at this particular time is so important. Bank safety and soundness and overall financial stability are enhanced when banks' regulatory capital measures adequately reflect risk, as well as when banks continually improve their risk-measurement and risk-management practices. The advanced approaches of Basel II are a significant improvement over the existing Basel I-based rules on both of these scores. Aligning regulatory capital requirements with risk and fostering good risk measurement and management practices for our largest and most complex banking organizations, will, I believe, contribute to safer and sounder banks and a more resilient financial system.

The advanced approaches of Basel II go a long way toward correcting many of the flaws that have become evident in the Basel I-based rules for large, complex banking organizations. The advanced approaches are designed to substantially reduce some of the inappropriate incentive effects and opportunities for regulatory capital arbitrage present under Basel I. They require banks to assess the creditworthiness of individual borrowers, such as lower credit quality mortgage borrowers, and individual loans and investments, such as highly structured asset-backed securities, and to hold capital commensurate with that risk. Recent market events highlight why this assessment is so important. The enhanced risk-sensitivity of the advanced approaches requires banks to hold a larger capital cushion for higher-risk exposures and thereby creates positive incentives for banks to lend to more creditworthy counterparties and to lend against good collateral.

In addition, the advanced approaches in Basel II should produce improvements in the existing risk-management practices of banks. Indeed, the impending implementation of Basel II has already spurred banking organizations to develop more sophisticated risk-measurement and management processes. In reviewing these developments, supervisors will more readily be able to identify portfolios and banks whose risk management practices and risk exposures are significantly different from the range seen in other banks. Supervisors and bank management can take this information and use it to benchmark their risk assessments, models, and processes in a more detailed and regular manner.

Strong and risk-sensitive capital requirements are a critical component of the new advanced framework. Also important, however, are the other two pillars--supervisory oversight and market discipline. Under pillar 2 of the advanced approaches, banks must internally assess their overall capital adequacy--taking into account a number of factors and risks not explicitly captured in the pillar 1 capital requirements. Pillar 2 is a crucial element of the framework. Some of the less quantifiable risks, such as market liquidity and reputational risk, will be addressed through a bank's internal assessment process and supervisory oversight of that process. Likewise, enhanced public disclosures under Pillar 3 should improve transparency and allow market participants to better understand a bank's risk profile and its capital adequacy. Recent market events have underscored the importance of such transparency.

While I believe this new framework is a significant improvement over the current regime, we need to move forward carefully and with our eyes wide open. The advanced approaches are a significant change from our current, time-tested risk-based capital rules and we have therefore embedded certain transitional safeguards into the U.S. Basel II rule to ensure capital levels remain strong and we have sufficient opportunity to assess the framework before full implementation. We have maintained the transitional arrangements set forth in the 2006 proposal--resulting in a four-quarter parallel run of the existing and Basel II frameworks, followed by a more gradual and conservative phase-in process relative to the international Basel II framework. Specifically, after a successful parallel run, a bank would progress through three transitional periods during which the cumulative reductions of a bank's risk-based capital requirements would be limited. We also are retaining the leverage ratio and our existing prompt corrective action framework.

In addition, as noted in the July press release, we are committed to a robust and transparent study of the framework during the transitional phase to assess its overall effectiveness, and we will address any material deficiencies that we identify. During and after the transitional phase we will be relying upon ongoing, detailed analyses to continuously evaluate the results of the new framework in operation. A primary objective of this ongoing review will be to ensure that capital levels remain prudent. As has long been the case with our capital rules, we expect that adjustments will be made over time to address industry developments and identified shortcomings in the rule.

Now that the Basel II rulemaking process is nearing completion, our efforts will focus on individual bank implementation. Obviously, this step is as important, if not more important, than the rulemaking process. Implementation in a robust manner is crucial to the ultimate success of the new framework. It is important that we begin to observe how the new rule will work in practice--its advantages and limitations. I am confident both banking organizations and the supervisory community are up to the challenge.

Finally, I would like to note that while the Basel II implementation process is moving forward, we still have a lot of work to do. For example, staff is currently working on a notice of proposed rulemaking that would implement some of the simpler approaches from the Basel II framework--referred to as the standardized approach. The proposal is being developed as an optional risk-based capital framework for banking organizations that are not required to adopt the advanced approaches. I expect this proposal will be presented to the Board for consideration within the next several months.

I would now like to turn to Barbara Bouchard, who along with Roger Cole and the truly spectacular and dedicated Basel II team, played a crucial role in allowing Sisyphus finally to push the stone over the hill.

Last Update: May 08, 2017