Federal Reserve Board Oral History Project

Interview with

James V. Houpt, Jr.

Former Deputy Associate Director, Division of Banking Supervision and Regulation

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Interviewers: David H. Small, Gregory Feldberg, and Ben Hardaway

Federal Reserve Board Oral History Project

In connection with the centennial anniversary of the Federal Reserve in 2013, the Board undertook an oral history project to collect personal recollections of a range of former Governors and senior staff members, including their background and education before working at the Board; important economic, monetary policy, and regulatory developments during their careers; and impressions of the institution's culture.

Following the interview, each participant was given the opportunity to edit and revise the transcript. In some cases, the Board staff also removed confidential FOMC and Board material in accordance with records retention and disposition schedules covering FOMC and Board records that were approved by the National Archives and Records Administration.

Note that the views of the participants and interviewers are their own and are not in any way approved or endorsed by the Board of Governors of the Federal Reserve System. Because the conversations are based on personal recollections, they may include misstatements and errors.

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MR. SMALL. Today is Tuesday, April 18, 2006, and as part of the Oral History Project of the Board of Governors of the Federal Reserve System, we are conducting an interview with James V. Houpt, a recent retiree from the Board's Division of Banking Supervision and Regulation. I am David H. Small, and I'm joined by Gregory Feldberg and Ben Hardaway, all of the Board staff. Thank you for joining us.

MR. HOUPT. Pleasure to be here.

MR. SMALL. Tell us about how you came to the Fed, your views on working for the central bank, and what your outlook was.

MR. HOUPT. The army brought me to Washington in 1970. I was stationed at the Pentagon. When I got out in 1972, I finished my MBA at George Washington University. After college, before going into the army, I worked for six months for the Comptroller of the Currency [OCC] as an assistant bank examiner out in Indiana. So, given that previous experience in the banking system and with bank examinations, the Fed was attractive to me. The Board had an ad for a budget analyst. I was hired in the controller's office for the first two years, working with different division budgets.

Early Years Working at the Board on International Banking Matters

MR. HOUPT. Then in 1975, I was hired by Frederick R. "Fred" Dahl into Bank Supervision. Fred had an international banking section, so I came into that. That group dealt with a broad range of international banking topics and had probably less than a dozen people. Part of the group—the on-site examination function—dealt with supervisory matters, such as foreign exchange trading by large banks, while other parts processed applications involving the Fed's foreign or international banking regulations and worked on various policy issues. At that time international banking was relatively new for most of U.S. banking institutions. The big

three—Citi, Bank America, and Chase—and a few others had their established networks around the world, but most banks had limited international activity.

I started off doing foreign branch applications. Those were the days when you needed approval for almost anything, including the establishment of Edge corporations and virtually all foreign investments by U.S. banking organizations. One of my first material applications and my first Board presentation—this was when Arthur F. Burns was Chairman—dealt with a minuscule investment by a U.S. bank holding company in a Brazilian firm that had a warehousing operation in the United States. This U.S. activity was insignificant in size, but it raised important policy issues under Section 25A of the Federal Reserve Act concerning the application of the term "incidental."

Under that law, U.S. banking organizations could make investments abroad, provided that any U.S. activities that those investments entailed were incidental to the foreign or international activity. Although this matter had not been specifically addressed before by the Board, [the] staff agreed that for the ruling to be consistent with the legislative history and with prior decisions by the Board, the proper interpretation of incidental should not be based on the size of the foreign company's U.S. activities, but on whether those U.S. activities were integral or directly related to the parent's foreign activities.

My first Board presentation was a recommendation of denial of this small investment by the bank. The Board accepted the recommendation and turned down the request. I felt that, as staff members, we did the right thing in the context of interpreting the law and congressional intent, but I thought it was unfortunate that the regulatory process led to a denial of such an immaterial investment. I was pleased, then, that the Board formally changed this interpretation

when it revised its Regulation K (which governs international activities of U.S. banking organizations) in the early 1980s.

Then Fred put me and Michael G. "Mike" Martinson, a colleague, on the project of reviewing changes to the bank Call Report. International banking was definitely growing and was quite significant for at least a few of the institutions, but there was almost no information provided about international activities in the Call Report. I think there was a single line on deposits in foreign offices. So the report wasn't shedding much light on overseas activities. Consequently, Mike and I joined an interdivisional group led by Stanley J. "Stan" Sigel from the Board's Research Division. He was a confident, articulate fellow with good organizational skills, and he carried a big stick—which he needed—to impose a level of discipline on the various divisions that proposed Call Report changes. That effort led to wholesale Call Report changes in, I think, 1978, when we began to get some good information on foreign activities. I remember at the time how Mike and I would virtually shed blood defending our need for every new item of information we requested on the Call Reports.

A couple of decades later I would turn around almost every quarter and see that entire schedules of new information had been added to the Call Report—quite a contrast from how we worked in those early years. Of course, much of that change had to do with automation. For the banks, providing information is much easier today than it was back in the 1970s—at least we would make that point with our Board committees and hope it was true for the banks. But in those early days—the 1978 changes—there was a lot of debating, arguing, and defending about almost every item of information we wanted to collect. It was a good educational process, though. It forced us to delve deeper into these issues, consider what pieces of information were

most relevant and, under Stan's requirements, develop a defense for each of item: "Why do you need this, why is it material, what will it do for you?" and so forth.

In my case, the Call Report project provided a good foundation for learning more about the terminology and the nature of the different instruments that banks employed or were developing, and it helped me better understand the reporting process and the types of information that the Fed collects. In an institution like the Board and the Federal Reserve, more broadly, having a good understanding of the streams of information that we have is helpful. Most of us are ultimately analysts. In this institution, opinions are great, but what are the facts? If you know how to get those facts and defend your case, you're that much ahead. So I felt that working on these major revisions to the Call Report was a good training process and also provided the Board with information it didn't previously have about an important and rapidly growing aspect of banking.

In the fall of 1977, about two years into my term in bank supervision, John E. "Jack" Ryan, then our director, restructured the division and split Fred's foreign banking section into its functional parts. All applications (foreign and domestic) went into a single applications group. All supervision activities went into another group, whether they were foreign or domestic. Most policy issues were handled by a newly formed group called the Financial Analysis section that was led by Samuel "Bud" Tally, who had been an officer over in Research. Mike, Kay J. Auerbach, and I formed an international component of the Financial Analysis section and worked on other things as well. The purpose of that group—which I think was a good one, and it exists today in various forms—was to provide more analytical strength to the division. We created a database of statistics related to various banking issues and brought together folks to

think about policy issues related to banking supervision. It was a good group; we worked on a variety of different issues, bank capital standards to a large degree.

Mike Martinson, in particular, worked with the OCC in creating a reporting system for monitoring the foreign exposure of U.S. banks (the Country Exposure Report). That information, in turn, led to the birth of the Interagency Country Exposure Review Committee (ICERC). Both projects were important in assessing the amount and quality of exposures of U.S. banks to developing countries during 1975-1990, in particular, and in accommodating a resolution to the banking industry's foreign debt problems.

The oil crisis had occurred in the early 1970s and interest rates were rising throughout that period, so debt servicing by these foreign country borrowers was becoming an important issue to a lot of large U.S. banks. I was not on the supervision side as far as going into the banks, but my understanding at the time was that our examiners were criticizing or questioning the exposures of our large banks to countries like Brazil and Argentina. These banks would bring in their economists (who were compensated many times more than our examiners were), point at each country's economic charts, and say, "Look how all the signals are turning up—what's the problem, examiner?" We weren't making a lot of headway in getting our banks to calm their lending or to reduce their exposures. So the ICERC process was established to provide official and consistent ratings for the banks' exposures and to create a supervisory classification process for them. Although the banks had some input into that process, the committee's decisions provided an official, interagency decision on the carrying value of foreign country loans that was not subject to further debate.

Another important issue that I was directly involved in during the early 1980s was foreign ownership of U.S. banks. Foreign banks and foreign individuals were acquiring

ownership of U.S. banking organizations with increasing frequency. The Hong Kong Shanghai Banking Company wanted to buy Marine Midland in New York, a significant institution at the time. That proposal got the attention of Congressman Benjamin Rosenthal from New York. He chaired a subcommittee of the House Banking Committee and decided to hold a series of hearings on the topic. Governor Henry C. Wallich was our international governor at that time and was a highly regarded and well-known economist. He was asked to lead the Board's effort in responding to these hearings. I was assigned to work with him in studying the issues and helping with testimony. After working with him through a couple of hearings and listening to the rhetoric that foreign banks or investors were going to come into our banks and do nasty things, it struck me that the concerns and criticisms didn't hold water.

I realized that it would be helpful to see what the facts were, so I put together an empirical study using two sample groups, foreign-owned banks and domestically owned banks. I used a statistics method called the t-test, which involved pairing each foreign-owned U.S. bank with a U.S.-owned "peer" bank of similar size and, as much as possible, with one in the same community or geographical area. I then looked at how various financial ratios for the foreign-owned bank changed during its period of foreign ownership compared with the changes for its U.S-owned peer bank (for example, changes in the composition of the balance sheet, such as mortgage, consumer, wholesale, and foreign lending; profitability; and capital ratios). At the time, some 30–40 pairings were available. That analysis did not reveal any damning evidence critical of foreign ownership. It shed important empirical light on what the actual experience had been. I went up to the Hill and discussed the results with the head of the committee staff and gave him a copy of the paper.

At the time, Robert R. "Bob" Bench—a deputy comptroller of the OCC—was also wrestling with this issue, because Marine Midland, then a state-chartered bank, was seeking a national charter in order to expedite its acquisition. Murial Siebert was banking superintendent of New York and did not want to approve the acquisition. To get around the N.Y. authorities, Marine Midland sought to shift charters with the view that the OCC would approve it. So Bob was also interested in my paper and was looking for cover so the OCC could proceed with Marine Midland's application to become a national bank.

Both House and Senate banking committees wrote letters to Chairman Paul A. Volcker, specifically asking for copies of my paper. I was quite happy to hear Governor Wallich say that he thought the paper helped defuse legislation and that it was an important study for the Board. At that time I was a grade 12, which would be our current grade 25, I guess. Earlier I mentioned Mike Martinson and his role in ICERC. When Mike Martinson first started chairing ICERC, I think he was a grade 13—a 26 now. That's quite a contrast with the type of roles and responsibilities young staffers get today.

MR. SMALL. Was that true across responsibilities or was that true in your area because it was a relatively new area?

MR. HOUPT. A bit of both. My recollection or impression was that people were given more responsibilities and exposure at an earlier stage back then, but the topics were new so there was not an established cadre of expertise on some of these matters.

MR. SMALL. Through this policy group was there a conscious effort to bring a more explicit analytic framework or to augment the bookkeeping, so to speak?

MR. HOUPT. That financial analysis group was created to serve these kinds of functions, to shed some light at a more empirical level. Bud Tally used to say that, when he had

the group, the function of the group was to do research with a little "r," as opposed to the research you do across the street—much more extensive and quantitative and complex. But we weren't above doing a t-test. Bringing more empirical facts and analytics to the issues was needed. The whole process led to the now-well-established quarterly report on the condition of our 50 largest bank holding companies and to a more comprehensive and consistent analysis of the condition of these institutions. The report actually started with the 25 largest bank holding companies, by pulling information from regulatory reports, primarily the Y-9, which was not then nearly what it is now, and also from shareholder reports that are not always prepared and presented on a consistent basis.

These and other efforts gave us databases to work with. The Country Exposure Report, for example, highlighted the scope of weak exposures to foreign parties and the need to manage the problems more aggressively and successfully. Risks posed by the sheer volume of these problem loans were made worse by the banks' low level of capital ratios, which had declined pretty steadily throughout the 1970s. Those declining ratios and mounting problem loans led Chairman Volcker to implement formal regulatory capital standards—at least I give him credit for making it happen. Before that time, supervisors relied mostly on moral suasion, browbeating, approval of applications, and other supervisory techniques or regulatory pressure to prevent institutions from leveraging more than folks were comfortable with.

In 1981, I think, we got the first official regulatory capital standard, the primary capital ratio, which in the beginning was based on a minimum 5.0 percent equity to assets ratio. There was also a total capital ratio that added subordinated debt to the numerator. I think it was set at a minimum of 5.5 or 6.0 percent. The fact that these requirements were official regulatory

standards finally provided the examiners with the clout they needed to limit the amount of bank leverage.

In my view, the standard served its purpose, but something as simple as equity to assets was easily circumvented, and we began to see changes in the composition of bank balance sheets. Since the rule viewed all assets alike, we began to see riskier loans replacing higher quality securities on bank balance sheets. Given the new constraints, banks not surprisingly booked assets that were going to make them the most money. That process of asset substitution played out for a while and put pressure on us to develop something more sophisticated—something that gave some recognition to asset composition and also to growing levels of off-balance-sheet activities that presented risk.

Another event in the 1970s that was important to international bank supervision involved the failure of Bankhaus Herstatt. Herstatt was a mid-sized German bank, but one that had significant foreign exchange operations. When it became insolvent, the German authorities closed the institution in a rather awkward manner by not taking into consideration the time changes around the world. They closed the institution after the U.S. banks had made their exchange payments to Herstatt, but before Herstatt had settled with the U.S. banks, so there were losses in the Western Hemisphere. That experience led to creation of the Cooke Committee, named after its first chairman, Peter Cooke of the Bank of England. The Cooke Committee, which eventually became the Basel Committee on Banking Supervision, led to all of the subsequent bank capital standards and to greater coordination and development of bank supervisory standards. The Cooke Committee was formed originally from Herstatt to coordinate international supervisory activities: educating folks how to do things, like closing internationally active banks, and developing networks of communications. The view was, "If I close a bank,

it'll have a bearing on your market; wouldn't it be nice if I give you a heads-up that it's happening? This is our plan to deal with it. Don't panic." That was the beginning of the Basel Committee, and others can certainly say more about the Basel Committee than I can.

Capital Standards

So now—in 1981—we have the primary capital standard in the United States, doing its thing, putting some limits on bank leveraging, but with lots of room for game playing. That produced pressure to do something more sophisticated. Abroad, we've got the Cooke Committee, with Fred Dahl serving as the Board's representative. Year after year that Committee seemed to be pursuing development of an international capital standard but was making little apparent progress. In addition to safety and soundness issues arising from leverage, there were the competitive aspects that come about with any standard. French banks, being government owned at the time, were leveraged highly, like 100 to 1. Japanese banks, needing capital and having support of "Japan Incorporated," were also highly leveraged. So there was this competitive dimension demanding an international convergence of capital standards.

MR. SMALL. Would you say this is something bankers were calling for?

MR. HOUPT. Yes, certainly from the competitive aspect. Not that they wanted everything that came from it, but they did support the effort to do something to bring the French and the Japanese in line. The Japanese banks were growing rapidly internationally and the French banks were too, but to a lesser degree; not so much in the United States at that time, but certainly in an internationally competitive market for deposits, loans, and so forth.

Then (William) Bill Taylor became our director in 1985. He eagerly wanted some progress on capital standards too. Essentially, he took control of that process. I remember one time he stopped by my office, and said, "Jim, you go to London every once in a while. Where do

you stay?" I said, "I stay in a nice hotel, but it's small." Bill Taylor was a driving, dynamic fellow. Where was he going with this, I wondered. He said, "I'm going to go to London, and I don't want to stay in a big fancy hotel." So I said, "The rooms in my hotel are nice and clean, but they are small, Bill." He said, "That's OK, what's the name of it?" "It's the Gore Hotel, a nice hotel." It was once the townhouse of the Marquess of Queensberry, who set the rules for boxing years ago. Anyway, it was now a hotel. Well, he stayed there. When I returned to London a few months later, the folks at the hotel desk were saying, "Oh, your Mr. Taylor was here, he had the limousines lined up in front of the hotel," and that was not their routine experience. The Japanese, I was told, were racing in and out, and I guess the Brits were there, too, all meeting in the hotel's little lounge. In short, Bill had commandeered the hotel for international negotiations that provided the basis, at least as I understand it, for the U.S.–U.K. Capital Agreement.

That agreement, in turn, led to Basel I. The Japanese were brought on board to that U.S.–U.K. agreement and then they all presented it to the Basel Committee and said "Look, we're going to get off the dime here, we're actually going to do something, do you want to join us? Do you want to get involved and influence it a bit? Or do you just want to watch us do this?" From my perspective, that is what broke the logjam with all of these discussions over international capital standards. Bill said "We're moving forward, we've crafted all of these agreements. Get on board or not, the train's moving." So the broader Basel Committee participants, all of the G-10 countries, got engaged and pretty much came out with what Bill and others had crafted earlier. That standard addressed some of the issues about asset composition that were not addressed by our earlier total equity to total asset ratio. At least loans were now being treated

differently than government securities in computing capital. Nevertheless, in most cases, a loan's a loan still, and we know where that eventually led.

Richard Spillenkothen was Bill's right-hand man in crafting a lot of that capital standard. I remember one dark, rainy evening, sitting in the Special Library with Governor J. Charles Partee who was chairing the Bank Supervision Committee. They were discussing what had emerged from the Basel Committee, and whether three or four different categories of ratings of assets were sufficient. That approach was not very sophisticated and left lots of room for capital arbitrage. Partee, however, was content not pursuing more categories, given the level of sophistication of risk measurement by banks then and concerns that spurious precision in a regulatory standard could misguide the private sector's decisions on capital allocation throughout the economy. If we got into the more in-depth analytics of it, we could slice bank exposures a lot of different ways—e.g., by industry, by the failure rate or loss rate of loans to various industries—but the view was we shouldn't go there. The view was that three or four categories ought to suffice given where the banking system was in measuring risks, concerns of credit allocation, and so forth. So anyway, in 1988, Basel I was finally put in place.

Bank Supervision and Regulation

MR. SMALL. You said that the first capital standards were so broad that they almost induced banks into taking riskier assets because an asset is an asset. Could you give an example? Does any example come to mind where regulations spur development of bank-lending activities or asset market developments?

MR. HOUPT. Whether driven by regulation or more by market forces, the growth of off-balance-sheet activities is an example. The primary capital standard didn't address off-balance-sheet activities. Of course, in 1981, they were not so material. Banks would make loan

commitments, but they weren't doing a lot of the derivative activities that later emerged. Throughout the 1980s, off-balance-sheet activities grew substantially and became quite important. Although Basel I handled them in an arguably crude way, at least it addressed them and probably in a reasonably effective way at the time. On the balance sheet, we saw banks selling low yielding state and federal government securities that carried low or no credit risk and expanding their consumer and commercial loan portfolios.

MR. SMALL. Were there events or crises that were particularly important in spurring on the regulatory process?

MR. HOUPT. Well, of course, the Continental Illinois Bank failure was around that time. I guess around the late 1980s, mid-1980s, supervision practice began to focus more on process and controls than on validation of balance sheets, and—except for the large Shared National Credits—more on internal evaluations of asset quality than on examiners' evaluation. Maybe part of it was that the size of these institutions was becoming much greater, compared to our supervisory resources to evaluate a lot of these loans. Growth in off-balance-sheet activities provides another good example of how the underlying risk of an institution can change quickly between examinations through proprietary trading activities or through risk management activities designed to hedge or expand balance sheet exposures.

Especially at large banks, there's a greater need to get comfortable with the institution's on-going, internal processes and controls and see that they're sound, rather than relying on traditional "point in time" examinations of asset quality. But someone closer to the supervision process could speak more about that. At least that's my story line, and it's what we used to say at a lot of hearings and testimony. [Laughter] And then, of course, Chairman Alan Greenspan

was quite supportive of that effort to focus on systems and controls and clearly encouraged supervisors in that direction.

MR. SMALL. Was Chairman G. William Miller also pushing change in the supervisory process?

MR. HOUPT. I don't recall much from a supervision perspective of an active role or guidance from Chairman Miller. Of course I was pretty junior at that time. My primary recollection of him was that he ran an efficient Board meeting, meaning that topics seemed to get wrapped up quickly. I recall once being at a Board meeting, an open public session, and the Board was dealing with Call Reports or some reporting issue. I wasn't at the Board table. I was sitting in the last row of the visitor's section. One of the Board members raised a question, and no one at the table had an answer. That happens, and typically things move on, but this time things weren't moving on. Miller appeared to want an answer, so I stood up in the back of the room and gave one that seemed to satisfy folks. I wondered later whether I was supposed to have done that. But anyway, I don't recall Miller having much involvement in supervision. These were dicey times because of inflation and monetary supply issues; I suppose his attention was there, rather than with bank supervisory matters.

MR. SMALL. Were there Governors that were particularly forceful? Were there Governors who took the lead with some of this, or was it more internally driven by your division directors?

MR. HOUPT. I was always a fan of and impressed with Governor Partee, both for his intellect and his understanding, and on a personal note, how easy he was to work with. He was a gentleman, but you could say that with all of our Board members. As an institution, we're blessed; we truly have been, with good Governors. I can recall one exception that we can

probably all remember, but for the most part, we have had really good Board members who are both highly competent and good to work with; certainly Governors Partee and Wallich, in my early years and later Governor John P. LaWare, who had banking background before coming to the Board. He brought some good expertise to the Board from the banking side because the Board at the time was pretty much filled by economists. So it was good to have his banking experience there. As I recall, LaWare was here during a time of a lot of bank failures. I would frequently work with him on testimony and speeches and would often go up to the Hill with him when he testified on different issues—the condition of the banking system and those kinds of things. I can remember at many of these hearings, the lawmakers would ask, "So what's the next crisis that we'll have to deal with? What should we be paying attention to now?" Of course, the answer then was the same as the answer now and the answer 10 years from now: "If we knew that, there wouldn't be an issue to deal with because we would have solved or prevented it, hopefully." That was LaWare's response. He was always good to work with.

I remember periodically throughout my career dealing with issues of whether the Fed should be in bank supervision. The first time I was involved with it was in the Volcker days dealing with the Task Group on Regulation of Financial Services chaired by Vice President Bush under President Ronald W. Reagan. The administration had a plan to get the Fed out of bank supervision and—in hindsight—it was fun to watch the process unfold or, indeed, unravel. In the beginning, it seemed to me as if Chairman Volcker was not engaged in the discussions and that the forces of evil were building against us. Then he gave a speech at an American Bankers Association conference in Hawaii and the tide quickly turned.[1]

[1] Editor's note: Paul A. Volcker (1983), "Remarks," at the Annual Convention of the American Bankers Association, Hawaii, October 10.

As I mentioned before, by the mid-1980s, U.S. banks had a lot of foreign exposure on their books that were of substantial threat to their health. Chairman Volcker lectured them in that ABA conference, asking, "Do you really want a banking system in which the Fed has no particularly strong interest or ability to deal with bank supervisory issues, such as international lending issues and so forth?" [Laughter] That was when he and Board General Counsel Michael Bradfield and other folks were orchestrating the resolution to the foreign debt crisis and doing a lot to keep many of our largest banks afloat. I wasn't there, but you can almost see a bunch of bankers scratching their heads thinking, "Gee, maybe we don't want to get behind this effort to remove the Fed from supervision."

At the time, the Fed was not popular among the banks because of our regulatory role and the Board's practice of developing and applying its regulations in a way that reflected its best understanding of congressional intent. Sometimes that meant telling the banks "no," either through formal Board decisions on applications or through back channels by discouraging certain applications or advising banks to withdraw them because they would likely be denied. We were not the easy guy in town from the regulatory perspective.

Later, Bill Taylor had a big role in Citibank's survival by providing much of the leadership that was needed to address the problems that the institution was having. It was no secret that Citibank was in serious trouble in the early 1990s. Again, based on my understanding, I credit Bill Taylor as much as anybody for getting top management of Citicorp to deal with the issues they had.

Anyway, on the role of the Fed in supervision, when Volcker got actively involved the momentum did a 180. The whole tone of the conversation shifted. I remember drafting lists of the large banks with large foreign activities. One of the counter proposals was that "Well, okay,

we'll get out of banking supervision except for the 'internationally active' banking institutions." Start with Citi and work your way down to the 100th largest bank and nearly every one of them at that time had some nexus to international operations. And that proposal had legs for a while until someone at the Treasury recognized that's almost all of the banking system in assets." [Laughter] It was almost a reversal of what they started out to do, and then the process just died.

Later, under Chairman Greenspan's watch, it seems one way or the other it came up periodically. I remember Vice Chairman David W. Mullins Jr. wrote a nice piece in the *Wall Street Journal* laying out the role of the Fed and the importance of having a foot in bank supervision. So as I look at the situation now and see how things are going with bank charters and conversions and the declining role of state-member banks, I hope, as a loyal "Fedite" (as Edward C. "Ed" Ettin would say), that the Fed remains successful in maintaining a meaningful role in supervising large banks that are now all national banking organizations. Because it is important, I think, for the Fed to have insights about, and direct channels of communication with, these banks and to command their respect and attention on supervisory matters. Having the industry's attention and respect extends, in turn, to lots of policy issues—the Basel work, and so forth. If we lose that supervisory connection, we lose lots of insights into how banks operate and a lot of influence over the process.

I would say from my own involvement with the work of the Basel Committee on Banking Supervision that the role of the New York Fed has been extremely important. First of all, they have great people, at least the people I've associated with in Basel and elsewhere; they bring a lot to the table. New York has that physical proximity that's very helpful. They can run uptown or have someone come downtown for lunch, and they have their own examiners directly on site and actively involved with these institutions. That closeness helps us open

communications and better understand sound banking practices that can be applied to a host of supervisory and regulatory issues. Let's continue to defend the fort on that front.

MR. SMALL. How did the Fed interact with the other regulatory agencies and the Congress in debates on the proper place for regulatory policy?

MR. HOUPT. Ultimately, it was okay. There were some dicey times as the battles went on about the role of the Fed. There were different factions on the Hill and at the Treasury—and I'm thinking the main Treasury rather than the OCC—as far as the role of the Fed. I think in most working relations, from my perspective, we've had good relations and good communications with the OCC. From Basel activities, we got along fine and I certainly appreciated the role of the OCC in things I've done in Basel. People have been quite helpful and cooperative, for the most part arm-in-arm, and when we haven't been arm-in-arm, the dialog has been good enough to get to the right answer.

Interest Rate Risk; Domestic

MR. HOUPT. To that point, another activity I was quite involved with was interest rate risk, following the problems of savings and loans and enactment of FDICIA—the FDIC Improvement Act of 1991. One of the Act's provisions directed the regulatory agencies to develop capital requirements to address interest rate risk. Well, I was a new manager at the time, bushy-tailed and law-abiding. The legislation said we should do this so it seemed like the right thing to do. [James A.] Jim Embersit and I developed a framework that was fairly simple, but was also, we thought, a good rule of thumb for addressing the many complexities of interest rate risk. It would not put a lot of pain of regulatory burden on the industry, but would be reasonably effective at identifying institutions that were taking exceptionally high levels of risk. This approach recognized that interest rate risk had not been a particular problem for commercial

banks. Thrifts had substantial problems, but they also had a different business at the time. For commercial banks, interest rate risk was not then and still has not been a big problem. It will pinch margins and profitability at times, as perhaps it is doing now, but it hasn't been a material cause of commercial bank failures. So I didn't want to go too far down the road in developing a complex and burdensome—though more accurate—measure of interest rate risk, and folks in this division and Chairman Greenspan and other Board members thought this was a workable approach to pursue. So we created an interagency group to deal with the issue and followed that strategy for a while.

MR. SMALL. What was the proposal?

MR. HOUPT. Well, Jim and I wrote a *Federal Reserve Bulletin* article on our thinking and then later David M. Wright and I wrote another Bulletin article that evaluated and fleshed it out further.[2] Admittedly, the approach was a relatively crude, simple measure of risk, but I still think it was reasonably accurate at identifying institutions taking more extreme positions. After all, we were looking for a tool that would require more capital only from institutions taking relatively high levels of risk. Did we correctly rank-order the first 90 percent or 95 percent of the industry on interest rate risk? Not likely, but I believe we did a decent job of identifying those banks in (or near) the riskiest 5th percentile, which are the ones most warranting supervisory attention.

On a cost–benefit basis (both for supervisors and banks), it was important to recognize that interest rate risk was primarily an earnings issue for the banking system not a solvency issue. Focusing on the institutions that were rolling the dice seemed a reasonable approach to take.

[2] Editor's note: James V. Houpt and James A. Embersit (1991), "A Method for Evaluating Interest Rate Risk in U.S. Commercial Banks," *Federal Reserve Bulletin* (August), pp. 625–37; David M. Wright and James V. Houpt (1996), "An Analysis of Commercial Bank Exposure to Interest Rate Risk," *Federal Reserve Bulletin* (February), pp. 115–28.

Again, let's impose low cost, minimal burden to the industry, and move on. At every turn, however, we faced pressure from the other agencies, especially the OCC, for greater accuracy that would require substantially more information from banks. Suddenly, what was a simple and low cost approach—but still, I would argue, reasonably effective in meeting our needs—was becoming high-cost; so we balked. If we're going to do it, do it right, is generally a good philosophy, but in this situation we felt it was leading to overkill.

Eventually, the matter concluded to everybody's satisfaction during a meeting with Comptroller Eugene A. Ludwig; Governor Edward W. Kelley, Jr.; and Ricki Tigert Helfer, the Chair of the FDIC, at which we essentially agreed to let the effort die. At the Board, we had put a lot of blood, sweat, and tears into the proposal, doing our part to meet interagency deadlines that were agreed on, often by working until the wee hours of the morning. But the other agencies hadn't shared our enthusiasm. So Ludwig proposed that we simply develop some broad guidance to the industry or modify the regulation to say that banks should pay adequate attention to interest rate risk—essentially, that's my recollection about what it said—and then move on and declare victory. By that time, all of us were ready to "move on." Fortunately—and importantly—by then the condition of the banking industry had also improved to the point that the risk of congressional criticism from our taking such a "minimalist" approach toward interest rate risk was low.

Before the meeting ended and after the agency principals had all agreed on the approach to take, I was surprised when Comptroller Ludwig asked if I also agreed with the decision. Here I am, sitting next to my Governor, so sure I did! But Ludwig wanted the handful of staff participants from all of the agencies in addition to the principals to acknowledge agreement with the approach, and maybe that was to his credit. That way there should be less back-fighting or

possible complaining to Senate staff, who seemed not so convinced that this was the way to go. In any event, I doubt if any of us staffers had thoughts of doing that; we were all ready to move on. As I mentioned, commercial banks had avoided the interest rate troubles that the thrifts had encountered and were rapidly rebuilding their strength. By then we all had better things to do.

Nevertheless, in the Ludwig days—and this was on the heels of the effort trying to get the Fed out of supervision—interagency relations were sometimes dicey. There were few FFIEC (Federal Financial Institutions Examination Council) meetings. Ludwig was Council chairman then, and he just wouldn't call meetings. There seemed to be little dialog at senior levels among the agencies, but if you go down a notch on the ladder we usually got along fine. There were ups and downs like that.

MR. SMALL. Were there other ways that you were involved, or monitored, or participated in a thrift crisis and its resolution, or was that largely outside your responsibility?

MR. HOUPT. Yes, largely outside. I would make presentations to our Board on the condition of the banking system. I would be involved in speeches and testimony. From that perspective I tried to keep up with the issues, but as far as resolving any of these issues, it was Bill Taylor, it was Stephen C. "Steve" Schemering, and to a degree, it might have been Rich. But I wasn't directly involved in dealing with the thrift crisis.

The Development of Derivative Markets

MR. SMALL. How would you describe the development of derivative markets: how fast it was, what impact it had on banking? What problems, tools, or solutions did it have for the supervisors dealing with them?

MR. HOUPT. To date, I'd say it's had a favorable effect, providing additional mechanisms for institutions to manage their risk and hedge exposures and to "lay off" risk—as

the Chairman would say—to parties more willing and hopefully able to absorb those risks. Certainly, the growth of off-balance-sheet activities, the emergence of derivatives, the technology, the enhanced markets and so forth, all of this has led to more sophisticated, more complex financial management practices. We've talked about Basel I and its strengths and shortcomings, but all of these enhancements to financial risk management—in large part through derivatives—demanded more sophisticated capital standards, like Basel II. Ed Ettin, David S. Jones, and John Mingo had a major role in getting Basel II started by bringing to the attention of people the growing role of off-balance-sheet activities and how the current Basel I standards were inadequate. The current rule permits and encourages substantial capital arbitrage and does not, itself, provide incentives for better risk management that is necessary for complex derivatives activities.

Changes in Supervision: Nonbank Institutions

MR. SMALL. If you go far enough back in time and you supervised and regulated banks, typically, you had much of the financial sector covered. How has that changed, if at all, during your time here? With nonbank institutions, have banks become a smaller part of financial stability concerns?

MR. HOUPT. Compared with other countries, the United States has a much higher proportion of financial activity done outside the banks because of the depth and size of our capital markets. In Japan and perhaps in most European countries, lending is mostly done through banking organizations. So, for us, nonbank organizations are more important to the health of our financial markets than they are to most countries abroad. If we can control the soundness of the banking system, we will be doing a lot to keep things in order because they in turn should put requirements on their counterparties that protect themselves (the banks) and that

also help limit the risks the nonbanks take on. The experience with Long Term Capital Management (LTCM) in 1998 highlighted that point and the need for banks to monitor positions of their counterparties. Of course, LTCM blew up with no great losses to our banks, but it got everyone's attention and emphasized the need for collateral to cover customer and counterparty exposures and to understanding better the nature of their business. Those were some of the lessons.

Interaction with Chairmen

MR. SMALL. You were here under Chairman Burns. Do you remember any interactions with either Burns, Volcker, or others that come to mind?

MR. HOUPT. I think the only Board presentation I had with Burns was the application I mentioned earlier. Maybe there were others, but they weren't notable. In my mind that was the first one—then under Martin, various bank reporting issues and with Volcker, various condition of banking system issues.[3] I remember we would go in periodically and brief the Board on the condition of the banking system. At that time, the Chairman sat at one end of the Board table and the presenter sat at the other end, with other staff members sitting all around. Chairman Volcker, being six foot seven, had a special chair that gave him a little more legroom and also allowed him to tilt back. At closed sessions, he'd sometimes be quite informal, especially when presentations were over—sometimes he had the habit of leaning back and putting his foot up on the table. At least in the first part of his term he was also a cigar smoker—so he'd sit back, put his foot up, and mumble some question that, sitting on the other end of the table, you had no idea in the world what he asked. That happened a few times to me. Whenever it did, I would look,

[3] Editor's note: G. William Miller succeeded Arthur Burns as Chairman in 1978; he resigned in August 1979 to become Secretary of the Treasury and was replaced by Paul Volcker.

hopefully, halfway up the table at some of my colleagues wondering if anyone heard or understood the question, and typically they would bail me out. But I always wanted to ask the Chairman to please sit up, take the cigar out of his mouth, and quit mumbling. Of course, I was never quite ready to say that.

Chairman Volcker had a great sense of humor, in my view—not that I was so experienced or familiar with him. But at the Board meetings I attended, he would often make a comment or a little quip that was genuinely funny and would get everybody in the Board Room laughing—not because he was Chairman but because it was funny. You asked about Burns. No one would accuse Chairman Burns of having a great sense of humor. But Volcker did indeed.

Chairman Greenspan was always good to deal with, either during Board meetings or on more specific projects. He would often send complimentary remarks back on various analyses I would occasionally do for him, and of course I wrote/drafted quite a few speeches and testimonies for him dealing with supervisory matters or the condition of the banking system. The only "bump" I recall in that context was in drafting a speech for him addressing derivatives activities of banks. I believe that was to be one of his earlier public remarks on the matter and, while I knew the direction he wanted to go, what I initially sent him didn't hit the target. Pat Parkinson and I spent the afternoon in a nearby conference room reworking a few pages, and the result was fine. Usually, I enjoyed working on such projects for him, and—unlike some of my colleagues—I always felt I understood his comments and requests when meeting with him.

I was also most grateful to have Ed Ettin in the process. He was always good (and patient) in helping whenever I asked for his opinion regarding what the Chairman might or might not like, or on most matters, generally. Of course, Ed also drafted many Greenspan speeches and

was also good in circulating his drafts involving supervisory issues to me. I always enjoyed working with Ed and with his colleagues in the Research Division.

Basel Capital Standards: Interest Rate and Market Risk

We left off talking about Basel and the earlier days. My direct involvement with the Basel Committee and different subgroups began with interest rate risk. I talked earlier about my domestic involvement with that topic, and that experience had relevance in what Basel was doing at the time. This was the mid-1990s. Giovanni Carosio from the Bank of Italy led a subgroup of the Basel Committee that considered incorporating interest rate risk into the international capital standard—essentially what the Congress had asked the U.S. agencies to do through FDICIA.

In any event, I was asked to go over there and get involved. That work went on for about a year or so. As we tried to work through all the detailed issues and the complexities of measuring interest rate risk, it seems as if we were repeating our domestic experiences. The more accurately you want to measure it, the more information you're going to need and the more complex everything becomes. As we began to deal with the effects of optionality in interest rate risk and all the complexities and uncertainties associated with it, the effort seemed to be heading in a bad direction. This time, fortunately, the EU's scheduled requirement to converge capital requirements between banks and securities firms forced us to cease work on interest rate risk and to look, instead, at capital standards for market risk in trading activities. As with our domestic experience, we were once again rescued from going too far.

I mentioned earlier the role of the New York Fed and how valuable their involvement has been in Basel Committee initiatives. For market risk, their involvement and access to the big New York banks helped the Committee focus on Value at Risk (VaR) as a mechanism for constructing an international capital standard and again building on the internal risk

measurement practices of the leading institutions. Groups of us in the United States would visit some of these institutions—the Morgans, the Chases, the Citis, and so forth—and learn about how they're doing things and take what we learned to Basel. From the New York Fed, Chris (Christine M.) Cumming, now the First VP up there, was a very good leader of the working group in Basel—not a leader formally, but through her participation and by bringing insight and guidance to the table. A young guy named Darrell Hendricks from the New York Fed's research division also soon joined the group and it quickly became clear to everybody, "Gee, what bright people these two are." At the time I thought it would be interesting to see where their careers would go. Well, they have already advanced quite far; and they're both very deserving of it.

That work led to capital standards for market risk that were eventually adopted in 1998. Of course, Value at Risk, like all of our regulatory standards, has its strengths and shortcomings. It built on sound practices of banks and struck a reasonable balance between regulatory needs and industry burden and provided an incentive and a road map for the industry on how to strengthen a lot of banking practices. In some respects, developing a capital standard for trading activities was relatively easy to do because Value at Risk was an accepted practice within the banking system and was a decent measure for managers to use in summarizing their trading risks. JP Morgan, for example, had at the time what they called the 415 report, which referred to a summary report on the exposure of the institution that their chairman wanted to see at 4:15 p.m. each day shortly after the market closed. Value at Risk was the basis for that summary report.

Also, in the scheme of things, trading activities were not that big of a risk at the time for most banking institutions. Hopefully still. Typically, trading may have accounted for only 3 percent or 5 percent of the total capital requirement of even these big complex banks actively

involved in trading. So, if we got the requirement "wrong," we would not do too much damage. Market risk also provided us, as supervisors and regulators, a basis for going to school on how to build capital standards based on internal risk measurement practices of banks. In that sense, it set the stage for the more important work that was to come later on new capital standards for credit risk, now known as Basel II, where we were again looking to the industry and the internal practices of banks for the basis of a capital requirement. Unfortunately, in the case of credit risk, it was far more important, accounting for almost all of the capital requirements of most banking institutions, and also a much more complex risk to measure. Moreover, the industry practice for measuring risk was not as far advanced as it was with trading. So there were more obstacles at every turn.

Basel Capital Standards: Credit Risk

Meanwhile, fine work was being done here at the Board. From my narrow Federal Reserve perspective, it has been traditionally the Fed that has generally taken the lead in Basel Committee efforts to find solutions to major bank supervisory or regulatory challenges. In particular and for Basel II, John Mingo, an officer in our research division, had done a lot of thinking over the years on how to measure credit risk and, even well before it became a focus of international efforts, had urged the Board to work with the industry to sponsor the collection of data in order to build databases that banks could use to better measure credit risk. With that strong interest on his part and a strong understanding of banking practices in this area, he and David Jones developed a specific proposal for a capital standard. Eventually, David and John took their presentation to the Basel Committee's Models Task Force at a meeting we had in London. They explained the internal rating–based concept, the type of capital arbitrage that is going on or could be going on under the existing capital standard that may not be visible to many

bank supervisors. Their efforts succeeded in getting the Basel Committee interested in pursuing their approach.

Finally, we've recently issued the new proposal for public comment. In the beginning, though, there was great suspicion on the part of our European and Japanese colleagues that this was all an effort on the part of the Americans to get a capital break for our banks and to get a competitive edge on them because credit risk data were richest in the United States and our credit rating agencies were larger and more sophisticated. At least it was perceived that our banks were better positioned to generate the necessary statistics than were banks abroad. So there was an unfounded question of trust that we were trying to "pull" something when our true motive was almost the opposite; that is, we thought our banks may be undercapitalized relative to the credit risk they were taking. All the angst the U.S. agencies have had in finalizing the proposal and making it more rigorous than what has been proposed abroad would seem to underscore that point. It would appear that we in the United States have wanted to be more prudent in developing sound and rigorous standards than our colleagues abroad have been. It certainly seems that we have taken the effort more seriously and are trying to implement it more rigorously and with greater integrity than they have.

For different reasons I had some early questions myself, thinking, "Gee, if most of this effort is to promote sound risk measurement on the part of banks, why do we need a regulatory incentive? Why can't virtue be its own reward?" If you, as a banker, had the data and accurately measured the risk, you're going to be a better banker. You're going to identify and price the risk more accurately, reject loans that do not meet the necessary hurdle rates, and ultimately be a more profitable bank than competitors that do not have the data or conduct such thorough analysis. Why do we need a regulator to come along and force banks to do this?

To some degree, we tried to address those questions through various visitations to New York banks. We asked senior management how they determined whether their banks were adequately capitalized. The stories we got were not particularly encouraging. At some institutions, I felt they had much better answers to provide than they gave, but then again we were talking to fairly senior people, maybe not the people who were more directly involved in measuring the risk.

As we went from institution to institution, we would hear stories like this: "Well, we want to have a couple percentage points of buffer over your regulatory minimum; we want to have a regulatory capital ratio that's comparable or competitive with the group of peers that we, as a bank, identify as our primary competitors; and we want to make the folks at the ratings agencies content with our capital ratios. Of course the "buffer" they wanted was above the current regulatory minimums that were calculated using the current measure that we all acknowledged was crude and increasingly inaccurate. Later, when we talked to the ratings agencies about how they got comfortable with a bank's capital adequacy, we got similar stories: They said they looked at how banks compared with their peers, their capital levels over the regulatory minimums, and so forth.

So it became clear to me fairly quickly that we were not going to get much progress with the industry unless there really was a regulatory carrot and stick. Left to their own devices, bank managements would focus short-term and not make the investment in the information systems and data gathering processes that would be required to get what we felt would be a better and adequate handle on the credit riskiness of their portfolios. From my perspective, that helped me believe we were on a reasonable path and that much progress wouldn't happen otherwise. I

would say personally, as much as anyone in the Division of Banking Supervision and Regulation, I was a consistent supporter of Basel II and what it tried to do.

A difficulty with Basel II has been, from the beginning and probably going forward for a while, the fact that we were and still are ahead of the industry. To that point, I was never offended by comments some folks would make on occasion that regulators were always behind the industry. In my view, that's not an inappropriate place for regulators to be. It's the banks who are on the front line, making the loans, doing the banking business. They need to develop the procedures for controlling, measuring, and identifying the risks. It's through the supervisory effort that we regulators learn or know about those practices and spread information about sound practices from bank to bank. For us to be a bit behind is not bad—indeed, it seems often necessary and quite appropriate.

In the case of Basel II and capital standards for credit risk, the Fed felt it needed to spur progress. Banks were perceived as becoming so large and complex with all the industry consolidation and growth of the derivatives markets that they could present undesirable levels of systemic risk. The fact that there was less unanimity within the industry about how to measure credit risk and establish databases and techniques to do it made the process of developing Basel II much more difficult than it was to develop standards for market risk (i.e., trading activities), where we had accepted practices that we could latch onto.

In the evolution of Basel II we were developing a whole new paradigm: using internal risk measurements as key inputs for regulatory capital standards. But unfortunately, we could not build upon existing information and bank procedures that were well established. There was simply no widely agreed consensus within the industry on what parameters to use, and few—if any—institutions had sufficient historical data to support many of the required calculations. This

situation created great uncertainties about the effect of any regulatory proposal on bank capital—were the proposed regulatory formulas for converting internal risk measures to a minimum amount of regulatory capital properly (or reasonably) calibrated? To address this issue, the Basel Committee undertook what were known as Quantitative Impact Studies, or QISs. These were surveys in which selected institutions were asked to submit information about their internal assessments of credit risk in their portfolios.

Basel: Quantitative Impact Studies

The first one undertaken around 2000 was a very quick-and-dirty effort. At the time, there wasn't much enthusiasm on the part of Basel Committee members to ask their banks to do much. The OCC didn't want to be involved at all. So it was pretty much an issue, in the United States anyway, to go to only a few institutions and ask for relevant and readily available reports that could shed light on the matter. Of course that produced free-form, internal reports prepared with little guidance or instructions from us. The results were virtually worthless. The main benefit of the exercise was as a learning exercise illustrating that if we wanted to do it right, it was not going to be a low-cost effort. Something quick and dirty was not going to yield anything useful.

QIS-II came along a year or so later; in the United States that involved four large institutions. We provide them with specific formatted spreadsheets asking them to fill out certain things—but again, at a relatively low-cost effort.

MR. SMALL. Was the output a capital standard? Were the results useful?

MR. HOUPT. Yes, but the QIS-II was only partial because the capital proposal, itself, was only partial at that stage. It tested only the commercial portfolio and securities portfolio. It did not get much into retail and credit cards in particular. But it was helpful in guiding how we

wanted to proceed with those portfolios and where we wanted to dig deeper. Throughout this time David Jones, in particular, was doing great work and helping flesh out the algorithms for measuring the risk and understanding the techniques banks were using to measure risk. Darrell Hendricks was playing an increasingly important and always useful role and tapping expertise in the other agencies as well. Folks at OCC were also providing insights, expertise, and access to their banks. So it was becoming a bit more of a team effort at this point. QIS-II was helpful but still limited by the participation of the U.S. banks, limited by the questions we asked, and those questions in turn were limited by the stage of development of the proposal. QIS-III came along another year or two later. By this time, around 2003, QIS-III was a big deal. From the Basel perspective, it was also an attempt to reach out to countries that were not part of the Basel Committee to get them more engaged. Seeing the time and effort that would be needed to conduct and analyze QIS-III, I agreed to lead that effort and asked Bill Treacy to take my place on the Basel Committee's Models Task Force.

Even though Basel I was developed as a capital requirement for internationally active banks in countries represented on the Basel Committee, it soon became a worldwide standard. Not that every bank's accounting systems had the integrity they should have had, but at least everybody saluted the Basel requirement, whether they were in Zimbabwe or the United Kingdom. So there was a sense on the part of many countries around the world that did not participate in Basel that the Basel Committee was making all the rules and forcing them down everyone's throats, even though most countries didn't have anything to say. At least with QIS-III there was an effort to bring more countries into the process and to give them insight on what this is all about and what some of the effects on their banks might be and also to demonstrate that

the Basel Committee was giving at least some attention to the effects on banks from countries that were not on the Committee.

Of course, survey responses from some of these non-G-10 banks raised serious data quality questions, but that was true with a number of G-10 banks, too. In QIS-III there were submissions by U.S. banks that we certainly questioned. All of this was done as a voluntary effort—well, voluntary perhaps in name only—and also on a best-effort basis.

Ed Ettin orchestrated a meeting in our Board Room, chaired by Vice Chairman Ferguson. Comptroller Hawke came over, as did senior people from the FDIC. We sent letters to the CEOs of our 25 largest banks saying we were going to have this meeting to kick off QIS-III and would like their CFOs and chief risk managers to attend, or at least the CFOs, to attend. Not surprisingly, that effort encouraged all attendees to participate in the exercise. Indeed, a couple of institutions that were not invited later learned of the project and volunteered. We knew it would be a challenging, time-consuming effort on the part of the banks and that it was important for them to do a quality job. At the time, we were not sure how willing banks would be to participate. After the meeting, I remember standing in the doorway of the Board Room with Vice Chairman Ferguson and saying, "That went well. No one seemed to resist." And the Vice Chairman responded, confident and self-assured as always, that "Bankers don't come into this room to tell us 'no'." It was nice working at a place like that. Despite inherent data problems from banks throughout the world, QIS-III helped move the process forward.

The last QIS that I participated in—and the most important and controversial, because we were getting down to the wire—was QIS-IV that was conducted in 2004–2005. For this we had a few more banks, a more complete proposal, and much more extensive spreadsheets for conducting the survey. The spreadsheets and instructions were substantial, complex, and very

well done. In my view, the industry devoted substantial resources and did a very conscientious job in dealing with our request. It was not easy for a lot of them, but they cooperated. They were generally supportive of the process and wanted to get it done well—both to guide the regulatory process and to see how new capital standards might affect their banks.

MR. SMALL. What kind of data was requested? Was it twice as much data? Three times?

MR. HOUPT. Primarily, the proposal and related guidance on how to measure risk in credit card lending, asset securitizations, and various off-balance sheet hedging activities were now fleshed out. I think those were the main changes from QIS-III to IV. We essentially had a complete proposal that we were testing with IV, which we did not have until then. With IV, the United States was ahead of most of our Basel colleagues. Germany conducted QIS-IV pretty much on our timeframe, but the rest of the Basel member countries were not willing to do it until about a year later. In effect, they skipped IV and went to V (which we did not do). Our different timeframes reflected our respective schedules for domestic rulemaking. The spreadsheets used by all of us for QIS-IV and V were virtually identical.

All that is to say, we were ahead of other Basel members in seeing results from QIS-IV. Our U.S. results were not what people expected, showing generally substantial declines in capital requirements from the bigger banks. In some instances, though, there were substantial increases—which made us wonder what was going on and made the institutions wonder whether they could live with the consequences. Everybody was wondering "What's the truth?" Is it just inconsistency in interpreting the regulatory guidance we issued? Are they sufficiently consistent in their internal ratings? Are we all looking at the same kind of risk, with some banks rating a given risk an A, while others call it a triple B, and so forth? Some of the differences reflected

clear misunderstandings or outright errors on the part of the banks. I was coordinating the interagency group at the time. As we resolved aberrations, sometimes banks would fix their submissions; other times they stood by them.

So again, the question was "What was truth?" Is one institution indeed so much riskier or less risky than another institution? It was hard to square the circle and get everybody comfortable that these data and conclusions are correct and that they represented the true relative riskiness of the institutions and provided a useful indication of what the effect of the capital standard would be. There was lots of interagency angst in that process. The FDIC, in particular, did not want to see capital requirements for large institutions fall significantly; none of us did. We all simply wanted to understand what was going on and how best to proceed. The industry was always seeking clearer guidance on how to measure certain things and we often lacked the answers. Nevertheless, I think Basel II is a big step forward in bank regulation and supervision for promoting better risk measurement, and the answers will come in time. In any event, they will come much earlier, I think, than they would have come had we not pursued an internal rating–based capital standard.

Credit Ratios

MR. SMALL. About the credit ratio, at an extreme, I could see the objective being that if you placed the correct capital standards for all credit risks, all banks would end up with the same amount of credit risks because you imposed the capital ratios appropriately.

MR. HOUPT. Yes, to a degree, but then different institutions often have different levels of risk appetite and expertise in different segments of the lending business that will entail different levels of capital.

MR. SMALL. On the other extreme, I could see capital standards just being a tool for transparency. What was the underlying philosophy of these credit risk standards—to impose and equalize the credit risk across banks? Or was it a transparency objective to allow the rating agencies and markets to see the amount of credit risk clearly and let the markets price that bank appropriately, given that the market has the right information to do it?

MR. HOUPT. From my perspective, the reason was to better match capital requirements with true underlying risk and to encourage better risk measurement because of the growing complexity and sophistication of the lending and credit granting process and also get at the potential capital arbitrage that could be going on under Basel I. There were incentives for banks to take on more risks because they could often get greater economic reward without incurring higher regulatory capital requirements. So a taxpayer, essentially taking on the risk of that institution, faces a moral hazard problem: The banker makes more profits and bonuses, but if something goes wrong, someone else picks up the pieces. As we work with regulatory capital standards, supervisors want to avoid creating their own moral hazard by providing or dictating risk measures for banks that are too specific and detailed because banks can then say, "Well, we used the regulatory tool, what else should I do as a banker?" We want banks to make their own decisions. We don't want to have a single risk measure out there for institutions to use. We want them to make their own judgments on the riskiness of credit and markets and so forth. And that was true with the Value at Risk measures, too. In that case, we certainly want the institutions to construct (within limits) their Value at Risk process as management feels appropriate, which might well be different from the way it's done by the bank across the street.

So there is some flexibility in exactly how to do this. I always thought we wanted it tied to how management felt was best and prudent for business purposes. And there's a market

discipline, too. Success in the marketplace beyond the short-term was one test that you were on the right track. Yes, we were looking at internal credit risk models, but they were just that—they were internal risk models, and one's judgment on the riskiness of exposure to a given company may be different than someone else's. There's a difference of opinion, there's a market. We don't expect everybody to judge a given credit exactly the same, but we should hope and expect as we go forward evaluating a bank's adherence to Basel II standards that there was enough testing and that overall each bank is within limits of reasonableness. If one bank is consistently rating specific exposures as less risky than are a group of peer banks, that ought to raise supervisor questions.

But there ought to be a range of tolerance that is healthy and necessary. Of course the Basel II proposal has three pillars. Market transparency is an important part too. The question there is: What is the best set of disclosures for an institution to make and will the market and the bank analysts and others pay much attention to these disclosures? That's a question I've had throughout my career. As we crunch numbers in our role as supervisors and use the wealth of information we have in the Fed, and as I've talked to different analysts over the years and asked them if they look at different reports, I've been surprised at the small number of sources that many of them use. So, it will be an educational process on everybody's part—the banking community, the regulators, the market analysts, the bank analysts—to understand the implications of Basel II and to understand any public disclosures that come from it. Hopefully some of that increased disclosure and transparency will feed back and give supervisors a little help in providing discipline in risk taking.

The Future: After Basel II

MR. SMALL. Looking forward after Basel II and thinking about credit risks, whether or not it's done correctly, do you see ongoing capital arbitrage and other dimensions at risk? Do you see Basel III and IV dealing with those?

MR. HOUPT. Yes. I guess in a more perfect world we could minimize the amount of regulatory algorithms for measuring capital requirements and rely more heavily on internal calculations of the banks that are used for business purposes, but that are enhanced to provide sufficient rigor. With sufficient flexibility on the regulatory side, it seems the capital standard could evolve with risk measurement practices of the industry. As banks get better at measuring risk our regulatory standards can improve. A risk is that the regulatory community becomes overly prescriptive in what it requires to implement all of this. At some point the banks will say they simply can't maintain all of the different systems because of the cost and confusion. If we are not sufficiently flexible, they may ultimately do only what the regulators require because they can't ignore a regulatory requirement, but they can't afford also pursuing a different and perhaps better approach. If what we require diverges very much from what they would otherwise do for business purposes that could be unfortunate.

A key point, though, is that regulatory and industry objectives can differ, as institutions, for example, focus more short-term and give less—or no—attention to systemic risk. The process needs to be properly balanced, giving the industry sufficient flexibility while also protecting the public's interest.

Credit Rating Agencies

MR. SMALL. Does the third party of the rating agency somehow give you a benchmark as to whether you're getting it right or not?

MR. HOUPT. For example, Moody's assessment of Citigroup?

MR. SMALL. Yes.

MR. HOUPT. Well, supervisors have always given consideration to the market's view of the credit riskiness of an institution; that's good information to us. I'm not aware, in my experience, of when they were too dissimilar. There is also feedback both ways. The market—a Moody's—also gets information about regulatory or supervisors' views of an institution—is a company in the doghouse or is it not—aside from whatever they glean from financials and other insights from their analysis of the institution. In their own risk metrics of individual credits, the institutions look at any existing external credit ratings of their borrowers and have practices that are akin to those used by rating agencies. How consistent are bank internal credit ratings with those of external credit rating agencies? That was a part of the problem internationally. I mentioned earlier that the Europeans thought that we were trying to take advantage of them because external credit ratings were less common in Europe. So that external source, that assistance to a bank in developing an assessment of credit risk, is believed to be easier for U.S. banks than for European banks.

Industry Changes

MR. SMALL. You talked about being an accountant, and you talked about the regulatory process being a lot of examination of data, like being an accountant. But where you've ended up it's more of a finance-driven type of analysis of credit or risk. To simplify, you've gone from the accountants to the finance departments. The industry seems to have changed tremendously.

MR. HOUPT. That's a reasonable way to characterize it, I think. That speaks to the progress in risk measurement practices and the broadly higher level of complexity in most banks

now compared with years ago—often less transparency as you look at the financial statements of a financial institution now versus the 1960s and 1970s, maybe even 1980s. There is a greater need to rely, as we are, on the soundness of policies, procedures, and controls rather than on point-in-time analysis of a balance sheet, a financial statement, and there's a need to have capital standards that build upon current levels of sophistication as much as they can. I think this is a necessary process and hopefully one that will continue to evolve and perhaps evolve smoothly as industry practices continue to improve. And as they invest in the databases, those databases get richer year by year.

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MR. SMALL. That wraps it up unless you have further comments. You've been very helpful—thank you for your time.

MR. HOUPT. I guess I might conclude with a nice little bouquet for the Board. I say this with white hair and having retired—it has been a privilege to associate with an institution that has the integrity that I think the Federal Reserve has. Throughout my career, being able to sit in a Boardroom—and I emphasize "Boardroom," as opposed to an institution led by a single person, a secretary, with the openness of the discussion of policies and issues; and because of the openness, the greater discipline that is brought to bear on issues to bring out the "truth." [Laughter] Who knows what truth is? But from what I saw at many meetings, whether they were Board meetings or committee meetings or our division meetings, people sought to do the right thing, I thought. They weren't going after a particular angle or constituency. And again, maybe that's part of the Fed—the need to take a broad macro perspective, the responsibility for the financial system, the broad aspects of the economy. But the openness and the broad

perspectives and the people who have sat at these tables and the expertise they bring, it's been good.

I think of the role of the Fed in supervision. The synergies between supervision and research that exist in this institution do not exist nearly to the same degree in the other bank regulatory agencies. Economists at the Fed bring much to the supervisory process, and I think bank supervision brings practical insights and industry access to our Fed economists. I think it would be unfortunate for the Fed if it did not to hang onto bank supervision.

I would also like to acknowledge the important roles Roger Cole and Rich Spillenkothen had in making my career as successful and as interesting and enjoyable as it was to me. By promoting me into management in 1988, they did much to enrich my professional experience and to provide me the opportunities I had—including the "opportunity" to work many longs days throughout my remaining 17 years at the Board. I found them both to be professionally competent and supportive managers who were great to work with, and I am grateful to them.

MR. SMALL. Thank you.