Remarks by
FDIC Chairman Sheila C. Bair
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Good morning.

Risk management is a big part of our job at the FDIC. And like any other regulator, the more we know about what's going on in our financial markets, the better we're able to do our job of keeping our institutions healthy and competitive.

So I'm delighted to be back again this year to speak about the Basel II capital requirements, and especially to hear what's on your mind, and your assessment of where we're heading.

Things have changed

It's an old line, but I can't think of a better one: what a difference a year can make. The financial world is in a very different place today than it was just a year ago.

A year ago, the global financial system was still highly liquid.

Bank profits were at all-time highs.

Downgrades of triple-A-rated CDOs were virtually unheard of.

SIVs, mono-line insurers, municipal bond auctions, and mortgage-backed securities weren't making the daily headlines that they are now.

Also very different was the public debate about implementing the Basel II capital rules and the manner in which risk should be assessed, especially for the big banks.

Risk modeling

Many people truly believed the quantitative models underlying the advanced approach accurately reflected risk.

When it came to agency ratings, the consensus was even stronger that triple-A ratings equated to minimal or no risk at all.

Reflecting this belief in models and ratings, many were impatient with a go-slow approach to Basel II. They did not want capital safeguards, and they did not want the U.S. leverage ratio.

Today the financial world looks and feels vastly different.

- Over 1,200 triple-A-rated CDOs have been downgraded, many by multiple notches.

- The Case-Schiller index of U.S. home prices fell 8.4 percent in the 12 months ending in November.

- And U.S. bank earnings have taken significant hits from writedowns on CDOs and other structured instruments.

So what happened?

There are two sets of issues we need to look at.

The first involves crisis management.

There are many on-going discussions about what government can or should be doing.

I've spoken often in recent months about the critical role of the private sector in minimizing needless foreclosures in the wake of the meltdown in the mortgage credit markets, especially for homeowners with subprime adjustable rate mortgages.

But today I want to focus on another set of key issues, namely, what are the underlying problems that got us to this point and how we can do better in the future?

Breakdown in lending standards

The smoking gun for the current problems was the systematic breakdown in lending standards in a large segment of the U.S. mortgage market.

Very important legislative and regulatory initiatives are underway to put a stop to abusive and irresponsible mortgage lending practices.

We'll need significant reforms to restore confidence in the integrity of financial markets.

Based on what we know now, some of the lessons for the secondary market are pretty straightforward.

First, there was a major lack of transparency in structured finance.

And second, there was a pervasive, over-reliance on ratings and quantitative methods, as a substitute for good judgment and traditional credit discipline.

These two problems are closely linked.

If accepted market practice is to rely on a rating, then why demand additional information about collateral?

And if there is little or no demand for the information, why bother to produce it?

The result: an opaque market for CDOs and many other innovative products and financial tools.

When you think about it, we're living in the 21st century. This is the information age.

Shouldn't transparency in financial markets be the norm, not the exception?

If you want to analyze a rated corporate bond, for example, you can go to the SEC website and get financial statements and a wealth of reports about the borrowing corporation.

If the bond is actively traded, you can check out the latest secondary market prices and volumes in the Wall Street Journal or on your Bloomberg.

On the other hand, suppose you want to analyze a CDO.

You might ask for a standard spreadsheet of loan-level data. But you would probably find this unavailable, even for a potential investor.

And even a basic summary about the underlying collateral may not have been given due diligence or independent validation, and is unavailable to the general public.

Public information about transaction prices and volumes for these securities was, and unfortunately still is, non-existent. All price and volume data is proprietary or derived ad hoc from people in the business.

This dearth of information about collateral underlying CDOs is in no one's interest ... except possibly those with a monopoly on the data.

And the lack of transparency amplified the boom and bust dynamics the CDO market displayed.

Need for transparency and more data

To be honest, there wasn't an outpouring of demand by investors for information about CDO collateral.

Market practice, regulation, even legislation allowed investors to rely exclusively on the rating. And it was cheaper for them to do so.

The damage from reliance on CDO ratings has been acute.

Triple-A ratings were assigned to securities whose collateral was triple-B securities. In turn, mortgages underlying the triple-B securities had a variety of weaknesses.

These included widespread lack of documentation of income, high-loan-to-value, zero or negative amortization, and the now infamous, subprime hybrid ARMs.

Ratings were assigned to these CDOs using complex models. Great weight was put on historical loss experience, and the mathematics of correlation analysis.

Some bankers held these securities based on a rating, without a detailed understanding of the underlying collateral.

These banks, in effect, relied on quantitative methods and ratings, pushing aside their traditional credit culture and not asking the tough questions.

Banks bet heavily on ratings in other ways.

For example, some banks may have assumed they had zero net exposure to a security because it was hedged by a credit default swap with a triple-A rated bond insurer.

Others may not have adequately considered off-balance-sheet risks from SIVs and asset backed commercial paper.

Why would anyone question the ability of these conduits to roll over paper backed largely by triple-A rated collateral?

We need to ask ourselves how the marketplace came to be so heavily invested in the stability of such opaque structured finance credit ratings.

Frankly, it's quite possible that our regulatory polices have played a role.

Back in 2002, the availability of a 20 percent risk weight was expanded from the obligations of government sponsored enterprises to cover certain triple-A and double-A rated asset-backed, and mortgage-backed securities.

The same dollar of capital could now support as much as five times the volume of these triple-A securities.

It may not be entirely coincidental, that in the subsequent years, financial service companies swung into high gear creating new classes of rated securities.

With their promises of triple-A quality and higher yields in some cases, these products were very attractive to banks that wanted to boost returns on equity, and to economize on regulatory capital.

Some banks also economized on the expense of doing their own credit analysis. After all, these securities were top quality, triple-A.

In retrospect, regulators may have unintentionally, encouraged banks to bet heavily on a new class of non-transparent securities.

Moreover, in the Basel 2 advanced approach, regulators upped the ante ... lowering the risk weight on many of these CDO securities to as low as 7 percent.

The advanced approaches in general represent a heavy bet on the accuracy of models and quantitative risk metrics.

Based on specific assumptions about loss correlations, the framework promises heavy reductions in capital requirements for virtually any credit class with a favorable loss history. And this can encourage banks to lever up far more than they already have in a competitive dynamic to boost their return on equity.

So, here's the bottom line: We have a major lack of transparency in structured finance.

And we have regulatory policies including Basel II that may have the unintended consequence of encouraging some banks to bet heavily on non-transparent ratings and models.

How do we dig out?

So what do we need to do to improve transparency, and to restore confidence to financial markets?

The ratings agencies are working hard to improve processes and enhance transparency. These efforts are important and should go full speed ahead.

In this information age that all of us are living in, it's only common sense that detailed information about the collateral underlying any rated security should be readily available to the public.

It also makes perfect sense for ratings agencies to expect an independent review of the accuracy of information about the collateral. And price and trading volume data for rated securities should also be readily available.

Incentives needed

But it's not enough to have transparency if banks have no incentive to use the information.

Regulatory policies should not encourage banks to ignore traditional credit analysis in favor of placing financial bets whose success depends on the accuracy of any particular rating, or particular model.

For example, there's discussion of whether the use of ratings-based capital for structured financial products should be contingent on additional operational requirements.

In this case, we might consider requiring banks to demonstrate that they have detailed collateral information, and have performed an independent credit assessment.

Such ideas are being considered as part of a second look at the Basel II securitization framework.

Another area for reform may be the trading book capital rules.

These rules grant significant up-front capital relief, based on the presumption that unlike traditional bank loans trading assets are liquid and readily marketable.

However, certain CDOs and other structured finance products are often held in the trading book and fair-valued despite the fact that there is, apparently, little trading in some of these products.

The extensive use of the trading book for these illiquid, non-transparent securities is another unintended consequence of current regulatory policy.

Other things under discussion include better clarifying the trading book for liquid assets or putting some type of restriction on the regulatory recognition of certain types of subjective or non-transparent fair value gains.

None of these issues are simple. And there are differing views on how to address them among international bank regulators.

Nevertheless I strongly believe that to get the full benefit of greater market transparency, regulatory policies must give the right incentives.

If our regulatory policies encourage bank reliance on opaque, model-driven processes then transparency initiatives won't repair the damage done in recent months to the confidence and trust in our markets.

We've been successful in applying greater transparency in limiting regulatory reliance on non-transparent, model-driven processes in the U.S. approach to Basel II implementation.

The U.S. agencies agreed, by regulation, not to release any bank from its risk-based capital floors until the completion of an interagency study that gives the rules a clean bill of health.

Most important, we retain the leverage ratio. By providing capital even when the risk-based measures erroneously indicate minimal risk the leverage ratio is a critical part of our overall approach to capital regulation.

At the point that the risk-based measure calls a bank well-capitalized when its assets only narrowly exceed its liabilities, something has gone terribly wrong.

And at that point, government can too easily become the bank's capital.

Conclusion – back to basics

Let me end with a comment about a recent "Lex Column" that ran in the Financial Times.

The column had a table showing tangible equity ratios as low as 1 percent for some of the largest European banks.

The article goes on to say that: "Right now, many investors want Basel Zero" and concludes with a plea.

The plea was for not depleting capital further, and it called on bank supervisors not to get hypnotized by a single number.

Instead, the columnist called on regulators to follow the U.S. back-to-basics focus on a broad range of metrics including traditional equity ratios.

I could not agree more.

Who knows if we'll ever see a leverage ratio in Europe?

Dare I revive my call for an international leverage ratio?

One thing is for certain. The capital suggested by the advanced approaches can be far off the mark.

Now widespread recognition that there is more to sound risk management than mathematical formulas is progress in and of itself.

Thank you.

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