Remarks
By
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It is my pleasure to be here addressing Women in Housing and Finance. The FDIC is well represented in WHF, and we have benefited from active participation in its leadership -- Kathy James, Doris Marsh, Peggy Kuhn, and before them, Ruth Amberg have all helped bring the FDIC and WHF closer together.

As most of you know, the FDIC is the federal regulator of most of the community banks in the country. We also administer the federal deposit insurance funds, and it is our duty to make sure that all banks and thrifts holding insured deposits are safe and sound. For the vast majority of insured banks in the United States -- the state-chartered banks that are not members of the Federal Reserve System -- the FDIC is the primary federal regulator.

A tool we use to measure the safety and soundness of a bank is its capital ratios. I want to talk to you today about an interagency proposal that will seek comment on a bifurcated system for calculating capital requirements for banks and thrifts. We intend to release it next month.

Right now, U.S. regulators use a one-size-fits-all capital measure for all institutions. We would like to consider whether smaller banks, engaged primarily in traditional banking activities -- the community banks that vastly outnumber all other banks in this country -- should have correspondingly simpler capital rules. A capital framework can be developed for small banks with limited business lines that would be more efficient and less burdensome -- without compromising prudential standards. This concept is the right idea at the right time.

Why?

Large banks and thrifts are vital to our economy and our country. They help fund industrial and technological development and global commerce.

Compared to these internationally known large banking companies, community banks are very small in asset size. But the sheer volume of community banks is significant. The FDIC supervises about 6,000 of them. Let me put that in perspective for you. For every two banks OCC regulates, we regulate five. For every single bank the OTS ***or*** the Fed regulates, we regulate six. The numbers alone tell us how important community banks are across this country.

But it isn't just the "number" of small banks that makes them important.
People *choose* these banks because they are "community" banks. They are ***the*** banks for small-businesses, family farms, and local governments. The Americans who own and manage these enterprises need funding to make them succeed, just as surely as big businesses do.

We all know that small business is the backbone of our economy. Small businesses create more than 75 percent of all new jobs. They account for more than half of GDP. We also know that small banks are important for small business. We estimate that community banks fund more than 40 percent of bank small business loans. And, outside the largest metropolitan areas, they fund more than half of small business loans.

This is to their great credit: Small business lending has generally required local expertise for underwriting and monitoring a specific firm's risks, making it difficult for businesses to obtain credit from lenders who do not have a local presence.

Thus, it is not uncommon for a community bank to hold a share of the local small business loan market that is significantly larger than its share of the local deposit market.

Because we supervise the vast majority of these institutions, we at the FDIC know small banks. As FDIC chairman, I've worked to ensure that everything we do, everything we consider or implement, takes into consideration the needs of smaller institutions, as well as the large ones.

- In our *supervision*, we have streamlined procedures to accommodate small bank operations.
- In our recent *deposit insurance options paper*, we talk about whether we should have two approaches to risk assessments -- one for the small, traditional bank, the other for large, complex institutions.
- And, in our review of *regulatory capital requirements* -- again -- we see big and small banks and thrifts as very different.

In most of these supervisory and regulatory activities, a bifurcated approach better reflects the risk profile of the institutions we supervise. We believe we can take a bifurcated approach without sacrificing safety and soundness.

Let me say a word about the relationship between regulatory capital and deposit insurance premiums. Capital plays an important role in our current risk-based deposit insurance system, and is likely to continue to do so under any of our deposit insurance reform proposals. After all, capital influences a bank's risk of failure and the FDIC's expected loss as insurer. Capital is not, however, the only factor influencing a bank's risk of failure, and while we may be able to provide many small banks with a simpler capital framework, we still have to be mindful for deposit insurance purposes of the differences in risk that may exist between banks.

How did we get to where we are today?

As most of you know, the United States only formalized bank minimum capital ratios less than 20 years ago. Formal interagency capital standards were not adopted until 1981. Prior to that time, state laws or federal policies and practices prevailed. Through the regulatory framework established internationally by the Basel Accord in 1988, we began to coordinate our policies with banking supervisors in other countries. Within that framework, the FDIC, together with the other regulators, established risk-based capital requirements for U.S. banks and thrifts.

For those of you who have not been initiated into the cult of bank capital, this is how it works in the United States: All banks and thrifts are required to comply with two key minimum capital standards: a leverage ratio and a risk-based ratio.

The leverage ratio is a simple capital-to-assets ratio, essentially looking at how much equity shareholders have invested in a bank and comparing it to how much a bank has in loans, securities and other on-balance sheet assets.

The risk-based ratio conforms to the principles laid out in the Basel Accord. It also is a capital-to-assets ratio, but a bank's assets are divided into four categories that are weighted differently according to their relative risk -- so that, Treasuries would be weighted differently from corporate loans, for example. It is this risk-weighted amount, together with a calculation for off-balance sheet exposures, that theoretically makes the ratio more sensitive to the individual risk profile of a bank than a straight leverage-ratio calculation.

Regulators then look at a combination of the leverage and risk-based ratios to determine whether a bank is well capitalized or falls into one of the other categories. A bank must have 10 percent total risk-based capital and a 5 percent leverage ratio, for example, to be considered well capitalized.

The Basel Accord was written primarily with large complex internationally active banks in mind. Today, the FDIC and other bank regulators are in negotiations in Basel to revise the Accord to fine tune the risk-based ratio even further. New York Federal Reserve President William McDonough, as chairman of the Basel Committee, is leading that effort and is largely responsible for the fine work they've done so far. As many of you know, the Basel Committee is exploring the concept of using sophisticated internal risk measurement systems in the development of minimum capital standards. It is also developing a standardized approach that proposes revisions to the risk-based framework of the 1988 Accord that might incorporate external ratings in the assessment of a minimum capital requirement. These changes, in part, reflect advances in risk-management technology and processes at large banking institutions. They will, however, obviously make the capital calculation even more complex than it is today.

But, as we sit in Basel, U.S. bank regulators are also thinking about that man or woman who walks into a community bank in Iowa, or Nebraska, or Georgia and says, "I need a loan." We know that small traditional banks and their customers are not affected by the new internal risk measurement systems being talked about. In fact, using such systems would only serve to take time and money away from the real work of more traditional banks -- nine out of 10 banks in America.

That's right -- 89 percent of U.S. banks and thrifts, more than 8,000 of them, run a traditional banking structure. The median size of these banks is $70 million in assets.

I'd like to stress, however, that a simpler capital regime is not going to be permissible for ALL smaller institutions. Community banks can safely participate in some of the complex activities and product offerings that large banks do, so long as they also provide a skilled management team and risk-management safeguards. However, these banks are not likely to be eligible for the more streamlined capital approach we're talking about.

At the same time, there have been such significant changes in the concentration of industry assets that it is appropriate to recognize that smaller institutions today that limit their business to traditional banking activities pose a much different risk to the financial system than do large conglomerate institutions. A simpler approach to capital probably will be restricted to small banks with relatively simple and low-risk balance sheets, and very minimal off-balance sheet activities. One of the questions we expect to include in our proposal is how to define a non-complex institution for this purpose, while still requiring equivalently sound capital for all institutions.

Several alternatives for a simpler capital framework are being studied. Three options discussed in the interagency proposal include: (1) a simplified risk-based ratio, (2) a leverage ratio, and (3) a modified leverage ratio. Let me tell you a little about each option.

Simplified Risk-Based Approach

One option we've been thinking about is a modified version of what the Basel Accord revisions call the "standardized" approach. It would be risk based, but tailored to the typical less-complex risk profile of smaller institutions. We could accomplish this in different ways -- fewer risk buckets, less complex calculations, or fewer reporting requirements, for example.

The primary advantage of maintaining a risk-based measurement is that it does a better job than a leverage ratio of equating the amount of capital needed to a bank's level of risk. Community banks would continue to claim capital benefits from lower risk assets, as they do today for Treasury securities, government-sponsored securities and prime residential mortgages. And the incentives would be right, too, since banks also would continue to need more capital for higher risk assets.

The conundrum is how to "simplify" a "standardized" approach -- where to make the tradeoff between simplicity and accuracy, for example. We must ensure that, in our effort to attain these competing goals, we don't fall short of attaining either. We will look forward to your input in helping us answer some of those questions.

Leverage Ratio

A second option is to rely solely on the leverage ratio as a capital measure for non-complex banks. The primary advantages of the leverage ratio are its simplicity, transparency and the familiarity banks already have with it. Another advantage is that it

ensures a minimum amount of capital, which is useful since the risk-based calculation can theoretically result in an inappropriately low capital level in certain institutions.

Again, its drawback is that it is not risk sensitive. High risk investments require no more regulatory capital than low risk ones. That might create a disincentive to investing in safer, lower yielding investments. And the leverage ratio does not adequately account for off-balance sheet exposures. A risk-based measure more directly addresses these concerns.

However, as I mentioned, most small and non-complex banks, as defined by any new rule, would generally not maintain high-risk investments and large off-balance sheet exposures (other than, perhaps, commitments) anyway. Most community banks have the same types of traditional banking assets anyway. Therefore, for these banks, the leverage ratio may well be sufficient. Taking this approach to measuring capital requirements for community banks does not necessarily mean that capital levels might be higher -- just that capital requirements will be simpler to calculate. Even so, we will seek comment on whether there should be a trade-off between a simpler standard and a slightly higher leverage requirement.

And here may be the most important point in favor of the leverage ratio:

It is a startling fact: Today, for 98 percent of all banks and thrifts, the leverage ratio alone could tell us whether they are well capitalized. The risk-based ratio may not necessarily add anything for the narrow purposes of meeting minimum capital standards.

Community bankers and trade groups have told us that the risk-based framework is "regulatory overkill" for small and non-complex banks, that it is practically irrelevant to bank management as a useful, meaningful measure of capital adequacy. Our analysis indicates that, to a very large extent, they are right on target.

Modified Leverage Ratio

Our third option is an attempt to combine the best elements of both a simplified risk-based approach and a leverage ratio. A modified leverage ratio might retain much of the simplicity of the leverage ratio while addressing its principle drawback -- the failure to address off-balance sheet risks. A modified leverage ratio might incorporate, for example, interest-rate risk derivative products used for risk-management purposes.

A disadvantage of this ratio is that it may provide no capital benefit to institutions that maintain a low-risk profile, and would still be less sensitive to risk than a full risk-based capital standard. Thus, another modification might be to incorporate some recognition for lower risk assets in order to reduce incentives to hold higher risk assets.

You can see there is still much work ahead of us. We have to make a number of value judgments, and any changes we pursue will have to be coordinated with the Basel Accord, as well as the other U.S. regulators.

An interagency Advanced Notice of Proposed Rulemaking should be released in late October. It will discuss these concepts in more detail. But, in our drive to improve our regulatory capital framework, we must ensure that the solution considers the cost of compliance to our smaller institutions. The challenge is to find the right balance between simplicity and accuracy in capital requirements, in keeping with safety and soundness, for traditional community banks. With your participation, I'm sure we'll find that balance.

Thank you.

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