REMARKS BY
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'RISK MANAGEMENT: BASEL AND BEYOND'
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Good morning. It is wonderful to be here and we're honored all of you have taken time to attend this symposium today.

This is the second symposium sponsored by the FDIC this year. The first one was in early June, in Washington, and focused on the issue of financial transparency and corporate governance. That symposium — and this one — are evidence of the FDIC's interest in timely issues that have the potential to impact our balance sheet.

In today's business world, the issues are increasingly interconnected. We have seen this summer that it doesn't take long for an accounting scandal to bloom quickly into a crisis of confidence and slumping markets. The FDIC is unique in that it has both a regulatory and a financial interest in these events. Because our balance sheet is exposed to the vagaries of the economy and the marketplace, we take these issues seriously.

We also take seriously our seat on the Basel Committee — and I would add that we are the only supervisor on the Committee that is also a deposit insurer. So we come at the new accord from a different perspective — from the context of safety and soundness, to be sure, but also from the perspective of managing the exposure on our own balance sheet as well.

We take this responsibility seriously and we owe it to ourselves to consult far and wide for the best thinking on risk management. We have come together here today — you in the audience as well as our distinguished panelists — to do just that. Financial institutions follow these issues because of the volatile global financial marketplace in which they operate. The regulators should follow them because they are an important line of defense, protecting the safety and soundness of individual institutions and the system as a whole.

We hope today's program will be as useful to you as it will be to us.

We have been talking a lot lately about full disclosure. So I'll lead by example. I am a banker from Texas who very nearly lost my bank in the crisis of the late 1980s and the early 1990s. When I look back on that era, I keep coming back to an important point: the only thing that saved my bacon was capital. My judgement was just as flawed as the folks whose banks failed. I was operating in the same regional economic slump as everyone else. Yet, I'm standing here today as a CEO whose bank did not fail because we had the necessary equity to withstand the crisis, recover and grow. So in my own experience, I have found that predicting the future is a tricky thing, and bankers - whether they are big or small - need to have a cushion to protect them from the unexpected.

Having said that, the Basel Committee is on the verge of the most ambitious overhaul of international capital standards since the late 1980s. The old 'blunt instrument' approach to regulatory capital is outdated and it is time for a change. If this agreement is implemented, the bank regulators - for the first time — will get a picture of risk from the bank's perspective — from the inside, so to speak. We will work closely with financial institutions to understand their modeling techniques, their decision-making processes and their internal controls. Following this more precise understanding of an institution's risk, we will then work together with the bank management to make a judgement about how much capital is needed to hedge against the unexpected.

While the accord is expected to impact only a handful of large international banks at the outset, Basel II brings on important issues for both the financial services industry as well as the regulatory community.

I was on Capitol Hill recently talking with some of the folks who are working on the corporate reform bill in Congress. I asked them if any of them expected, eight months ago, that they would spend the summer crafting one of the most significant overhauls of corporate oversight since the Great Depression. They had not. Just as I'll bet few of you expected — when the year began — to spend your summer handling problems brought on by the most significant erosion of investor confidence in several generations.

These were unexpected events, and they've thrown a monkey-wrench into many of our long-held notions about the market, about growth sectors, and about the underpinnings of our system of corporate governance. The unexpected is a given in our fast-moving world, and the business of risk management is built around quantifying those risks you can understand, and then leaving yourself a cushion against the unexpected. In a word, capital.

For bankers, these are not academic discussions. By its very nature, the business of banking is the business of managing risk. Banks are highly leveraged enterprises. They depend on the confidence of the marketplace and the depositor community for funding. Their ability to identify, quantify and manage their risk is the lifeblood of their business.

When we think of risk management, what often comes to mind is the ability of a given institution to manage its credit risk. Is it able to make good lending decisions? Is it able to make a profit, while minimizing the defaults in its loan portfolio? Yet, as everyone in this room knows, there are many more risks faced by financial institutions. Reputational risk is important. As are market risk, operational risk and legal risk. All of these blend together to form the 'value at risk' of a given institution and an impression in the marketplace of whether the institution is a viable going concern or leveraged beyond its means.

We know that several of these risks can be modeled with some accuracy. Others are more difficult to quantify because they rely on external events, or can be impacted by unexpected developments.

This gets me to a very important point: it is up to the senior managers of the bank to make these sorts of 'universal' decisions. The models can point us in the right direction, or quantify many of the risks in an institution, but it is up to the senior management to make a judgement about where the model leaves off and how much additional cushion to allow as a 'margin for error'.

This is not an easy task. I know this because I have made these types of decisions as a bank CEO. I was struck by a quote recently in a trade publication from Bob Tortoriello — who is on our first panel this morning. He said:

"Being the CEO of a financial institution has always been a position that has enhanced responsibilities beyond what would apply to an 'ordinary' business corporation. That's the way it is, rightly or wrongly, because of the importance of banks and financial institutions to the economy."

I agree with this assessment of a bank CEO's role. They are different, and should be held to a higher standard. We have seen, with the large-scale corporate failures in recent months, that it is well within the grasp of humankind to guess wrong, to place a bad bet, to pursue flawed strategies. What makes the difference, in this arena, are those managers who are able to read the numbers and apply them to a more reasoned world view — and, ultimately, make good business decisions. And allow sufficient margin for error. When bankers fail in this important responsibility — especially in large, complex institutions — there is potential for a major economic disruption. That's why bankers are different, and that's why systems of oversight and governance within a financial services organization are so important.

Let's talk about this new Basel agreement, and how it will work. It will be built — as many of you know — around three basic principles: risk-based capital, supervisory judgement, and good market discipline. The basic concept is to build a stronger relationship between the risk in the largest, most complex institutions, and the capital they are required to hold. This is a sensible approach, given our enhanced ability to measure risk and given the hypercompetitive world marketplace. The better and more productive allocation of capital is the cornerstone of the free market system and we should pursue opportunities, as regulators, to enhance that.

But the devil is often in the details. And, in the case of Basel there are many, many pages of details.

First, let's look at the modeling. Bankers have always used risk modeling though we haven't always called it that — every generation brings on new terms for age-old devices.

The notion of lending money for interest is as old as recorded history, and I will bet you that even before recorded time lenders found ways to eyeball potential borrowers to find out if they were good for it. More recently, bankers relied on relationship, or reputational banking - lending money to people who had a good track record with the bank, had a reputation for repaying debts, or knew someone who did. In this century, we referred to this as the 'Five C's' — Character, Capacity, Capital, Collateral, and Conditions. The Five C's were an attempt to name and quantify the elements that made up a banker's understanding of the borrower and gut instinct.

In the last 30 years or so, banking organizations became more complex and the allocation of credit became more impersonal. In the credit card market, for example, there is no way bankers can personally know and attest to their customers' ability to repay. This — along with the sheer volume of credit demands — made it necessary to develop alternative ways to understand the risk of default. Firms began using credit reports and FICO scores to evaluate potential customers and control the risk on their books.

These innovations bred still more complexity. Financial entrepreneurs, spurred on by demand in the marketplace, found innovative ways to study the demographics, the FICO scores, and the default ratios to build profitable businesses in niche markets. Sometimes these entrepreneurs found ways to model an 'enterprise value' that worked wonderfully in theory but performed badly in the real world. We know this at the FDIC because we have sometimes had to come in to clean up the mess.

On the other hand, many institutions — including many people in this room — found ways to use the data generated over hundreds of thousands of loans and borrowers to get a better sense of the overall risk in their businesses. Indeed, as financial institutions have grown larger through consolidation and more complex across their business lines, modeling can be an effective means of keeping track of the risk in the bank at any given time.

When thinking about this widespread use of models, I would make a few observations. The integrity of the data inputs is crucial. At the FDIC, we have struggled with this as we have attempted to model scenarios on the receiverships and resolutions side of our business. We have found that the debates over the proper inputs and weighting can be difficult — and indeed small differences on the input side can produce wide variances in output.

Further, our bank examiners are accustomed to evaluating loan portfolios under the existing asset classifications: substandard, doubtful and loss. It will be a bit of a culture change for our folks to provide definitive opinions on the parameters and accuracy of the internal ratings models used by banks. It is for these reasons that we are interested in forming a closer partnership with the regulated institutions to ensure that we can properly make these evaluations and ensure that the data fed into the models produce good results and viable options for the decision makers.

But I would stress — here's the Texas banker coming out again — that there is some potential for models and assumptions to be flawed. There is also the occasional tendency toward optimism in modeling, as well — especially during long economic expansions. To address this, we must have good capital backstops, beyond the minimums computed by the models, to ensure the continued confidence of the marketplace and the protection of the system as a whole.

This is something all of us in the Basel process have agreed on. In my view, it is the part of the process we simply must get right. The models are wonderful as far as they take you; but the judgement and decisionmaking on overall capital will determine whether we have an industry that is overleveraged or one that can maintain the confidence of the market over the entire economic cycle. Indeed, if we allow the capital cushion to be determined solely by models, we could well end up with a system in which capital levels that are very low during good times and very high during times of economic difficulty. This would be disruptive. It is critical we exercise good judgement in determining proper cushions over the entire cycle.

These judgement calls will not always be easy. There will be great debates between the modelers, the management and the regulators about what the appropriate capital levels should be. That sort of healthy tension is not always bad. But for the system to work as it is envisioned, the relationship between the regulators and bankers is going to have to change in very fundamental ways.

On the regulatory side, we are going to have to develop a better and closer understanding of bankers' business priorities, modeling techniques, and what they're attempting to accomplish in the marketplace. Bankers, on the other hand, are going to have to look beyond their own interest and understand the priorities of the regulatory community — those being safety, soundness, systemic stability, and public confidence in our economic institutions. This transition will not be entirely smooth, but I can tell you that we're going to have to develop this sort of relationship if this new era of capital regulation is going to be successful.

I often talk to bankers about the banker/regulator relationship. It is a relationship that must be built on competence, mutual respect, and timely communication. I often talk about how we both have the same goal — a healthy, safe, and sound industry. This is all true — and then some — when it comes to implementing this proposed new accord. I believe we are making some progress on this new relationship in the development of Basel II. This trend must continue as we move toward implementation.

We both have a lot of work to do in the four years or so between now and when this new accord will likely take effect. The banking agencies will be working hard to develop our expertise and our evaluation techniques between now and then - and we at the FDIC will do all we can to ensure we are equipped to provide reasoned, independent judgements and evaluations. This is too important an exercise for us to behave any differently.

A final critical element to making this accord a success will be the marketplace itself. In fact, it might be the supervisors' best friend. If we've set the capital requirements too low, the markets will require more — but only if they have good information to rely on. One of the critical elements of the Basel accord — and one that hasn't been talked about very much — is the principle of disclosure and market discipline.

In some cases, under the new regime, disclosure will have to be enhanced and the ensuing market discipline will serve as an additional line of defense against poor judgement, a faulty strategy, or a flawed assumption. But we regulators have to be disciplined about how we approach this. There is a balance to be achieved here and we should work together with the industry to find it.

So let's get to work. The FDIC will form a working group made up of members of the financial services industry and the regulatory community. This group will work together to recommend a disclosure policy around four principles:

- First, it should provide the markets access to important and timely information so investors can make sound decisions and impose market discipline;
- Next, this policy should enhance the safety, soundness and stability of the financial system;
- Next, the policy should ensure we maintain a level playing field on disclosure between U.S. banks and their overseas competitors, and;
- Finally, the new disclosure regime should ensure the proper and timely implementation of the proposed new Basel capital accord.

Much work has been done in this area. The Shipley Report is one example of the industry and the regulatory community working together to develop a voluntary disclosure framework. We must continue our joint efforts to ensure both the regulators and the affected banks understand exactly how we intend to implement the new Basel accord's disclosure regime.

The FDIC will pursue this effort for several reasons. First, we believe the markets can provide a valuable assist when it comes to evaluating and pricing the risks in the banking sector. Second, the FDIC has the authority — under the FDIC Improvement Act — to require certain disclosures for all insured financial institutions. As our working group reviews these issues, we are interested in hearing from all interested parties. Our goal will be to make sure the interests of all parties are protected as we move forward into this new era of capital regulation.

All of this is intended to better define, understand, and manage the healthy tension that will always exist between risk taking in the financial marketplace and the capital cushion underpinning the business of banking. I understand the competition, the pace, and the technology that allows financial institutions to make their risk evaluations more precise. But I also know, from hard won experience, that beyond the modeling data lies a judgement call that the senior managers and supervisors must make: how much capital is sufficient to protect confidence and stability? I know, from hard won experience, that when it comes time to restore trust and inspire confidence, capital that once seemed to be excess suddenly becomes invaluable. And I know from hard won experience that when times get tough, there is sometimes a tremendous difference between ability to pay and willingness to pay. Sometimes the best hedge against the unknown is plain old equity and money in the bank.

So let's venture into this new era in a spirit of partnership, cooperation and mutual respect. But let's also make sure we're also putting in place safeguards to protect ourselves from the unpredictable things that occasionally happen in life.

Basel's success will depend on it.

Thank you. Enjoy the conference.

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