Chairman Donald E. Powell
Federal Deposit Insurance Corporation
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Good morning. It is a privilege to be here and I am honored you asked me to speak to you today. I appreciate the fact that so many of you took time out of your busy schedules to come to Washington and participate in this gathering. Some of you came from great distances to be here and it is good to see you.

There are many different perspectives represented in this room. Economic conditions around the world are not identical. The business of banking is conducted, and regulated, in different ways around the world. My perspective is that of a former banker who has experienced both boom times, and devastating local economic conditions. Based on my experience as a banker and a regulator, I know how regulators relate to banks, and I can tell you that relationship is not the same during the boom as it is during the crisis. Today I want to share some ideas about striking the right regulatory balance, and the challenge of regulating banks during expansionary times.

My idea of good regulation is straightforward. Ensure adequate capital, enforce the laws, but do not over-regulate. My remarks today will simply elaborate on what this should mean for regulators, particularly during expansionary times.

This topic is relevant because the economic expansion in the United States that began several years ago is picking up steam. Economic growth accelerated during 2003 to more than 3 percent – and came on strong particularly in the last two quarters of the year. Growth was more balanced, investment picked up, and trade balance was improved to the point where exports are now growing faster than imports.

As we settle into this period of economic growth, U.S. banks are performing at record levels. The banking industry reduced provisions, improved efficiency and improved gains on asset sales, offsetting margin compression, and banks are posting record earnings. Asset quality remains strong and has remained so throughout the recent recession, disproving the old adage I was taught that banks mirror the overall economy. Further, it is important to note that capital ratios – a critical concern for us at the FDIC – remain at record levels.

While there are many reasons why U.S. banks have fared so well through the recent recession, one set of factors merits particular attention – namely, the legislative and regulatory changes that eased regulatory barriers in this country and allowed our banks to diversify their income streams. Diversification of the income stream clearly helped buffer credit losses during the recent recession. The aggressive use of technology and the growth of nationwide credit provision have opened up remarkable avenues for bankers and customers to design, market and consume new banking products and services. As the industry consolidates – and the press for a truly nationwide banking platform continues – banks are using the resulting economies of scale and scope to provide services to their customers in new and profitable ways. Bank managers have capitalized on all these developments to transform their business and are well-positioned to enter the next economic expansion.

As we look to the future, we see continued great opportunity for banks in the marketplace, a continued pace of breathtaking change, and a new view of how we regulate that most fundamental indicator of banking confidence and stability: capital. All of this raises an important question for policymakers and regulators alike: what policies should we pursue to ensure the stream of great news out of the banking sector continues? How can we ensure that great market experiments are allowed to happen – but without endangering the stability of our financial system?

In short, what should be the broad contours of the regulators' policy agenda during the next expansion?

Perhaps the greatest challenge for regulators is deciding when to step in and when to stand on the sidelines. And as institutions grow larger and more complex, the stakes involved in that decision – the consequences of ill-conceived action or inaction – are greater than they have ever been. Striking this regulatory balance is not easy. In many ways an economic expansion is the most challenging time for bank regulators. During crisis, the urgency of the demands from elected officials and the restive marketplace ensure supervisors are highly attuned to the importance of the fundamentals – strong capital, sound asset values, proficient management and a solid business plan. We are more inclined to look under rocks, question assumptions, and look at the mechanics and motivations behind major decisions.

By contrast, during expansions there can be a tendency for supervisors to be less assertive about bedrock capital, asset valuations, and the assumptions underlying profitable lines of business. It can be much more difficult, during good times, for supervisors to come into the bank in an adversarial role and demand change when times are good and risks seem few and well-managed.

None of this is to say that regulators go away during good times. Far from it. At least here in the U.S., we continue to issue reams of paper instructing banks on how to run their businesses – describing guidance for this or that, issuing reminders of best practices, responding to whatever the latest scandal may be.

There is a tendency for these things to become the primary manifestation of regulatory presence during an expansion and I would argue that it is exactly the opposite of what we should be doing. In my view, we should issue fewer pieces of paper telling banks how to govern themselves, and instead spend more effort on ensuring capital adequacy and sound asset values, and enforcing the laws and regulations we do have. We should be questioning the underlying assumptions of the marketplace and ensuring banks are prepared fundamentally for the day when some of those assumptions may prove unfounded. For example, are banks prepared if the current trends in housing values were to flatten or even reverse themselves? What are the long-term ramifications of consumer lending strategies that de-emphasize repayment of principal in favor of fee generation? Are information-based credit-scoring or economic capital allocation strategies based upon reliable information? Such questions may not seem urgent in the face of strong growth and expansion, but a supervisory regime that does not ask such questions risks fueling the next crisis.

I believe expansions – and the favorable winds of growth and profit – should be seen as an opportunity for balance sheet housecleaning. Removing the questionable items and strengthening the fundamentals of your business will limit the severity of the next crisis – whatever it may be – and will diminish the likelihood of punitive legislation that reforms, in a very detailed and prescriptive manner, all the things we failed to address when times were good. If you don't believe this is true, just ask those in the accounting profession. Or the mutual fund profession. Or the investment banking profession. We've seen numerous examples in the past few years of industries that were so caught up in the euphoria of the bull market, the Internet, the IPO boom, whatever – that they failed to get the fundamentals right. The consequences are greater regulation and less flexibility.

What, exactly, does "getting the fundamentals right" mean in the context of banking? Here are some ideas for consideration.

First, we should clean up our definition of capital. Over the past ten years, we have allowed a variety of hybrid capital instruments into tier 1 capital that have significant attributes of debt. Trust-preferred securities, REIT-preferred securities and others have enabled banking organizations, through a complicated set of engineered transactions, to convert what is essentially debt into an entry shown between liabilities and equity on these organizations' balance sheets. As many of you know, recent changes in U.S. GAAP are causing many of these instruments to be explicitly labeled as liabilities on financial institution balance sheets. In my view, regulators should take advantage of this external stimulus and begin the process of strengthening our definition of tier 1 capital.

The capital negotiations in Basel are trending toward the notion that capital exists to absorb unexpected loss – and, accordingly, we should ensure, both domestically and internationally, that we allow into tier 1 only those instruments that are available to absorb unanticipated loss on a going-concern basis. Harmonizing a cleaner definition of regulatory capital may not, of course, be an easy process or one that can be completed quickly. Why should we do it? First, converging on a cleaner definition of capital is fundamental to achieving internationally a uniform regulatory solvency standard. Second, it can become more difficult over time for regulators to wean the financial system of a dependence on these second-tier capital instruments. At some point the financial costs of a clean-up become persuasive arguments for inaction—but if a clean-up is needed, there is no time to begin like the present.

Another item for our consideration today is the importance of getting the Basel II agreement right. In many ways this agreement is about codifying the best practices in risk management – practices the market rightly demands of large, sophisticated banking organizations. Basel II should put us on a path toward better risk management, better transparency, and better methods for both bankers and regulators to differentiate, and provide capital for, relative levels of risk. There are some near-term technical issues to be dealt with before we can prepare the agreement for a final round of tests. Many of you know what they are – the treatment of retail credits, the treatment of securitizations, and credit risk mitigation, among others. Longer term issues, more process oriented, include ratings validation, interagency cooperation, home-host supervision issues, and the treatment of non-Basel banks in the United States. I have no doubt we have both the will and the means to work constructively to address these issues – and the FDIC is working with our fellow Basel Committee members to achieve workable solutions to all these problems.

But there is a bigger issue at play in the Basel II discussions that transcends the day-to-day negotiations for us – and that is the matter of capital adequacy. What impact will this Accord have on the overall levels of capital in the largest U.S. banking organizations? And, more specifically, what impact will this agreement have on the framework of capital regulation here in the United States?

Some issues that seem purely technical could have tremendous consequences in terms of overall levels of regulatory capital. In order to get to an adequate level of capital, the Basel II agreement assumes that institutions will input a “stressed” loss severity into the formulas. Because the Basel models do not account for the fact that loss severities rise during recessions, we are counting on banks to calculate and input the stressed loss severities for us. Yet we have heard loud and clear from banks that they are extremely concerned with the burden, the subjectivity, and what they view as the excessive conservatism of requiring them to compute stressed loss severities.

The use of an appropriately conservative set of risk inputs is absolutely crucial to the soundness and long-term success of the Basel II capital formulas. If banks were merely to use risk inputs that correspond to an average of historical loss rates, our analysis indicates that the Basel II formulas would result in risk-based requirements that are well below those currently existing. Given the potential for these formulas to affect considerable reductions in capital requirements, we must be sure that any such reduction is warranted based on banks’ underlying risk profiles, and is not merely the result of specific modeling assumptions or use of risk inputs that do not adequately capture the possibility of economic stress.

Accordingly, in the home stretch of the development of Basel II, we are focused on finding a way to ensure the use of appropriately conservative bank risk inputs, in a way that balances the interests of bank supervisors, our own interests as deposit insurer, and the legitimate comments and concerns of banks. This is a threshold issue for the FDIC. Marginal capital charges under Basel II’s advanced approaches are highly dependent upon assumed risk inputs, and developing a satisfactory process for determining those inputs is a prerequisite to any agreement that the FDIC would endorse. We are working closely with our fellow U.S. regulators and the other member countries of the Committee on this issue and have every reason to believe it will be resolved successfully.

And what about the U.S. leverage ratio? A number of banks and trade associations have argued that Basel II makes it obsolete. I would say the opposite. Basel II makes the leverage ratio more important than ever. Economic capital is a statistical construct that is measured by human beings. Its estimation necessarily involves simplifying assumptions, some degree of reliance on historical data, and some narrowing of the scope of inquiry. In short, we only measure a subset of risks and we measure them imperfectly. Consequently, minimum capital requirements to address these residual risks will always be a critical part of any risk based capital regulation. This belief has animated the FDIC's view of Basel II from the beginning.

Other countries may address this issue of residual risk and modeling uncertainty exclusively through their process of bank supervision. That is their prerogative. We do expect, however, that the reader of the new capital Accord should be able to find conceptual support for a cornerstone of U.S. supervisory and regulatory policy. I am not aware of any disagreement within the U.S. regulatory community on this point and I am confident this issue can be resolved to the satisfaction of all Basel participants.

Looking to the future, we fully expect that there will be a robust debate in the U.S. about what the right level of the leverage requirements should be. We will welcome that debate, and we expect that the result will be a regulatory framework that combines Basel II with the U.S. Prompt Corrective Action framework, including a set of leverage requirements, in a way that greatly strengthens the U.S. financial system.

Thus far, I have been largely concerned with the FDIC's agenda in the area of capital regulation. I now turn to the subject: "what is in this for you?"

I have long held the view that the marketplace should drive innovation in the financial services sector – and the role of the regulatory community is to ensure financial stability is maintained and the taxpayer is protected from undue risk. And it is the innovations of the marketplace that will be the continued lifeblood of the financial services sector. Speaking at a very high level, the fact that banks in the U.S. remain subject to the rigors of Prompt Corrective Action is an important reason why we regulators might justify tolerating an even greater degree of market innovation than if our banks were allowed to fly much closer to the ground in terms of capital.

As I think about this, I can imagine a world in which financial institutions are engaged with financial markets, with financial firms, and with commercial firms, in ways none of us can currently envision. These combinations could conceivably lead banks to perform their intermediary function, and serve their customers, in ever more efficient and cost-effective ways. That world makes sense to me—and purely from a safety and soundness standpoint I can support it— but only if the underpinnings of that innovation is a sound and well-protected base of capital.

This is important because, even as we move forward with Basel II, there will be countless implementation decisions to make, many of which will center around the amount of discretion banks have to solve business problems for themselves. The greater assurance U.S. regulators have, through our Prompt Corrective Action requirements, for example, that we are not handing over all of the keys to bank capital, the more we can and should put the onus of making detailed business judgments where it belongs—on you, the bank management.

It is important, as well, to use the good times here in the States to do all we can to reduce regulatory burdens on the industry. That is why the FDIC volunteered to take the lead on a U.S. interagency project to reduce regulatory burden. The Economic Growth and Regulatory Paperwork Reduction Act—EGRPRA—requires the U.S. bank regulators to conduct a periodic review of regulation for the purpose of identifying unnecessary or unduly burdensome regulations, and eliminating or simplifying such regulations as appropriate.

Cleaning the regulatory stables is important, but we must also be aware, going forward, of this question of burden when we consider new regulations. We cannot enact new rules simply because they seem like a good idea, or because they appear to be responding to the latest headline in the newspapers. Our regulatory actions should be directed at those areas that pose the greatest risk to the safety net and achieve the highest levels of public good. Regulation as a proxy for public relations is an ill-fitting suit, and the cumulative impact of these rules could raise the barriers to entry into the business of banking and leave us with a less vibrant and consumer focused industry.

In short, the challenge will be to strike the right balance during the next expansion: Do not over-regulate, but do ensure adequate capital. If we get this right, our industry is well-positioned to innovate, prosper and serve its customer base in ways we cannot even imagine today.

Our industry has undergone an amazing transformation of size, scope and complexity in the past two decades that has left it more secure and more stable than it has ever been. This has brought benefits to bank customers, profits to shareholders, and acclaim to bank management. Properly so. Let us all commit to using this time of good fortune to shore up our balance sheets and do the fundamental housecleaning necessary to ensure this amazing transformation continues and that banks continue to lead our economy forward.

Thank you for the opportunity to speak to you today.

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