Remarks by
Sheila C. Bair, Chairman,
Federal Deposit Insurance Corporation;
before the
Conference on International Financial Instability:
Cross-Border Banking and National Regulation; Federal Reserve Bank of Chicago and the International Association of Deposit Insurers;
Chicago, Illinois
October 5, 2006

Good evening. It is a pleasure to be here tonight. I would like to thank President Moskow and Chairman Sabourin for inviting me to speak this evening. I would also like to thank Doug Evanoff and George Kaufman for putting together an excellent program.

The topics of this conference -- cross-border banking and national regulation – affect financial stability and public confidence, two things the FDIC stands for at home and seeks to foster abroad. Tonight I would like to talk about three areas the FDIC views as critical for ensuring global stability and confidence: strong international capital standards, credible deposit insurance systems and an international strategy for large bank resolution.

Significant progress has been made in improving international standards for effective prudential supervision. These improvements have not, however, eliminated the potential for banking crises to occur. When crises arise, such as the Asian crisis of 1998, the economic costs and dislocation are significant, with implications for growth and stability not just in the region, but around the globe. For example, in Indonesia, the country perhaps the hardest hit by the Asian crisis, 83 out of their 228 banks were closed and, by the end of 1998, nonperforming loans peaked at 57 percent of total loans. As a consequence, Indonesia experienced a seven percent decline in its GDP.

In addition, banking crises in one country can spill over to others. For example, in 2001 the financial system in Uruguay was not initially affected by the exchange-rate crisis in neighboring Argentina. However, when severe withdrawal restrictions were imposed on bank customers in Argentina, many turned to their accounts in Uruguay, precipitating a bank run there. The subsequent collapse of the banking system in Uruguay ultimately led to widespread unemployment and a 20 percent decline in the country's GDP.

As these experiences illustrate, banking crises have very real effects on domestic economies and the global marketplace. Crisis prevention and containment depends on strong national regulation and international cooperation and coordination. The first place to start is with capital.

Basel II and the Importance of an International Capital Standard

For the past three days I have been in Mexico attending the biennial conference of National banking supervisors. The conference focused on the core principles for effective banking supervision and their importance in protecting banking safety nets worldwide. So of course, we spent a lot of time talking about capital.

As you know, on September 5, the FDIC Board of Directors, along with the other federal banking regulators voted to publish the Basel II Notice of Proposed Rulemaking for public comment. In conjunction with Basel II, U.S. bank and thrift regulators also are developing a more risk sensitive capital framework for non-Basel II banks, known as Basel IA, which we hope to publish for comment in the near future.

It is appropriate and necessary that we move forward with the Basel II process. While views and opinions differ about the changes that may be needed, there is one area where I believe there is much common ground: The implementation of Basel II must not result in significant reductions in capital or in the creation of competitive inequities among different types of insured depository institutions.

I look forward to receiving the comments on the NPR and I will approach them with an open mind. I am particularly interested in comments on the question of whether the regulators should allow alternatives to the Advanced Approach. The U.S. is the only country proposing to make the Advanced Approaches mandatory for some banks. Several large banks have asked to be allowed to use the Basel Standardized Approach for calculating their requirements.

The Standardized Approach links risk weights to external ratings and includes a greater array of risk classes than are included in the current rules. It is simpler and less costly to implement than the Advanced Approach. In addition, because there is a floor for each risk exposure, it does not provide the same potential for dramatic reductions in capital requirements and therefore would not pose the same issues about competitive inequity. On the other hand, there is the argument that only the Advanced Approach provides an adequate incentive for strengthening risk measurement systems at our largest banks. Whether our largest banks should be required to use the Advanced Approach is an important policy issue.

I will support implementing the Advanced Approach only if I can develop a comfort level that strong capital levels will be preserved. In addition, I have an open mind regarding the possibility of allowing a U.S. version of the Standardized Approach as an alternative option for implementation of Basel II in the U.S.

In my view, no discussion of capital can be complete without a few words about the leverage ratio. The FDIC has consistently supported the idea that the leverage ratio—a simple tangible capital to assets measure—is a critically important component of our regulatory capital regime. I am pleased that all the U.S. bank regulators have expressed their support for preserving the leverage ratio. I appreciate that banks in most other Basel Committee countries are not constrained by a leverage ratio and that effective capital standards around the world vary widely as a result. Indeed, if large European banks were subject to the leverage ratio mandated by U.S. Prompt Corrective Action standards, several would be categorized as undercapitalized.

For this reason, in testimony before the Senate Banking Committee and during the meetings this past week in Mexico, I raised with my colleagues the issue of international supplemental capital measures, such as a leverage ratio. The leverage ratio provides U.S. supervisors with comfort that banks will maintain a stable base of capital in both good and bad times. I appreciate that other countries have different approaches to supplemental capital measures, and I look forward to learning more about them. Several countries face the prospect of double digit drops in risk based capital for many of their large banking organizations under Basel II's advanced approaches. As Basel II moves forward, the question of supplemental capital measures such as a leverage ratio will assume greater importance. I look forward to further discussions with the Basel Committee and the larger international community on this question. Deposit insurers, in particular, should be part of this debate, given the importance of capital as a first line of defense against bank failures. We need a minimum cushion of capital for safety-and-soundness throughout the global banking system.

The Importance of Establishing a Deposit Insurance System

While capital can help prevent a financial crisis, an effective deposit insurance system can mitigate its affects. The lessons of past banking crises have demonstrated the importance of developing legal procedures for efficiently closing banks and having a system in place for paying off depositors and creditors. These are some of the most important and least-recognized benefits of establishing an explicit, limited-coverage deposit insurance system. Countries without systems in place tend to resort to ad hoc strategies when banks fail. In these cases, countries are often faced with unfortunate options, such as providing guarantees to all depositors and creditors, usually at 100 percent; delaying problem bank resolution to the point where a single bank failure is transformed into a larger event; or forbearing on problem bank resolutions and thereby increasing moral hazard and the likelihood of future crises.

Coordination and Cooperation among Deposit Insurers

When it comes to designing and maintaining effective and efficient deposit insurance systems, countries can benefit from the collective knowledge and experience of two important groups: the International Association of Deposit Insurers and the European Forum of Deposit Insurers. Both were formed in 2002 to enhance deposit insurance effectiveness and promote cooperation among deposit insurers and other safety net players. Currently, these associations have a combined membership of 94 deposit insurers.

Over its short existence, IADI has set out much useful guidance—taking into account each country's different circumstances, settings and structures. It has facilitated the sharing and exchange of expertise and information on deposit insurance issues through training, development, and educational programs. And IADI has undertaken specialized research on operational issues relating to deposit insurance.

As you can see, what IADI brings to our efforts on crisis prevention and response is unique: the collective experience and hands-on learning of the world's deposit insurance practitioners. This is scarce knowledge that we cannot afford to ignore.

Cross-Border Risks and Resolution Issues

The final key to global stability and confidence is an international strategy for large bank resolution. I would like to take a few minutes to talk about the challenges involved in resolving large bank failures and our efforts to address them.

Banks are taking advantage of technology and increasing international trade to expand their businesses and geographically diversify their risks. As many speakers at this conference have noted, this increase in cross-border banking could present significant deposit insurance and bank resolution issues.

Currently, there are few formal agreements between countries on how to deal with the failure of a large international bank. If a failure occurs an "every country for itself" scenario could easily be envisioned. Legally binding multi-lateral agreements on the treatment of failed bank creditors could be useful in a crisis but may be difficult to attain. Progress can be made by working cooperatively at the staff level of relevant agencies within each country. These discussions can be used to acquaint each party with the relevant laws and procedures in other countries and, potentially, to yield agreements between countries regarding the exchange of information and protocols that can be used during a crisis.

Concluding Remarks

Financial stability and public confidence are two things that are easy to take for granted until they are tested. Strong and fair international capital regulation, well-constructed deposit insurance systems and an orderly and collaborative approach to a large international bank failure are three cornerstones to preserving stability and confidence on the global stage. I look forward to working with all of you to reduce the likelihood of a banking crisis and to improve our collective ability to respond to one. Thank you.

Last Updated 10/06/2006