Remarks
by
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FDIC to CSBS 2006 Annual Meeting and Conference
May 19, 2006

Thank you for that very kind introduction. I am delighted to be here at the CSBS 2006 Annual Meeting and Conference.

As you know, I worked for many years on Capitol Hill for the Senate Banking Committee and interacted often with CSBS and its outstanding team, including Neil Milner, John Ryan, Buz Gorman and Leslie Woolley. I have always had the highest regard for CSBS and the critical role that state banking supervisors play in our system of banking regulation. In that regard, it has been a very comfortable shift for me to go from the Committee to the FDIC, which has traditionally had a close working relationship with CSBS in our role as the primary federal supervisor of the majority of community banks in the United States.

Before I come to my principal topic this morning, I would like to say a word of appreciation about two outstanding state banking supervisors, John Ducrest of Louisiana and John Allison of Mississippi, for the extraordinary leadership they have provided to the community banks in the Gulf Coast region that were heavily impacted by the hurricanes. This has been a matter of particular interest to the FDIC since the majority of those community banks are state-chartered, non-member institutions for which the FDIC is the primary federal supervisor, as well as the deposit insurer. I would like to thank John Ducrest and John Allison for their remarkable efforts and for the exceptional cooperation they have provided the FDIC.

Today I would like to take a few minutes to share with you some thoughts on an issue that holds great consequence for the safety and soundness of the United States banking system -- the Basel II international agreement on bank capital. I will also comment briefly on Basel II's relationship to Basel IA, which I know is of great interest to you as well. As the federal deposit insurance agency for all U.S. banks and thrifts, the FDIC has a keen interest in the capital adequacy of the institutions it insures.

As you know, the four federal bank and thrift regulatory agencies – the Federal Reserve, the Comptroller of the Currency, the Office of Thrift Supervision, and the FDIC – have reached agreement on a notice of proposed rulemaking to implement Basel II. The NPR, as it is called, is currently undergoing review by the Office of Management and Budget , which is required for the OCC and the OTS since they are Treasury agencies. Once that review is complete, the four agencies are expected to publish the NPR and put it out for public comment for a 120- day period, along with the proposed reporting requirements and changes to the market risk rules. The draft NPR was actually approved at a meeting of the Federal Reserve Board in March, so it has been out for public review.

I would like to make the starting point for my remarks today the enactment of the Federal Deposit Insurance Corporation Improvement Act of 1991, known as FDICIA. That law established for the first time statutory requirements for both risk-based capital and the so-called leverage ratio, and a system of prompt corrective action to enforce capital requirements. The law was a response to both the thrift crisis and the severe problems encountered by the commercial banking industry in the late 1980s.

It is worth examining the experience of the U.S. bank and thrift industries since the enactment of FDICIA. There has been a steady rise in both the capital levels and the profitability of federally insured banks and thrifts since FDICIA's enactment in 1991. In fact, both bank capital and bank profitability are at or near historic highs today.

There are three conclusions I draw from these facts and recent experience. First, strong bank capital and bank profitability are not incompatible. Second, our banking system right now is in very good shape and stands on a foundation buttressed by this strong capital and enhanced profitability. Third, the current capital position of the U. S. banking system is an important strength that has been built up during an extended period of economic growth and should be preserved as a cushion for when economic conditions are not as favorable as today. I think these are important points to keep in mind as we consider making changes in bank capital requirements.

Like FDICIA, Basel I addressed regulatory concerns regarding capital adequacy.

Basel I, which of course was the predecessor to Basel II, was adopted in 1988

in response to the erosion in the capital base of large international banks here and abroad that coincided with the severe emerging market debt crisis of the 1980s. In this context, bank supervisors from the major industrial countries sought to set international standards for the capital increase required to maintain confidence in the international financial system and to support banks' off-balance sheet activities that circumvented simple asset-based measures of capital adequacy. It was also an effort to introduce risk sensitivity to capital regulation. Basel I addressed these issues in fairly simple ways that had the overall effect of raising capital levels internationally and in the United States.

The impetus for Basel II was the view that Basel I, with its four-bucket approach to risk management, was insufficiently risk sensitive and created incentives for banks to engage in capital arbitrage – keeping high-risk assets and selling off low-risk assets, which under Basel I received the same capital treatment. Conceptually, Basel II was based on the premise that regulatory capital for the large, complex, internationally active banks needed to be tied more closely to the internal risk-based models that the institutions were developing to measure their economic capital. The view was that they would more accurately measure the risks to the institutions and improve their safety and soundness.

Developing agreement among the Basel Committee member countries and implementing Basel II has proved to be a daunting task that is now in its seventh year. It is important to recognize that the premise for the agreement from its inception was that it would broadly maintain the aggregate level of risk-based minimum capital requirements. In 2004, the Basel Committee on Banking Supervision summarized its goals regarding capital adequacy as follows: "The Committee believes it is important to reiterate its objectives regarding the overall level of minimum capital requirements. These are to broadly maintain the aggregate level of such requirements, while also providing incentives to adopt the more advanced risk-sensitive approaches of the revised framework."

The purpose of the agreement is to improve risk management by the largest internationally active banks without a significant reduction in aggregate risk-based minimum capital.

It was because of that commitment to preserve capital that the regulatory agencies were so concerned over the results of the most recent U.S. Quantitative Impact Study, known as QIS-4, which was conducted last year with a group of the institutions that are expected to participate in Basel II. The QIS-4 results showed a decline in aggregate minimum risk-based capital of 15.5 percent. The median decline was 26 percent, with one participating institution realizing a decline of nearly 50 percent. Tier 1 capital requirements, of critical importance from a safety and soundness perspective, declined by 22 percent, with half of the institutions reporting reductions in those capital requirements of more than 31 percent. Almost all of the participants reported minimum Tier 1 capital requirements that would be prohibited under current prompt corrective action requirements.

The results of QIS-4 were viewed by all the bank regulatory agencies as unacceptable. The QIS-4 numbers resulted in a pause by the agencies in moving forward with the Basel II process. The agencies ultimately announced an agreement on September 30 of last year on a plan that provided for safeguards and a longer transition period, specifically a one-year parallel run for Basel II in 2008 and then a three-year implementation period from 2009-2011. The three-year implementation period provided for certain prudential safeguards including floors on how much risk-based capital could fall for any given participating institution of 5 percent in the first year, 10 percent in the second year, and 15 percent in the third year. The agreement also stated that the agencies anticipated that there will be further revisions to the Basel II-based capital rules prior to the termination of the floors, and that the agencies will retain both the existing prompt corrective action and leverage capital requirements in the proposed domestic implementation of Basel II.

With that framework in place, the agencies proceeded to work on reaching agreement on a notice of proposed rulemaking for Basel II. I would briefly like to review the overall capital objectives contained in the NPR with you because, in my view, they lay out the fundamental principles for proceeding with Basel II in the United States.

First, the NPR states that the agencies remain committed to the objective contained in the underlying Basel II Accord of broad maintenance of the overall level of risk-based capital requirements while allowing some incentives for banks to adopt the advanced approaches. The NPR also states that were the QIS-4 results produced under an up and running risk-based capital regime, "the risk-based capital requirements generated under the framework would … be considered unacceptable."

Second, the NPR identifies a 10 percent downward limit on aggregate reductions in risk-based capital requirements that if exceeded will trigger regulatory changes. The NPR states:

"If there is a material reduction in aggregate minimum regulatory capital requirements upon the implementation of Basel II-based rules, the agencies will propose regulatory changes or adjustments during the transitional floor periods…In any event, the agencies will view a 10 percent or greater decline in aggregate minimum required risk-based capital…as a material reduction warranting modifications to the supervisory risk functions or other aspects of this framework."

Third, the NPR provides that the agencies will carefully consider during the transitional floor periods whether dispersion in risk-based capital results across banks and portfolios appropriately reflects differences in risk. In addition to the impact on aggregate minimum risk-based capital, the QIS-4 results indicated unacceptable levels of capital dispersion among the participating institutions for assets with comparable risk. A conclusion by the agencies that dispersion in risk-based capital requirements does not appropriately reflect differences in risk could be another possible basis for proposing regulatory adjustments or refinements during the transitional floor periods.

Fourth, the NPR provides that regulatory changes will be made, including fundamental changes if necessary, to address competitive effects of differential capital requirements between institutions that participate in Basel II and those that do not participate. This is a critically important point, in my view. The purpose of Basel II was to improve the risk-sensitivity of U.S. capital requirements. It was not intended to have a significant impact on the competitive relationship between institutions that participate in Basel II and those that do not participate. Basel II should not tilt the playing field toward either group. The NPR makes clear that the agencies will be prepared to make fundamental changes in the framework, if necessary, to address this issue.

Finally, the NPR reaffirms the commitment of the agencies to preserve the current leverage ratio and the current system of prompt corrective action under Basel II. The NPR states,

"The agencies reiterate that, especially in light of the QIS-4 results, retention of the Tier 1 leverage ratio and other existing prudential safeguards (for example, PCA) is critical for the preservation of a safe and sound regulatory capital framework. In particular, the leverage ratio is a straightforward and tangible measure of solvency and serves as a needed complement to the risk-sensitive Basel II framework based on internal bank inputs."

I believe these are a sound set of objectives on which to proceed with the NPR – broad maintenance of the overall level of risk-based capital requirements; a 10 percent downward limit on aggregate reduction in minimum risk-based capital; comparable capital requirements for similar portfolios to minimize dispersion; a level playing field between institutions that participate in Basel II and those that do not; and retention of the leverage ratio and prompt corrective action.

I would like to conclude with these final thoughts. Some may question the prudential safeguards that the agencies have put in place for the proposed implementation of Basel II as unduly restrictive. In this regard, it is important to remember that the agencies chose to go forward with the NPR utilizing the same formulas for credit risk that produced the clearly unacceptable QIS-4 results. The agencies view the parallel run and transitional floor periods as a trial of the new framework under controlled conditions. The belief was that the best way to assess the impact of the formulas would be to implement them, subject to controls. The agencies hope that, through improved inputs from the participating institutions and with supervisory guidance from the agencies, more acceptable results will be produced. But that is a hope, and it seems to me these safeguards are highly appropriate.

In addition, in my view the 10 percent downward limit on aggregate minimum risk-based capital reduction is an important safeguard not only to preserve overall capital under Basel II, but also as a means to keep the relative impact of Basel II and Basel IA within manageable limits. The agencies are in the process of reviewing the comments on the Advanced Notice of Proposed Rulemaking (ANPR) issued by the agencies on Basel IA, which is intended to produce a more risk-sensitive system of capital regulation for institutions that do not participate in Basel II. The comment letter submitted by CSBS on the Basel IA ANPR notes that it seems unlikely that Basel IA will produce decreases in minimum required capital equivalent to Basel II, and that you continue to be worried by the probable drop in minimum required capital created by Basel II. You strongly suggest that the Basel II comment period be sufficient to ensure a lengthy overlap with the comment period for Basel IA, and I believe that is the intention of the agencies. You also recommend that the banking agencies conduct a more rigorous study once the detailed Basel IA proposal is available and before changes to capital requirements are implemented. I think that is a suggestion that should receive serious consideration.

Finally, as we proceed with the Notice of Proposed Rulemaking for Basel II, we should keep in mind that the United States has enjoyed an unusual period of sustained economic growth with only a mild recession over the past decade. That growth has contributed to the strong profitability and the strong capital base of the U.S. banking industry. While we all hope that the current high level of economic activity will continue, it would be a mistake, it seems to me, to take for granted that the next 10 years will be equally benign. We should therefore be particularly cautious and prudent in making changes to our system of bank capital.

Basel II was intended to bring about technical improvements in the risk-sensitivity of bank capital in the United States while broadly maintaining the overall level of risk-based capital requirements. I think these are both worthy goals, and the achievement of both of these goals, in my view, is essential for the safety and soundness of the U.S. banking system.

Thank you very much for your attention this morning. I look forward to a continued close working relationship between CSBS and the FDIC.

Last Updated 5/19/2006