Remarks
by
FDIC Chairman Sheila C. Bair
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Good morning and thank you for inviting me to speak. There's plenty to talk about this week. You can't seem to avoid talk these days in America about the credit markets and subprime mortgages no matter where you go. Everybody's talking about the problem in the housing market, wondering what it all means, and when it'll end. And everyone is talking about Basel II and whether it would have helped or hurt the strength of financial institutions.

Re-thinking Basel II: lessons learned

So, let me share a few thoughts on credit market developments from a regulatory perspective. We don't know yet how this market will play out. As many of you know, credit losses can take several years to work through the system. Nevertheless, some facts are evident now, and some lessons can be learned—including for Basel II.

Lesson One: Beware the models and the "procyclicality" they can bring

The U.S. has taken a lot of heat for our cautious approach to Basel II implementation. But what we have seen in the credit markets this year fully vindicates the U.S. approach. I believe that our "go slow approach" to adopting radical changes to our capital regulations will pay large dividends when all is said and done. Our banks went into the crunch cycle in a strong position. So far this year, the 10 largest U.S. banking organizations lost $285 billion in market capitalization. That's a 25 percent decline from year end 2006 levels. The big five U.S. investment banks lost $ 65 billion in market capitalization. That's a 21 percent decline. Europe has not been immune. The top 10 European banking organizations lost $ 99 billion in market capitalization. That's down almost 10 percent from a year ago.

It's striking how quickly conditions turned after a 10-plus-year-run of record bank profits and how problematic a big spike in regulatory capital would be as banks deal with this current environment. The catalyst for this about face, of course, was the rapid proliferation of complex high risk mortgages untested in an environment of higher interest rates and declining home values.

The risk models used by financial institutions and ratings agencies failed to predict the fallout from the subprime meltdown. Driven mostly by historical loss statistics, models use rearview vision to predict the future. By nature, they cannot see what lies ahead, coming down the road. Models are helpful as a risk management tool. But they are not

always reliable predictors of credit performance and should never be expected to predict the effects of a sea-change in lending.

But such models are, in fact, what anchor Basel II. And their weaknesses, as starkly revealed by today's market turmoil, are a very bright, flashing yellow light warning us to drive carefully. Errors in quantitative models might not be so important, if market players did not rely on them as heavily. But they do.

Investors around the world bought up huge amounts of complex structured securities based solely on favorable agency credit ratings which have proven unreliable because they are model driven. Often these were money-market investors seeking not only returns, but safety and liquidity. As it became clear the ratings on collateralized debt obligations (CDOs) and other complex securities masked considerable risk, investors pulled back. The structured finance market has evaporated.

Lesson Two: liquidity is fickle

The confluence of credit risk and lost confidence in ratings reminds us of another lesson: What the market gives in liquidity, the market can swiftly take away. Basel II is for the most part silent on liquidity. So was Basel I. But since Basel II is generally expected to require less capital, unaddressed risks, such as liquidity, loom very large indeed. This is one of the reasons the U.S. thought it was imperative to keep our leverage ratio. Consider this unknown risk as another yellow warning light.

Lesson Three: There's no such thing as "off-the-balance-sheet"

Another fact put in sharp relief by the credit crunch is how off-balance sheet risks that seemed risk-free can quickly become very real. As investors have fled complex securities issued by off-balance sheet investment vehicles, sponsoring banks have been forced to use their own money to support them. This has happened even when the bank had no legal obligation to do so. And in such cases, neither Basel II nor Basel I requires capital. This is a gap in the rules, yet another warning light along the road.

Market developments also spotlight valuations of complex, illiquid exposures. Basel II assigns pennies, even fractions of pennies, of capital per dollar on many highly rated CDOs, even though market indexes suggest write-downs of 20, 30, or 40 percent. This disconnect between the risks as measured by the Basel II securitization framework, and current economic reality, merits scrutiny.

Finally, market developments illustrate another key fact. In periods of stress, financial activity migrates to banks because banks enjoy access to deposit funding and other government support as funding mechanisms. This migration into banks takes many forms. Banks take on the risks of off-balance sheet entities. They may support money-market mutual funds. Regulators get requests for waivers of statutory firewalls between banks and affiliates.

Diversified financial companies shift activities into insured banks. And stable retail deposit funding assumes tremendous importance. In short, banks are safe harbors for the economy in stormy weather. The FDIC helps provide that safe harbor. And they need adequate capital to carry out this vital role.

A roadmap for Basel II

With this in mind, let me lay out a roadmap for responding to some of these issues. Despite all the warning signs, I think everyone would agree now is not the time to rewrite the Basel II rules. And the Basel Committee's decision remains valid that the old rules did not fully address today's complex risks taken by large banks. The advanced approach is an attempt to improve on the old rules. But we need to take the time to fully evaluate the new framework to make sure it an improvement.

Just as any motorist would do when confronted with yellow warning lights, regulators should proceed with caution. I'm very happy that's what the U.S. did. We include several safeguards in our final rule that will keep our banking system strong, even if the new rules fail to work as intended.

Three U.S. safeguards

First, three transitional floor periods will prevent abrupt declines in capital requirements.

Second, we require that no bank will be allowed to exit its risk-based capital floors until regulators publish a study after 2010 that gives the new rules a clean bill of health. This study will analyze the adequacy and consistency of capital levels under the new rule. It will look at how banks and supervisors are evaluating the reasonableness of key risk estimates. And it will review how the new capital requirements change over the business cycle.

Finally, and of utmost importance, U.S. leverage requirements remain unchanged. This backstop guarantees a capital cushion, even when risk-based capital rules erroneously indicate minimal risk. Strong capital allows banks to recognize losses and put problems behind them during times like we are now experiencing. And strong capital gives banks the financial flexibility to serve as shock absorbers to our economy during difficult times.

Mid-course correction

So how do we deal with some of the issues raised by the current market turmoil? Short of re-writing Basel II, we'll need to make some mid- course adjustments. For example, consider the problem of unreliable credit risk models. In the U.S. we have safeguards in place that give us time to evaluate the models and make adjustments if and when appropriate.

To the extent that Basel II results in excessive leverage at financial institutions, bankers and supervisors may need to consider the causes, and whether supplemental approaches to capital adequacy are appropriate.

What about liquidity risk? One possibility would be supervisory guidance on managing liquidity risk. And to be useful from a U.S. perspective, any work on liquidity would need to reaffirm the importance of adequate liquidity in our insured institutions.

Do we need more capital for off-balance-sheet-risk? There is certainly a technical gap in the rules. But it's not clear how the balance of pros and cons comes out if we are talking about moving aggressively on this in today's market. This issue should be considered carefully, with any near-term concerns addressed by supervisors.

Finally, how should supervisors be viewing portfolios of potentially illiquid, complex securities? For capital purposes, it's probably safe to say that supervisors should be cautious about treating complex and illiquid securities as "extremely high quality," regardless of their rating.

In today's market, it would be imprudent for bankers or supervisors to assume that all highly rated structured securities are safe and liquid. For our part, we're asking examiners to dig deeper into these portfolios in certain cases. Getting better and timely information about the collateral underlying these securities would be very useful.

I believe this would promote safer and sounder lending, and improve market liquidity. I don't think anyone has the answer today on exactly how to do this. But more transparency in the ratings process is clearly needed.

Conclusion

Finally, let's not forget that today's losses are part of the natural process of correcting past mistakes. The capital we have in the banking system is the shock absorber that allows the financial system to do just that. After a period of record earnings, U.S. banks entered this downturn in the credit cycle in a position of strength, in part, because strong regulatory mechanisms promoted a solid capital base. The U.S. Basel II rules preserve that strength. This gives me confidence that our banking system will navigate these difficult times, emerging in a stronger position to support future global prosperity.

Thank you very much.

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