Remarks By
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Good morning, and thank you. According to the conference program, I'm to speak on "The Dream of a Single Global Standard." When they wrote that, I think someone must have had a sense of humor.

Or perhaps the question the conference sponsors really wanted to ask was: "When Will the Americans Finish the Rule?" Sorry to let you down. I'm not here to answer that question. But we are working on it. We want a consensus on appropriate safeguards that will allow our banks to implement Basel II.

Today, I would like to share my concerns about the advanced approaches. And then give you my sense of where we are in the process.

Eight years in the making

When I became FDIC Chairman last June, Basel II had been in the making since at least 1999, when the first consultative paper was published. Eight years is a long time for developing any regulation.

But the length of the process reflects the difficulty of building consensus on such an extraordinary and very complicated undertaking. Eight years of intensive technical consultation with large banks continues to this day.

There's also been significant evolution in the policy arena. The 1999 Basel Committee paper I mentioned, said there would be no reduction in capital requirements. That statement has since been modified, of course, to allow for some reduction in capital requirements to provide incentives to adopt the advanced approaches.

U.S. regulators have assured Congress that our intention was not to produce substantial reductions in capital requirements for the large banks adopting the advanced approaches. And my opinion on this has always been that we don't want capital reductions to be a tool of international competition. That is a game with no winners.

When I became Chairman, the Basel II process was already steeped in controversy in the U.S., and had been for some time.

As the new head of the U.S. deposit insurer, it was obviously my obligation to find out what the controversy was all about. So I learned as much as I could as quickly as I could. Frankly, the more I learned, the more uncomfortable I became. But given the long history of the process … I wanted to find a way to move forward. And the many safeguards that had already been built into the proposed rule helped give me comfort that we were moving ahead in a controlled and responsible manner. That is why I scheduled a meeting and voted to publish the Notice of Proposed Rulemaking just a few months after I became Chairman.

Protecting the capital cushion

The rulemaking included safeguards against unconstrained reductions in risk-based capital requirements. My support for the proposed rule was contingent on these safeguards.

The importance of the safeguards is not a personal point of view, but an institutional one. While all bank regulators are responsible for safety and soundness, the FDIC explicitly insures over $4.2 trillion in deposits. We also have a statutory mandate to promote public confidence in the U.S. banking system.

A critical point that everyone must keep in mind is that the Basel II framework was developed and debated during a very benign period of economic growth and strong bank profitability.

The recent trouble in U.S. sub-prime mortgages is a clear reminder of how fast and decisively market conditions can change. It points to the danger of thinking that banks will have enough lead-time to ramp up their capital as economic conditions deteriorate.

Some fear we may be approaching a more general turning point in the credit cycle. As regulators, we want to ensure that banks have a strong enough capital cushion to withstand a downturn.

For the last two decades, the Basel Committee keeps coming back to the same basic question: How much bank capital is enough?

The Four Risks

I don't think you can answer that question unless you consider four significant risks in connection with Basel II's advanced approaches.

Risk number one: The advanced approaches come uncomfortably close to letting banks set their own capital requirements. That would be like a football match where each player has his own set of rules. There are strong reasons for believing that banks left to their own devices would maintain less capital -- not more -- than would be prudent.

The fact is, banks do benefit from implicit and explicit government safety nets.

Investing in a bank is perceived as a safe bet. Without proper capital regulation, banks can operate in the marketplace with little or no capital. And governments and deposit insurers end up holding the bag, bearing much of the risk and cost of failure.

History shows this problem is very real … as we saw with the U.S. banking and S & L crisis in the late 1980s and 1990s.

The final bill for inadequate capital regulation can be very heavy. In short, regulators can't leave capital decisions totally to the banks. We wouldn't be doing our jobs or serving the public interest if we did.

Risk number two: The jury is still out on whether the Basel II advanced approaches can tie capital requirements to risk, as intended.

Why? Because the key risk inputs that drive the advanced approaches are subjective … unreliable and unproven.

Let me hasten to say that some large banks have internal risk-rating systems that do a good job of grading relative risks within their portfolios. But in the advanced approaches, if Bank A has a small capital requirement, and Bank B has a large capital requirement, we are supposed to assume that Bank A has a safer portfolio.

Unfortunately, in the advanced approaches, these two banks could simply be measuring identical risks in different ways. Regulators have taken appropriate care not to micro-manage internal ratings systems. But the resulting wide latitude in capital requirements could lead to inconsistency across banks. And it could lead regulators to accept capital requirements that are too low.

Risk number three: Even if banks and supervisors could somehow work together to average out the subjective and divergent risk inputs, the advanced framework may still deliver insufficient capital.

Let me use the U.S. residential mortgage market as an example, which all of you know is having problems. In our QIS-4 exercise, we looked at the potential capital impact of the advanced approaches. For all residential mortgages, the median reduction in capital requirements was 64 percent … and for home equity loans, it was 77 percent. More than a few of our 26 banks reported that their minimum risk-based capital requirement for mortgages went down by 90 percent or more.

To me, one of the most troubling aspects of Basel II is that a purely historic look at mortgage data might have justified such numbers. We also saw the same kind of aggressive reductions in capital requirements under the advanced approaches for most commercial real estate loans … and for many commercial and industrial loans … with median reductions exceeding 50 percent.

These kinds of results are simply unacceptable. Redefining capital requirements sharply downward in this way under the advanced approaches, risks increasing the fragility of the global banking system.

In response to such criticisms, many argue that supervisory diligence under Pillar 2 will somehow protect against inadequate capital under Pillar 1. More specifically, they say required stress-testing by banks will take care of any capital shortages under Pillar 1.

This brings me to the final risk on my list.

Risk number four: Despite the best of intentions … banks and supervisors may be ill-equipped to mitigate deficiencies in the advanced approaches. If the basic capital standards are unreliable, how can we have confidence that supervisory add-ons will be sufficient or consistent?

To put this in terms of the advanced approaches, neither banks nor regulators know how much stress to build into the capital calculations. This is far more than a technical problem for future research. There are real limitations on our ability to identify important changes in market practices as they are occurring and to think concretely about the implications.

Consider the U.S. sub-prime mortgage market that is having trouble. This market has some uniquely American characteristics, but it's a case study that all nations can learn from. Over the last few years, sub-prime mortgage lending grew dramatically as a percentage of the overall mortgage market. Most of us saw this as a very positive trend. It gave unprecedented access to home ownership and wealth, especially for low-income earners.

What we couldn't see until late in the game was how pervasive … and how quickly … risky lending practices had become. Borrowers with weak credit were offered loans with initial teaser rates that are now resetting at unaffordable higher rates, leaving these borrowers with mortgage obligations as high as 60 percent to 70 percent of income.

Loans were frequently made based on "stated income," without documentation. Many of these loans, some 2 million this year and next, will reset with the potential for widespread foreclosures.

I don't know of anyone in the regulatory community or the ratings agencies who really "connected the dots" on this problem until late last year. Certainly, we all knew sub-prime lending was a growing asset class. We all understood that borrowers were exposed to rising interest rates. And we all knew that home prices would not rise at double-digit rates forever. But it took a long time to see the problem, and now we're scrambling to fix it.

What's the lesson in all this?

If the regulators were behind the curve in discerning the risks in these widely-used and simple mortgage products, how can we expect to fully understand the risks in more complex and dynamic products, such as Collateralized Debt Obligations (CDOs), credit derivatives, and leveraged lending and hedge funds?

I believe the lesson here is that these products and markets pose risks and stresses that may be impossible to quantify. It's easy to assume that banks and supervisors will set a principles-based approach to build an appropriate level of stress into the advanced capital calculations. But I fear that in reality, the lag in identifying and understanding changes in market practices will make this very difficult.

To complicate matters, other incentives could emerge for some banks to boost return on equity, capture business and the like … which could drive stress-calculations the wrong way. The risk, of course, is that if we have an inadequate Pillar 1 capital requirement, supplemented by inadequate consideration of potential stress under Pillar 2, we will end up with inadequately capitalized banks.

Where are we?

So, where does that leave us? Wither Basel II? To be honest and frank, we don't yet know whether Basel II's advanced approaches will work. We don't know whether, or when, the risk inputs will become reliable. We don't know whether the level of minimum capital requirements will be sufficient. And nobody knows how to build enough stress into the capital calculations to address the non-transparent and ever-changing risks that banks are taking.

Given this uncertainty, regulators must proceed with caution. We're public servants, and that's our job. Safeguards against precipitous and open-ended declines in risk-based capital requirements should be removed only when the global framework has proved its capital sufficiency and reliability.

At this time we are still working through these issues in the United States, including whether to allow the standardized approach for all U.S. banks.

Conclusion

We've been at this a long time. But the stakes for our global banking system are very high. Today, our banks are strong and profitable. They are engines for job creation and economic growth. And I'm hopeful that we'll be able to resolve these four risks and move forward with Basel II in a way that assures the future health and stability of the global financial system.

Let there be no doubt. I support moving ahead with the Basel II framework and doing so expeditiously. No one wants this issue resolved more than I do. But I do not see how the FDIC can responsibly agree to remove important safeguards before we have evidence that the advanced approaches will work. That would be akin to trying to put the toothpaste back into the tube.

Thank you.

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