Ensuring Adequate and Competitive Capital Levels in a Rapidly Changing Banking Environment

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It is a pleasure to be here with you today.

We are in a period of revolutionary change in the financial industry that is greatly influencing the way banks and financial institutions operate.

The financial industry is becoming much more diverse. In the United States, for instance, some banks—typically smaller banks—continue to specialize in traditional deposit and loan activities. Others—usually larger banking organizations—now engage in a far more complex set of financial services, including trading, clearing, and other securities and capital markets activities. Many of these activities are further conducted on a global basis. I imagine there are similar differences in the financial industries of many African nations where the branches of very large foreign banks are operating in the same markets as local banks.

This growing diversity among financial institutions, combined with rapid technological innovation and financial deregulation, is having a profound effect on the regulatory and supervisory framework. A key question for us, as bank supervisors, is how can we respond to these changes in a manner that ensures a safe and sound banking system without undermining the industry's ability to innovate.

Banking supervisors worldwide are having to move toward a more risk-focused supervisory framework that looks at the effectiveness of the risk management process. In addition, supervisors are grappling with the issue of how they can best tailor regulations to a diverse group of institutions without giving a competitive advantage or imposing regulatory burdens unevenly. An important example of such a challenge is the Basel II Capital Standards and the approaches that countries are now taking to implement it.

My goal here is to make you aware of important elements of the Basel II implementation in the United States. As part of this I'll describe various related steps we are taking to establish a

workable capital framework for banks that do not engage in significant international or nontraditional activities. To give you the broadest understanding of our process, it will be helpful to review how our financial system and its supervision have changed in recent years. These changes have led to greater diversity among individual institutions and a transition to a more risk-based supervisory framework.

Basel II, to be successful, requires a good risk-based capital program. To be fully successful, it must also rely on strong supervision and market discipline—as reflected in part by Pillars 2 and 3 of the Basel framework. It is the combination of capital standards, supervisory oversight and public disclosure that will allow a risk-based capital and supervisory program to succeed.

Financial market developments in recent years

The world is experiencing a rapid evolution of its financial markets. Innovations in technology and finance have greatly lowered the cost of financial transactions, while dramatically increasing global communication and access to financial information.

The implications are enormous. Banks no longer operate within a segmented financial system, which had previously limited competition among banks, thrifts, credit unions, securities firms, insurance companies and the capital markets. As a result, each of these industries is expanding, causing banks and other financial institutions to face new and growing competition.

Meanwhile, lower costs for information, transactions and data processing have combined with applied financial theory to open the door to new and complex financial instruments and better ways to manage risk. Examples include derivatives, securitized assets, and new risk management models and systems. For banks—particularly larger banks—these changes have

meant less need to hold and fund assets on their own balance sheets, a more accurate means for measuring and managing risk exposures, and new ways of lending, using such tools such as credit scoring and the internet. These same developments are further enabling capital and financial markets to fulfill some of the same roles as banks in funding the credit and investments needs of households and businesses.

A final effect of technological innovation is to make financial intermediation more of a global activity. With lower communication and information costs, banks can extend their international financial activities and follow individual firms as their business needs become more global in scope.

Resulting changes in the supervisory and regulatory system

In the United States, significant changes in the supervisory and regulatory system have been required to keep up with these marketplace developments. Previous regulatory restrictions, such as deposit interest ceilings, limits on permissible banking activities and constraints on geographical expansion, have proven unworkable or ill-advised in this changing financial environment. As a result, substantial deregulation has occurred. Banks and other financial institutions now have much greater latitude in deciding what products they can offer, how they price them and how they can expand their business.

For U.S. banking supervisors, these changes mean less reliance is placed on rules and restrictions in ensuring a safe and sound banking system. For larger banks that are heavily involved in transactional activities through their trading, clearing and derivatives operations, supervisory review of current balance sheet positions provides only limited insight into a bank's risk exposure. In response to this changing banking environment, supervisors are developing a

more risk-focused supervisory framework. They are giving greater emphasis to the unique characteristics of each bank and to the processes, management information systems and internal controls that a bank has in place to manage and control its risk exposure.

A second implication of this financial revolution is that supervisors must interact with a much more diverse group of banks. Although all banks have seen technology and financial innovation greatly change their operations, the more significant changes are occurring at the larger U.S. banking organizations. Examples include the development of complex financial instruments; entry into securities, insurance, trading and other capital markets activities; more sophisticated risk management practices; and expansion of global financial activities. The wider range of products being offered by financial institutions and the merging of banking, securities and insurance activities is also leading to the growing importance of large bank and financial holding companies. This development is shifting more risk management practices to the parent company level and thereby increasing the importance of consolidated supervision.

The growing diversity among financial institutions requires regulators to take a multifaceted approach to supervision and regulation by designing provisions that reflect the underlying risks and are either limited in their coverage or apply only to a particular group of banks. Examples of targeted supervision in the United States include examination frequencies, bank holding company inspections, internal audit standards and the Basel capital requirements themselves.

The role of Basel II in this environment

For bankers, investors and regulators, a critical step in this new environment is to bring a bank's capital into a closer relationship with its risk exposure. Since its adoption, the Basel I

framework has helped to provide some fairly broad adjustments in capital standards for credit risk and, more recently, market risk. However, the Basel I risk weights fail to address significant differences in the quality of individual assets and off-balance-sheet exposures. Consequently, banks have been required to put the same amount of capital behind their highest and their lowest quality loans—a feature of Basel I that makes it costly to keep better assets on the balance sheet and provides incentives to arbitrage this capital framework.

Complex financial instruments also have made the simpler Basel I standards more difficult to implement. Basel I, for instance, fails to take advantage of the substantial progress and advances some banks have made in their internal credit rating systems, financial models and economic capital calculations.

Because of the need to have capital standards reflect these advances, the United States is in the process of adopting Basel II and, in some instances, Basel IA. For the largest banks in the United States, the goal at this time is to adopt the advanced (internal ratings-based) approach in Basel II rather than the standardized or the foundation internal ratings-based approaches. The advanced approach would apply to core banking organizations—those with consolidated assets of $250 billion or more, or with consolidated on-balance-sheet foreign exposures of $10 billion or more. Other U.S. banking organizations—opt-in banks—could voluntarily adopt the advanced Basel II standards, provided they receive approval from their regulators after submitting detailed implementation plans.

Nine U.S. banks have been identified as core or mandatory Basel II banks, and another 10 to 15 banks are expected to be voluntary opt-in banks. Current plans are for these banks to comply with the advanced measurement approach for operational risk. However, and

noteworthy, our recent request for public comments asks for views on whether large banks should be able to use the other credit and operational risk alternatives in Basel II.

Our implementation of Basel II will be phased in over a number of years to give banks and the markets time to learn and adjust to the new standards. Full implementation of Basel II for U.S. banks may not be until 2012 at the earliest. While U.S. regulators have concerns that this delayed implementation will put U.S. banks behind some of their international counterparts, we want to make sure that banks maintain adequate capital levels while implementing their risk models and transitioning to Basel II.

I mentioned Basel IA a moment ago. This approach would be available to banks that are not far enough along in their credit rating systems and models to adopt the Basel II standards. One of the intentions behind Basel IA is to keep these banks from being put at a capital disadvantage when competing in the same loan markets as Basel II adopters.

This alternative approach would allow a greater variety of risk weights compared to Basel I. For instance, Basel IA would allow a range of risk weights for residential mortgages based on loan-to-value ratios and possibly the borrower's credit history. Other proposed aspects of Basel IA include greater use of external credit ratings to set risk weights and lower risk weights for small business loans guaranteed by owners and collateralized by business assets.

Banks not electing to use Basel IA could continue to use Basel I, unless regulators decide that the organization's risk profile would not be captured adequately by the existing standards. These Basel I banks would presumably be those that already hold capital in excess of the standards and don't want to be burdened with the cost of shifting to a new capital framework.

The combined framework of Basel I, IA and II consequently reflects the view that a "one size fits all" approach to capital won't work very well in today's diverse banking environment.

Rather than relying on one capital framework that would be too burdensome for smaller banks or too simplistic to capture risk exposures at larger institutions, U.S. supervisors will be taking a more varied approach.

Capital ratios aren't enough

The role of overseeing the safety and soundness of financial institutions necessarily involves much more than calculating capital levels and implementing capital standards. Basel II itself, in fact, recognizes that numerical capital standards aren't enough and, accordingly, includes Pillars 2 and 3. These two pillars establish a framework for ensuring that supervision and market discipline have an appropriate role in the risk-based capital process.

Beyond this role in reinforcing capital standards, risk-based supervision and marketplace discipline fulfill an even broader and more essential role in directing the actions of financial institutions toward a stable financial environment.

A new supervisory framework and increased market discipline should be regarded as essential elements as we develop a more risk-based approach to both bank capital and banking oversight. Risk-based supervision will have to replace the more restrictive banking rules of the past. Additionally, markets, in fulfilling their established role of allocating resources, will have to pass judgment on acceptable bank capital and risk levels.

With regard to bank supervision, there is no question supervisors need to review and assure banks of all sizes accurately measure, manage and report the risks they assume. In the transition to a more risk-based capital and supervisory framework, an accurate picture of a bank's major assets and risk exposures will be of central importance, with this picture based increasingly on a bank's internal credit and risk analysis. Consequently, bank supervisors will

need to work with banks and their management to ensure that a bank's current systems and practices are adequate and capable of accurately informing the market of its financial and operating position. As reflected by Basel IA and II in the United States, risk-based supervision will need to be tailored to the individual bank and its activities, but the basic objective remains the same—ensuring a safe, sound and competitive banking system.

Market discipline and public disclosure—as reflected in Basel II's Pillar 3—are important tools a country and its banking supervisors can use to reinforce a risk-based approach to supervision and capital standards. In many instances, market discipline and disclosure provide the most effective way to encourage bank management to pursue sound policies and make any needed changes, especially at the world's largest banks. Financial deregulation has clearly elevated the role of market discipline in allocating financial resources and ensuring sound banking conditions. A number of recent studies, in fact, have concluded that weaknesses in market discipline have contributed to many of the recent financial crises.

Under the Basel capital standards, market discipline and public disclosure have a critical role to play. For market discipline to be effective in this process, investors and depositors must have the necessary information and the confidence to make decisions about which financial institutions are deserving of their funds. At the heart of this market process, banks will need to be open about their risk exposures, the adequacy of their risk measuring and management practices, and their capital decisions. In turn, supervisors will have to take a strong position in ensuring that bank disclosures are accurate and complete.

Disclosure and transparency will be of significant value in other aspects of the Basel implementation process as well. In this regard, the quantitative impact studies that have been conducted for Basel II have shown a substantial variation across banks in their calculations of

required capital. Variation is also likely to occur over the credit cycle, depending on how long of a period banks use to calculate default and loss probabilities. Other differences will exist internationally as countries implement Basel II. All these differences will be difficult to resolve if bank investors, creditors and private credit rating agencies don't have the basic information needed to draw independent decisions.

For emerging market countries, disclosure and transparency will be especially important in the transition to a more risk-based supervisory and Basel capital framework. Sound accounting practices and timely and accurate identification of credit problems will be necessary for a risk-based approach, whether capital or supervisory, to work. Moreover, a country and its financial markets must ensure that institutions disclose accurate and material information about their performance, credit quality and overall condition. As central bankers and supervisors, many of you will undoubtedly have to play a critical role in improving public disclosure and transparency, especially as you continue developing your supervisory frameworks and oversight of financial markets.

Summary

The implementation of Basel II reflects the advances that are occurring in banking—both in terms of technological change and the progress banks are making in their own risk management systems. Basel II is also serving as a reminder of the growing diversity of banks within individual countries and across countries. One result of this changing financial environment is to make a risk-based approach to capital requirements more essential, particularly as countries deregulate their financial markets and remove provisions that once served to limit risk taking.

However, I want to reemphasize that just making a commitment to more risk-based capital standards will not be enough.

For new capital standards and the remainder of our supervisory framework to be effective, we will also have to take a risk-focused approach to our supervision. In this approach, we must ensure that the major risks at individual financial institutions are identified and that these institutions are taking the necessary steps to manage their risk exposures. In addition, we need to promote greater market discipline and disclosure for financial institutions, thus bringing bank investors and creditors in as a more effective force in directing the actions of banks and bank management.

Overall, we will need to strike the proper balance in this changing financial environment among the numerical calculations of Basel II, the use of risk-focused supervision and the discipline provided by the marketplace. All of these factors must be designed to reinforce each other and address the variety of risks that different institutions incur.