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Statement of

Susan Schmidt Bies

Member

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Chairman Shelby, Senator Sarbanes, and members of the Committee on Banking, Housing, and Urban Affairs, I thank you for the opportunity to join my colleagues from the other federal banking agencies to discuss the current status of Basel II in this country, as well as the status of proposed amendments to our existing Basel I-based capital rules.

Introduction

The Federal Reserve considers the maintenance of strong and stable financial markets as an integral part of our responsibility and critically related to safety and soundness of the participants in those markets. Financial stability contributes to sustained economic growth by providing an environment in which financial institutions, businesses, and households can conduct their business with more certainty about future outcomes. Part of maintaining a strong financial system is ensuring that banking organizations operate in a safe and sound manner with adequate capital cushions that appropriately support the risks they take.

As many of you are aware, there have been two major developments within the past six weeks regarding U.S. regulatory capital requirements that apply to banking institutions. First, on September 30, the U.S. banking agencies announced their revised plan for the implementation of the Basel II framework in the United States. Second, the agencies published for comment an advance notice of proposed rulemaking (ANPR) pertaining to amendments to the existing Basel I-based capital rules (the amended Basel I). Taken together, these proposals on Basel II and the amended Basel I represent substantial revisions to the regulatory risk-based capital rules applied to U.S. banking institutions, from the very largest to the smallest. From the Federal Reserve's perspective, these two initiatives, when implemented successfully, should produce a much-improved regulatory capital regime in the United States that enhances safety and soundness. The Federal Reserve considers the ongoing discussion between the Congress and the

U.S. banking agencies--and, of course, with the banking industry and members of the public--to be critical to the success of both sets of proposals.

Reasons for Pursuing Basel II

We have all witnessed the substantial changes in the U.S. banking industry over the past decade, including growth in size and geographic scope, expansion of activities, development of new instruments and services, and greater use of technology. As a result, we have seen the rise of very large entities with large geographic reach operating in many lines of business and engaging in complex and sophisticated transactions. The largest institutions have moved away from the traditional banking strategy of holding assets on the balance sheet to strategies that emphasize redistribution of assets and actively managing risks. These dramatic changes to the risk profiles of many banking organizations have only accelerated with the continued evolution of many, often complex, financial tools, such as securtitizations and credit derivatives.

Additionally, risk-management techniques employed by many banking organizations continue to change, improve and adapt to the ever-changing financial landscape. For instance, operational risk was not part of our risk-management thinking ten years ago, but tools to identify, measure, and manage it are now becoming prevalent. Also, the lines between the banking book and the trading book have blurred significantly and organizations continue to move resources and products to optimize earnings and manage risks. And finally, global competition has intensified significantly, as the ability of customers to choose from a variety of local and international banking firms, as well as non-bank competitors, has increased.

While the current Basel I-based rules have served us well for nearly two decades, they are simply not appropriate for identifying and measuring the risks of our largest, most complex banking organizations. Basel I, even when periodically amended, must be straightforward enough for even the smallest banking organizations to implement with relative ease. Thus, the categories of risk used to determine capital are very broad and are intended to capture the “average” risk levels across the banking system for that generic exposure.

Large financial institutions, however, tend to manage risk in more proactive ways, and are able to take advantage of new innovations in financial instruments to hedge, sell, or take on risk exposures to support their business strategies and profitability targets. As a result, they are able to remove balance sheet exposures for risks where they feel regulatory capital is set too high, and thereby reduce minimum regulatory capital. Smaller organizations generally do not have the risk-management systems or scale of transactions to make these practices economically viable.

While the balance sheet focus of Basel I is appropriate for most banking organizations, the largest organizations have significant exposures off the books, and these risk exposures need to be considered explicitly in determining minimum regulatory capital for these sophisticated organizations. Large organizations are increasingly gravitating toward fee-based revenue streams. This is due to securitizations of loan portfolios that retain the responsibility of servicing the loans, buying and selling financial instruments for customers, and growth in business lines where fees are generated by transactions and account processing. These activities have little exposure shown on the balance sheet at a moment in time, but failure to operate complex systems and negotiate complex financial deals in a sound manner can lead to large loss exposures given the volume of activity that runs through the line of business. They also use sophisticated models to manage credit, market, and interest rate risks. Poor data integrity, model reliability or lack of sufficient controls, can create losses when management action relies on the faulty results of decision models.

Finally, the complexity of these organizations makes it more difficult for executive management to view risk in a comprehensive way, both in terms of aggregating similar and correlated risks, but also identifying potential conflicts of interest between the growth of a line of business and the reputation, legal and compliance risks of the firm as a whole, In recent years, large financial institutions have reported losses from breaks in these operating controls that in some cases have exceeded those in credit or market risk.

The Basel II framework should improve supervisors' ability to understand and monitor the risk taking and capital adequacy of large complex institutions, thereby allowing regulators to address emerging problems more proactively. It should also enhance the ability of market participants, through public disclosures, to evaluate the risk positions at those institutions by providing much better risk measures. The advanced approaches under Basel II, which include the advanced internal ratings-based approach (or A-IRB) for credit risk and the advanced measurement approaches (or AMA) for operational risk, offer particularly good improvements in terms of risk sensitivity, since they incorporate advanced risk-management processes already used today by best-practice institutions.

Indeed, the expected improvements in risk measurement and risk management form the core of our reasons for proposing Basel II in the United States. Its advanced approaches create a rational link between regulatory capital and risk management. Under these approaches, institutions would be required to adopt a set of quantitative risk-measurement and sophisticated risk-management procedures and processes. For instance, Basel II establishes standards for data collection and the systematic use of the information collected. These standards are consistent with broader supervisory expectations that high-quality risk management at large complex organizations depends upon credible data. Enhancements to technological infrastructure--

combined with detailed data--will, over time, allow firms to better track exposures and manage risk. The emphasis in Basel II on improved data standards should not be interpreted solely as a requirement to determine regulatory capital standards, but rather as a foundation for more advanced risk-management practices that would strengthen the value of the banking franchise. But while the new framework would, in our view, provide useful incentives for institutions to accelerate the improvement of risk management, we believe that in most areas of risk management institutions would continue to have the choice among which methods they employ.

Thus, from a safety and soundness regulatory perspective, for these large, complex financial organizations, regulators and market participants need the information provided by the advanced framework of Basel II.

Recent Developments with Basel II

The Federal Reserve considers the agencies’ September 30 announcement relating to Basel II a good outcome and an example of successful interagency cooperation. As you may recall, in April of this year the agencies announced jointly their reaction to initial results of a fourth quantitative impact study pertaining to Basel II, known as QIS4. As the April statement indicated, we were concerned about results from QIS4 that showed a wider dispersion and a larger overall drop in minimum regulatory capital requirements for the QIS4 population of institutions than the agencies had initially expected. The initial QIS4 results prompted the agencies to delay issuance of a notice of proposed rulemaking (NPR) for Basel II in order to conduct further analysis of those results and their potential impact. The agencies' reaction to the initial QIS4 results, deciding to take additional time to understand more fully the information provided by the QIS4 institutions, is an indicator of how seriously we are taking Basel II implementation.

During the summer, the U.S. agencies conducted additional analysis of the information reported in QIS4. That analysis is for the most part complete. Based on the new knowledge gained from the additional QIS4 analysis, the U.S. agencies collectively decided to move ahead with an NPR but adjust the plan for U.S. implementation of Basel II. Adjustments to the plan include extending the timeline for implementation and augmenting the transitional floors, which should provide bankers and regulators with more experience with Basel II before it is fully implemented in the United States. In addition, the agencies stated specifically in our joint press release that after completing a final rule for Basel II, we intend to revisit that rule prior to the termination of the transitional floors. That is, we expect to perform additional in-depth analyses of the Basel II minimum capital calculations produced by institutions during the parallel run and transitional floor periods before we move to full implementation without floors. This is consistent with the overall process we have laid out for implementing Basel II. We want to ensure that the minimum regulatory capital levels for each institution and in the aggregate for the group of Basel II banks provide an adequate capital cushion consistent with safety and soundness.

Probably the most important thing we learned from the QIS4 analysis is that progress is being made toward developing a risk-sensitive capital system. In terms of the specifics of the analysis, we learned that the drop in QIS4 capital was largely due to the favorable point in the business cycle when the data were collected. While the previous QIS3 exercise was conducted with data from 2002, a higher credit loss year, QIS4 reflected asset portfolio, risk management information and models during one of the best periods of credit quality in recent years. We learned that the dispersion was largely due to varying risk parameters used by the institutions, which was permissible in the QIS4 exercise, but also due to portfolio differences. That is, banks have different approaches to risk-management processes, and their models and databases reflect those differences.

We also learned that some of the data submitted by individual institutions was not complete; in some cases banks did not have estimates of loss in stress periods--or used estimates that we thought were not very sophisticated--which caused minimum regulatory capital to be underestimated. Based on the results of QIS4, the Federal Reserve recognizes that all institutions have additional work to do. In our view, the findings did not point to insurmountable problems, but instead identified areas for future supervisory focus. In that way, the analysis was critical in providing comfort to enable us to move forward.

It is also helpful to remember that the QIS4 exercise was conducted on a best-efforts basis. It was just one step in a progression of events leading to adoption of the Basel II framework. We certainly expect that as we move closer to implementation, supervisory oversight of the Basel II implementation methodologies by our examination teams would increase. Indeed, during the qualification process we expect to have several additional opportunities to evaluate institutions' risk-management processes, models, and estimates--and provide feedback to the institutions on their progress. So while the QIS4 results clearly provided a much better sense than before of the progress in implementing Basel II and offered additional insights about the link between risks and capital, QIS4 should not be considered a complete forecast of Basel II's ultimate effects. It was a point-in-time look at how the U.S. implementation was progressing.

Institutions participating in QIS4 put a lot of time and effort into assisting with the QIS4 analysis. For that reason, we owe it to the institutions to provide feedback prior to engaging in a detailed public discussion of the findings. Those feedback sessions, a full interagency effort involving an interagency agreed-upon presentation of the results, are now underway and we expect them to be largely completed by the end of this month. The agencies plan to release a public document describing our findings shortly after these sessions are completed, we hope by the end of the year.

Proposed Next Steps in the Basel II Process

I would now like to describe some possible next steps in the Basel II process. To be clear, these thoughts represent our best estimates at this time and could change, given the extensive opportunity for public comment and additional interagency discussions to come. But I thought it would at least be helpful to offer the Federal Reserve's perspective.

First, we support the idea of finishing an NPR on Basel II and related supervisory guidance as soon as possible, which right now looks to be in the first quarter of 2006. We believe that the best way to further augment our understanding of the impact of Basel II is to issue the NPR and hear reaction from the Congress, the industry, and the public. In addition, we are interested in issuing the NPR and related supervisory guidance as soon as possible so that bankers can have a better idea of supervisory expectations relating to Basel II. The NPR will help bankers identify the areas where they need to strengthen their risk-measurement processes as they continue to prepare for adoption of Basel II.

After the end of the NPR comment period, the agencies plan to review the comments and decide more specifically on how to move forward. The agencies would then develop a strategy for issuing a final rule on Basel II, of course taking into account comments received. Once the final rule is issued, those institutions moving to Basel II would complete preparations to move to a parallel run, a period in which minimum regulatory capital measures under both Basel II and

Basel I will be calculated. Under the current timeline, the parallel run would start in January 2008.

The parallel run period, which is intended to last for four continuous quarters, should provide us with additional key information about the expected results for Basel II on a bank-by-bank basis, as well as the level of bank preparedness to operate under Basel II. Once an institution conducts a successful parallel run, the relevant primary federal supervisor would then confirm the bank's readiness and give permission for the institution to move to the first initial phase of adoption, into the initial floor period. It is only after an institution has operated to the primary supervisor's satisfaction in the parallel run and each of the three years of floors that it would be allowed to have its minimum regulatory capital requirements determined by Basel II with no floors.

During U.S. implementation of Basel II, if at any stage in the process we see something that concerns the banking agencies, we will reassess and propose amendments to relevant parts of the framework. The agencies have already decided to embed in the planned timeline the possibility for a later revision to the initial Basel II rule (before the floors are removed), since it is expected that new information provided in the parallel run and floor years might point to a need for adjustments to that initial rule. This is entirely consistent with the path we have taken in the past regarding Basel I, to which there have been more than twenty-five revisions since 1989. The Federal Reserve considers all of the planned safeguards and checks and balances to be sufficient for Basel II to be implemented in the United States effectively, and with no negative impact on safety and soundness or the functioning of banking markets.

Proposed Amendments to Basel I

As I noted, the Basel II proposal is not the only minimum regulatory capital proposal being contemplated by the U.S. banking agencies. We have issued an ANPR for amendments to Basel I that is another important initiative in our efforts to update regulatory capital rules. The regulatory capital rules to be amended by the ANPR would apply to thousands of banking institutions in the United States, while the Basel II proposal would likely only apply to ten to twenty at inception. The agencies are focusing considerable attention on the potential interplay between the proposed Basel II rules and the proposed Basel I amendments in order to ensure that the goals for each are achieved.

The Federal Reserve's statement pertaining to the release of the ANPR highlighted that the revisions are intended to align risk-based capital requirements more closely with the risk inherent in various exposures. The ANPR relates, in part, to some long-standing issues in our current capital rules that have been identified (such as requiring capital for short-term commitments). We also noted that the amended Basel I is intended to mitigate certain competitive inequalities that may arise from the implementation of Basel II rules (such as lowering the risk weight for some residential mortgage exposures). In considering these possible revisions, the U.S. agencies are seeking to enhance the evaluation of bank portfolios and their inherent risks without undue complexity or regulatory burden. In issuing the ANPR, an *advance* notice, the agencies are emphasizing that views are still being developed and additional comment from the banking industry and other interested parties would be both beneficial and welcome before we move forward. We are intentionally leaving a number of areas open in order to solicit a broad range of comments before we narrow down the range of possibilities.

The U.S. banking agencies have identified over the past several years a number of issues that need to be addressed within our current Basel I rules. The development of Basel II-based rules also creates the need for the U.S. agencies to amend the current rules in order to address issues relating to competitive impact. While we view that impact as limited, we want to ensure that institutions not moving to Basel II have equal opportunities to pursue business initiatives and are not placed at a competitive disadvantage or otherwise adversely affected. That is why we are being very careful to analyze the potential results of these two efforts in tandem, and asking for the Congress, the industry, and others to provide comments on the potential effects of both initiatives.

We believe that the revisions to Basel I-based rules should benefit most institutions by better reflecting current risk exposures in regulatory capital requirements at little additional burden. Naturally, regulatory capital requirements are usually not the binding constraint for banking organizations. Nearly all institutions hold capital in excess of the minimum required regulatory ratios, in many cases several percentage points above, to satisfy rating agencies, debtholders and shareholders, and counterparties in the market. By the same token, pricing in the banking industry is not driven by regulatory capital, but rather, as most would intuitively assume, by supply and demand and business decisions made by bankers. But we think regulatory capital can act as a useful gauge of risk-taking, even though it would not be the deciding factor in business decisions.

With respect to the proposals for amended Basel I, as well as Basel II, the Federal Reserve fully supports retention of the existing prompt corrective action (PCA) regime, which the Congress put in place more than a decade ago, as well as existing leverage requirements. In addition to the safeguards planned for initiatives being discussed today, we at the Federal

Reserve take comfort that the PCA and leverage requirements will continue to provide a level of protection for depositors, consumers, and the financial system as a whole. These regulations help to ensure a minimum level of capital at individual institutions and in the aggregate that we consider to be absolutely vital to the health of our banking system and the economy more broadly.

Importance of the Rulemaking Process

At the Federal Reserve--indeed, I think I can say among all the U.S. banking agencies--we understand and respect the rulemaking process and the legal requirements for implementing regulatory revisions. This, of course, includes comment periods for each of our regulatory capital proposals and transparency in our overall process. We encourage a healthy debate about the agencies' proposed initiatives--including the recently revised timeline for Basel II. We look forward to continuing to engage the industry, the Congress, fellow supervisors, and others in a discussion about what effects the Basel II framework and the Basel I revisions might have on our banking system. The proposals are intended to provide the right incentives for bankers, but if the proposals do not achieve this goal, we want to know why. In the past, when we have been provided with well-documented and convincing reasons for making a change to the Basel II framework or the U.S. implementation process, we have heeded those arguments. We expect to have the same posture regarding comments on the proposed Basel I amendments. We continue to recognize that vigorous discussion and debate produce a much better product. And we expect to remain vigilant about the potentially unintended and undesired consequences, particularly those that might affect a certain class of banks.

Additionally, I would like to emphasize that from my perspective the U.S. agencies continue to work well with one another on these regulatory capital proposals in a general environment of cooperation and good will. While the U.S. agencies naturally disagree on certain policy matters and implementation issues from time to time, we at the Federal Reserve are pleased with the outcomes to date and recognize that all four agencies are making considerable contributions to the overall effort.

Dialogue with the Industry

The extension of the U.S. timeline for Basel II, along with the ongoing proposals for amended Basel I, obviously present some challenges for U.S. institutions. We will continue our efforts to ensure that we hear about these challenges and do our best to assist institutions in meeting them. First of all, bankers must keep track of the latest proposals and understand what they could mean for their own institutions. For those institutions looking to prepare for adoption of Basel II, making the manifold upgrades in risk-measurement and -management systems--not the least of which is developing credible databases--is even more difficult, especially since complete and final supervisory expectations have yet to be released. But we certainly hope that institutions do not lose momentum based on the revised timeline for Basel II; indeed, that timeline reflects our assessment of the work that still lies ahead.

While institutions might be challenged to move forward in certain areas until the Basel II NPR and its associated supervisory guidance is issued, we still believe that they can make strides in other areas. For one, the agencies all along have emphasized the importance of institution-specific implementation plans, which include gap analyses, clearly-defined milestones, and remediation plans. In other words, we think that institutions could now continue development of the corporate governance surrounding each institution’s efforts in Basel II implementation and focus on their individual implementation processes. In addition, supervisors have begun to discuss individual QIS4 results with each participant; these discussions include specific feedback about the institution's results and some general peer comparisons.

Additionally, we do recognize that the recent update to U.S. implementation plans could generate some challenges for U.S. institutions as they try to implement Basel II worldwide, as well as for foreign banks operating in the United States. Overall, we think these challenges are manageable and we can facilitate solutions to them during the implementation process. While not downplaying potential challenges, the U.S. agencies, in deciding to adjust implementation plans, thought it was important to ensure that implementation in the United States be conducted in a prudential manner and without generating competitive inequalities in our banking markets. As before the September 30 announcement, we continue to work with institutions and foreign supervisors to minimize the difficulties in cross-border implementation. Our support includes extensive discussion with other countries in the Basel Accord Implementation Group, as well as more informal, bilateral discussions with institutions and foreign supervisors. Our view is that these cross-border issues do not necessarily represent fundamentally new problems; while requiring some work, these challenges are manageable. It is also useful to point out that all Basel member countries have their own rollout timelines and national discretion issues, not just the United States--which is entirely appropriate. In order to assist institutions in resolving their cross-border challenges, we are eager to hear specifics from institutions so that we can develop targeted solutions.

Conclusion

Mr. Chairman, in my remarks today I have described the Federal Reserve's views on suggested changes to the current regulatory risk-based capital regime, namely the proposals for Basel II and amended Basel I. I have outlined the need for change, the work completed to date, and some of the lessons learned. In our view, recent exercises such as QIS4 have served as useful indicators of the progress being made and the direction needed for these initiatives on regulatory capital requirements. QIS4 was part of an extended series of activities to ensure that the suggested regulatory capital revisions are implemented in an appropriate and prudent manner. From the Federal Reserve's perspective, we should continue to move forward with the activities I described, while seeking comment and listening to feedback at every stage.

Our support for Basel II stems from the belief that it would provide a much better measure of minimum regulatory capital at the largest, most complex institutions, aligning capital with risks to which these institutions are exposed. We also believe that Basel II would bring about substantial improvements in risk management to those institutions. At the same time, amending Basel I for the vast majority of banking institutions in the United States could improve the reflection of risks in Basel I-based rules without much additional burden. Taken together, these initiatives should ensure adequate minimum capital cushions, allow fair competition, maintain safety and soundness, and enhance financial stability.

I am pleased to answer your questions.