For release on delivery
10:00 a.m. EDT
September 26, 2006

Statement of

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Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing, and Urban Affairs

United States Senate

September 26, 2006

Chairman Shelby, Senator Sarbanes, and members of the Committee, I thank you for the opportunity to discuss recent developments relating to bank regulatory capital requirements in the United States, including the U.S. implementation of Basel II and updates to regulatory capital rules for market risk.

As Committee members may know, in the past three weeks there have been some very positive developments in the process to revise regulatory capital requirements for large, internationally active U.S. banking institutions. First, the board of the Federal Deposit Insurance Corporation on September 5th approved the Basel II notice of proposed rulemaking (NPR). At the same time, the FDIC board approved an NPR that would update the U.S. regulatory capital rules for market risk exposures. The Office of the Comptroller of the Currency and the Office of Thrift Supervision took similar actions on the same day. Together with the Federal Reserve's approval of the draft Basel II NPR in March and the market risk NPR in August, these steps completed all necessary approvals for the two NPRs. Then just yesterday, the two NPRs were published in the *Federal Register*, initiating the process for formal public comment. Proposed templates for regulatory reporting requirements associated with the two NPRs were also published for comment yesterday in the *Federal Register*.

The market risk NPR is based on a set of revisions developed jointly by the Basel Committee and the International Organization of Securities Commissions (IOSCO) in 2005 to update the Market Risk Amendment (MRA) developed a decade ago by the Basel Committee. The revised market risk rule would apply to any banking organization that has significant trading book activity, whether it stays on Basel I or moves to Basel II in the United States. The market risk NPR is intended to improve the risk sensitivity of the market risk capital framework and to reduce the incidence of arbitrage between the banking book and the trading book. Further, the NPR will serve to level the playing field between U.S. banking organizations and securities firms that are subject to similar capital requirements.

Moving to the main focus of today's hearing, the Basel II framework represents an important effort by bank supervisors to integrate modern risk-management practices with regulatory capital requirements. We are pleased that the four federal banking agencies have reached consensus to move ahead with the process for Basel II implementation. We recognize the significance of this development to the industry, the Congress, and others who have waited for greater specificity about U.S. efforts to implement Basel II. It has taken quite a bit of work to reach this point. I would like to thank my colleagues here at this table and their staffs, as well as the Fed's own staff, for their tireless efforts.

Overview of Proposed Rulemakings

The Basel II NPR is designed to improve the risk sensitivity of U.S. bank regulatory capital requirements and to enhance the risk-measurement and -management practices of large, internationally active U.S. banking organizations. The NPR is based on the 2004 capital adequacy framework released by the Basel Committee on Banking Supervision. That framework contains the now-familiar "three pillars" of regulatory capital requirements for credit and operational risk (Pillar 1), supervisory review (Pillar 2) and public disclosure (Pillar 3). As you are aware, the agencies propose to adopt all three pillars in the United States. Pillar 1 of Basel II provides banks with three options for computing credit risk capital requirements and three options for computing operational risk capital requirements. In Pillar 1 as proposed by the Basel II NPR, however, only the advanced internal ratings-based approach (A-IRB) for credit risk and the advanced measurement approaches (AMA) for operational risk would be available, and the framework as a whole would be required only for the largest, most complex, internationally active U.S. institutions.

The A-IRB approach for credit risk in the Basel II NPR requires institutions to estimate key risk parameters for each type of credit exposure, subject to supervisory review, and to calculate a capital requirement by using those risk parameters as inputs to supervisory formulas. The AMA approach for operational risk requires institutions to calculate a capital requirement based on their individual operational risk profile--again, subject to supervisory review. The Basel II NPR also specifies, as part of Pillar 2, that each institution must develop a rigorous internal process for assessing its overall capital adequacy in relation to its total risk profile through the economic cycle. These internal assessments will enable each institution to determine the appropriate level of capital for its unique long-term business strategy. These Pillar 2 internal capital assessments are, we believe, critically important, and are also subject to supervisory review. Finally, institutions must publicly disclose key information relating to credit and operational risks, under Pillar 3, to ensure adequate transparency for market participants, customers, and counterparties, so that market discipline can also work effectively to differentiate risk exposures among banking organizations. I would like to stress that the Basel II framework has three Pillars and note that Pillars 2 and 3 are critical components of the overall framework. They should not be overlooked.

As I noted, proposed reporting requirements for institutions planning to adopt Basel II and the updated market risk rules in the United States were also recently published in the *Federal Register*. Each institution that qualifies for and applies the Basel II capital rules and the updated market risk rules would file quarterly regulatory data, some of which would remain confidential, for the agencies' use in assessing and monitoring the levels and components of each reporting entity's risk-based capital requirements and the adequacy of the entity's capital. These data also would support the agencies' efforts to analyze the quantitative impact and competitive implications of the Basel II capital rules and the updated market risk rules on individual reporting entities and on an industrywide basis. In addition, the reporting schedules will help clarify for these entities our expectations surrounding the systems and other infrastructure necessary for implementation and validation of the two proposals. The submitted data would supplement on-site examination processes, and the data released publicly would provide other interested parties with information about banks' risk profiles and capital adequacy.

Importance of the Regulatory Capital Proposals

While our reasons for moving to Basel II have not changed since we began this endeavor, I believe they are worth reiterating. Our core reason is that the current Basel I framework is inadequate for the largest, most complex U.S. banking organizations. The current Basel I capital requirements simply are not able to capture the full array of risks facing these organizations. For example, they do not explicitly recognize the operational risk embedded in many of the services from which the largest institutions generate a good portion of their revenues today.

Further, Basel I does not differentiate the riskiness of assets within the major asset types based on either borrower creditworthiness or the presence of collateral or other risk mitigants. This lack of sophistication can lead to significant distortions and capital arbitrage. The capital required for each exposure should reflect the credit risk of that particular exposure. As banks consciously choose to take higher risk exposures, Basel II requires them to hold additional capital to reflect their business choice. Basel I capital is fixed throughout economic and business credit cycles, and as such, does not require banks to increase capital as their potential for losses rises. Basel II addresses this by including in Pillar 2 the requirement that the bank have a plan in place to ensure that sufficient capital will be available in the downturn of the economic cycle. Thus, for the largest organizations, we need to move beyond Basel I to a more risk-sensitive and more comprehensive framework for assessing capital adequacy. Basel II represents the concerted efforts of the international and U.S. supervisory community, in consultation with banks and other stakeholders, to develop such a framework, drawing upon well-known economic capital concepts that the largest banks already employ as part of their risk management efforts.

In addition to its supervisory authority, the Federal Reserve, as the nation's central bank, has responsibility for maintaining stable financial markets and ensuring a strong financial system. That responsibility mandates that we require banking organizations to operate in a safe and sound manner with adequate capital that appropriately supports the risks they take. This is especially critical in today's environment where we have a growing number of banking institutions with more than $1 trillion in assets, complex balance sheets, opaque off-balance sheet transactions, and far-reaching operations that pose significant risk-management challenges that are fundamentally different from those faced by smaller institutions. Naturally, we must also ensure that our regulations and supervisory oversight are in tune with bank practice, are able to identify the risks being taken by banks today, and have enough flexibility that they will continue to be prudent and relevant in an ever-changing risk environment. As Chairman Bernanke has noted, a regulatory and supervisory system that is not in tune with the financial marketplace may increase the costs of regulation, stifle efficiency and innovation, and ultimately be less effective in mitigating the moral hazard problems associated with the federal safety net.

The advanced approaches of Basel II are much more risk sensitive, cover more areas of potential risk facing banking organizations, and provide better incentives for institutions to improve risk measurement and management. In addition, Basel II provides supervisors with a more conceptually consistent and more transparent framework for evaluating systemic risk in the banking system, particularly through credit cycles. In sum, Basel II will establish a more coherent relationship between regulatory measures of capital adequacy and day-to-day supervision of banks, enabling examiners to better evaluate whether banks are holding prudent levels of capital given their risk profiles.

Continuing the Implementation Process

The agencies' proposed rulemakings, representing our view about how Basel II should be implemented in the United States, have now been published in the *Federal Register* for review by the industry, the Congress, and the general public. The core goal of Basel II, as noted earlier, is to promote the stability of the U.S. financial system by ensuring the safety and soundness of U.S. banks. As Chairman Bernanke has said, the ability of Basel II to promote safety and soundness is the first criterion on which the proposed Basel II framework should be judged. The agencies have presented proposals and will now engage in a continuing dialogue with all interested parties as to whether those proposals meet our stated objectives and how they can be improved.

During the entire process to develop our proposed rulemakings, the agencies have been engaged in a dialogue with the industry, the Congress, and others about both the general direction that U.S. Basel II implementation should take and specific implementation details. Many of the comments received to date have been incorporated into our proposals. In that respect, we have been carefully considering comments received so far and discussing among ourselves how to address them. In addition, we have conducted extensive analysis of other information we have collected, such as the results of quantitative impact studies (QIS), and those results have helped shape the proposals as well. In making adjustments to our proposals based on comments and new information, we have been as transparent as possible. Going forward, we will seriously consider all comments on the proposals. For example, the proposals contain a number of specific questions soliciting comments in key areas. With these questions, the agencies are trying to highlight areas on which we would like additional information. The agencies will continue to carefully consider all comments received and thoroughly analyze all relevant information as we work to develop a final rule for Basel II.

The agencies' Basel II proposals contain certain transitional safeguards beyond what is contained in the 2004 Basel Committee framework. Indeed, these proposed safeguards reflect our intent to ensure that there are no material weaknesses in our proposals prior to full operation. In the coming years, we will continue to monitor institutions' progress toward satisfaction of the Basel II risk-measurement and -management infrastructure standards. In addition, our proposals contain a parallel-run period of at least one year in which we will have the ability to analyze and directly compare capital requirements under existing rules and those produced by Basel II while institutions remain subject to the current rules. Beyond the parallel run, the agencies have proposed a three-year transitional floor period, more stringent than that in the 2004 Basel II framework, to prevent an unwarranted decline in capital levels. In addition, current supervisory safeguards, such as the existing leverage ratio and prompt corrective action, will continue to provide an important backstop against a potential unwarranted decline in bank capital levels. In general, if we at the Federal Reserve see that the U.S. Basel II proposals are not working as intended, we will seek modifications to them.

Providing Alternative Approaches

I also want to acknowledge that the agencies have received comments from several banks and other parties suggesting that banks should have more choices with regard to both credit and operational risk in the U.S. implementation of Basel II. We have taken these suggestions seriously, and the NPR now includes a specific question on whether the U.S. version of Basel II should include a so-called "standardized" approach.

As you may know, in many other countries *all* banking organizations are required to adopt Basel II because Basel I will be dropped when Basel II takes effect. Since Basel II will then apply to a wide variety of banking organizations, the 2004 framework provides for alternative approaches.

The possibility of introducing a standardized option for credit risk, similar to that set forth in the original Basel II 2004 framework raises some difficult public policy issues, which I hope will be addressed by commenters. Foremost is whether such a standardized option is sufficiently risk-sensitive for the largest, most complex, internationally active U.S. banking organizations and whether related disclosures would contribute to better market discipline.

While it is true that large international banks in the other G-10 countries theoretically have a choice among the various Basel II credit risk and operational risk approaches, in practice it appears these banks will be adopting the more risk-sensitive advanced approaches. Indeed, the Basel Committee's report on the results of the fifth Quantitative Impact Study (QIS-5) shows that although the Basel II standardized approaches are available in the G-10 countries other than the United States, no large internationally active bank in those countries has indicated that it plans to adopt the standardized credit risk approach. All fifty-six of the large, non-U.S. banks in the sample said they are most likely to adopt the internal-ratings based approaches for credit risk.[1]

A second public policy issue is how to address the potential for cherry-picking that could accompany a standardized option for credit risk. A number of banks have suggested that their ideal Basel II capital rule would allow them to mix and match elements of both the standardized and advanced approaches--perhaps the standardized approach for wholesale and retail credits, the AMA for operational risk, and the expected positive exposure approach for derivatives and securities financing transactions. Allowing such customization or cherry-picking, where a bank is allowed to select a different approach for each portfolio in order to minimize its aggregate capital requirement, could materially weaken the regulatory capital framework for U.S. banks and, along with it, the effectiveness of prompt corrective action policies. Clearly, there is a natural tension between the private interests of banks in maximizing shareholder profits, on the one hand, and the public interest in protecting the federal safety net and promoting bank safety and soundness, on the other hand.

Lastly, some have suggested that perhaps Basel IA could serve as a standardized approach for our core Basel II banks. Unfortunately, the agencies have been designing Basel IA with the very different risk profiles and economic resources of our smaller banks in mind, and in particular to address competitive concerns between smaller banks and the Basel II banks. We hope that comments on the Basel IA NPR will give us guidance in this area also.

In sum, the Federal Reserve believes strongly that very careful consideration will need to be given to the possible design and implementation of any standardized approach for Basel II in the United States should the agencies decide ultimately to move in that direction. We look

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[1] See Basel Committee on Banking Supervision, "Results of the Fifth Quantitative Impact Study (QIS5)," Table 3, The Bank for International Settlements.

forward to getting more detailed comments on how a standardized approach might fit into the U.S. Basel II framework.

Proposals to Amend Existing Basel I Rules

At this point, I would like to say just a few words about ongoing efforts to revise the existing Basel I regulatory capital rules for non-Basel II institutions. We expect only one or two dozen institutions to move to the U.S. version of Basel II in the near term, meaning that the vast majority of U.S. institutions will continue to operate under Basel I-based rules, which we intend to amend through a separate rulemaking process. The U.S. Basel I framework has already been amended more than twenty-five times since its introduction in response to changes in banking products and the financial services marketplace. The agencies believe that now is another appropriate time to propose modifications to our Basel I rules. The agencies have issued an advance notice of proposed rulemaking (ANPR) discussing possible changes to increase the risk sensitivity of the U.S. Basel I rules and to mitigate competitive distortions that might be created by introducing Basel II. We have reviewed comments on the ANPR and are working on a notice of proposed rulemaking. We are mindful that amendments to the Basel I rules should not be too complex or too burdensome for the large number of small- and mid-sized institutions to which the revised rules might apply. Indeed, a number of those commenting on the ANPR advocated leaving existing rules unchanged.

With regard to both the Basel II proposals and the proposed Basel I amendments, we understand the need for full transparency. For that reason, we expect to have overlapping comment periods for the Basel II NPR and the NPR for the proposed Basel I amendments. In fact, we want all interested parties to compare, contrast, and comment on the two proposals in overlapping timeframes. Accordingly, either of our proposals could change as a result of comments received or new information gathered.

Conclusion

From the Federal Reserve's perspective, the publication of interagency proposals relating to Basel II is a very positive development and demonstrates the ability of the agencies to work cooperatively to modernize our regulatory capital framework. The Federal Reserve's commitment to the Basel II process remains as strong as ever, even as we recognize that the proposals remain subject to further comment and that there is likely much more work to be done. We encourage comments from all interested parties and will give them careful consideration. I would like to emphasize that the Federal Reserve desires to ensure that the final rule for Basel II is a substantial enhancement over existing Basel I rules, appropriately capturing the risks of our largest, most complex banks, and encouraging continual improvement in risk-measurement and -management systems. We look forward to working with the other agencies as we enter into the final rule phase of the Basel II process.

We recognize that many institutions have been diligently preparing for Basel II implementation and we understand our obligation, as supervisors, to support institutions wanting to adopt Basel II at the first available date. We suggest that those institutions continue to move forward with implementation planning, including identification of gaps in their own preparation.

Finally, I would like to assure the Committee members that we at the Federal Reserve are pursuing Basel II because we believe it will help to preserve the safety and soundness of our nation's banking system. In our dual role as the central bank and supervisor of banks, bank holding companies, and financial holding companies, the Federal Reserve is committed to ensuring that the Basel II framework delivers a strong and risk-sensitive base of capital for our largest and most complex banking institutions. That is why we stand behind the additional safeguards contained in the Basel II NPR to ensure strong capital levels during the transition to the new framework. We will remain vigilant, on an ongoing basis, in monitoring and assessing the impact of Basel II on both individual and aggregate regulatory capital requirements and in employing rigorous and thorough analysis to support our evaluation. By so doing, we believe that the proposals being discussed today can be implemented responsibly and in a safe and sound manner.

Thank you very much for your attention. I welcome any comments you may have and will be happy to answer any questions.