Ben S Bernanke: Basel II - its promise and its challenges

Remarks by Mr Ben S Bernanke, Chairman of the Board of Governors of the US Federal Reserve System, at the Federal Reserve Bank of Chicago's 42nd Annual Conference on Bank Structure and Competition, Chicago, 18 May 2006.

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I am pleased to speak to you this morning at what has become, over more than four decades, perhaps the most prestigious conference for bankers, academics, and bank supervisors in the United States. In every year but one of his tenure, Chairman Greenspan spoke at this meeting, and he sometimes used the occasion to advocate major changes to the bank regulatory system. Notable examples include the revisions to deposit insurance and bank capital standards that were embedded in the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), the relaxation of restrictions on interstate banking in the Riegle-Neal Act of 1994, and the repeal of Glass-Steagall's limits on combinations of commercial and investment banking implemented by the Gramm-Leach-Bliley Act of 1999.

Today, I will discuss the importance of implementing another major change in the way we regulate and supervise banking organizations, especially our largest, most complex, and most internationally active firms.[1] That change is the modernization of our approach to assessing the adequacy of bank capital, within the context of the framework that has come to be known as Basel II. The current system of bank capital standards, the so-called Basel I framework agreed upon internationally in 1988, was a major step forward in that it embodied the important principle that regulatory capital requirements should be tied to the risks taken by each banking institution.[2] However, the relatively crude method of assigning risk weights to assets, as well as an emphasis on balance-sheet risks as opposed to other risks facing financial firms, limits the overall responsiveness of capital requirements to risk under Basel I, which renders that system increasingly inadequate for supervising the largest and most complex banking organizations. For these 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 supervisory community, in consultation with banks and other stakeholders, to develop such a framework.

The broad principles of Basel II have become increasingly clear over many years of discussion and consultation, and I will review them briefly. I will argue that a framework built on these principles is the right one for supervising the largest and most complex institutions. Moreover, the Basel II framework is inherently dynamic; it will be able to adapt to ongoing innovation and change. But I also want to convey today that Basel II remains very much a work in progress. As we proceed toward the implementation of this framework, success will require that bank regulators, the banking industry, the Congress, and other relevant parties engage in an ongoing and frank dialogue, and that policymakers be open-minded, flexible, and ready to make needed adjustments. For our part, the Federal Reserve is committed to getting Basel II right.

Financial innovations in mortgage and other markets

As in years past, the Chicago Fed has chosen wisely in selecting the theme of the conference. Innovations in the financing of homes and other real estate have come at a remarkable pace over the past decade or more, leading to more sophisticated and flexible instruments, more liquid markets, and better risk-sharing. Taking full advantage of these innovations has required banks and other institutions to make important improvements in risk measurement and risk management.

Financial innovations and improved risk management have not been limited to real estate finance, of course. Securitization, improved hedging instruments and strategies, more-liquid markets, greater risk-based pricing, and the data-collection and management systems needed to implement such innovations have also occurred in other retail and wholesale markets.

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[1] In my talk, I will use the terms "bank" and "banking organization" interchangeably.

[2] A second major contribution of Basel I was that it created international standards for measuring bank capital.

In my judgment, these developments, on net, have provided significant benefits. Borrowers have more choices and greater access to credit; lenders and investors are better able to measure and manage risk; and, because of the dispersion of financial risks to those more willing and able to bear them, the economy and the financial system are more resilient. To be sure, rapid financial innovation carries some risks, if new instruments are used improperly or if the market infrastructure that facilitates the trading of those instruments is inadequate. Regulators must be aware of and ready to mitigate those risks. Overall, however, the public interest is served both by the prudent use of new financial instruments and by the improvements in risk-measurement and risk-management practices that prudent use requires.

Implications for financial regulation

As market participants innovate and markets become more efficient and sophisticated, bank regulators and supervisors must ensure that they do not fall behind. Indeed, a regulatory and supervisory system that is increasingly divorced from actual business practice may well become counterproductive. A regulatory and supervisory system that is not in tune with practice may increase the costs of regulation, stifle efficiency and innovation, and ultimately be less effective in mitigating the moral hazard problems associated with the financial safety net.

Most regulatory changes are incremental, which is entirely appropriate given the inherent uncertainties about how best to respond to market developments and the desire to avoid unintended consequences. Examples of incremental regulatory change are common. For example, the U.S. banking agencies have made more than twenty-five amendments to the Basel I framework in response to ongoing changes in banking and financial markets.

But sometimes a more fundamental rethinking of the regulatory framework is needed. Sometimes a crisis is the catalyst for such rethinking, as in the case of the deposit insurance and capital policy reforms in FDICIA that I mentioned earlier. At other times, major change is motivated by the gradual accumulation of factors, such as the blending of commercial and investment banking that evolved before passage of the Gramm-Leach-Bliley Act. I would put the need for Basel II squarely in this latter category. No immediate crisis requires us to move toward Basel II, but the gradual evolution of market practice and the emergence of very large and increasingly complex banking organizations operating on a global scale require that we make significant changes in the way we assess capital adequacy at these organizations. Indeed, waiting for a crisis to force change would be foolish; by moving forward now, we have the luxury of being deliberate in the development and introduction of a system that promises significant benefits.

Why Basel II?

Many aspects and possible effects of Basel II have been debated, including its potential effects on banks' costs and on the competitive landscape. I will discuss some of those aspects shortly. It is important to keep in mind, however, that the core goal of Basel II is to promote the stability of the U.S. financial system by ensuring the safety and soundness of U.S. banks. Its ability to promote that objective is the first criterion on which the proposed Basel II framework should be judged.

I stated that the core goal of Basel II is to promote the stability of the U.S. financial system; but, as everyone here understands, the U.S. banking and financial system is increasingly interwoven with that of the rest of the world. Indeed, increasing globalization was a major factor that led the U.S. banking agencies to negotiate the Basel I agreement in 1988. Of course, the extent of globalization of both financial and real product markets is even more extensive today, and systemic financial problems will not respect national borders. Thus, it remains very much in the interest of the United States to continue to encourage international cooperation and consistency in regulating and supervising those banks that pose the greatest potential systemic risk. For this reason, we have chosen to work with our international and domestic colleagues on the Basel Committee to develop a new capital framework for the largest, most complex, and most globally active banking organizations.

To maintain U.S. and global financial stability, we want to ensure that banks, particularly our largest and most complex institutions, will remain able to serve their customers and meet their obligations as lenders and counterparties during periods of economic or financial stress. That requires, of course, that banks have both adequate capital and strong risk management. Because confidence promotes stability, it is also important that supervisors and market participants are able to assess for themselves the financial soundness and risk-management capabilities of these institutions.

Basel II is a comprehensive framework for improving bank safety and soundness by more closely linking regulatory capital requirements with bank risk, by improving the ability of supervisors and financial markets to assess capital adequacy, and by giving banking organizations stronger incentives to improve risk measurement and management. The framework encompasses three elements: risk-focused regulatory capital requirements, supervisory review, and market discipline. These are the so-called three pillars of Basel II.

Under Pillar 1, the risk sensitivity of minimum risk-based capital requirements would be much greater than under the current accord. This greater sensitivity would be achieved by linking each banking organization's capital requirement to empirically based measures of credit and operational risk, as determined in part by risk parameters estimated by that organization, such as a loan's probability of default and its expected loss given default. The methods used to construct such estimates would be subject to supervisory standards, guidance, and reviews, including a requirement that the risk parameters used for Pillar 1 be consistent with risk assessments actually used by the bank for its internal risk management. The Pillar 1 treatment of credit risk also reflects more accurately the risk-reducing effects of guarantees, credit derivatives, and securitization, thus improving regulatory capital incentives for banks to hedge portfolio credit risks. The incorporation of operational risk in Pillar 1 is also a significant step, which recognizes that operational failures are indeed a potentially important risk for many banks, one that they should actively seek to minimize. In addition, Pillar 1 incorporates a more comprehensive treatment of trading account risk.

We should not underestimate the importance of strong minimum capital requirements. Strong capital helps banks absorb unexpected shocks and reduces the moral hazard associated with the federal safety net. A key lesson of the banking and thrift crises of the late 1980s and early 1990s is that prudent and explicit minimum regulatory capital requirements are needed to ensure that banks maintain adequate capital and to anchor an effective supervisory system. For example, explicit minimum regulatory capital requirements that accurately reflect a bank's risk provide more-effective triggers for prompt corrective action.

Besides making regulatory capital ratios more risk-sensitive, Basel II provides a consistent framework for improving supervisory assessments of capital adequacy and risk management. Under Pillar 2, a bank would be required to maintain a capital cushion above the regulatory minimums to capture the full set of risks to which the bank is exposed. These include liquidity risk, interest rate risk, and concentration risk, none of which is reflected in Pillar 1. Currently, the U.S. banking agencies assess a bank's overall capital adequacy as a normal part of the examination process. But the overall quality of both the supervisors' and each bank's assessments of capital adequacy should improve greatly under Basel II because of the expanded information that will be available from Pillar 1, from supervisory reviews of a bank's systems for implementing Pillar 1 and Pillar 2, and from the bank's own analyses.

Under Pillar 3, banks will be required to disclose to the public the new risk-based capital ratios and more-extensive information about the credit quality of their portfolios and their practices in measuring and managing risk. Such disclosures should make banks more transparent to financial markets, thereby improving market discipline.

Taken together, these three pillars provide a broad and coherent framework for linking regulatory capital to risk, for improving internal risk measurement and management, and for enhancing supervisory and market discipline at large, complex, and internationally active banks. The three pillars build on the economic capital and other risk-management approaches of well-managed banks and better align regulatory and supervisory practices with the way the best-run banks are actually managed. As a result, Basel II will be better able than the current system to adapt over time to innovations in banking and markets. In addition, Basel II sets standards for risk measurement and management and for related disclosures that will give banks ongoing incentives to improve their practices in these areas. Indeed, we have already seen significant progress in risk measurement and management at many banks in the United States and elsewhere as a result of the Basel II development process. More progress can be expected as we move forward.

The need for ongoing dialogue and flexibility

Basel II has the potential to provide significant benefits, but any policy change as fundamental as Basel II inevitably creates uncertainties and raises difficult and complex tradeoffs. Successfully dealing with these challenges requires that the banking agencies, the industry, and other stakeholders maintain a frank and ongoing exchange of views and remain flexible and open-minded as we tackle difficult issues.

In this spirit, I urge the industry and other interested parties to comment thoroughly on the Basel II Notice of Proposed Rulemaking (NPR), proposed supervisory guidance that will come out in the near future, and the upcoming proposed changes to Basel I that would apply to the vast majority of banks not subject to Basel II. In an effort to aid this process, I would like to touch on a number of concerns that have been raised regarding Basel II.

The first issue is the complexity and potential cost of the framework. The Basel II NPR is long and detailed. The draft agreed upon among the banking agencies and approved unanimously by the Federal Reserve's Board of Governors in late March is just short of 450 pages. The length and complexity of that document, not to mention the additional supervisory guidance that will be needed, have led some to fear that the costs of implementing Basel II in the United States will outweigh any benefits it brings in terms of greater safety and soundness of banks, improved risk measurement and management, and better market discipline.

I understand these concerns. We must recognize, however, that the Basel II proposal is complex for the good reason that modern risk measurement and risk management are inherently complex activities. Indeed, some commenters have argued that Basel II is overly simplistic in certain areas. The draft proposals also represent many judgments about how best to deal with sometimes competing objectives. On the one hand, the system must be enforceable and it must allow for reasonable comparability of regulatory capital ratios across large, complex, and diverse institutions. Thus, some standardization is required. Regulators and supervisors also owe it to the industry and other market participants to be as clear as possible about what we mean by such core concepts as the probability of default and loss given default and about our expectations for how banks go about estimating such parameters.

On the other hand, the diversity of practices across banking organizations, the absence of any single, definitive "best practice," and the need to provide strong incentives for improving risk measurement and management require that the system be flexible enough to allow the exercise of judgment by supervisors and bankers. This need for flexibility and the use of judgment is the major reason that we have long emphasized that the supervisory reviews in Pillar 2 are a necessary complement to the explicit minimum regulatory capital requirements set forth in Pillar 1.

Naturally, we would like to see the framework implemented as cost-effectively as possible. The desire to avoid unnecessary regulatory costs is another reason why we have tried to build Basel II on what banks are already doing. However, Basel II does ask banks to make some infrastructure investments whose primary purpose is to help supervisors validate and compare banks' systems--investments that many banks would not otherwise make. Feedback from the industry regarding our proposals in this area would be very helpful.

A key mechanism in Basel II for balancing the inevitable tensions that arise when attempting to achieve sometimes competing objectives is the so-called use test. Under the use test, the systems and processes that a bank uses for regulatory capital purposes must be consistent with those used internally. Note that I use the word "consistent," not "identical." For example, minimum regulatory capital need not equal the economic capital requirements computed internally by a bank, but our intent is that the two will be highly correlated. In addition, Basel II seeks to accommodate a range of risk-measurement and risk-management practices, a range that can change over time. No regulator wants to impose a single definition of "best practice" or to set current practice in stone. In light of questions about the use test, I would highlight our desire for specific feedback on how best to implement this important principle.

More generally, I hope the industry will work with the agencies to identify aspects of the framework that are neither cost-effective nor supportive of sound risk management. Relative to the Advanced Notice of Proposed Rulemaking issued in 2003, the current NPR incorporates many specific suggestions from the industry along these lines. Important examples include the definition of default and the treatments of expected losses, loan-loss reserves, credit derivatives, and securitization. If more adjustments are needed, we are ready to listen and adjust.

Another concern that has been expressed regarding Basel II is that it will unfairly tilt the competitive playing field. This concern has two aspects. First, some have argued that the bifurcated application of Basel II within the United States could allow domestic banks that adopt the framework both lower capital charges on certain activities and lower overall regulatory capital requirements compared with other domestic banks. Lower regulatory capital charges would, it has been argued, translate into a cost advantage for adopters that would place non-adopters at a competitive disadvantage. In addition, some fear that adopters would use any newly created excess regulatory capital to acquire smaller banks.

It is an important principle that differences in capital rules among institutions should not distort financial markets or create artificial competitive advantages for any particular class of banks. With this principle in mind, the Federal Reserve has conducted research on the potential competitive impacts of Basel II, and all of the U.S. banking agencies have received comments from many sources. Based on this information, the banking agencies have announced their intention to propose revisions to the existing Basel I capital standards that would aim to mitigate competitive inequities. Proposals should be released in the not-too-distant future, and I urge interested parties to give us specific advice regarding what else we may need to do to reduce any unintended competitive consequences of Basel II.

The second competitive equity concern relates to the international consistency with which Basel II will be implemented. Inconsistency in international standards of implementation and enforcement, it is sometimes said, will put internationally active U.S. banks at a competitive disadvantage and may also hurt purely domestic U.S. banks vis-à-vis the U.S. subsidiaries of foreign banks.

All bank regulators recognize that achieving international consistency will be a challenge. However, this problem is not really new. Companies operating across national borders, and their supervisors, are familiar with the challenges of complying with sometimes conflicting legal and regulatory requirements. Still, we recognize that some international implementation issues will be more complex than those we currently face. U.S. regulators are working hard through the Basel Committee and with individual firms and national supervisors to address international implementation issues. A great deal more effort and cooperation will be needed, but I believe that, as in the past, we can craft an acceptable set of agreements and work out means of resolving future issues.

The final concern I will discuss is the worry that Basel II could lead to a substantial decline in minimum regulatory capital requirements at adopting banks. I emphasized earlier that, for supervisors, an overarching lesson from the banking and thrift crises of the late-1980s and early-1990s is the importance of prudent minimum regulatory capital standards. All the banking agencies are committed to this principle.

At present, we cannot quantify precisely how much Basel II, once fully implemented, will affect banks' risk-based capital requirements relative to Basel I levels. Although our quantitative impact studies have been useful, they have been conducted using bank systems and measurements that generally would not be expected to meet the Basel II standards. We will learn more as the process moves forward, the standards and guidance come into sharper focus, and banks upgrade their risk-management systems.

Because of the irreducible uncertainty in this process, the implementation plan set forth in the NPR incorporates extensive safeguards to limit the potential for unintended consequences, including any possibility of a large decline in required capital levels. These safeguards include a minimum one-year parallel run for each bank, during which the bank will calculate what its risk-based capital requirement would be under Basel II, even though its actual requirement will be determined using the Basel I rules. Following the parallel run, each bank will be subject to a transition period of at least three years during which capital floors based on the Basel I rules will ensure that there is no sharp decline in regulatory capital. In addition, the agencies have committed themselves, throughout the transition process and beyond, to continually evaluate the effects of the new framework and to make any needed adjustments to ensure prudent levels of capital. Finally, I would note that, even when Basel II is fully implemented, all banking organizations will continue to be subject to the current minimum leverage-ratio requirement and prompt-corrective-action rules.

This step-by-step implementation plan, which all the U.S. banking agencies support, should ensure that banking organizations maintain strong capital positions throughout the transition years and after. Moreover, safety and soundness depends not only on the absolute level of capital in the banking system but on how well that capital is deployed. The Basel II framework should make any given level of bank capital work harder, so to speak, by aligning capital more closely with risks taken, by providing incentives for banks to improve their risk management, and by enhancing market discipline through greater transparency. To reiterate, however, to make that framework achieve what is intended requires getting the details right. Therefore, I once more urge the banking industry and other members of the public to review the NPR and the draft supervisory guidance closely and to provide the agencies with constructive comments on all aspects of the proposed framework.

Conclusion

In summary, I believe the time has come to move to the next stages of implementing Basel II. This framework will modernize bank supervision and bring supervisory practice into line with best industry practice. Substantial benefits will ensue--most importantly, a safer and sounder banking system--but uncertainties remain. Satisfactory resolutions of these uncertainties will require hard work and close cooperation among bank regulators, the industry, Congress, and other key players. There is a long way to go, but the Federal Reserve is committed to this task. It is very much in the best interest of all Americans for the next generation of bank capital standards to be as effective as possible in promoting the stability of the U.S. banking and financial system.