

Remarks by
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Thank you for that kind introduction—it is a pleasure to be here with you today. For fifty years, the Exchequer Club has been providing a forum for the exchange of ideas on important issues affecting the financial services industry. Today, I hope to contribute in a modest way to that continuing debate by focusing on the two most significant policy initiatives completed during 2010 – Dodd-Frank and the Basel III capital framework – and discuss their effects on the financial services industry in 2011 and beyond. Because one is 2,000 odd pages of legislation and the other 116 pages of dense rules text, I will – of necessity – focus my comments today on a few key issues at the intersection of the two.

In particular, I want to consider three key questions that will arise in implementing the new Basel III capital framework: Basel III imposes a stricter definition of capital, with greater reliance on common equity; should it apply to all US banks? Basel creates formal regulatory liquidity requirements for the first time; should all banks be required to adopt that new framework? Basel III specifies higher minimum capital requirements, with the prospect of even higher capital required for the world’s largest banks; how should these requirements be applied in the US banking system?

The questions themselves suggest how important Basel III is to the industry, and why it is so important that banks begin focusing now on implementation. We're still early in the process of developing rules to implement the new framework, and there will undoubtedly be many interpretive issues that we will need to resolve prior to full implementation. Indeed, the first capital buffer requirements won't kick in until 2016. This long phase-in was designed specifically to provide banks with sufficient time to move to the higher capital and liquidity standards gradually while – at the same time – continuing to perform their critical financial intermediation role for the broader economy. However, it is not clear that markets will wait years for banks to demonstrate how they will meet the new requirements.

So, one of my key messages today is that even while supervisors continue to assess how best to implement the requirements of Basel III and Dodd-Frank, it is not too early for banks to begin assessing the potential changes in store and their implications for their organizations. This will also position the industry to provide supervisors with meaningful comments as the rulemaking advances.

Let me briefly review the new Basel framework. Finalized at the end of 2010, Basel III is designed to strengthen global capital and liquidity requirements and promote a more resilient banking sector. The hallmark of these changes is an increase in the required level and quality of regulatory capital, especially greater reliance on common equity. Basel also introduced other significant enhancements, including expanding the types of risk captured under the capital rules, especially in bank trading books; increasing the focus on consideration of systemic risk issues in bank supervision practices and capital rules; and establishing for the first time an international leverage ratio requirement

and global minimum liquidity standards. Still to come are decisions on identifying systemically important financial institutions and the potential application of a capital surcharge to those SIFIs; and assessing the role of contingent capital.

While significantly broader in scope than Basel III, Dodd-Frank focuses on many of the same issues and concerns. For example, Dodd-Frank requires more stringent prudential standards, including capital and liquidity requirements, for larger, more systemically important institutions; it touches on the quality of regulatory capital by limiting the degree to which certain hybrid instruments can be included; it establishes specific requirements relating to the leverage ratio; and it requires studies on contingent capital. Both efforts remain works in progress. Dodd-Frank requires supervisory agencies to undertake numerous studies and craft rules, most of which are still in the developmental stage. And even though Basel III capital and liquidity rules texts were published in December, work on a U.S. notice of proposed rulemaking to implement these standards is just getting underway and final rules lie well into the future.

It will be a challenge to meet all these objectives sensibly because the two sets of requirements are complicated; the two frameworks do not mesh perfectly; and there is a fundamental question of how banks of different size should be affected. It is reasonable to have more complex and stringent rules for larger and more complex banks, and U.S. banking law generally – and Dodd-Frank in particular – frequently makes distinctions between large and small institutions.

But some of the complexity we face arises from mission creep in Basel. In its formative period, the Basel Committee's focus was cross-border cooperation. Later, this evolved to standard setting for the minimum level of required capital at internationally

active banks. Over time, Basel capital rules for institutions active in cross-border finance became the benchmark for national banking systems more generally.

Implementation of Basel II in the United States has evolved in fits and starts over several years, and this work had not been completed at the onset of the crisis. The so-called advanced approaches of the Basel II framework, which are mandatory for only the largest U.S. banks, were finalized in late 2007. Although those large U.S. banks are implementing the requirements of that framework, no U.S. bank is yet fully operating under that regime. A less sophisticated version of Basel II – the so-called Standardized Approach – has been proposed for use by smaller U.S. banks, but that framework has not been finalized in our domestic rules. Basel III represents both a layering on and a revision of these advanced and standardized Basel II approaches.

Given this history, you will not be surprised to learn that all of this does not fit together seamlessly! In fact, we will be ripping out seams and redesigning this garment for years to come. But for now, the challenge is to fit it to our banks, ensuring all are adequately covered. So, the first question regulators face is: which U.S. banks should be compelled to adopt the stricter definition of capital mandated by Basel III?

Basel III's increased emphasis on quality of capital takes the form of a stricter definition of what counts as capital. The financial crisis clearly demonstrated that common equity is superior to other capital instruments in its ability to absorb losses on a going-concern basis. Innovative instruments, which had become an ever-larger proportion of the capital base for banks of all sizes, were found lacking. Basel III addresses that problem by defining regulatory capital more narrowly, placing greater reliance on common equity.

This common equity ratio cannot be met through the issuance of other forms of capital, even relatively high-quality capital such as non-cumulative perpetual preferred stock. Basel III also tightens the definitions of other forms of regulatory capital – Tier 1 and Tier 2 – to keep out some of the innovative or “hybrid” capital instruments. This more restrictive definition of capital is consistent with relevant provisions contained within the Dodd-Frank Act. For example, with certain limited exceptions, including an exception for smaller bank holding companies, Dodd-Frank directs supervisors to remove innovative instruments, including TRUPs, from the definition of regulatory bank capital.¹

Because Basel III – in strictest terms – is an agreement that is to be applied to *internationally active banks*, application by the United States to several thousand of other banks (and thrifts) is discretionary. But, even if Basel III changes don’t have to be applied to all U.S. banks, there is obvious merit in doing so, underscored by the experience of U.S. banks during the crisis. If we believe a capital instrument is not loss absorbing, it should not be recognized for regulatory purposes regardless of whether a bank is it internationally active or not. A greater regulatory focus on common equity should make sense for all banks.

Let me emphasize that no decisions have been made on this issue. If we do decide to go with wider application, we would need to make appropriate exceptions for smaller institutions that receive different treatment under Dodd-Frank. But this pending question underscores why banks of all sizes should pay close attention to the Basel III rulemaking process.

¹ See Dodd-Frank Act section 171(b); 12 U.S.C. § 5371(b).

This issue of scope applies equally to the liquidity standards introduced in the new regime: which U.S. banks should be compelled to adopt the *liquidity* standards of Basel III?

Lack of liquidity was evident at many banks during the crisis, both large and small, and there was widespread reliance on the Federal Reserve and other central banks to provide liquidity. During the early phase of the financial crisis, many banks – despite adequate capital levels – still experienced difficulties because of inadequate liquidity management. Indeed, the crisis highlighted the importance of effective liquidity management to the proper functioning of financial markets and the banking sector.

Developing liquidity standards across banks with dramatically different business strategies and liquidity management approaches is a daunting task – so daunting, in fact, that it has never before been implemented as a formal standard. However, in the end, the Basel Committee decided that common minimum standards on liquidity were crucial to reducing the likelihood and severity of another crisis.

The Basel III standards were developed to achieve two separate but complementary objectives. The first objective is to promote short-term resilience by ensuring that a bank has sufficient high quality liquid resources to offset cash outflows under acute short-term stresses. The Committee developed the Liquidity Coverage Ratio, with a one month time horizon, to achieve this concern. The second objective is to promote longer-term resilience by creating additional incentives for a bank to fund its ongoing activities with stable sources of funding. The Net Stable Funding Ratio has a time horizon of one year and has been developed to provide a sustainable maturity structure of assets and liabilities. Its goal is to limit over-reliance on short-term

wholesale funding during times of buoyant market liquidity and encourage better assessment of liquidity risk across all on- and off-balance sheet items.

Dodd-Frank does not directly require that all U.S. banks be subjected to Basel III-type liquidity measures and standards, but it does require more stringent liquidity requirements for larger bank holding companies. Therefore, as U.S. regulators decide how to apply formal liquidity standards to US banks, they are effectively required to consider the liquidity standards for all banks in order to apply more stringent requirements to the largest banks.

But what should the standards be? Sound liquidity management is fundamental to the safety and soundness of all banks, but does it make sense to impose the detailed Basel liquidity standards to the vast majority of banks that have relatively simple balance sheets and liquidity profiles? Additionally, the Basel III liquidity standards are still being reviewed and remain untested, unlike capital standards that have been around in various incarnations for many years. The need for more robust testing and calibration is the main reason that the first introduction of liquidity standards is delayed by a matter of years compared to the revised capital standards. Although much work remains, it certainly behooves all banks in the United States to pay close attention to, and provide comment on, the rulemaking process with respect to liquidity.

Alongside the tighter definition of capital, another key element of the Basel III package is a substantial increase in minimum risk-based capital ratios – requiring banks to hold more capital for every dollar of risk exposure they have. Thus, my third question: Should all banks have to meet the higher minimum capital requirements specified in

Basel III, and should the world's largest banks have to hold even more capital than the Basel III agreements reached thus far?

The centerpiece of the Basel III reforms is higher capital requirements that will essentially move Tier 1 common ratios from roughly 2% under current rules to 7% – minimum standard plus capital conservation buffer – by the end of the decade. U.S. regulators have to decide how to implement this, but I would again note that the United States is under no obligation to apply this standard to all banks. And it is worth remembering that the new Basel standards were developed based on quantitative analysis of the data collected from only the largest, internationally active U.S. banks. But the rest of the world is adopting this as a general standard, and it is an important issue for U.S. regulators to address.

Depending on where the general level is set, Title I of Dodd-Frank requires supervisors to develop more stringent prudential standards – including risk-based and leverage capital standards – for large bank holding companies and non-bank financial companies over \$50 billion in assets.² And the international regulatory community is continuing to develop higher standards, very possibly including an additional capital charge, for systemically important financial institutions – the so-called SIFIs. This will include the largest and most complex of the world's banks – in the U.S case, some of the very banks around which the 7% standard was designed.

The Basel Committee, the Financial Stability Board, and other international groups have on-going projects to both define globally systemically important institutions and assess how much additional “loss absorbing capacity” these global SIFIs need to maintain. This work is expected to be completed by the end of 2011. There are many

² See Dodd-Frank Act section 165(a); 12 U.S.C. § 5365(a).

variables, but the question we must answer in the U.S. is how to apply Basel III and Dodd-Frank in a way that complies with their requirements, while at the same time appropriately differentiating among at least three groups – community banks, banks of \$50 billion and above, and mega-banks.

Informed public comment will be invaluable as we consider questions such as what the minimum requirement should be for global SIFIs? Can any, or some portion, of the capital surcharge be met with non-common equity instruments, including contingent capital, assuming a robust market in these instruments develops over time? Should there be a difference in the minimum capital ratio between community banks and mid-sized banks? These are all important questions – questions that warrant robust debate and analytic review.

Let me offer one cautionary note to conclude this discussion of capital and liquidity. Strong capital and other financial standards provide important defenses for banks. But seemingly formidable capital levels can evaporate if not supported by a culture of sound management and institutional governance. Our experience during the recent crisis shows that we need to elevate expectations related to "management" of banks, but especially the largest, most complex institutions. The OCC expects large banks to instill a culture that invites credible challenge by willing and informed board members. Board members need to engage management and prudently challenge the balance between risk taking and reward. In so doing, directors should help define, formalize, and communicate a risk appetite for each line of business as well as on a firm-wide basis. Furthermore, large banks should operate with strong audit and risk management functions. Board members and the executive management team should

ensure that both audit and risk management teams are visibly and substantively supported. Strong management along these lines will complement strong financial requirements.

Returning to the intersection of Basel III and Dodd-Frank, there remains a great deal of debate and rule writing before we can fully answer the questions I've posed. We will have to carefully consider both domestic and international competitive equity concerns and public comments received on the current and future rules the agencies will propose. And I have not even addressed all the questions we must answer regarding capital. How shall we reconcile the revised capital ratios with the U.S. prompt corrective action framework? How will the international leverage ratio be implemented in the United States given our existing leverage ratio? Will it even be possible to write Standardized and Basel III capital rules that incorporate the use of external ratings, given the Dodd-Frank Act's prohibition on the use of ratings? In some cases, changes or clarifications in law may be needed before we can proceed.

But if there is much to do, our worry is over too much of a good thing. Dodd-Frank and Basel III are landmark policy responses to one of the most severe financial crises in our history, and they share many important objectives. If we implement the reforms in a coordinated, mutually reinforcing manner, we should enhance the safety and soundness of the U.S. and global banking system, and do so without damaging competitive equity or restricting access to credit.

It is a tall order. We are hard at work on it. Thank you for your attention.