It is a pleasure to be here today, because the IIB’s annual Washington conference provides a timely opportunity to examine the key issues facing the banking industry, both in the United States and abroad. Today I would like to discuss efforts underway to guard against a recurrence of the financial crisis that did so much damage, not just to banks and financial services companies, but to consumers, businesses, and communities around the world.

Let me begin with a general theme that I will return to later. As we consider critical systemic reforms, we inevitably confront the very real tension between two competing objectives. On the one hand, we need to adopt the kinds of real prudential reforms – to capital, liquidity, and risk management – that will fortify the financial system to prevent inevitable future problems from mushrooming into the type of meltdown we sustained in the fall of 2008, with devastating effects on the real economy. On the other hand, if we swing the pendulum too far too fast – requiring banks to hold too much capital and liquidity – we risk a significant and suboptimal restriction of credit, which can also have dire consequences for the real economy. Managing this tension and striking the right balance will be, I predict, the central challenge to policymakers around the world in the next year. In this context, let me make my own proclivities clear: we
simply have to make the financial system more resilient to future shocks, which means we cannot let the mere possibility of reduced credit availability in the future thwart our efforts for change. The issue should not be whether we strengthen the system, but instead, how much we do so, and how quickly we do so, given the credit tradeoffs we face.

In some respects, the specific issues we are addressing now to strengthen the system are not new. The seven years I spent working for the Senate Banking Committee and the Department of Treasury were dominated by the thrift and banking crises of the late 1980s and early 1990s, and capital issues were uppermost in our minds. Congress and the banking regulators eliminated regulatory accounting principles that masked losses, and they established new rules requiring much higher levels of capital than had previously been the norm. They also imposed the “prompt corrective action” regulatory regime that required regulators to address banking problems much earlier in the credit cycle.

In some ways that system has served us well. Going into the financial crisis, U.S. banks had considerably higher capital bases than they did 20 years before, when the previous crisis hit. But these stronger capital positions were not strong enough, especially for risks in the trading book; they did not adequately capture off-balance sheet risks; and they could not compensate for the woefully inadequate liquidity positions that left banks unprepared for the capital markets seizure of 2008. Indeed, no one imagined that the highly liquid markets and seemingly healthy financial institutions of a few years ago could suddenly be subjected to a financial crisis on the scale of the one we’ve just
been through – many times greater than the U.S. savings and loan and banking crisis twenty years earlier.

Given the global scale and scope of the crisis, it is not surprising that a defining feature of current reform efforts is the focus on international coordination in crafting solutions. This development is entirely appropriate. The crisis showed no respect for national borders and clearly demonstrated how interconnected financial markets and institutions had become. International solutions are required, which accounts for the enormous energy devoted to reform efforts by the G-20, the Financial Stability Board, the Basel Committee on Banking Supervision, and other international bodies representing the securities, insurance, and accounting standard-setters, among others. These international reform efforts focus on both micro-prudential reforms needed to strengthen the level and quality of international capital and liquidity standards for individual banks, as well as the introduction of macro-prudential standards to address pro-cyclicality and systemic risk.

I want to discuss today the work of the Basel Committee, not only because of the importance of its contribution to improving international financial stability, but also because the issues it is addressing are complex and would benefit greatly from industry comment. The Committee’s response to the financial crisis has been outlined in four recent documents, two issued last July and two last December. The July papers describe final changes to the international Basel II framework, while the two December papers outline additional proposed changes. Taken together, they are intended to promote a more resilient banking sector by strengthening the standards for capital, liquidity, and risk management. Of course, these changes will not become operational until individual
countries adopt regulations and rules to implement them, which is the last stage in achieving comparable standards internationally.

One of the July papers established higher capital requirements for credit risk in trading positions, introducing what amounts to a stress test for value-at-risk models. The “stress VaR” will help ensure that periods of relatively benign market conditions, when combined with the relatively short “memory” of some market risk models, do not lead to capital requirements that are insufficient when market conditions become more volatile.

The second paper released in July introduced substantially higher risk weights for the most complex of the structured securitization products such as collateralized debt obligations. With 20-20 hindsight, we know all too well about the outsized losses produced by CDOs, especially ones that carried investment grade ratings, and the increased requirements are intended to address just this risk.

In December, the Committee published two other papers, including the so-called “Resilience” paper, which proposed a number of changes intended to improve the loss absorbing quality of capital; establish an international leverage ratio backstop to the risk-based capital requirement; and dampen pro-cyclical features of the current regulatory framework. Meanwhile, the Committee has begun a new quantitative impact study to gauge the effect of these proposed changes on the measured capital ratios and liquidity profiles of banks, with the results due back by April 30.

Given the importance of these four documents, let me describe them in a bit more detail.

One set of changes involves important enhancements to the market risk rules governing trading activities. While much attention has been paid to the role of lending
activities in the financial crisis, it was the trading book that was the source of the early, enormous losses for banks that began the unraveling. Trading book regulations have not been materially changed since 1996. The current crisis clearly demonstrated that the value-at-risk framework underlying that regulation produced exceptionally low levels of capital for the outsized and complex risks that generated such large losses at the start of the crisis.

In response, the Basel Committee, as mentioned, has added a stress component to the value-at-risk requirement. In addition, the new standard introduces an incremental risk capital charge for unsecuritized credit products, which covers the risk of both default and non-default credit losses resulting from credit rating downgrades. And the new approach applies the higher banking book capital charges to securitized products held in the trading book, eliminating the disparity between the two. Taken together, these changes will significantly and appropriately increase the level of capital held for trading activities, while reducing the incentive for regulatory arbitrage between the banking and trading books.

More generally, the securitization process itself is significantly affected by the Committee’s recent changes. As noted, capital requirements have been increased for re-securitization exposures such as CDOs and collateralized mortgage obligations. In addition, capital charges for short-term liquidity facilities to off-balance sheet conduits have been raised, a step that will ensure that more capital is provided to support activities that may present ongoing risk to the bank. And the Committee is requiring that banks conduct more rigorous credit analyses of externally rated securitization exposures and not simply rely on external credit ratings.
Turning to another capital issue, when the Basel Committee finalized the Basel II Accord, it focused exclusively on the denominator of the risk based capital ratio in an attempt to appropriately capture and calibrate risks to capital from the assets it supports. But it did not change the numerator, meaning the way in which capital is defined, which importantly affects its loss absorbing quality. Reflecting lessons from the crisis, the Committee has now proposed changes to the capital definition that would improve the quality, consistency, and transparency of the capital base of financial institutions. This is a very important change that will place a much greater focus on holding higher proportions of the most loss absorbing capital, i.e., common stock.

As important as capital is, in 2008 and 2009 even well capitalized banks were threatened by liquidity problems. In fact, a key characteristic of the financial crisis was a massive withdrawal of liquidity and the inability of banks to deal with the liquidity shortage. The Basel Committee has attempted to address that issue by proposing a global minimum liquidity standard for internationally active banks, which includes both a 30-day liquidity coverage ratio and a longer-term structural liquidity ratio. This new regime is designed to strengthen liquidity risk management, measurement, and supervision, but in many ways, designing a widely applicable liquidity standard is more challenging than designing a capital standard, because liquidity risk can be much more idiosyncratic.

Cutting across all of these issues is the pro-cyclicality of the capital and accounting regimes. One year ago, almost to the day, I addressed the IIB Washington conference and discussed my concerns with the way current accounting rules inappropriately require banks to build reserves too late in the credit cycle, when it is much more difficult to do so. In my speech, I urged a more counter-cyclical approach
that would allow provisions to be made earlier in the cycle, when times are better. Although very important details are yet to be worked out, I am pleased that this approach is now under active consideration by accounting standard setters, and has been strongly endorsed by the Basel Committee as well.

Taken together, all these changes are intended to enhance financial stability through higher levels and quality of capital, improved liquidity, and reduced incentives for excessive risk-taking. Although we still must go through a rulemaking process in the United States to implement final changes to the Basel II framework, I should emphasize that the policies outlined in these four papers reflect the current direction of supervision in the United States. We have already placed great emphasis on both higher levels and higher quality of capital.

For example, the Supervisory Capital Assessment Program, or SCAP – better known as the supervisory stress test – was intended to ensure that banks had an adequate buffer of common equity to withstand a severely adverse economic downturn. Nineteen large bank holding companies were tested under this program, ten of which were required to raise new equity capital to achieve this buffer. In addition, banks seeking to repay government capital under the TARP program were required, as a condition for doing so, to raise additional equity capital to increase their buffer beyond the level required by the stress tests.

As a result, the largest U.S. banks that participated in the stress test raised over $93.3 billion in common equity since the SCAP results were announced last May. The ratio of this high quality common equity to risk-based assets has therefore reached a historically high level in many of these banks, in several cases exceeding or expected to
exceed eight percent by the end of this year. Indeed, in the aggregate, this “Tier 1 common” ratio has moved steadily higher for all national bank holding companies, from 5.1 percent on March 31, 2009, to 7.9 percent as of December 31, 2009.

While this progress is palpable and has significantly strengthened the banking system, it is imperative that we ensure that the improvement is more than temporary. The changes proposed by the Basel Committee are intended to ensure that such higher levels of better quality capital are maintained over the long run, by institutions worldwide, so that the global banking system is less leveraged, less pro-cyclical, and much more resilient to be able to withstand future shocks. While these proposals will certainly need to be refined, I think they provide an excellent basis for moving forward, and they deserve broad general support.

As crucial as the substantive elements are in the four Basel papers, another effort underway is equally if not more important. That is the Quantitative Impact Study that I mentioned earlier. This study, which will be carried out during the first half of this year, will provide a comprehensive assessment of the impact of the various proposed capital and liquidity standards. This in turn will be used in conjunction with the comments received on the December consultative papers to better evaluate and assess individual aspects of the proposals. But more importantly, its purpose is to help answer the critical “how much” questions: how much additional capital and liquidity should be required for each of the proposed new standards, and how much higher should overall capital and liquidity be for each bank? And how do the myriad new proposed standards fit together and work together?

1 Approximately 225 companies where national bank assets account for at least 50 percent of total corporate assets.
This “calibration” exercise, as it is sometimes called, will be a hugely difficult and important challenge for the Basel Committee as it moves forward. But this is the right approach, because considering how the proposals work together as a whole will give us a better understanding of how the reforms will work in practice. It should also help us fine tune the rules to ensure that they really are appropriately reflective of risk.

Most important, the calibration exercise is where we will squarely confront the critical issue that I mentioned at the outset. As policymakers make decisions on how much capital and liquidity banks should be required to hold to make the system stronger and safer, they will need to assess how much such actions could inappropriately restrict the flow of credit to individuals, businesses, and governments that is so important to economic growth.

The Basel Committee has been especially mindful of avoiding this painful potential trade-off now, at a time when the global economic recovery is so fragile. Under the current Basel timetable, while the fully calibrated standards are to be finalized by the end of 2010, they are only to be phased in as economic conditions improve and financial markets become more stable, with the aim of implementation by the end of 2012. And of course, given the magnitude of the changes proposed, the Basel Committee has also called for appropriate transition and grandfathering arrangements.

I think this is the right approach. In the United States, the OCC and the other banking regulators certainly understand how fragile the economy and financial markets are at this point, and we have been at pains to remind banks of their responsibility to serve the borrowing needs of creditworthy customers. None of us wants to take
precipitous action on new capital rules or liquidity requirements that might lead to an abrupt reduction of credit to creditworthy borrowers.

That said, if in the name of short-term credit availability we fail to follow through with longer term enhancements to capital and liquidity requirements, we risk perpetuating an insufficiently strong global banking system. That would be a mistake. Long-term economic growth requires safe, sound, and strong banks, with capital and liquidity standards sufficiently robust to withstand even severe downturns.

In short, if we are going to err, I believe we should err on the side of safety and soundness. This bias, over the long run, will help ensure a sustainable level of credit growth that is consistent with our longer term goal of financial stability around the world.

Thus far, I think the Basel proposals generally strike the right balance, but there is much work ahead in fine tuning and implementing them. Getting them right won’t be easy, and calibrating them correctly will be more difficult still. This will require everyone’s best efforts, and I hope each of you will help by reviewing the proposals and providing thoughtful comments to your respective supervisors. We need the best possible input to make our financial system strong, resilient, and able to safely provide the funding fuel that is so critical to all parts of the global economy.

Thank you very much.