Letter from the Director

In June 2004, the Basel Committee on Banking Supervision introduced a new capital adequacy framework for large, internationally active banking organizations. The proposed new capital framework, the *International Convergence of Capital Measurement and Capital Standards: A Revised Framework* (known as "Basel II"), will implement a new "three-pillar" approach for ensuring prudential capital supervision: (1) minimum capital requirements, (2) capital adequacy and systems review, and (3) enhanced market discipline through required disclosure. The Federal Deposit Insurance Corporation (FDIC), as a member of the Basel Committee, has agreed to the revised international framework and is working with our colleagues at the other U.S. federal banking and thrift regulatory agencies toward its domestic implementation through notice and comment rulemaking.

Only certain aspects of the international framework will be presented for U.S. implementation. Once adopted in the United States, Basel II will allow large and complex banking organizations to make greater use of their own internal risk measurement systems as inputs to capital calculations. Today, international supervisors are working toward the implementation of Basel II, and are developing final supervisory standards and detailed guidelines and review procedures. Twenty-six U.S. banking organizations are participating in a fourth quantitative impact study (QIS 4) to assess the impact of the new standards. Should these 26 banks ultimately adopt Basel II, fully 56 percent of U.S. banking assets will be subject to the new capital regime, at institutions in possession of over 40 percent of FDIC-insured deposits. Understandably, the FDIC is dedicating significant resources to the development and implementation of Basel II capital standards and qualification guidelines.

On May 11, 2005, FDIC Director Thomas Curry testified before Congress regarding the FDIC's views on the implementation of Basel II in the United States. The testimony focused on the potential impact of Basel II on minimum capital requirements and on the competitive playing field for U.S. banks. Director Curry reported the FDIC's preliminary conclusion that the results of QIS 4 do not provide comfort that the Basel II framework will require an adequate level of capital. He went on to outline FDIC concerns about the consistent applicability of the framework across banks and the potentially significant competitive implications. While acknowledging the significant concerns outlined in his testimony, Director Curry expressed a belief that these issues could be resolved, and that the FDIC stands ready to move forward with Basel implementation when this is done.

As we move toward adoption of this more risk-sensitive regulatory capital framework, many issues, questions, and challenges have been presented. This Letter from the Director is intended to answer some of your questions. It also gives me a forum to thank the many FDIC employees who have been working to achieve a successful framework that will properly measure risk for capital adequacy purposes. I thank them for their effort and dedication.

Why do we need a new international capital standard? The 1988 Capital Accord was adopted to advance a uniform capital system for internationally active banks that was more sensitive to banks' risk profiles. The 1988 Capital Accord sought to address industry innovations, correct improper incentives, and strengthen the industry's capital position. Basel II shares the same goals. Basel II is designed to better align risk-based regulatory capital requirements with the risks underlying most activities conducted by large, internationally

active banks and to address financial innovations that have occurred in recent years.

How does Basel II change the way capital adequacy is determined? A key innovation of Basel II is the use of banks' internal risk estimates as inputs to the calculation of minimum capital requirements. Basel II requires banks to determine capital requirements for exposures to credit risk, operational risk, and market risk (for institutions with significant trading activity). The Basel II qualification standards and guidelines impose significant demands to ensure banks are making fair, accurate, and effective measurements of risk exposures and assessing their capital adequacy relative to overall risk. Disclosure requirements are imposed to allow market participants access to key information about an institution's overall risk profile so the market can comprehensively assess an institution's capital adequacy.

Are all banks required to adopt Basel II capital standards? In the United States, only "core" banks would be required to adopt the Basel II standards. Core banks would be those with total banking assets in excess of $250 billion or on-balance-sheet foreign exposures in excess of $10 billion. Other institutions, "opt-in" banks, are banking organizations not subject to Basel II on a mandatory basis but that choose to apply those approaches voluntarily. In each instance, supervisory approval is required prior to the adoption of the advanced approaches. Given the stringent standards and guidelines under development, it is estimated only around 20 of the largest and most sophisticated U.S. banks will become subject to the new framework.

What about the remaining institutions not subject to the Basel II revisions? Inherent in establishing "qualifying" criteria for a bank to be allowed to use the Basel II capital standards is that all nonqualifying banks are effectively subject to a different capital regime. This brings to the forefront a host of issues of paramount importance to the industry and supervisors. Several community banks and trade groups have indicated that if Basel II is implemented, the current capital framework must be revised to enhance its risk sensitivity in order to minimize the competitive inequities that may flourish under a bifurcated capital framework.

Some banks have indicated Basel II may place community banks and thrifts at a competitive disadvantage because the advanced Basel II approaches would likely yield lower capital charges on many types of products offered by both large and small banks, such as residential mortgage, retail, and small business loans. Many well-respected observers have indicated the competitive equity disparities that may arise from a bifurcated capital framework merit a closer look at the current rules. These concerns warrant close review and consideration by the agencies. To that end, U.S. banking agencies are considering ways to revise the existing rules for the nearly 9,000 institutions that will not be subject to Basel II, to ensure capital remains broadly representative of the risks inherent in these institutions.

Where do the bank examiners fit into this process? One of the most challenging, and important, aspects of the new proposal will be the judgment of the bank examiner who will have to determine whether a core or opt-in bank has developed sufficient operating systems and information to qualify for the Basel II capital approach. Quantitative models and methods are vital to the process, but the importance of rigorous evaluation of the risk management environment by our examination force cannot be overstated.

To face this challenge, the FDIC is taking steps to ensure we bring the

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right expertise to bear on the Basel II effort. Numerous initiatives are designed to build upon the strength of the FDIC's existing large bank operations and to focus personnel with quantitative and supervisory expertise on understanding banks' rating systems, models, and capital assessment strategies. Enhanced training programs are under development to allow our supervisory staff to develop and maintain such expertise.

In conclusion, Basel II is a progressive approach to the determination of capital adequacy. It is a novel and complex capital framework proposed to be adopted by the largest internationally active insured depository institutions in the United States. The core of the framework is greater use of internal risk assessments to determine overall institution exposure. The FDIC is working with its sister regulatory agencies to develop detailed minimum operating standards to ensure the integrity of banks' internal assessments. The application and supervision of these new standards will present significant challenges, but I am confident the FDIC is well prepared to fulfill our crucial role as both supervisor and insurer.

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