Capital, Credit Risk, Counterparties, Compliance, Compensation: The Strategic Framework of Bank Supervision

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Well, you've been busy! And, that's just the beginning. While the banking system is off the brink – I devoutly hope – a lot of insured depositories have a long way to go before they see daylight. That private capital is coming into the industry is of course very encouraging, but for the most part it's very picky capital exacting tough terms from the soundest institutions. We've got a long way to go to get banks back on their feet and more than a few will falter along the way.

And, when you're done with the current crisis, there's the urgent repair work already under way to prevent a new one. Since you've all got so much on hand dealing with the banks you supervise, I'll turn today to the emerging regulatory framework. This is of more than academic interest – if you accept a bank's strategic plan now without a full understanding of what it will need to do tomorrow, you will only delay a costly reckoning. As insured depositories strengthen, you must help them not only meet their current challenges – tough as they are – but also at the very same time prepare them for a far more rigorous set of rules buttressed by unforgiving market expectations. To be sure, regulators cannot make business decisions for bankers, but banks that fail to anticipate the new regulatory environment will be very, very poor strategic-risk managers – a real safety-and-soundness problem as recent events have grimly proven all too well.

What I'd like to do this morning is briefly summarize five critical elements of the new regulatory landscape. These are:

- **Capital**: We're looking at tough new capital standards that will finally break the hold Basel I rules have exercised for far too long in the U.S. New capital will redefine the competitive landscape – bank vs. bank, bank vs. non-bank, and line-of-business commitments throughout the financial services industry. You need to get your banks ready for this and also ensure their stability now, preventing undue dividend payments or similar transactions while the industry and markets remain under stress.

- **Credit Risk**: In part due to these new capital standards, banks will be forced to find new ways to manage credit risk. It's critical they do this in a sound, disciplined way – not just find new, high-risk ventures before examiners figure them out and regulators reign them in. Think commercial real estate in the lead-up to this bust and be very, very afraid. But, if the new credit-risk standards are crude – as some proposals to date appear – then we'll just choke off the recovery. Getting this new framework right is among our most critical challenges.

- **Counterparties**: Another major thrust of the regulatory rewrite focuses – rightly – on liquidity risk. This will reduce one form of exposure among inter-connected firms. However, little-noticed aspects of the Administration plan will also break up the credit links between big firms and the degree to which insured deposits can fund non-traditional activities. I think this will break up big banks, with far-reaching strategic impact throughout the financial-services industry.

- **Compliance**: Congress is currently considering creating a Consumer Financial Protection Agency (CFPA). I don't have to tell you that political pressure has added to the policy impact of embarrassing lapses in the consumer-protection area at all of the banking agencies. As a result, compliance is taking a far higher role in prudential exams, ending the longstanding divide between the two sides of the supervisory shop and posing significant legal and reputational risks for the banks you examine.

- **Compensation**: Needless to say, pay packets are about to get opened, and all of you here will have to read them. This is a brand new role for most of you and one that will pose particular challenges even though I think the net impact on prudential regulation will be negligible.

Our time together doesn't permit going into great detail on each of these critical challenges, but I'd like now to turn to the key elements of each of them which each of you will confront in coming days.

Capital

At the G-20 Summit in Pittsburgh just two weeks ago, heads of state set a timetable for rewriting the Basel II rules. Think about that for a moment – heads of state like President Obama actually considered the capital rules once derided as so technical that only junior-level bank risk managers were charged with thinking about them. When the President, Treasury Secretary and other top officials make decisions on bank capital, it's time for senior management also to turn to these emerging rules to identify strategic challenges, competitive threats and new-product opportunities. As they do so, banks will of course look first to their own bottom-line interest, not necessarily to public-policy or market-integrity considerations. This will, of course, put you squarely in the middle, working with your banks to understand their concerns and with regulatory-policy officials to craft constructive capital regulations without unintended consequences for smaller and mid-size institutions.

Tough choices are just weeks away. The G-20 charged global regulators to complete a new round of regulatory-capital standards in draft form by year-end. At the same time, all of the nations at the summit pledged to bring their banks under Basel II by 2011. This will finally force the U.S. to end the protracted debate over these rules – who should be under them, how many options are offered, and so on. Instead, we're going to finalize an array of new standards, modifying the global ones for U.S. considerations, and nail them to the door of each of the banks you supervise.

To be sure, the rules won't go into effect until 2012 or so. But, banks can't turn their portfolios upside down over night nor can they raise capital on a whim. They must thus begin to plan now for the far different regulatory capital regime to come. Each of you can and must play a key role in advising your banks now about this emerging challenge and help lay the strategic groundwork to ensure that each and every bank that makes it through this crisis is ready to do business going forward.

Credit Risk

A lot went wrong with judging credit risk both in assets held in portfolio and those sent into the secondary market. I won't detail the major causes for the credit-risk cataclysm – think subprime mortgages, commercial real estate, syndicated loans – but there's a common element to the solution now well under way. The banks you supervise will need to rely to a far greater extent on proven sources of capital, either their own or from capitalized providers of credit risk mitigation like private mortgage insurance and, if they rise from the dead, monoline bond insurers.

The new credit-risk framework will require "skin in the game" to ensure that originator and issuer incentives are far better aligned with borrowers and investors. If private capital can't bear at least some of a bank's credit risk, then the new framework will force collateral, margining or other up-front risk-shares from borrowers and counterparties – again, skin in the game.

Now, let's turn to why I reach the conclusion that capital will need to be pledged whenever direct or indirect credit risk is created. One widely-acknowledged reason for the credit crisis is the lack of stress testing both in bank modeling and regulatory-capital rules. This failure is being quickly remedied and you should expect your banks – large and small – to understand how to judge their credit books on a forward-looking, stress-scenario basis that takes fat-tail – that is, catastrophic – risk fully into account. Strict stress testing focuses not just on probability of default, but also on loss given default – one reason I think banks will need quickly to look to loss-sharing structures.

Another reason for up-front credit enhancement, or collateral, results from the mud all over the credit ratings agencies or CRAs. Regulators have been slow to follow Congress' direction in 2005 to end their reliance on CRAs, but now global policy – again, starting with the heads of state at the G-20 – have directed them to do so. Congress is also kicking back into action on this point. As a result, a new Basel rule – soon to be implemented here – requires banks to validate CRA determinations on which risk-based capital weightings are based using their own credit-risk analytics. I expect similar requirements – that is, bank understanding of risk, not just a quick look for AAA – to be adopted in a wide array of other arenas. If your banks aren't ready to undertake independent credit-risk analytics, you need to help them gain this capability as quickly as possible. Indeed, even if they could still rely to some degree on the CRAs, wouldn't it be nice if banks all by themselves knew what they're doing both for themselves and their customers?

Finally, there's another critical looming challenge in the credit-risk arena: specific capital-at-risk requirements for asset securitizations. The European Union has already adopted a flat five percent risk-retention requirement, and I am glad to see global regulators and, again, the G-20 expressing qualms about so simple an approach. The Obama Administration has proposed a more nuanced risk-retention requirement, which is the direction I think the U.S. will adopt. However, regardless of the details, I expect risk retention to be a new element in asset securitization, significantly altering secondary markets and reducing "commoditization" in many sectors, residential real estate included. This is, I think, good news for smaller institutions, although they will need carefully to understand the role they can best play in the complex new landscape just beginning to emerge from the market's debris.

Counterparties

As I mentioned, there are several little-noticed – but very important – initiatives under way to break up too-big-to-fail banks. In fact, these proposals would not only force the biggest institutions to reconsider all the businesses they are in and the funding on which they rely, but also sharply limit the degree to which any bank can have too much exposure – credit or liquidity risk – to a single counterparty. This will significantly reduce funding and other support available to very large hedge funds and similar entities, most of which have grown comfortable relying just on one or two big banks to serve all their needs. If these counterparties are forced, as I think they will be, to rely on many more institutions, they too will pose far less systemic risk going forward even as their ability is sharply limited to continue to do business as is.

What are these initiatives? Two critical ones are:

- New Inter-Affiliate Transaction Restrictions: Sections 23A and 23B of the Federal Reserve Act aren't light reading, but the Obama Administration's team has clearly plowed through them. The bill would significantly reduce the ability of banks to fund non-traditional activities with insured deposits and to do business with affiliates on anything other than arm's-length terms. Regulators will impose these restrictions even if the Obama bill's language isn't enacted. Translation: insured deposits will fund banking and banking only, ending much of the value of owning an insured depository in a non-traditional holding company.

- Loan-to-One-Borrower Limits: The Obama team takes these limits – which you all know well – and rightly applies them to a far wider array of counterparty exposures. This would bring risk limits up to date with risk exposure, which long ago expanded beyond traditional lending arrangements. Translation: large counterparties will need to meet their funding, credit and other needs from a wide array of financial institutions, breaking the stranglehold on the capital markets now enjoyed by a very small number of very large banks.

Compliance

I don't need to tell you all that consumer-compliance concerns lie at the heart not only of the market crisis, but also of the political challenges facing each of your agencies. Congress and consumer advocates are understandably furious not just about mortgage foreclosures, but also over a raft of other practices in retail finance that bank regulators are only now addressing. In fact, each time the FRB looks at something – mortgage lending, credit cards, overdrafts – and pronounces itself "shocked, shocked" at one banking practice or another, regulatory critics only grow angrier. Just as banks do themselves no good by suddenly changing their ways when Congress is hot on their trail, so regulators actually undermine their credibility with belated reforms. This isn't to say the reforms are sometimes warranted. However, as regulators veered from unquestioning industry ally to unilateral consumer advocate, their credibility was not enhanced.

It remains to be seen how legislation to create a Consumer Financial Protection Agency will fare and what will happen to the banking agencies' compliance responsibilities. What I know now, though, is that each of your agencies is taking a new tack on consumer compliance. To see it writ bold, look at the Fed's new standards for the non-bank subsidiaries of bank holding companies. It takes a tough line on consumer compliance, most strikingly by telling examiners to ensure that their counterparts at the BHC consider consumer compliance as important as prudential risk management. The Fed said it this way because it

wants consumer concerns to start with the CEO and it wants you to be the ones to tell them so.

Compensation

As anyone near AIG who saw all the pitchforks heading towards it after bonus revelations knows, compensation is a hot button. I have never, ever seen passion like this on a banking issue, with Members of Congress from both parties falling over each other to introduce compensation restrictions and voice ever-higher pitched outrage about banker pay. Because passion rose so high, it cooled almost as fast as the individuals involved in the AIG case surfaced, the complexities of compensation dawned on Congress and, as is often the case, attention turned to other matters.

This isn't to say, though, that compensation reform is off the table. Again, the G-20 heads of state spoke up on this point, blessing a new set of compensation standards the FRB will soon propose for the U.S. Bankers pale at the sight of these standards, but they need to understand how much tougher they could have been. The U.S. and U.K. took a lot of grief from the French and Germans, who wanted specific pay and bonus caps, not just these new principles. With German elections over, some of the heat has passed, but it will grow in no time if international observers think the U.S. is lagging on the promises made at the G-20. And, of course, one can count on criticism from Congress when the FRB publishes its guidance – pretty much anything the industry likes in it will get blasted from on high.

So, where does this leave you? Squarely in the middle, trying to implement compensation practices that better align institutional incentives with prudential ones even as bankers howl at the mere thought of you telling them what to do.

Is there a good way out of this awkward position? Unfortunately, I don't think so. Had capital, credit-risk, counterparty standards and compliance requirements been up to snuff, then inappropriate or even scandalous compensation could never have happened. If a broker can't sell a risky mortgage to a bank because the bank has appropriate underwriting standards, the broker won't have anything to sell, let alone to get paid for. If an investment banker can't push all his or her product to a single gullible buyer besotted by credit ratings, then again there isn't a sale and there can't be a bonus. If boards of directors had their eyes on enterprise risk management, not quarterly earnings, yet again compensation problems couldn't have occurred because corporate practice would have been prudent from the get-go.

The Real Challenge: Back to Basics

With all the new challenges, it's easy to lose track of one additional critical task for each of you here today: don't lose track of the basics. Much in the pending reforms repairs errors that never should have been allowed in the first place. For example, we're all falling all over ourselves now writing complex new liquidity-risk standards, with the G-20 directing several new ratios in this area. But, if we'd had remembered a basic lesson from the S&L crisis – don't fund short and lend long – we wouldn't be here today.

As I look at the market now, I see all too much evidence of ongoing failure to catch early-warning signs blinking bright red. Example: how could GE's banks grow 10,000 percent in just a quarter or two from late last year to this year? Another lesson of the S&L crisis – written now in law – is that asset growth of thirty percent or more a year is a warning sign. GE isn't the only bank, though, that grew humongously – think Indy Mac, Fremont and more than a few others no longer among us.

And, there's the role of bank directors. Years ago, the then-head of examination at the OCC told me of a huge Texas bank he had closed. It had the most beautiful board room he'd ever seen – and he'd seen lots. As he described it, "It slept eight." That's sadly still all too often the case. Look for example at Bank of America – how in the world did the board – and the bank's supervisors – fail to ensure a clear, current succession plan. When the CEO walked, the bank was thrown into still more chaos – a safety and soundness problem if ever there were one.

So, let me stop where I started – boy, are you busy! You play perhaps the most critical role in ensuring that a sound banking system rises from the ashes. You play a real role in driving policy to ensure it comports with on-the-ground reality. Tell your bankers the truth, hard as it often is. Make them see over the parapet even when they don't want to. And, even as you do this, get ready for new rules that will redefine the strategic framework of U.S. banking and, with it, the franchise value of many of the banks with which you work.