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Statement of the Shadow Financial Regulatory Committee

on

Expanded FDIC Examination Authority

February 14, 2005

Primary responsibility for bank examination is divided among the four federal supervisory agencies: the Federal Reserve, the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), and the FDIC. In addition the FDIC has backup authority to examine any depository institution for insurance purposes. A Memorandum of Understanding with the other supervisory agencies has limited that authority to institutions with a CAMELS rating of 3, 4 or 5. In January 2005 the FDIC's Board of Directors granted new authority to its Chairman to order special examinations of apparently healthy institutions whose primary supervisor is not the FDIC when there is uncertainty or subjectivity associated with the bank's modeling of its capital requirements under Basel II in accord with the bank's internal risk measurement models.

The FDIC's concern, apparently, is that the bank's model may be mispecified or misapplied, so that its capital may be less than its true risk condition would dictate, but for the FDIC position to be valid, one would have to believe that the Federal Reserve, OTS or OCC lack the capability to detect the problem or the will to resolve the problem.

The Shadow Financial Regulatory Committee (SFRC) has no doubt that the models that will be put into place under Basel II will be difficult to evaluate. Calibration exercises undertaken by the Basel Committee on bank data indicates that the models will generally result in lower capital requirements for credit risk for large banks than those that currently exist. The SFRC has on several occasions indicated its belief that capital requirements should be increased rather than decreased (albeit with subordinated debt viewed as an appropriate—indeed, desired--form of regulatory capital), so it is clear that the Committee is sympathetic to the concerns of the FDIC.

Nevertheless, the Committee believes that it would be a mistake to add an additional layer of supervision and oversight of the large bank risk modeling process. Such supervision requires sophisticated skills and would be expensive to replicate. As an alternative, the Committee suggests that all supervision of modeling by U.S. depository institutions be the responsibility of the Federal Financial Institutions Examination Council—an existing interagency organization created to harmonize policies among the agencies. The financial and econometric expertise needed for the complex task of examining large bank risk models, which is now distributed among the agencies, would be consolidated in a single organization.