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TESTIMONY OF

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COMPTROLLER OF THE CURRENCY

Before the

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

April 20, 2004

Statement Required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

I. INTRODUCTION

Chairman Shelby, Senator Sarbanes, and members of the Committee, I appreciate this opportunity to review the condition of the national banking system. My written statement covers two principal areas.

First is the continued strong performance and condition of the national banking system in the face of a changing banking environment. National banks continue to display strong earnings, improving credit quality following the recent recession, and sound capital positions. That continued strong performance reflects, in general, past good lending and investment decisions. In addition, to some extent, that performance reflects changes in business strategies and risk management practices. Banks have adopted better risk management techniques and have benefited from greater geographic diversification. Nonetheless, risks remain, including the growing importance of operating, strategic, and reputation risk as banking companies adapt to change by using technology, different products or strategies, or more complicated business structures.

Second, we continue to adapt supervision to the changes in banking. Among the most important strategies we employ to maximize the effectiveness of our examination and supervision program is our risk-focused approach to supervision, which is designed to address change. That risk-based approach has enabled us to turn increasing attention to operating, strategic, and reputation risk.

The approach that the U.S bank regulators have taken to the effort to reform international bank capital standards, known as Basel II, provides a distinct example of how we are adapting to change. While we recognize that we can improve capital regulation to take into account changes in banking and risk management, we have advocated proceeding with appropriate caution. In my statement today, I will discuss the proposed capital reform and the commitment that I have made that any reforms of the regulatory capital rules will be adopted in a prudent, deliberate fashion.

II. THE CONDITION OF THE NATIONAL BANKING SYSTEM

The OCC supervises federally chartered national banks and federally licensed branches of foreign banks. As of year-

end 2003, the national

banking system consisted

of approximately 2100

banks (26 percent of all

commercial banks). Of

these, 2001 were FDIC-

insured banks, holding total

assets of \$4.3 trillion. The

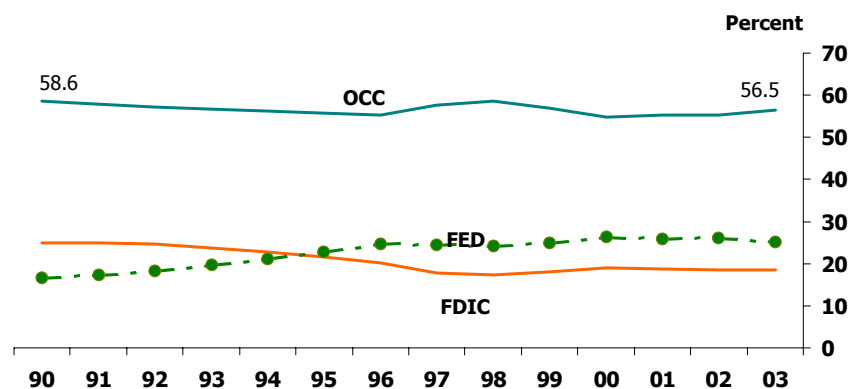
rest were uninsured bank

and trust companies. The OCC also supervises 53 Federal branches of foreign banks. While the

number of national banks has declined for nearly two decades, and the assets of the system have

steadily increased over the same period, the national bank share of total system assets has

**Share of commercial bank assets
by Federal bank supervisor**



Source: Integrated Banking Information System (OCC).

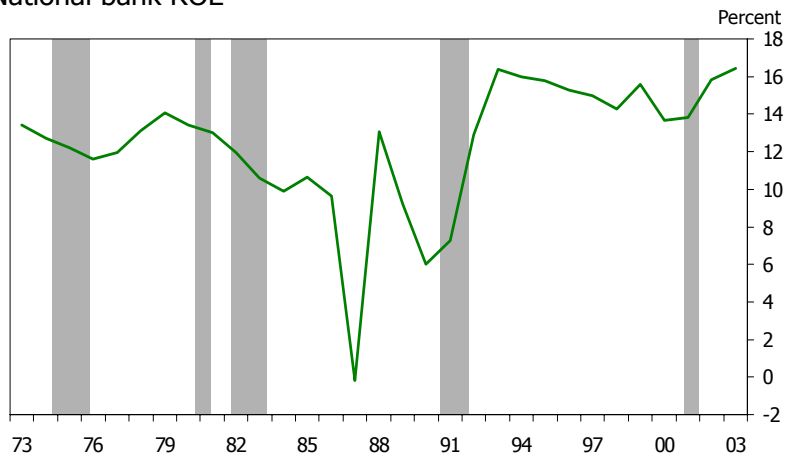
remained roughly constant, and now stands at 56.5 percent. The national banking system includes many of the largest banks by asset size, but community national banks are by far the most numerous in the system.

Financial Performance

The financial performance and condition of the banking system is strong. Earnings have

National bank ROE at record high

National bank ROE



Source: Integrated Banking Information System (OCC)

Data as of year-end. Shaded areas represent periods of recession.

remained at historically

high levels for a decade.

Until 2002, aggregate net

income for national banks

had never exceeded \$12.5

billion in a quarter, and the

industry's average return on

assets had never exceeded

1.5 percent, at least not

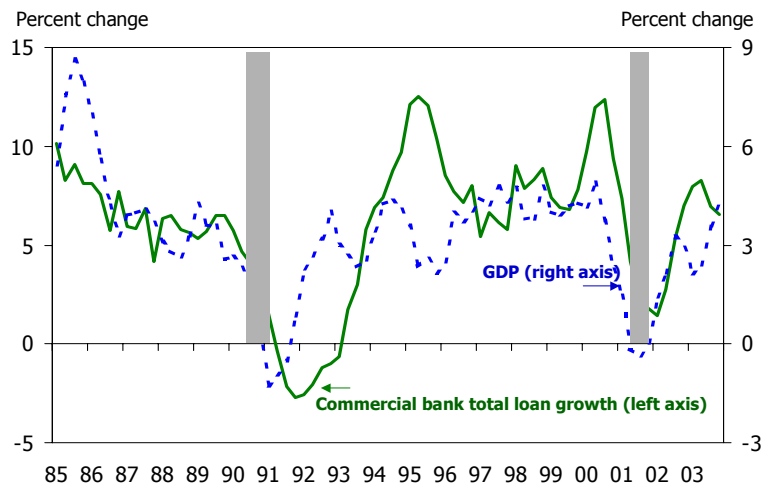
since the quarterly reporting

began in 1984. But since the beginning of 2002, national banks have exceeded both earnings milestones in every quarter but one. In 2003, national banks set new records for both return on equity and return on assets. Although the slow economy led to weakness in some areas, including business lending, the contractions in these areas were more than offset by growth elsewhere.

Total loans held by banks continued to expand throughout the recent economic cycle, growing by 7.8 percent in 2002 and 7.6 percent in 2003. In contrast, starting with the recession of 1990-91, total loans held by national banks fell for 10 consecutive quarters. Where the earlier recession affected all sectors of the economy, the recent recession was concentrated more extensively in the business sector, in part due to the fallout from the tech/telecomm bubble in the late 1990s. This caused a sharp fall in the demand for business loans, particularly at large banks.

Loan growth continued throughout this recession

The reduction in corporate lending by banks also was due to the competitiveness of corporate bond issuance due to low interest rates. Many large and even medium-size firms have been able to access the bond market at very low rates throughout this



Source: Integrated Banking Information System (OCC); BEA/Haver Analytics

Quarterly data through Q2-2003. Shaded areas represent periods of recession.

economic slowdown, which has further reduced the demand for larger commercial loans. This has affected especially the lending activity at the largest banks, because they tend to have potential business customers who have greater access to other financial options. Community banks, in contrast, taking advantage of their knowledge of local markets and business needs, have maintained their business lending throughout this cycle, with increases reported in their commercial and industrial (C&I) and commercial real estate loan books.

The mortgage and consumer sectors have been a strong source of loan growth for national banks. Residential real estate loans held by national banks rose at an annual rate of about 20 percent in both 2002 and 2003. Within this broad category, home equity lending has grown particularly fast, rising by 21 percent in 2001, 38 percent in 2002, and 37 percent in 2003. Throughout this cycle, consumers have taken advantage of declining mortgage rates to extract funds from the increased value of their homes. Some of these funds from the refinancing and home equity loan activity have been used, however, to pay off higher interest credit card and installment debt.

The low interest rate environment has been a plus and a minus for banks. Smaller banks with their greater reliance on retail funding have seen steady erosion in their net interest margins. By contrast, the largest banks, which rely more on wholesale funding, until recently experienced relatively high net interest margins. As of December 2003, the net interest margin for banks in all asset size groups has fallen below their historic averages. Despite the decline in margins, banks have reported continued growth in net interest income due to the strong expansion in household lending. As long as margins remain compressed, however, this growth in income is vulnerable if the volume of activity in the consumer markets falls.

The low interest rate environment also raises concerns about the extent to which banks may be taking on interest rate risk in an effort to maintain their interest income. Effective management of this risk will be important for banks in all asset size groups as the economy recovers, which is often accompanied by an increase in interest rates. We have alerted national banks to our

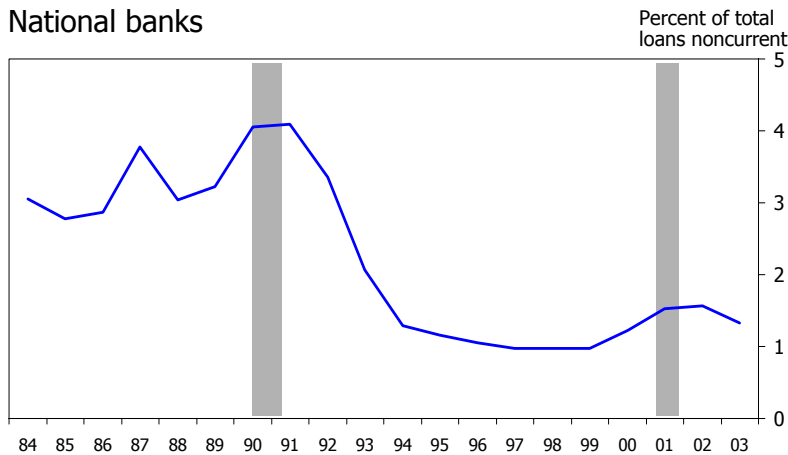
concerns on this score and provided advice on approaches on how best to address this "low rate set-up."

Deposits have continued to flow into banks, especially large banks, as might be expected when low interest rates hold down returns on alternative money market instruments. Deposits at national banks grew at 6.0 percent in 2001, 7.6 percent in 2002, and 8.6 percent (year-over-year) in 2003. The increase in deposits has fueled growth in bank assets. The assets of national banks grew 9.8 percent in 2003 (year-over-year), as compared to a 0.1 percent decline reported at this point of the recovery from the last recession. Nevertheless, we believe banks must be vigilant in their assessment of the potential sensitivity of their sources of funds to changes in the economic environment or, in some cases, the bank's own performance. The high level of liquidity in the banking system could be reduced rapidly if the relative yield on alternative investments

increased sharply or if banks failed to maintain certain performance levels required to retain some sources of funds.

Noncurrent loans remained well below level of early 90s

National banks



Source: Integrated Banking Information System (OCC) Data as of year-end. Shaded areas represent periods of recession.

While credit quality deterioration is typically an issue during recessions, the most recent experience for

national banks was much better than during the previous recession. This may well reflect

national banks' response to cautions issued by the OCC to bankers in the late 1990s to be vigilant about their underwriting standards. The noncurrent loan ratio for national banks (loans at least 90-days past due plus nonaccruals) reached a peak of 4.4 percent in 1991Q2; in contrast, at the peak in this economic cycle, reported in 2002Q2, the noncurrent ratio was 1.6 percent. For large banks (over \$1 billion in assets), the noncurrent loan ratio has now declined to 1.3 percent, near pre-recession levels. Smaller banks (under \$1 billion in assets) were not as affected by the stresses in the nonfinancial corporate markets and thus experienced only a modest decline in credit quality during the recession. While credit quality appears to be improving for the banking industry, the OCC continues to watch developments in areas that remain vulnerable, such as small business lending and certain real estate markets and property types.

The data on bank failures and new entrants to the commercial banking system also reflects a dynamic and healthy banking system. In 2003, two banks failed – one national and one state bank. By contrast, 100 commercial banks – including 33 national banks and 67 state banks – failed in 1992, the first year of recovery after the 1990-91 recession. The commercial banking system also had 111 new entrants in 2003; this compares to 40 new banks in 1992.

While the national banking system has displayed strong performance, even during the recent recession, history teaches us that we cannot know for certain what lies ahead, and banks' capital provides important protection against that uncertainty. National banks remain well capitalized and rest on a much firmer capital base than they did more than a decade ago. In 1990, for example, 6.3 percent of banks had risk-based capital ratios below 8 percent, which we would now consider undercapitalized, and 18.3 percent were below 10 percent. Today, all national

banks, with the exception of a few small banks under special supervision, have risk-based capital ratios above 8 percent, and more than 90 percent of national banks have risk-based capital ratios above 10 percent.

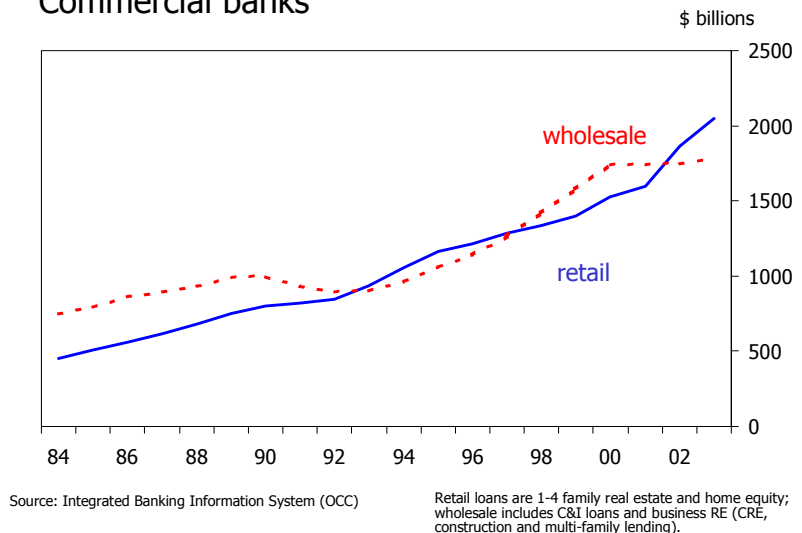
Continued, Gradual Change in Bank Strategies

Like other businesses, banks adjust their strategies in response to the lasting changes in their business environments. Over past decades, bank business strategies in the U.S. have evolved in response to changes in household financial practices, advances in financial knowledge and information and communication technology, and the relaxation of constraints against interstate banking and allowable bank activities. Since such changes are gradual, they are sometimes hard to recognize. Nonetheless, they result in real changes in the nature of the business.

For example, one change is an increase in the relative emphasis on lending to households, especially among the large banks. Over the last 20 years, large banks have moved increasingly into retail lending to take

advantage of cost-saving technologies and geographic diversification in a period of strong growth in the demand for retail products. In 1984, 30 percent of aggregate commercial bank loans were to households—residential mortgages, and loans

Retail loan share growing
Commercial banks



to individuals. By 2003, that ratio had risen to 46 percent. The increased emphasis on retail lending has been particularly pronounced in the largest banks. Among the largest 10 banks, the retail portion of bank loan portfolios has increased from 22 percent to 55 percent over the last two decades.

Another strategic change in banking is the improvement in financial risk management – the tools, products and processes. Since the last business cycle, banks have made substantial investments in this area. A fundamental shift in approach is occurring, from viewing risk on a transaction-by-transaction basis to a more holistic, portfolio view. Advances in technology have enabled banks to harness information to manage more proactively the risks in their portfolios. These include more sophisticated models to help banks underwrite and manage their credit risks and to conduct scenario analyses of their interest rate and liquidity risks.

Concurrent with the adoption of these enhanced tools has been the development of independent risk management units with responsibility for enterprise-wide risks. These units, which typically reside at the highest level of the corporation, oversee portfolio risk, balance the risks and rewards of new business strategies and initiatives, and ensure that business units and the bank as a whole comply with established risk tolerances and limits.

Risk management also has benefited from the broader array of products and tools that banks can use to adjust and manage their risk profiles. These tools help to foster deeper and broader financial markets and ultimately help to allocate risks to participants in accordance with their risk appetite and performance objectives. For example, banks have been particularly successful in

reducing their exposures to credit concentrations. The growth of the syndicated loan market has enabled banks to more broadly distribute credit exposures within the US banking system, as well as to foreign banking organizations and non-banks. Similarly, the expanding asset securitization market has provided banks with another avenue to manage concentration risks and to diversify their funding sources and to provide greater access to under-served markets.

The growth in the derivatives markets has provided banks with additional tools to manage their credit and interest rate risk exposures. Derivatives are also a valuable risk management product to help banks' institutional customers manage a broad array of risks arising from common business activities such as securing long-term funding or protecting the value of importing or exporting commercial goods. Banks' increased participation in residential real estate lending is one example of how derivatives have enabled banks to expand their product offerings while managing their risk profiles. Although residential real estate lending is typically associated with low credit risk as a consequence of diversification, solid collateral, and the borrower's vested interest, it can represent high exposure to interest rate risk. With the advent of products to hedge interest rate risk, such as interest rate swaps and options, banks have been able to expand their lending in this area while managing the risk of potential shifts in interest rates. In the absence of effective mechanisms to hedge such risks, it is unlikely banks would have been able to participate as actively in the growth of this sector.

Growing Importance of Operating, Strategic and Reputation Risk

Notwithstanding the strong financial performance and condition of the banking industry, and improvements in the management of key financial risks, critical challenges remain. Chief among

these is the need for banks to avoid missteps, abuses, or perceptions that could undermine the confidence and trust of their customers or financial markets. Recent events have demonstrated that bank soundness is much more than just a function of financial strength and that the risks facing the banking industry extend beyond the financial risks – credit, liquidity and interest rate risks – that have traditionally been the focus of bankers and regulators. Increasingly, bankers must be cognizant of and control the operational, strategic and reputation risks posed by their activities and how their activities will be perceived by the markets and their customers. A thorough evaluation of those risks and their potential impact on a bank’s longer-term strategic direction and its relations with its customers is paramount and must override pressures from management, analysts, or shareholders to increase short-term earnings at the expense of fundamental controls and safeguards.

Many of the recently publicized problems facing the industry have stemmed from breakdowns in key governance and control areas: insufficient oversight and due diligence in reviewing or considering complex financial transactions or new product lines; lapses in security controls and the safeguarding of customer information; over-reliance on third parties for critical services or product generation; and failure to adhere to sound internal audit and control procedures and processes. These breakdowns are not limited to banks of a specific size, market or product niche. Community banks have suffered losses stemming from over-reliance on loans, investments and services purchased from third-party vendors – often in an effort to augment otherwise lackluster loan demand. Several large banks have faced significant questions about their dealing with customers and alleged improper oversight and management of key product lines.

III. KEEPING PACE WITH CHANGE IN THE NATIONAL BANKING SYSTEM

Change is a consistent theme in the operation – and the supervision – of the national banking system today. National banks must evolve their businesses if they are to remain competitive in today's financial services markets. At the same time, the OCC must adjust its supervisory and regulatory approaches in order to ensure that national banks can avail themselves of all of the attributes of their charter safely and soundly. Among the most important strategies we have developed to maximize the effectiveness of our examination and supervisory program is our risk-focused approach to supervision.

The OCC's Risk-Focused Approach to National Bank Supervision

OCC's supervision by risk approach dates back more than 10 years and involves supervisory policies and processes that tailor our oversight to the key characteristics of each bank, including asset size, products offered, markets in which it competes, and the board's and management's tolerance for risk. This process provides an effective means for the OCC to allocate our supervisory resources and to better communicate to senior bank management the areas where they may need to correct problems before they become entrenched.

Risk-based supervision begins with an assessment of a banking organization's existing and emerging risks, and management's efforts to manage and control those risks, in nine specified risk areas: credit, liquidity, interest rate, price, foreign exchange, transaction, compliance, strategic, and reputation. Based on that assessment, the OCC examiner-in-charge or portfolio manager will develop and implement a detailed, supervisory strategy for the bank, based on its

risk profile and the complexity of its lines of businesses. Examiners identify areas of highest risk, assess what management is doing to address those risks, and communicate regularly with management to indicate where additional management actions are needed. In performing this evaluation, OCC examiners consider not only the activities of the bank and its operating subsidiaries, but also how the bank's risk profile is affected by the activities of other subsidiaries and affiliates.

Our assessment of the integrity and effectiveness of a bank's risk management systems includes appropriate validation through transaction testing. If this produces concerns, we will "drill down" to test additional transactions. If this reveals problems, we have a variety of tools with which to respond, ranging from informal supervisory actions directing corrective measures, to formal enforcement actions, to referrals to other regulators or law enforcement. The examination procedures implementing OCC's supervision by risk program are documented in the Comptroller's Handbook.

Supervision by risk provides an effective way to supervise banks in the current rapidly changing environment. It also allows us to apply a consistent supervisory methodology across an increasingly diverse group of banks and bank activities. Because the design of this approach requires that we customize an examination based on a bank's underlying risk characteristics, it allows us to more effectively direct OCC resources to the banks or activities within banks exhibiting the greatest risk.

In response to the growing divergence in the complexity and scope of operations between large and small banks, we have divided our day-to-day supervisory operations into two lines of businesses – our Community and Mid-size Bank program and our Large Bank program.

Our Community/Mid-size Bank line of business oversees over 2,000 national banks and Federal branches and agencies through our network of district, field and satellite offices. When examining this population of banks, examiners use a core set of examination procedures to draw conclusions about the magnitude of risk and the adequacy of the risk management system for each of the nine areas of risk. Even in low-risk banks, we sample, verify, and test the bank's policies, procedures, and systems. When risks are elevated; when activities, products and services are more complex or present greater financial or compliance risks; or when issues or problems emerge, examiners will expand the scope of their supervisory activities using more detailed guidance found in topical booklets of the Comptroller's Handbook series. Periodic monitoring of community banks, another key element of the supervisory process, is also designed to identify changes in the bank's condition and risk profile, including new products or services, and to assess bank corrective action on outstanding supervisory concerns between formal onsite examinations. This quarterly monitoring process allows examiners to identify significant changes in the risk profile of the banks they supervise on a timely basis.

Our Large Bank program focuses on the 24 largest national banks. The supervision of each large bank, overseen out of our headquarters office, is staffed by a resident examiner-in-charge and a team of examiners and specialists in areas such as commercial and retail credit, capital markets, bank technology, asset management, and compliance. These examiners and specialists track the

quantity and quality of risk management in real time so that our assessments are forward-looking as well as historical. This program allows the OCC to develop a more thorough knowledge of the bank than is possible through the traditional regime of periodic, discrete examinations. Over the years, we have also developed, tested, and refined this supervisory approach expressly to address the special financial and compliance challenges posed by bigger, more complex, and globally positioned banks. We are confident that this approach will be effective to supervise the "mega-banks," those with assets of a trillion dollars or more, which are forming as a result of recent acquisition activity in the industry.

Today's national banking system operates not just nationally, but globally. Our large banks all have operations or a presence overseas. The expansion of our large banks' operations across various legal entities and geographic boundaries puts an increased premium on coordinating our supervisory responsibilities with other domestic and foreign regulators. Domestically, we and the other banking agencies build upon each other's supervisory reviews and databases. We routinely share reports of examination and other agency-institution communications and provide each other with access to our organizations' structure, financial, and supervisory information. To help facilitate and coordinate our supervision of large, complex institutions, we share information on proposed examination and supervisory activities for the coming year and coordinate the planning and execution of those activities. When appropriate, we hold joint meetings with institutions involving matters of mutual interest and may conduct coordinated reviews or examinations where a business activity is conducted across legal entities. Our London office provides us with examiner expertise to interact with foreign supervisors and provides a platform to examine national bank branches overseas. Our London examiner staff provides a critical network to deal

with home/host country issues, information sharing issues, and outsourcing issues. We also participate in the Foreign Banking Organization program (along with the Federal Reserve Board) to examine and supervise Federal branches and agencies in the United States.

We also are deeply involved in the development of international bank supervision policy through our participation in the Basel Committee on Banking Supervision and in the Joint Forum, which is an international group of banking, securities, and insurance supervisors; through our regular dialogue with foreign banking regulators; and through our international and technical assistance programs that provide training and internship opportunities to bank supervisors. In fact, not long ago we detailed to the Treasury Department four experienced examiners who are now working in Iraq.

To help meet the challenges of an ever more complex banking industry, our resident and field examiners and specialists are supported by a team of policy specialists, analysts, accountants, and economists in our headquarters office who monitor industry, market and economic trends, provide technical expertise, and develop analytical tools and models to support our examination functions. For example, our “Canary” system monitors and identifies banks that may have high or increasing levels of credit, liquidity, or interest rate risks. Our credit risk and economics staffs have developed various analytical tools that assist examiners to identify portfolio or industry concentrations where risk may be increasing for more in-depth investigation. Our Risk Analysis unit – staffed by Ph.D. economists – provides on-site technical assistance to our resident staff in evaluating banks’ quantitative risk models and measurement systems. Our National Risk Committee serves as a coordinating body to gather and disseminate information from throughout

the OCC and the financial markets on emerging risk issues and advises me and the OCC's Executive Committee on a quarterly basis of emerging issues and potential policy and supervisory responses.

Our combination of continuous on-site supervision, with the "ground level" intelligence it provides on each individual bank's activities and strategies, coupled with our broader, systemic risk analyses, allows us to quickly adjust our supervisory strategies to emerging risks and issues that may arise at individual institutions, within business segments or across the industry as a whole. It also allows us to leverage the diverse skill sets that are needed to supervise our most complex institutions effectively.

Response to the growing importance of operating, strategic, and reputation risk

To address the growing importance of these non-financial risks, we have taken a number of steps to strengthen our supervision and oversight in the critical areas of audit and corporate governance. In April 2003, we issued an updated examination booklet on Internal and External Audits. This booklet sets forth our expectations that well planned, properly structured, and independent auditing programs are essential to effective risk management and internal control systems. The revised booklet incorporates issues related to recent events related to audit programs, including the independence provisions of the Sarbanes-Oxley Act and the implementing rules and regulations of the Securities and Exchange Commission.

We have also updated our booklet, "Detecting Red Flags in Board Reports – Guide for Directors." This guide provides a bank's board of directors with an overview of information

generally found in board reports and highlights various “red flags” – ratios or trends – that may signal existing or potential problems.

In response to the continued evolution of banking products and structures, the OCC’s Committee on Bank Supervision has recently directed the formation of an internal group within the OCC to oversee and evaluate how new banking products and structures may affect our supervisory activities. This review committee will function similar to the new product review committees found at some of our larger institutions. The committee will have membership from our various supervisory operations, risk, legal, and information technology units.

We have also taken steps with the other U.S. banking agencies in the areas of audit and corporate governance. For example, in August 2003, the agencies issued final joint rules that strengthen their authorities to take disciplinary actions against independent public accountants and accounting firms that perform audit and attestation services required by section 36 of the Federal Deposit Insurance Act. The rules establish procedures under which the agencies can, for good cause, remove, suspend, or bar an accountant or firm from performing audit and attestation services for insured depository institutions with assets of \$500 million or more. In March 2003, the agencies issued an updated “Interagency Policy Statement on the Internal Audit Function and Its Outsourcing” to reflect provisions of the Sarbanes-Oxley Act and SEC rules regarding auditor independence. The revised policy statement also provides enhanced discussion of the responsibilities of a bank’s board of directors and senior management with respect to internal audit and reiterates the need for banks to maintain strong systems of internal controls and high quality internal audit programs.

More recently, the OCC has worked with the Federal Reserve Board and the Securities and Exchange Commission to develop an interagency statement on sound practices for conducting complex structured finance activities. These activities generally involve the structuring of cash flows and the allocation of risk among borrowers and investors to meet the specific objectives of the customer in more efficient ways. They often involve professionals from multiple disciplines within a financial institution and may be associated with the creation or use of one or more special purpose entities designed to address the economic, legal, tax or accounting objectives of the customer. In the vast majority of cases, structured finance products and the roles played by financial institutions with respect to these products have served the legitimate business purposes of customers, and these products have become an essential part of U.S. and international capital markets. A limited number of complex transactions, however, appear to have been used to alter the appearance of a customer's public financial statements in ways that are not consistent with the economic reality of the transaction, or to inappropriately reduce a customer's tax liability.

The interagency statement, which we expect to soon publish in the Federal Register for comment, describes the types of internal controls and risk management procedures that can assist financial institutions to identify and address the reputation, legal and other risks associated with complex structured transactions. The statement, among other things, provides that financial institutions should have effective policies and procedures in place to identify those complex structured finance transactions that may involve heightened reputation and legal risk, to ensure that these transactions receive enhanced scrutiny by the institution, and to ensure that the institution does not participate in illegal or inappropriate transactions. The statement also

emphasizes the critical role of an institution's board of directors and senior management in establishing a corporate-wide culture that fosters integrity, compliance with the law, and overall good business ethics.

While regulatory and supervisory initiatives such as these are important to help banks manage operational, strategic and reputation risks, it is incumbent on the banking industry to assume primary responsibility for its own conduct in these areas. In a speech last year before the American Bankers Association, where I discussed the issues of fair dealing and treatment of customers, I stressed that the ultimate protection for banks is to instill in all employees a dedication to the highest standards of fairness and ethical dealing; to make clear to employees that no loan, no customer, no profit opportunity is worth compromising those standards; and to take swift and decisive action where those standards are violated. The OCC is committed to be vigilant in this area and has and will continue to take responsive action when we discover abuses or weaknesses. I expect bankers to do the same.

Basel II Developments

Because national banks have international as well as domestic operations, the OCC must – and we do – become involved in the development of approaches to bank supervision at the international level. Currently, the most significant of these approaches is the ongoing effort to revise the 1988 Basel Capital Accord. Let me briefly provide you a status report on this effort.

There have been a number of articles in the press in recent weeks about positions that U.S. regulators, and the OCC in particular, may be taking that I believe warrant some clarification and amplification.

First, let me stress that my U.S. colleagues and I share an overarching goal that Basel II be implemented in a manner that is entirely consistent with the safety and soundness and continued competitive strength of the U.S. banking system.

As I have said, banks' current financial and capital positions are strong, but as the industry continues to evolve, so does its risk profile. Recognizing and adapting to changing risk profiles and changing risk management practices is critical to maintaining those strengths. These observations inform our approach to negotiations in the Basel Committee on Banking Supervision regarding Basel II. However, while we recognize that we can and should improve capital regulation to take into account changes in banking and risk management, a basic tenet in our negotiations over reform of the international capital standards is to *do no harm*. U.S. banks are world leaders in many aspects of banking – credit cards and securitizations, for example – and we must assure that these important markets are not disrupted or impaired in the name of achieving international conformity in capital rules. In view of the fundamental strength and resilience of the U.S. financial system, we believe that reforms to our regulatory and supervisory structure must be adopted in a prudent, reflective fashion.

Thus we are fully committed to three things: first, an open rule making process in which comments are invited and considered, good suggestions are heeded, and legitimate concerns are

addressed; second, a reliable quantitative analysis in which we can assess the likely impact of Basel II on the capital of our banks prior to its adoption; and third, a prudent implementation in which we make well reasoned and well understood changes to bank capital requirements and incorporate in those changes appropriate conservatism. In this regard, I welcome the questions and issues that members of this Committee and its staff have raised about this important project and I have repeatedly stressed to the Basel Committee the important role that Congressional oversight plays in our deliberative process.

The U.S. agencies' insistence on a thorough and rigorous deliberative process already has resulted in important modifications to the Basel II proposals. One of the most significant of these issues – and one that U.S. banks were virtually unanimous in criticizing in response to the Basel Committee's third consultative paper (CP-3) – involved the fundamental question of what losses capital requirements should be designed to cover. CP-3 would have calibrated capital to ensure coverage of both expected losses (EL) plus unexpected losses (UL). However, banks in the U.S. today generally measure and manage their internal economic capital allocations by reference to UL only, and most banks consider EL to be covered by a combination of reserves and credit pricing. As we examined this issue, we became convinced not only that the banks were conceptually correct in their arguments, but that retaining the EL plus UL calibration would have severe ramifications – not the least of which might be to seriously jeopardize the industry's acceptance of Basel II framework as being a conceptually sound framework. While many on the Basel Committee resisted this initially, the Committee ultimately put forth a new proposal in October to modify the calibration of Basel II to UL only. This modification was strongly endorsed by industry participants and has now been agreed to by the Committee.

The Committee announced several other important modifications to CP-3 in January that are responsive to numerous comments we received on CP-3 and the U.S. agencies' advanced notice of proposed rulemaking (ANPR) that was issued last August. These modifications include simplifying the proposed treatment for securitizations and aligning it more closely to industry practice and an agreement to find a prudentially sound solution that better recognizes credit mitigation techniques used by the industry. Other issues are still under discussion by the Committee's various technical working groups and are scheduled to be considered by the Committee at its meeting in May.

Probably the most difficult policy issue remaining involves the appropriate risk-based capital treatment of certain retail credit products – unused credit card lines in particular. This issue is critically important for national banks and for the cost and availability of consumer credit. It is also an area in which consensus has been hard to come by. Given the prominence of the retail lending business for U.S. banks, and for national banks in particular, there is little room for substantive compromise, and the OCC will not accept provisions that are likely to unduly disrupt or disadvantage established, well-functioning business practices. We believe that this issue will be resolved in a manner that appropriately addresses safety and soundness objectives without altering legitimate business practices.

Notwithstanding the difficulty of these issues, the Committee's goal is to be in a position by mid-year to release a text that will provide the basis for each country's national implementation process. Let me reiterate that point: the release of the next round of proposals does not represent

a final agreement or accord; rather, it is the platform from which we will launch our more in-depth domestic deliberative process. In the U.S., that process will have several key steps.

First, the U.S. agencies will conduct a fourth quantitative impact study (QIS 4) in the third and fourth quarters of this year. This study will be based on the Committee's mid-year release and will differ in some important aspects from the Basel Committee's earlier quantitative studies. QIS-4 will not only be conducted against the background of a more fully articulated proposal, but will include a more prominent supervisory role to ensure greater reliability and consistency in survey results than has occurred in the past. We continue to believe that we cannot responsibly adopt final rules implementing Basel II until we have both determined with a high degree of reliability what the impact will be on the capital of our banks, and we have made the judgment that the impact is acceptable and conducive to the maintenance of a safe and sound banking system in the U.S. We believe the results of QIS 4 will be more useful than any data we currently have in determining the magnitude of the impact of Basel II on bank capital and potential competitive inequities, as well as determining ultimately what to do about them.

Second, in another effort to increase our practical understanding of the effects of Basel, the U.S. agencies have commenced an operational risk benchmarking review at a number of the largest institutions. Information obtained through this effort will enhance agency understanding of current qualitative and quantitative operational risk practices and will assist agency efforts to develop additional supervisory guidance and training materials for banks and examiners on the operational risk component of Basel II. Throughout this period we will continue our dialogue with banks and other interested stakeholders on various issues that Basel II may raise.

Those projects and discussions will help us in the third key step in Basel implementation, developing a joint notice of proposed rulemaking (NPR) that will set forth the proposed regulatory text for Basel II in the U.S. Currently we anticipate that such an NPR will be released for public comment in late 2005 or early 2006. At the OCC, we have made a preliminary determination that this rulemaking will be a “significant regulatory action” for purposes of Executive Order 12866. Consequently, we will prepare and submit to the Office of Management and Budget’s (OMB) Office of Information and Regulatory Affairs (OIRA) an economic analysis that includes:

- a description of the need for the rules and an explanation of how they will meet the need;
- an assessment of the benefits anticipated from the rules together with, to the extent feasible, a quantification of those benefits;
- an assessment of the costs anticipated from the rules together with, to the extent feasible, a quantification of those costs; and
- an assessment of potentially effective and reasonably feasible alternatives to the planned regulation and an explanation why the planned regulatory action is preferable to the identified potential alternatives.

We have begun discussions with the OMB’s OIRA regarding the how these analyses will be designed and conducted. Our analysis will be published as part of our notice and comment process.

Finally, as the rulemaking process for the domestic implementation of Basel II moves forward, we and the other U.S. agencies are exploring the implications that Basel II may have on non-mandatory banks and what, if any changes we should make to our capital regulations for those banks. Any such changes will, of course, be subject to public notice and comment.

As my testimony conveys, while we have made important strides in trying to develop a more risk-sensitive capital framework for internationally active banks, there is still a long way to go before Basel II is completed and adopted. As I have repeatedly stated before Congress and in the Basel Committee, a new accord cannot be completely finalized until national implementation procedures have been completed and I am committed to a notice and comment process that is open and fair and responsive to public comments. The OCC and other U.S. agencies have recognized the possibility that, even in the late stages, public comments might reveal flaws in the proposal that will need to be addressed before we can issue final implementing regulations. The OCC's ultimate willingness to sign onto Basel II is going to depend on whether we are satisfied with the final product.

IV. CONCLUSION

In conclusion, Mr. Chairman, the national banking system is sound, and its recent performance has been strong. It has successfully weathered the recent recession, and it is responding in dynamic fashion to the changes in the financial services marketplace. The OCC, too, is keenly focused on keeping pace with change – by improving the approaches we use to supervise the industry, and by striving to ensure that national banks remain the safe, and sound, competitive,

and high integrity engines of our economy that they were designed to be. We look forward to working productively with you, with the members of this Committee, and with state officials as we pursue our efforts to achieve that goal.