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Basel II: A Brave New World for Financial Institutions?

The American Academy in Berlin has attracted a remarkable succession of speakers and presenters from various fields of accomplishment -- people united by the world standard of their own work and a common commitment to German-American friendship and international cooperation. I am honored to follow them to this podium.

In light of the principles to which the Academy has dedicated itself, I can think of no better place to discuss the work we are doing in the Basel Committee on Banking Supervision to craft a new international accord on regulatory capital requirements for banks. That is my subject today.

I think it's quite appropriate that we discuss this subject in this splendid building, which I'm told was once the home of the eminent banker Hans Arnhold. Bankers have long been among the most international -- and indispensable -- of business people. When the absolute monarchs of centuries ago felt overwhelmed by the financial burdens of maintaining armies and appearances, they turned to private bankers. Indeed, the power of bankers came to rival -- and in some cases to surpass -- that of the sovereigns they served. It was the duc de Richelieu, prime minister under Louis XVIII, who was supposed to have observed, "there are six great powers in Europe: England, France, Russia, Austria, Prussia, and Baring Brothers." These may have been the words of an obsequious loan-

seeker or those of a resentful debtor. But they also were not that far from the literal truth.

Skip ahead two centuries and bankers were still playing a primary political role as well as a financial one. In the 1920s and early '30s, through their formal and informal networks, bankers were at pains to prop up the international order when economic nationalism and political paralysis threatened to send the whole structure careening into crisis. Ultimately that crisis could not be averted; but in retrospect it's remarkable that bankers were able to sustain capital flows, international ties, and political stability in the face of an increasingly dysfunctional world order as long as they did.

Although we need no longer count on bankers to fill such systemic vacuums of political leadership, they continue to perform many functions essential to international stability and economic growth. Indeed, the globalization of capital markets may be considered as one of the defining developments of the whole post-World War II era, and we assign it significant responsibility for some of the great economic successes of our times – and the success we hope to achieve in the future. As Walter Wriston memorably put it, capital today goes where it is wanted and stays where it is well treated. That doesn't mean governments are passive bystanders in the process: meeting today's daunting financial challenges requires a sound, competitive, and effectively supervised international banking system.

While the international integration of banking and financial markets has been a source of enormous strength to the world economy, it also exposed it to vulnerabilities from unexpected sources. The 1974 failure of the Bankhaus Herstatt – a modest sized bank that I'm sure would not have appeared on any global problem bank list, had one existed -- sent shock waves through the financial sector, demonstrating that weakness in

the banking system or the supervisory regime in a single country may have the potential to cause disruption not only within that country but also internationally. Herstatt became a catalyst for the G-10 nations to establish the Basel Committee a year later, with a view to promoting common standards and best practices of prudential supervision, and assuring that no internationally active banking establishment should escape competent supervision.

Much of the Committee's work over the past two decades has focused on capital adequacy standards for internationally active banks. The principal objective has been to articulate a common set of rules for those banks confronting one another as competitors around the world, and to relate capital rules, as far as possible, to the varying risks presented in the asset make-up of these banks.

The Committee's landmark Capital Accord issued in 1988 – what we now refer to as Basel I – ran little more than two dozen pages and was adopted within seven months after the Committee's first (and only) consultative paper was published for comment. Basel I established the framework for the risk-based capital adequacy standards for counter-party credit risk used by all G-10 countries and by most other banking authorities around the world. The first Capital Accord represented an important convergence in the measurement of capital adequacy, a strengthening in the stability of the international banking system, and a removal of a source of competitive inequality arising from differences in national capital requirements.

The shortcomings in Basel I have been recognized for a number of years. Principal among them is that it established capital requirements that were only remotely related to actual risks, and that were susceptible to significant arbitrage. Moreover, since

Basel I the banking industry has become exceedingly more complex. Increasing use has been made of sophisticated funding tools, such as securitizations, and of complex derivatives to reduce capital requirements and to hedge and manage risk, and the state of the art of risk measurement and modeling has advanced very significantly.

These changes led the Basel Committee five years ago to embark on an effort to improve and modernize Basel I – an initiative we now call Basel II. That effort has absorbed an incalculable amount of time, energy and resources on the part of the Basel Committee, its member agencies and their staffs, and the banking industry worldwide. The Committee has published three consultative papers detailing a new approach to capital determination, together with volumes of supporting research and position papers. Its various task forces and working groups have spent countless hours in debate, deliberation and drafting. Three “quantitative impact” studies have been performed in an attempt to estimate the effect of a new approach on the capital of our banks, and the Committee itself has met in plenary session at least quarterly to review progress and discuss issues. The most recent consultative paper – CP-3 – runs more than 200 pages, and is mind-numbing in its complexity.

While I don’t propose to address the details of Basel II this evening, it may be helpful to describe its structure in broad outline.

The new approach would be built on three “pillars” – the first, a set of formulas for determining regulatory capital requirements; the second, a set of principles for the exercise of supervisory oversight; and the third, a set of disclosure requirements intended to enhance market discipline.

Pillar I basically sets out three means for calculating capital requirements:

- 1 The “standardized” approach – essentially, a set of refinements to the Basel I risk buckets -- which provides for the use of external ratings in certain circumstances, and gives some weight to risk mitigation devices.
- 2 The “foundation internal ratings-based (IRB)” approach, which sets forth a methodology for using a bank’s own internal risk rating system, including its calculated probabilities of default (PD), as a base for calculating capital, using a factor for loss given default (LGD) provided by supervisors.
- 3 The “advanced IRB” approach, which bases capital calculations on the bank’s own supervisory-validated credit risk rating systems, including bank-calculated PDs and LGDs.

In each of the three approaches there would be a separate calculation for determining capital to cover operational risk. In measuring their operational risk, banks would be able to choose between a basic approach based on gross income of the company, a standardized approach that looks at gross income within individual business lines, and an internal models-based advanced measurement approach.

One might infer from CP-3 that the pressures for revision of Basel I have not evolved solely from the original Accord’s technical shortcoming, or from the changes in the business of banking and risk management that have occurred since 1988. CP-3 and the deliberations that generated it reflect a disposition in the Basel Committee to define a far broader and more prescriptive role for itself.

For one thing, the Committee has devoted significant attention to the interests of non-G-10 countries. Not only has the “standardized” approach been formulated with the intention of making it suitable for use by less complex banks in less developed economies

throughout the world, but the Committee itself has engaged in increased outreach to and consultation with banking authorities in these countries.

For another, in proposing a set of highly detailed rules, the Committee has evidenced a strong distrust of supervisory discretion in the process of capital determination, and has sought to confine the role of discretion in the establishment of regulatory capital requirements.

To be sure, there are good reasons to be concerned about discretionary supervision that is not strongly anchored to solid principles. We have all seen examples of supervisory forbearance where serious problem – indeed, chronic insolvencies – have been left to fester while supervisors have hoped for economic reversals or political bailouts – generally with disastrous consequences. The U.S. savings and loan crisis of the 1980s is a compelling reminder of the dangers of unbridled discretion.

But bank supervision does not lend itself well to a “black box” treatment. My view, at least, is that there is too much in the operation of complex banking institutions that requires subjective analysis, evaluation and expert judgment – the quality of management, the adequacy of internal controls, the extent of compliance with laws and regulations – and the very “culture” of the organization itself. Yet the monumental prescriptiveness of Basel II seems at times to be motivated by a conviction that if only the rules can be made sufficiently detailed and escape-proof the Holy Grail of competitive equality can be discovered.

While I have enormous regard for my colleagues on the Committee, I must confess that I am very concerned about this approach. I am concerned that the level of prescriptiveness reflected in the current version of Basel II does not mesh well with the

traditional U.S. approach to bank supervision and threatens to change it in a way that could be very unhealthy. Not only do we place substantial importance on the expert judgments of experienced bank examiners, but, under legislative mandate, we have grounded our system of supervision on the concept of prompt corrective action – that is, we place very heavy emphasis on supervisory actions that force restoration of capital well before real net worth turns negative. To this end, we have attributed significant importance to the maintenance of a specified minimum leverage ratio – a practice that is not common in many other supervisory regimes. Basel II is not grounded in a similar requirement for prompt corrective action, and it remains to be seen how a more formulaic approach will fit with our traditional approach.

I am also concerned that the effort to homogenize capital rules across the world may do serious damage to certain markets in which U.S. banks – particularly national banks – have been world leaders, such as credit cards and securitizations. We have to exercise great caution that we do not, in the name of achieving international uniformity, needlessly disrupt settled banking practices and established, well-functioning markets.

Finally, I am concerned that the Basel II process does not mesh well with the traditional U.S. approach to rulemaking. Indeed, much of the criticism that has been aimed at the U.S. in recent months reflects a lack of understanding of both our supervisory process and our domestic rulemaking process. Because the very purpose of the American Academy in Berlin is to foster international understanding and the sharing of differing points of view, I'd like to use this occasion to discuss three of the major issues on which our views – and I speak now solely for the OCC – have caused some consternation among our colleagues and as to which some elaboration may contribute to

international understanding. They are complexity, scope of application, and timing and process.

Complexity. I suppose that in describing CP-3 as “mind-numbing” in its complexity I have already tipped my hand on this issue. In my view, CP-3 is complex far beyond reason. Aspects of it – the formulas relating to securitizations, for example – are so complex that the mere visual depiction of them has been cause for ridicule, which serves only to undermine public regard for the Committee.

When I have made this point in the past, the rejoinder has been a rather patronizing dismissal. “We live in a complex world,” the apologists for Basel II’s complexity say. But I believe that the complexity of Basel II has far exceeded what is reasonably necessary to deal with the complexity of today’s banking industry. There are viable alternative approaches in addressing, from a practical standpoint, the complexities of today’s financial marketplace. Had there been greater willingness in the Committee to tolerate greater exercise of supervisory discretion, a more “principles-based” approach could have been taken. One might think that our experience with the accounting standard-setters would have lead us in a different direction, for in the field of accounting we have seen how efforts to be comparably prescriptive have resulted in more, rather than fewer, loopholes.

But complexity has more insidious implications for the goal of competitive equality in light of the vast differences in the nature of bank supervision among the countries participating in Basel II. The OCC has full-time resident teams of examiners on-site in our largest banks – as many as 35 or 40 at the largest. Supervision of these banks is truly continuous. In some of the other member countries comparably sized

banks may be visited by examiners only every other year, or even less frequently. In some countries much of the responsibility for supervision is relegated to outside auditors. A recent OCC survey showed that we have by far the lowest ratio of banking assets per supervisory staff member of any G10 country – perhaps the best indicator of a supervisory system’s capacity to assure compliance with supervisory mandates. Can anyone reasonably assume that a mandate of the complexity of Basel II will be applied with equal forcefulness across such a broad spectrum of supervisory regimes? I am tremendously concerned that, given such disparity and the complexity of the mandate, banks in our system could be placed at a serious competitive disadvantage.

I recognize that this argument may prove too much – that if complex rules cannot be evenly applied across a broad variety of supervisory regimes, then how can we expect more discretionary rules to be evenly applied? The answer, of course, is to put greater emphasis on the attainment of parity among supervisory regimes. Uniformity of application and competitive quality will remain elusive goals, irrespective of the prescriptiveness of the rules, so long as we have wide variations in the nature and content of supervision itself.

Moreover, complexity imposes a whole range of costs, not the least of which is a loss of both credibility and a broad base of support. What people cannot understand they are unlikely to trust, and I suspect that the lukewarm reception Basel II has received in some quarters can be attributed to that factor alone. There is also little doubt that exhaustive efforts to dictate details and eliminate opportunities for the exercise of supervisory discretion has unduly prolonged the production process and tried the patience of those who have taken responsibility for bringing Basel II to a conclusion. I am still

hopeful, however, that we can achieve a better balance between hard-wired rules and the exercise of informed supervisory judgment.

Scope of Application. Basel II, by its very terms, is intended to apply to “internationally active” banks, just as was Basel I. In the U.S. we have more than 9,000 federally insured banks and thrift institutions, of which little more than 100 exceed \$10 billion in size. And even among that number, all but a handful are local or regional banks with virtually no international operations. Thus, U.S. regulators have been faced with a choice: Do we apply Basel II across the board, imposing on all of our banks the rigidity and complexity of the new Accord? Or do we attempt to identify those banks that are truly “internationally active” and of sufficient size to be systemically important and apply Basel II only to them?

The latter approach was a clear choice for us. We defined the scope of application of Basel II by setting dollar thresholds of asset size and international exposures, and by that means identified about ten banks that we would treat as mandatorily subject to Basel II. We also made the judgment that these banks had sufficiently substantial resources and sophistication to move immediately to the advanced IRB approach, and thus we saw no useful purpose to be served by offering our banks the option of using either the foundation IRB or standardized approaches.

We will permit, but not require, other U.S. banks to apply the advanced approaches of Basel II, under the same standards that must be met by the group of mandatory banks. To borrow a phrase from our British colleagues at the FSA, our approach to those banks will be one of “no compulsion, no prohibition.” Our expectation is that a number of banks in the next tier below the ten mandatory banks, whether or not

“internationally active,” would likely seek supervisory approval to become “Basel II” banks, for a variety of reasons. We estimate that the mandatory Basel banks plus those that we expect to opt in to Basel II will account for close to 99 percent of the foreign exposures of all U.S. banks. Thus, we believe we are completely in harmony with the intent of Basel II.

Some have been critical of the U.S. for refusing to subject our smaller banks to even the standardized approach – particularly some of those countries that intend to apply Basel II to all of their banks. They seem to suggest that it is hypocritical of the U.S., as a Basel Committee member, to participate in the promulgation of capital standards intended to be usable by the rest of the world while refusing to apply those standards to its own banks.

This criticism, to be charitable, is simply uninformed. While I fully support the Committee’s objective of framing capital rules that can be adopted well beyond the G-10 countries, I believe that smaller banks in the U.S. are both better capitalized and more robustly regulated than their counterparts anywhere else in the world – indeed, they are generally better capitalized than our larger banks. They already bear substantial cost burdens imposed by the extensive complex of laws and regulations under which they operate, and we see absolutely no useful purpose to be served in adding to the burdens of our community banks by subjecting them to the complexities of Basel II.

It may well be that in some countries, simply by reason of their size or geography, many smaller banks might be considered to be internationally active, and therefore properly includable within the scope of Basel II. We also appreciate that the European Union may decide, in the name of pan-European uniformity, that Basel II should apply to

all banks in the EU, and we certainly respect that decision. But in joining in the work of the Basel Committee we did not surrender our discretion to supervise our banking system in the way that we deem most appropriate, and just as we do not criticize those countries that have opted for a regime of supervision much less demanding than ours, we think it inappropriate for us to be criticized for the choice of supervisory approaches that we make with regard to our small, non-internationally active banks.

Timing and Process. The deliberations over Basel II have been going on for about five years now, and there are many observers who are extremely concerned that further delay in the promulgation of a “final” document may threaten the prospects for achieving a new Accord. Some have argued that delay simply provides an opportunity for more issues to be raised and for more special pleading by affected interest groups. Others have expressed concern that if the European Parliament recesses without adopting the new rules we may be back to square one when that body is reconstituted after elections. Even some bank executives have argued that their ability to get continued funding from their boards for Basel II preparation may be endangered if directors sense that Basel II will not occur.

These are undeniably significant concerns, and I think it behooves the Committee to convey a strong sense of purpose and momentum. To this end, we concurred in the announcement made by the Committee after its last meeting that it would work towards resolving outstanding issues by the middle of next year. We will work assiduously to meet that target so as to permit national implementation processes of Basel members to commence.

But my personal view is that we cannot afford to ignore substantial issues, or to

sweep recognized problems under the rug, simply to be able to issue a document by some target date. It is far more important to get the new Accord right than to get it done on some predetermined schedule. One clear lesson we should have learned over the past five years is that this is an exceedingly complicated and difficult process, and that new issues tumble out of the deliberations at every turn. Indeed, even though we resolved some major issues at the last meeting of the Committee in Madrid, we have encountered new issues in the implementation of that resolution. Moreover, in the Committee's announcement following the Madrid meeting several other issues were identified that remain to be resolved. Our work to date on those issues makes quite clear that we still have some difficult choices ahead.

To those who say that delay will simply allow others – legislators, interest groups and financial institutions -- to raise more issues, I respond that if we have not anticipated or dealt with the important issues that might be raised we run a serious risk of having a seriously flawed product or a product that will not command the broad base of support that a proposal as far reaching as Basel II must have.

One of the industry's most serious criticisms of Basel II to date has been that it does not contemplate full credit-risk modeling – that is, that it does not take into account portfolio effects of the mitigation of risk through diversification. The new Chairman of the Committee has stated publicly that this is a subject to which the Committee will soon turn its attention.

Given the complexity of this issue – which, in fairness, was not simply overlooked by the Committee, but put on a back burner in order to move ahead on other fronts – would involve significant delay. Yet at least one trade group that has been

vociferous in its criticism of the Committee's failure to move to full modeling has been equally vociferous in urging the Committee to act expeditiously in adopting Basel II. I do not see how we can have it both ways.

Earlier this year, following the issuance of CP-3 by the Committee, we in the U.S. published an Advance Notice of Proposed Rulemaking, or ANPR, which described CP-3 and solicited comment on a number of important questions. That comment period closely followed the comment period set by the Committee itself for CP-3. We received extensive comments in response to both CP-3 and the ANPR, many of them highly critical of the proposal. It became absolutely clear to me that some significant changes were needed in CP-3 if we hoped to avoid a train wreck, and at its last meeting the Committee agreed to some of these – most notably a change that provided for capital to be calibrated only against unexpected losses, rather than the sum of expected and unexpected losses, as CP-3 had provided -- the so-called EL-UL issue

When we responded to these comments by urging the Committee to make changes we were accused by some of trying to “renegotiate the deal” – a charge that seemed to me to betoken a fundamental misunderstanding of not only the Committee's process, but the U.S. domestic process as well. CP-3 was not, of course, a “deal”; it was a proposal – a significantly incomplete proposal, at that. The very purpose of soliciting comments was to identify potential problem areas, and the EL-UL issue stood out like a sore thumb. Indeed, the alacrity with which the Committee agreed to a change in this area reflected its own recognition that a change was required. The most significant reservations related to concerns about what such a change might imply for the timetable.

We have also found that some of the outcries about timing have displayed a lack

of understanding of the process that we in the U.S. must go through before we can give final assent to Basel II. Our capital requirements are promulgated in agency regulations that have the force of law, and our Administrative Procedure Act requires that before we adopt final implementing regulations we must publish proposed regulations and provide opportunity for public comment. It may be beneficial to describe, in practical terms, the milestones we must meet prior to final implementation of Basel II.

First, we obviously we cannot initiate formal implementation efforts until the Basel Committee itself has come out with a definitive paper. As noted earlier, it is our hope that we will resolve outstanding issues so as to meet the Committee's goal of issuing such a paper by mid-year 2004. With that said, however, the list of issues the Committee identified in the post-Madrid press release – including the treatment of retail credit, securitizations, and credit risk mitigation – are significant and challenging

Second, we in the U.S. have expressed the intention to conduct a fourth quantitative impact study, or QIS, based on the final Basel document. While the Committee conducted QIS-3 late last year, I believe that study had significant shortcomings – not the least of which was that CP-3 was seriously incomplete at the time. Moreover, there was virtually nothing in the way of supervisory validation of the process by which the banks participating in the study made their estimates of capital impact. It was essentially a unilateral process that did not reflect the kind of rigorous oversight role that supervisors would play when Basel II actually goes into effect. I do not believe that any responsible bank supervisor can or should make a judgment about the impact of Basel II on the capital level of the banks it supervises based on QIS-3. And that means that at the present we have really no sound basis whatsoever for assessing capital impact.

I would hope that the Committee itself would see the wisdom of conducting its own QIS-4, but whether it does or not, we intend to do so.

Third, the Administrative Procedure Act requires that the U.S. agencies publish, and provide an opportunity for comment, proposed regulatory language on Basel II in the form of a Notice of Proposed Rulemaking, or NPR. Assuming no significant issues are encountered in the preceding stages, the drafting process of the NPR, together with the comment period and the analysis of comments, will take us well into 2005. It is at that point that we can publish final implementing rules.

Let me turn for a moment to the role of our Congress in this process. Over the course of the Basel II process we have provided informal briefings to congressional staff on the progress of the effort, but it has only been fairly recently – as the Committee's proposals have become more fully fleshed out -- that members of Congress have engaged significantly on the specifics of the proposal. This is in marked contrast, I should say to some of the other member countries, such as Germany, where legislators have been involved in influencing, even dictating, some of the positions of their representatives from the very outset of the Basel process.

We have heard a number of concerns expressed from members of Congress. Some have borne down on the proposed treatment of operational risk, reflecting the anxieties of important institutions in their constituencies who believe they may be very adversely affected. Others have expressed concern about competitive inequities between regulated and unregulated institutions, between U.S. and foreign banks, or between large and small institutions. Still others have raised questions about the decision-making process – how U.S. positions are arrived at, how the Basel Committee itself reaches

decisions, and what the role of Congress should be.

In my view these are perfectly appropriate concerns. U.S. supervisory agencies are, after all, creatures of the Congress, and our authority to set capital requirements for banks derives from statutes enacted by the Congress. The process of legislative oversight is as important to the integrity and legitimacy of the final product as the process of public comment itself. While we have heard some rather thoughtless and unhelpful comment about the involvement of our Congress from some offshore observers – to the effect that members are simply reflecting the interests of their political constituents – these observers reflect a fundamental lack of understanding of the democratic process and really should know better.

We have given the Congress strong assurances that our domestic rulemaking process will have real integrity to it – that we will not only provide opportunity for comment, but that we will give serious consideration to those comments, and, if need be, come back to the Basel Committee where we believe additional change is necessary to make the final product acceptable to us.

This has obvious implications for the future course of Basel II. As I have said, we have given the Committee a commitment to work diligently toward the goal of producing a “final” version of the Accord by mid-year 2004. However, no one should underestimate the difficulty of the issues that remain to be resolved or the very high potential for new issues emerging as we move forward. QIS-4, which will follow the Committee’s definitive paper, will be an especially important event for us, since it should give us a far clearer picture of how Basel II is going to impact on the capital of our banks. Should QIS-4 lead us to project that there might be wide or unwarranted swings in the

capital of our banks, either up or down, that will present us with a very significant decision point, and we would feel compelled to bring that concern back to the Committee.

I am much more skeptical about the currently stated goal of achieving implementation of Basel II by the end of 2006. There is a staggering amount of work confronting both us and our banks before Basel II can be implemented, and I am absolutely confident, based on past experience, that as we move into the implementation phase we will uncover a myriad of issues not previously thought of or addressed. The Committee has established an Accord Implementation Group composed of highly qualified supervisors to address implementation issues, and the work of that Group will be of enormous importance as we move ahead. Once again, I believe it is far more important that we get these decisions right than that we adhere to some preestablished schedule, and while I fully understand the anxieties and pressures that have come to bear with respect to the promulgation of Basel II, I think there should be far less concern about the actual date of implementation. It is obviously premature to address the implementation date, but I would simply observe that having at least another year of data upon which to base the models that our banks will be using should be viewed as a strong plus.

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When the Basel Committee on Banking Supervision was founded nearly three decades ago, its goal was to develop standards, guidelines, and principles that its member countries would implement in ways best suited to their unique national arrangements – political as well as supervisory. That approach, based on the spirit of consultation, respect

for sovereign differences, and recognition of the limitations of the Committee's authority as a consultative body, has been one of the Committee's great strengths over the years. In tackling the formidable challenges of bringing a new capital accord to fruition, we should draw as much as possible upon those strengths and those experiences.

From the very beginning, it was clear that the Committee's success in virtually everything it undertook would turn on its ability to reconcile widely varying national supervisory practices. I believed then – and believed just as fervently today – that the better able we are to harmonize and accommodate those differences, the more likely we are to achieve the common supervisory excellence and global financial stability to which all nations aspire.