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Statement required by 12 USC 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.

Introduction

Chairman Shelby, Senator Sarbanes, and members of the committee, I am pleased to have this opportunity to present the views of the Office of the Comptroller of the Currency (OCC) on deposit insurance reform. For almost 70 years, federal deposit insurance has been one of the cornerstones of our nation's economic and financial stability. It has relegated bank runs to the history books and helped our country weather the worst banking crisis since the great depression without significant adverse macroeconomic effects.

Despite this admirable history, there are flaws in our current deposit insurance structure. In fact, efforts to address weaknesses in the system uncovered during the banking and thrift crises of the 1980s and early 1990s have not been entirely adequate to the task. Indeed, the legislation adopted in response to those crises has actually constrained the Federal Deposit Insurance Corporation (FDIC) from taking sensible and necessary actions. This is particularly the case with respect to the FDIC's ability to price deposit insurance in a way that reflects the risks posed by different depository institutions, and to the funds' ability to absorb material losses over the business cycle without causing sharp increases in premiums. Failure to address these issues in the current financial environment poses the danger that the next major domestic financial crisis will be exacerbated rather than ameliorated by the federal deposit insurance system.

In summary, the OCC recommends that

- The FDIC be provided with the authority to implement a risk-based deposit insurance premium system for all banks;

- The current fixed designated reserve ratio (DRR) be replaced with a range to allow the FDIC more flexibility in administering the deposit insurance premium structure over the business cycle;

- Any program of rebates or credits issued when the fund exceeds the upper end of the DRR range take into account the fact that the FDIC and the Federal Reserve already deliver a substantial subsidy to state-chartered banks by absorbing their costs of federal supervision, and that deposit insurance premiums paid by national banks pay, in part, for the supervision of state chartered banks;

- The Bank Insurance Fund (BIF) and Savings Association Insurance Fund (SAIF) be merged; and
- Coverage limits on deposits not be increased.

Eliminating Constraints on Risk-Based Pricing

The ability of the FDIC to set premiums for deposit insurance that reflect the risks posed by individual institutions to the insurance funds is one of the most important parts of deposit insurance reform. While current law mandates that the FDIC charge risk-based insurance premiums, it also prohibits the FDIC from charging premiums to any institution in the 1A category—in general, well-capitalized institutions with composite CAMELS ratings of 1 or 2—whenever the reserves of the deposit insurance funds are at or above the designated reserve ratio (DRR) of 1.25 percent of insured deposits. As a result, 91 percent of all insured depository institutions pay nothing for their deposit insurance even though all institutions pose some risk of loss to the FDIC. Moreover, quite apart from the risk that a specific bank might present, banks are not required to pay even a minimum "user" fee for the governmentally provided benefit represented by the deposit insurance system—a benefit without which, as a practical matter, no bank could engage in the business of taking deposits from the public.

A system in which the vast majority of institutions pay no insurance premium forgoes one of the major benefits of a risk-based pricing system—creating an incentive for good management by rewarding institutions that pose a low risk to the insurance funds. A mandated zero premium precludes the FDIC from charging different premiums to banks with different risks within the 1A category, despite the fact that within the 1A category there are banks that pose very different risks to the funds. The FDIC should be free to set risk-based premiums for all insured institutions.

Dampening Procyclicality and Fund Management

Under current law, whenever the reserve ratio of the BIF or SAIF falls below 1.25 percent, the FDIC is required either to charge an assessment rate to all banks high enough to bring the fund back to the DRR within one year, or if that is not feasible, an assessment rate of at least 23 basis points. This sharp rise in premiums, or "cliff effect," is likely to hit banks the hardest when they are most vulnerable to earnings pressure. To avoid creating this procyclical volatility in deposit insurance premiums, it would be preferable to let the funds build in good times and to draw down slightly in bad times.

The OCC supports giving the FDIC the authority to establish a range for the DRR to replace the present arbitrary fixed DRR of 1.25 percent. The FDIC should have the authority to set the range based on its assessment of the overall level of risk in the banking system. We also believe that in establishing the range, the FDIC should provide notice and an opportunity for the public to comment on the proposed range. If a fund falls below the bottom of the range, we believe it would be preferable to allow the FDIC to rebuild the fund gradually to eliminate the 23 basis points "cliff

effect." Adoption of a range and elimination of the "cliff effect" would allow the FDIC more flexibility in administering the premium structure and would minimize the likelihood of sharp increases in premiums during economic downturns when banks can least afford them.

If a fund exceeds the upper boundary of the DRR range, the FDIC should be authorized to pay rebates or grant credits against future premiums. While such credits or rebates seem reasonable, there are two principles that should be observed in determining their allocation and use. First, a system of rebates or credits should not undermine the risk-based premium system. Thus, rebates or credits should not be based on an institution's current assessment base. If they were, rebates or credits would lower the marginal cost of insurance. For example, if an institution with a risk-based premium of 3 basis points received a rebate or credit of 2 basis points for each dollar of assessable deposits, its true premium would only be 1 basis point. Another implication of rebates or credits not undermining risk-based premiums is that institutions that paid high insurance premiums in the past because they posed a higher risk to the funds should not receive larger rebates than less risky institutions of the same size. The fact that these high-risk institutions did not fail during that period does not alter the fact that they subjected the funds to greater than average risks. Finally, an institution that is faced with a high premium because of high risk should not be allowed to completely offset that premium with credits.

The second principle is that the payment of rebates and credits should take into account the fact that not all insured institutions receive the same services for their deposit insurance dollars. The FDIC uses proceeds from the deposit insurance funds to cover its own costs of supervising state-chartered banks, and it does not pass these costs on to the banks. In 2001, this amounted to an in-kind transfer from the FDIC to state nonmember banks of over $500 million. During this same time, by contrast, national banks paid over $400 million in assessments to the OCC to cover their own costs of supervision.[1] In a regime under which all institutions were paying premiums, national banks should not be required to pay both for their own supervision and also for a portion of the supervisory costs of their state-chartered competitors. It would be unconscionable for the FDIC to issue credits or rebates to state-chartered banks without first taking into account the subsidy it provides to these banks by absorbing their costs of supervision—a subsidy that is funded in good part by deposit insurance premiums paid by national banks.

Merger of the BIF and the SAIF

One of the most straightforward issues of deposit insurance reform is the merger of the BIF and the SAIF. The financial conditions of thrifts and banks have converged in recent years, as have the reserve ratios of the two funds, removing one of the primary objections to a merger of the funds.

[1] The Federal Reserve pays for its supervision of state member banks out of funds that would otherwise be remitted to the Treasury. Thus, the taxpayer pays for the supervision of state member banks.

As of the third quarter of 2002, the reserve ratio of the BIF was 1.25 percent, while that of the SAIF was 1.39 percent. The reserve ratio of a combined fund would have been 1.28 percent as of the same date. As is described in greater detail below, many institutions now hold some deposits insured by each fund. But under the current structure, BIF and SAIF deposit insurance premiums could differ significantly depending on the relative performance of the two funds, raising the possibility that institutions with similar risks could pay very different insurance premiums. This would unfairly penalize low-risk institutions insured by the fund charging the higher premiums.

In addition, a combined fund would insure a larger number of institutions with broader asset diversification than either fund individually. It would also decrease the exposure of the funds—especially the SAIF—to a few large institutions. Industry consolidation has led to increased concentration of insured deposits in a handful of institutions. As of September 30, 2002, the three largest holders of BIF-insured deposits held 15 percent of BIF-insured deposits. The corresponding share for the three largest holders of SAIF-insured deposits was 18 percent. For a combined fund the figure would have been 14 percent. For all these reasons, merger of the two funds would result in a diversification of risks.

Further, there is significant overlap in the types of institutions insured by the two funds. As of September 30, 920 banks and thrifts, or roughly 10 percent of all insured depository institutions, were members of one fund but also held deposits insured by the other fund, and BIF member institutions held 43 percent of SAIF-insured deposits. Finally, merger of the BIF and the SAIF would undoubtedly result in operational savings as the two funds were combined into one.

Increasing Coverage Limits

The question of deposit insurance coverage limits is a challenging one, in part because it is easy for depositors to obtain full insurance of deposits in virtually unlimited amounts through multiple accounts. Proponents of an increase in coverage assert that it would ease liquidity pressures on small community banks and better enable small banks to compete with large institutions for deposits. However, there is little evidence to support this contention. Over the twelve months ending September 30, 2002, deposits at commercial banks with under $1 billion in assets grew at a healthy 3.8 percent annual rate, while loan volume actually declined. As a result, loan-to-deposit ratios at such institutions fell from 88 percent to 79 percent.

In addition, it is not at all clear that increasing deposit insurance coverage would result in an increase in the deposits of the banking system. One effect could be to cause a shift in deposits among banks. It is far from clear, however, that any such redistribution of existing deposits would favor community banks. Depositors who multiply insurance coverage today by using multiple banks might consolidate their deposits in a single institution if coverage were raised, but there is no way of determining which institutions would be the ultimate beneficiaries when the switching process ended. Moreover, it is quite possible that larger, more aggressive institutions might use the expanded coverage to offer even more extensive governmentally protected investment

vehicles to wealthy customers. That could cause an even greater shift of deposits away from community banks and increase liquidity pressures.

For many of the same reasons that we object to an increase in the general insurance limit, we are also concerned about proposals to use the federal deposit insurance system to favor particular classes of depositors such as municipal depositors. Increasing the limit on municipal deposits would not provide municipalities with greater protection—they can already secure their deposits—and it is by no means clear that increasing the deposit insurance limit would result in funds flowing into community banks. In addition, an increase in insured coverage could spur riskier lending because banks would no longer be required to collateralize municipal deposits with low-risk securities.

Conclusion

The OCC supports a merger of the BIF and the SAIF and proposals to eliminate the current constraints on deposit insurance premiums. We also favor elimination of the current fixed DRR and its replacement with a range that would allow the FDIC more flexibility in administering the deposit insurance premium structure. We believe that any credits or rebates issued when the fund exceeds the upper range of the DRR must first take account of the subsidy that state-chartered banks receive as a result of having the costs of their federal supervision absorbed by their federal regulators and the fact that deposit insurance premiums paid by national banks in effect pay for a large portion of this subsidy.

Statement of John D. Hawke, Jr., Comptroller of the Currency, before the U.S. House Subcommittee on Domestic and International Monetary Policy, Trade and Technology of the Committee on Financial Services, on the proposed revisions to the Basel Capital Accord, Washington, D.C., February 27, 2003

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Introduction

Chairman King, Congresswoman Maloney, and members of the subcommittee, thank you for inviting the Office of the Comptroller of the Currency (OCC) to participate in this hearing on proposed revisions to the 1988 Capital Accord developed by the Basel Committee on Banking Supervision ("Basel Committee"), and the policy implications and effects these revisions will have on domestic and international banking systems. I welcome the efforts of the subcommittee to focus attention on these critical issues. Given the importance of the U.S. commercial banking system to our domestic economy, it is essential that any regulatory changes that might affect our banking system's financial condition and competitiveness be fully understood and considered by the banking industry, the U.S. Congress, and the American public.

The 1988 accord, referred to as Basel I, established the framework for the risk-based capital adequacy standards for commercial banks in all of the G–10 countries, and has been adopted by most other banking authorities around the world. U.S. banking and thrift agencies have applied the 1988 framework to all U.S. insured depository institutions.

Over the past several years, the Basel Committee has been developing a more detailed and risk-sensitive capital adequacy framework to replace Basel I. The OCC and the other U.S. banking agencies expect to revise U.S. risk-based capital regulations to reflect the primary components of the Basel Committee's new capital adequacy framework (Basel II), but before doing so, the agencies will publish proposed revisions for public comment. Let me be absolutely clear about the integrity of this rulemaking process: the OCC, which has the sole statutory responsibility for promulgating capital regulations for national banks, will not sign off on a final Basel II framework until we have fully considered all comments received during our notice and comment process, as we would with any domestic rulemaking. If we determine through this process that changes to the proposal are necessary, we will not implement proposed revisions until appropriate changes are made.

The OCC fully supports overhauling the existing capital adequacy framework. The original Capital Accord, groundbreaking when adopted in 1988, has become increasingly obsolete. Moreover, the OCC fully endorses the goals and objectives of Basel II. The Basel Committee's efforts in this

regard are to be commended. They have advanced the cause of international cooperation, supervisory competence, effective risk management practices in financial institutions, and the safety and soundness of the global financial system.

Having said that, I should add that significant work remains before the current draft of Basel II can be considered final. Supervisors and bankers, as well as legislators and other interested parties, need to gain a level of comfort that the revised Capital Accord has truly achieved the objectives first enunciated by the committee in 1999. This minimum level of comfort is conditional on achievement of the revised Capital Accord's objectives from both a theoretical as well as a practical perspective.

In working towards finalizing Basel II, we must also be mindful of the risks of excessive complexity. Achieving a level playing field among large international banks has been a principal objective of the Basel Committee since its formation and is a major goal of Basel II. However, the more complex Basel II is, the more difficult it will be to implement it consistently across countries, especially in light of widely varying supervisory structures and approaches. We also need to think carefully about the competitive effects of Basel II on the domestic banking scene. Maintaining an appropriate competitive balance in the United States between our large, internationally active banks, on the one hand, and the thousands of smaller banks and thrift institutions, on the other, is a crucial consideration. Finally, we need to avoid issuing a rule that is so prescriptive in its approach that it would discourage innovation in market practices and advances in risk management. I will address each of these challenges below.

Background

The Basel Committee was established in 1974 by the governors of the central banks of the G–10 countries in the aftermath of disturbances in international currency and banking markets, notably the failure of Bankhaus Herstatt in West Germany. Originally, the Basel Committee focused primarily on cooperation and information sharing among its members. Increasingly, the committee has come to see its role as promoting international harmonization through the issuance of "best practices" papers and the development of supervisory standards to which its members voluntarily agree to adhere. The committee does not have any formal authority, and its standards are not legally binding on its members. The committee's current members are the senior officials of bank supervisory authorities and central banks of Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom, and the United States.

One of the most significant efforts of the Basel Committee was the development and issuance of the 1988 Capital Accord (Basel I). 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.

However, by the late 1990s, the committee realized that Basel I had become outdated. The increased scope and complexity of the banking activities of our largest banking institutions over the last decade, and the unintended consequences of various provisions of the regulations, severely undercut the utility of the Capital Accord. Basel I simply does not provide large, internationally active banks with a meaningful measure of the risks they face or the capital they should hold against those risks.

In commencing the effort to revise its Capital Accord, the Basel Committee adopted five key objectives to guide its efforts:

- The accord should continue to promote safety and soundness in the financial system, and should at least maintain the current overall level of capital in the system.
- The accord should continue to enhance competitive equality.
- The accord should constitute a more comprehensive approach to addressing risks.
- The accord should contain approaches to capital adequacy that are appropriately sensitive to the degree of risk involved in a bank's position and activities.
- The accord should focus on internationally active banks, although its underlying principles should be suitable for application to banks of varying levels of complexity and sophistication.

The development of Basel II has been a prolonged and often difficult process. The first public document, Consultative Paper No. 1 ("CP–1"), was issued in June 1999. That document provided the framework of Basel II but provided few details. The committee provided additional detail on the specifics of Basel II in its January 2001 issuance of Consultative Paper No. 2 ("CP–2"). Although it was more than 500 pages long, CP–2 still left a number of key issues unaddressed and unresolved. Industry reaction was mixed, with concerns expressed regarding the incompleteness of the proposal, regulatory burden, the treatment of operational risk, and a potential spike in regulatory capital requirements.

Current Basel Proposal

Since the issuance of CP–2, the Basel Committee and its numerous task forces and working groups have been laboring to complete a series of revisions to Basel I. In addition to assessing the comments received on the first two consultative papers, committee staff and principals have made numerous contacts with third parties to understand the nature of the comments and to assess more completely the likely effect of Basel II on measured levels of required regulatory capital, risk management systems, data requirements, supervisory programs, and credit availability.

An important component of the impact assessment has been the Basel Committee's quantitative impact surveys. The committee concluded its third Quantitative Impact Study, known as QIS–3, on December 20, 2002. The objective of the three impact studies has been to assess the impact of Basel II on required capital levels across all Basel-member countries. The individual bank regulatory capital amounts submitted under the impact studies provide indications of whether the committee has met the first key objective for the new Basel Accord—ensuring that the new framework maintains the current overall level of capital in the system. At this point, Basel Committee staff is still analyzing the results of the QIS–3 exercise.

The Basel Committee has outlined an aggressive timeline for the remaining actions leading to the adoption of Basel II. As described by the committee in a July 2002 press release, and subsequently reaffirmed, the remaining timeline for adoption of Basel II is as follows:

- May 2003: Issuance of Consultative Paper No. 3. A three-month comment period is expected for this document.
- December 2003: Finalization of Basel II by the Basel Committee.
- December 2006: Implementation of Basel II.

Forthcoming Consultative Paper No. 3

While work on Consultative Paper No. 3 ("CP–3") continues, we are in a position to describe much of its expected content. The attachment to this written statement provides a summary of the substantive provisions likely to be contained in CP–3. As before, this iteration of the proposed new accord will have three mutually reinforcing "pillars" that comprise the framework for assessing bank capital adequacy. The first pillar of the new accord is the minimum regulatory capital requirement. The Pillar 1 capital requirement includes a credit risk charge, measured by either a standardized approach or one of the new internal ratings–based ("IRB") approaches (foundation or advanced), an operational risk charge, and a market risk charge. Again, the attached document provides a more detailed description of the various components of the Pillar 1 charge.

Pillar 2 addresses supervisory review. It is "intended to ensure not only that banks have adequate capital to support all the risks in their business, but also to encourage banks to develop and use better risk management techniques in monitoring and managing these risks." This pillar encourages supervisors to assess banks' internal approaches to capital allocation and internal assessments of capital adequacy and, subject to national discretion, provides an opportunity for the supervisor to indicate where such approaches do not appear sufficient. Pillar 2 should also be seen as a way to focus supervisors on other means of addressing risks in a bank's portfolio, such as improving overall risk management techniques and internal controls.

The third pillar recognizes that market discipline has the potential to reinforce capital regulation and other supervisory efforts to ensure the safety and soundness of the banking system. Thus, the

committee is proposing a wide range of disclosure initiatives, which are designed to make the risk and capital positions of a bank more transparent. As a bank begins to use the more advanced methodologies, such as the advanced IRB approach, the new accord will require a significant increase in the level of disclosure. In essence, the trade-off for greater reliance on a bank's own assessment of the building blocks of capital adequacy is greater transparency.

U.S. Implementation Actions

It is important to recognize that the Basel Accord is not self-executing in the United States. Even when adopted by the Basel Committee, the revised Basel Accord will not apply to U.S. institutions unless and until the U.S. banking agencies adopt regulations to implement it. In accordance with the Administrative Procedure Act, 5 USC 551, et seq., the U.S. banking agencies must publish notice and seek comment from all interested persons on any such proposal, and must fully consider those comments, before adopting a new capital regulation in final form. Obviously, the OCC and the other federal banking agencies intend to fully comply with these requirements. We believe that the solicitation and assessment of comments is a critical step in determining the workability and effectiveness of Basel II and related domestic capital regulations.

This summer, the U.S. banking agencies expect to issue an advance notice of proposed rulemaking ("ANPR") soliciting comment on proposed revisions to the existing domestic capital adequacy regulations that would implement Basel II. The ANPR, which would be largely based on CP–3, would provide a description of proposed revisions to current capital regulations, seeking comment on outstanding or contentious issues, a draft of qualifying criteria for those banks seeking to make use of the advanced methodologies set forth in Basel II (i.e., the Advanced IRB approach for credit risk and the Advanced Measurement approaches ("AMA") for operational risk), and supervisory guidance articulating general supervisory expectations. Recognizing that CP–3 will likely be as lengthy and complex as its predecessors, we understand the importance of U.S. banks being able to review and comment on U.S. implementing documents as soon as practicable. By describing these concepts within the context of our existing regulatory and supervisory regime, this ANPR will provide a meaningful forum for a dialogue on Basel II.

After fully assessing comments generated during the ANPR process, the U.S. banking agencies will develop specific regulatory language for a full notice of proposed rulemaking ("NPR"). In order to meet the aggressive timeline for the adoption of Basel II, the agencies anticipate issuing the NPR in the fourth quarter of 2003. Again, the banking industry and other interested parties will have a full opportunity to comment on this fully articulated proposal before any revisions to our capital regulations are finalized.

I want to focus on two important unique features of the U.S. regulatory capital regime that will be highlighted in the ANPR and NPR—the scope of application of Basel II and the content and structure of the proposed revisions to the capital adequacy regulations. First, the U.S. expects to set forth in the ANPR definitive criteria for identifying which banks in the United States will be

subject to the new accord. In 1988, despite language in the Capital Accord that permitted a more limited application, U.S. banking and thrift agencies applied the Basel framework to *all* U.S. insured depository institutions. As we will highlight in the forthcoming ANPR, the U.S. agencies have determined to apply Basel II concepts more narrowly. Specifically, proposed regulatory text incorporating Basel II concepts will apply on a mandatory basis only to large, internationally active institutions that compete on a significant global basis with other financial service providers. Other institutions will have the opportunity to voluntarily opt into the Basel framework upon application to, and approval by, their primary federal supervisor.

Preliminary analysis by the U.S. agencies suggests that under the narrow approach we are proposing, there are currently fewer than a dozen U.S. banks that would be mandatorily subject to Basel-based regulatory capital requirements. Of course, the approach of requiring only a small population of banks to comply with Basel II will be subject to notice and comment in the ANPR and will be definitively resolved only after the U.S. rulemaking process has been completed.

Second, in developing revisions to existing capital adequacy regulations, U.S. banking agencies recognize that the revised regulation, and interagency implementation policy, need not follow the literal structure and language of Basel II. While consistent with the objectives, general principles, and core elements of the revised Basel Accord, the language, structure, and degree of detail of U.S. implementing documents could be very different from Basel II. These implementation differences are reflective of the particular statutory, regulatory, and accounting structures and practices in place in the United States, including, for example, regular on-site supervision, our prompt corrective action rules, and our minimum leverage ratio for capital adequacy. As is described more fully in the attachment, the U.S. agencies will likely propose for notice and comment a Basel II-based regime incorporating the Advanced IRB approach for credit risk, the AMA for operational risk, and the internal ratings approach for market risk.

As noted above, we believe that the solicitation and careful consideration of comments is a critical step in the overall assessment of Basel II and related domestic capital regulations. U.S. banking agencies will work within the Basel Committee to ensure that comments by U.S. banks or other interested persons are appropriately taken into account prior to the finalization of Basel II.

Status of Basel Proposal—Outstanding Issues

Despite the protracted nature of Basel II deliberations, significant issues remain, and the aggressive timeline for implementation of Basel II noted earlier will almost certainly be under pressure.

In commencing an objective assessment of the status of Basel II, it is important to reiterate and reaffirm the commendable work of the Basel Committee, and in particular, the strong and intelligent leadership of its chairman, William McDonough, president of the Federal Reserve Bank of New York. The OCC strongly supports the objectives of Basel II. These objectives, restated above, constitute a sound conceptual basis for the development of a new regulatory capital regime and should continue to serve as a useful benchmark to gauge our progress in this effort.

While theoretically sound, the concepts underlying Basel II present significant implementation challenges. Those concepts have their foundation in modern financial theory. However, some of the concepts, such as the advanced IRB approach for credit risk and the AMA for operational risk, are untested, with only limited industry practice to substantiate their practicality. Agency staffs have worked diligently but have not yet achieved a necessary level of comfort with the effectiveness of many of these Basel concepts in application. Moreover, the agencies have not fully assessed the effect of Basel II on bank regulatory capital, risk management systems, data requirements, supervisory programs, and credit availability. For example, there is an obvious tension between the objectives of maintaining the current overall level of capital in the banking system, on the one hand, and, on the other, providing an inducement to banks to lower their capital by investing in more refined risk measurement systems. A discussion of some of the specific unresolved implementation issues is provided below.

Complexity

Perhaps the most important objective for Basel II enumerated by the Basel Committee is that the accord should promote approaches to capital adequacy that are appropriately sensitive to the degree of risk involved in a bank's balance sheet and activities. This desire for risk sensitivity has led to a proposal that focuses on a bank's own determination of risk. Reliance on internal determinations of risk for capital adequacy, however, is a radical departure from Basel I and mandates changes in the way we structure the capital framework. In order for external stakeholders—shareholders, creditors, and supervisors—to have confidence in the capital numbers produced by the proposed system, bank internal risk determinations will have to be verifiable. Much of the material developed as part of the Basel II process seeks to specify expectations for rating systems, control mechanisms, audit processes, data systems and other internal bank processes in an attempt to gain comfort with the reliability of internal determinations of risk by individual banks. The challenge for supervisors, however, is to create a verifiably accurate system that does not at the same time stifle innovation in risk management and that takes into account practical cost/benefit considerations.

I have consistently expressed profound concern about the level of detail and specificity of the Basel proposal. In my view, the complexity generated in Basel II goes well beyond what is reasonably needed to implement sensible capital regulation. CP–2 reflected a desire to develop encyclopedic standards for banking systems that minimizes the role of judgment or discretion by those applying or overseeing the new rules. While the intent of such prescriptiveness is to promote consistency and uniformity in the application of Basel II, this approach is highly problematic, especially in the rapidly changing financial landscape that confronts both financial institutions and supervisors. It must be recognized that credit risk management is continuing to evolve in the financial services industry. Banks currently use a variety of different approaches to estimating appropriate capital levels and no "best practice" has yet emerged.

A highly detailed capital rule may make it easier to compare banks' capital numbers. But it may not be possible, or even desirable, for the Basel Committee to craft a capital rule that prescribes to the same level of detail a uniform set of risk management systems and processes that each individual bank would be expected to put into place. Our large banks are not homogeneous entities—their operations and business strategies vary significantly. A highly detailed and prescriptive rule that would apply to every large bank may have unintended consequences. And while we do not know the magnitude of the cost of attempting to implement such a prescriptive rule, we do know that there will be costs. One cost will be the burden on banks of conforming their current systems and processes to what is required under the new rule. A related cost is that we may lock banks into a particular way of measuring risk that may, ultimately, prove to be inferior to, as yet, undiscovered techniques.

We should remember that Pillar 2 and Pillar 3 were introduced precisely because of recognition by the committee of the limitations of Pillar 1's formulaic approach to determining capital requirements. Pillars 2 and 3 offer complementary sources of discipline over bank risk taking. In short, with more modest expectations concerning the need for precision under Pillar 1 come more modest demands for prescriptiveness.

While much is still unclear about the issues that will determine the correct balance between prescriptiveness and flexibility in the proposed capital reform, I offer three guiding principles. First, the capital rule that we implement must respect the evolutionary nature of risk management. As regulators we must acknowledge that we are still in the relative early days of credit risk measurement and we must recognize the inevitability of further innovation. We are about to propose a capital rule that will require banks to devote significant resources to developing and implementing complex measurement systems, data systems, and control structures. While we believe that some amount of additional expenditure for those purposes is justifiable on the basis of a new approach to regulatory capital requirements, we recognize that there will be a limit to that justification. And one factor that contributes to that limit is the possibility that banks will want to change those systems and structures in response to improvements in risk measurement technology.

Second, Basel reform should, in our view, be more principles-based than is suggested by the level of detail in the Basel documents. Attempting to regulate a bank's internal capital assessments, a complex and evolving field, by issuing detailed and prescriptive rules will most likely create an environment in which banks are constantly developing new instruments and practices not anticipated by the rules. The concern about the complexity of Basel II is similar to the current debate on possible improvements to the U.S. financial reporting system, especially as it relates to the

[1] See section 108(d), Sarbanes–Oxley Act, Public Law No. 107–204 (January 23, 2002)

[2] See Written Statement, Robert K. Herdman, chief accountant, U.S. Securities and Exchange Commission, before the Subcommittee on Commerce, Trade and Consumer Protection, Committee on Energy and Commerce, U.S. House of Representatives (February 14, 2002).

U.S. accounting standards process. As you know, in the Sarbanes–Oxley Act, Congress required the Securities and Exchange Commission (SEC) to study the adoption of a system of principles-based accounting standards.[1] In recent testimony,[2] the chief accountant of the SEC described the rules-based versus principles-based accounting standards debate in the following way: "Rule-based accounting standards provide extremely detailed rules that attempt to contemplate virtually every application of the standard. This encourages a check-the-box mentality to financial reporting that eliminates judgments from the application of the reporting." A principles-based accounting standard "requires financial reporting to reflect the economic substance, not the form, of the transaction. . . . Principle-based standards will yield a less complex financial reporting paradigm that is more responsive to emerging issues."

Third, regardless of the degree of specificity of the proposal, the document must be written in a manner that is understandable to the institutions that are expected to implement it, and to third parties, without regard to the complexity of the subject matter. It is imperative that the industry and other interested parties understand the proposed regulatory requirements and appreciate the supervisory expectations, if they are to provide a meaningful assessment of the consequences of the proposal. It is also imperative that any final capital rule be understandable by banks and supervisors in order to minimize unnecessary regulatory burden due to misunderstandings and confusion. And finally, given the importance of disclosure under Pillar 3 in reinforcing the efficacy of capital regulation and supervision, it is imperative that outside stakeholders in banks understand the operation of capital requirements.

Competitive Equality

The second stated goal of the Basel Committee in developing Basel II was that "the accord should continue to enhance competitive equality." Despite QIS–3 and other similar efforts, however, we are not in a position to definitively assess the full range of consequences from the implementation of Basel II, including its effect on competitive equality in the global financial marketplace. We are particularly concerned that Basel II may create or exacerbate relative advantages between domestic banks and foreign banks, between banks and nonbanks, and between large domestic banks and mid-size/small domestic banks. It is imperative that the U.S. banking agencies remain sensitive to these concerns and assess, to the extent possible, any unintended consequences resulting from the implementation of Basel II.

One of the primary objectives of the Basel Committee itself is the reduction of gaps and differences in international supervisory coverage by national supervisory agencies, especially as it relates to large internationally active banks that compete on a significant global basis with other financial service providers. This principle of competitive equality and a level playing field for international banks is an admirable one and an appropriate goal of the committee's efforts. Yet one must question whether the exceedingly complex and highly prescriptive approach to capital reflected in Basel II will truly foster competitive equality.

Global rules, no matter how carefully weighed and measured, are not a satisfactory substitute for judgment, especially in a field like financial risk management, where the state of the art is constantly in flux. In the United States, we have a highly developed—some say intrusive—system of bank supervision. For example, the OCC has full-time teams of resident examiners on site at our largest bank—as many as 20 to 30 examiners at the very largest. In addition, most U.S. institutions are also subject to holding company supervision by the Federal Reserve, and in some cases by the FDIC and state supervisors. In other countries, by contrast, supervision may rely less on bank examiners, as we know them, and more on outside auditors to perform certain oversight functions. Given such disparities in the methods of supervision, I submit that U.S. banks are more likely to be subjected to more vigorous enforcement of a set of complex and prescriptive rules and less likely to be the beneficiaries of permissive exceptions, than banks in countries whose supervisory practices fall at the other end of the spectrum.

Second, for many banks, the principle source of competition is not other insured depository institutions, but nonbanks. This situation is especially pronounced in businesses such as asset management and payments processing. As you are aware, however, regulations implementing Basel II–based concepts in the United States will apply only to insured depository institutions and their holding companies. While differences in regulatory requirements for banks and nonbanks exist today, many institutions have voiced concern that implementation of Basel II may unduly exacerbate the current differences. These concerns have been focused on the effects on competition from the application of the operational risk proposal and the enhanced disclosures required under Pillar 3.

Third, there is concern about the potential effect of Basel II on the competitive balance between large and small banks. As implemented in the United States, Basel II would result in a bifurcated regulatory capital regime, with large banks subject to Basel II–based requirements and small and mid-sized banks subject to the current capital regime. This structure is premised on the belief that, to the extent possible, regulations should reflect the size, structure, complexity, and risk profile of banking institutions. The Basel II framework was developed to address the unique risks of large internationally active institutions. Mandatory application of such a framework to small banks, with its associated costs, was deemed inappropriate. In fact, the banking agencies sought comment from the banking industry, especially smaller institutions, on the development of a simplified capital framework specifically for non-complex institutions.[3] Industry comments were overwhelming negative on the proposal—most institutions felt that the cost of adopting a new regulatory capital regime outweighed any potential benefits. Accordingly, the banking agencies tabled the proposal.

With that said, the banking agencies need to continue to assess the competitive effects of a bifurcated regulatory capital regime. There are two primary concerns in this regard. First, banks using

[3] See Advance Notice of Proposed Rulemaking, Simplified Capital Framework for Non-Complex Institutions, 65 *Federal Register* 66193 (November 3, 2000).

a Basel II–based regime will likely have a lower minimum capital requirement, allowing those banks to grow and compete more aggressively with small banks for both assets and liabilities. That concern is discussed in more detail in the "Calibration"section below. Second, banks using a Basel II–based regime will have a lower marginal regulatory capital charge for some types of loan products. As stated by the FDIC in a recent paper,[4] under the current capital regime, the regime applicable to most small banks after Basel II, a bank making a $100.00 commercial loan is required to hold $8.00 in capital. For banks using advanced methodologies in a Basel II–based regime, the required capital for that same loan would range from $0.37 to $41.65, depending on the riskiness of the credit exposure.[5] The banking agencies must continue to assess this situation and, if warranted, take steps to mitigate adverse effects on the competitive balance between large and small banks. We would be concerned if, as an unintended consequence of the implementation of Basel II, we significantly alter the structure of banking in the United States.

Operational Risk

Perhaps the most contentious aspect of the proposed revisions to the Basel Capital Accord has been the introduction of operational risk as a separate and distinct component of minimum regulatory capital. I should say at the outset that the OCC supports the view that there should be an appropriate charge for operational risk. Indeed, our banks already take account of operational risk in their own internal economical capital allocations. Since the issuance of CP–1 in June 1999, there have two competing views on the regulatory treatment of operational risk. Some have argued that operational risk is sufficiently similar to credit risk and market risk to be included in the Pillar 1 charge, while others have maintained that operational risk inheres in the quality of an institution's internal control systems, supporting a Pillar 2 approach in which supervisors focus on a qualitative evaluation of such systems. I have consistently advanced the position before the Basel Committee that any charge for operational risk should be committed to the discretion of bank supervisors, under Pillar 2 of the proposal, rather than being calculated through a formulaic approach under Pillar 1. I regret to say that I have not been able to persuade the committee as a whole to adopt this approach.

Nonetheless, it should be recognized that Basel's operational risk proposal has changed considerably since CP–1, reflecting some convergence from the ongoing debate about whether the subject should be addressed under Pillar 1 or Pillar 2. The current operational risk proposal, especially the option of the AMA, which the OCC helped develop, is a significant improvement over earlier proposals. Recognizing the early stage of development of operational risk as a separate discipline,

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[4] See "Basel and the Evolution of Capital Regulation: Moving Forward, Looking Back," FDIC Emerging Issues Paper (January 14, 2003).

[5] Calculations reflect representative lower and upper bounds for capital to be held in support of the $100.00 loan. Lower bound reflects an LGD of 10 percent (high recovery) with a one-year maturity loan. Upper bound reflects an LGD of 90 percent and a five-year maturity loan.

the AMA is a flexible approach that allows an individual institution to develop a risk management process best suited for its business, control environment and risk culture. The AMA tries to balance this need for flexibility with the establishment of broad standards for the identification, measurement, management, control, and mitigation of operational risk to ensure a measure of consistency of application.

Despite recent improvements in the operational risk proposal, the OCC remains receptive to comment on this aspect of Basel II. While credit, market, and operational risks can all cause significant financial losses to financial institutions, those risks are not identical in character, and the differences need to be reflected in any regulatory capital regime incorporating an operational risk charge. Unlike credit risk and market risk, which a bank consciously assumes in the expectation of financial return, operational risk is an unwanted byproduct of day-to-day business activities. At the same time, banks can take significant steps to mitigate exposure to operational risk *ex ante*, rather than relying on capital to absorb losses *ex post*. As was described in a recent paper,[6] the trade-off a bank faces in managing operational risk is not risk versus return, but risk versus the cost of avoidance.

As events in recent times have confirmed, internal control deficiencies, external and internal fraud, system breakdowns and other similar "operational" risks can result in significant financial losses, undesirable earnings volatility, and reputation damage for individual institutions. The challenge for banks and bank supervisors is to identify the appropriate response to those risks. Banks have used an assortment of risk management tools in addressing operational risk, including enhanced controls, audit, improved risk measurement, pricing, insurance, and capital. As the U.S. banking agencies develop the domestic capital rules, qualifying criteria and supervisory guidance for operational risk, supervisors must ensure that implementing regulations and policies appropriately reflect the full range of management choices in addressing this risk.

Calibration

As discussed earlier, the first objective of the Basel Committee in embarking on the Basel II effort was to calibrate minimum capital requirements to bring about a level of capital in the industry that, on average, is approximately equal to the global requirements of the present Basel Accord. That calibration was to be designed to provide an incentive to banks to develop and maintain sophisticated and risk-sensitive internal ratings-based systems. The recent QIS–3 exercise was designed, in part, to determine whether this calibration exercise was successful. While, as noted earlier, the Basel Committee has not yet officially received a report on the results of the QIS–3 exercise, issues concerning the overall calibration of regulatory capital amounts can be identified and discussed.

[6] See "Operational Risk Capital: A Problem of Definition," Andrew Kuritzkes, *The Journal of Risk Finance* (Fall 2002).

To ensure that it meets its goal of avoiding significant decreases in the aggregate level of required capital in the banking system, the committee has proposed the use of a minimum floor capital requirement in the revised accord. Under this approach, there will be a single overall capital floor for the first two years following implementation of the new accord. This floor will be based on calculations using the rules of the existing accord. Beginning in the first year following implementation, minimum regulatory capital at an individual bank cannot fall below 90 percent of the minimum level required under the capital rules, and in the second year, the minimum will be 80 percent of this level.

Based on preliminary analysis, the minimum floor capital requirements may prove binding on a number of U.S. institutions. The OCC does not believe that a reduction in minimum regulatory capital requirements for certain institutions is, in and of itself, an adverse feature of Basel II. Such a result is only acceptable, however, if the reduction is based on a regulatory capital regime that appropriately reflects the degree of risk in that bank's positions and activities. The OCC is not yet in a position to make that determination as it relates to Basel II. Given our current understanding of the data provided by banks that participated in QIS–3, and the uncertainty surrounding those submissions, the OCC is not yet comfortable allowing national banks to materially lower their current capital levels simply on the basis of the output of the currently proposed Basel II framework.

Conclusion

As I have indicated, the OCC strongly supports the objectives of Basel II—a more risk-sensitive and accurate capital regime. However, I believe that significant work remains before the current draft of Basel II can be considered final. This summer, the OCC and the other banking agencies expect to seek notice and comment on an ANPR that translates the current version of Basel II into a regulatory proposal and accompanying supervisory guidance for U.S. banks. Once this process is complete, we will be in a position to have a full and complete consideration of the proposal from all interested parties. As I said in the beginning of my statement, the OCC, the agency to which Congress has committed the authority to define capital requirements for national banks, will not sign off on a final Basel II framework until we have fully considered all comments received during our notice and comment process. If we determine through this process that changes to the Basel proposal are necessary, we will press the Basel Committee to make changes, and we preserve our ability to assure that any final U.S. regulation applicable to national banks reflects those views. Given the importance of this proposal, the significant issues that remain unresolved, and the prospect that whatever emerges from this process is likely to govern the financial landscape for years to come, we need to take whatever time is necessary to develop and implement a revised risk-based capital regime that achieves the stated objectives of the Basel Committee in both theory as well as practice.

I am pleased to have had this opportunity to provide our views on this important initiative, and I would be happy to answer any questions you may have.

Attachment

Summary of Basel II: The Proposed New Accord
Office of the Comptroller of the Currency

The Basel Committee has been developing the new accord over the past five years. During that time, two full-scale consultative papers (June 1999 and January 2001) and numerous working papers supporting various elements of the new accord have been released to the industry for comment. This summary is intended to convey a general idea of the structure and substance of the proposed new accord, and does not attempt to provide a complete analysis. It is based on the most recent publications from the Basel Committee, notably the "Technical Guidance" of the Quantitative Impact Study and the recent consultative paper of Pillar 3 on transparency and disclosure; the underlying documents can be found on the Basel Committee's Web site at http://www.bis.org/bcbs/index.htm.

The new accord will include menus of approaches for measuring the capital required for credit risk, market risk, and operational risk. For credit risk and operational risk, each of the proposed approaches is described briefly below; capital charges for market risk are unchanged in the new accord and are not discussed here. Some of the approaches described are unlikely to be implemented in the United States and have been noted as such. Moreover, based on preliminary analysis by the U.S. agencies, currently there are less than a dozen U.S. banks that would be mandatorily subject to Basel-based regulatory capital requirements. While other banks would be permitted to opt into the Basel rules (subject to meeting prudential qualification requirements), the U.S. capital rules will remain in place for the vast majority of U.S. banks that either are not required to, or do not opt to, apply the Basel II framework. Of course, any issues regarding U.S. implementation of the new accord will be definitively resolved only after the U.S. rulemaking process has been completed.

General Structure of the Proposed New Accord

The new accord has three mutually reinforcing "pillars" that make up the framework for assessing capital adequacy in a bank. The first pillar of the new accord is the minimum regulatory capital charge. In order to calculate the capital charge under Pillar 1, banks will have to determine the individual charges for credit, market and operational risk. The new accord offers a series of options for calculating credit and operational risk. Market risk will remain unchanged from a 1996 amendment to the accord. The new options for credit and operational risk were designed to be available to a wide range of banks, from relatively simple to very complex. For credit risk, the Pillar 1 capital requirement includes both the standardized approach, updated since the 1988 accord, and the new internal ratings–based ("IRB") approaches (foundation and advanced). Pillar 1 has been the focal point of much of the discussion and comment from the industry on the new accord.

Pillar 2 covers supervisory review and banks' obligation to hold sufficient capital vis-à-vis their risk profile. The pillar is "intended to ensure not only that banks have adequate capital to support all the risks in their business, but also to encourage banks to develop and use better risk management techniques in monitoring and managing these risks." This pillar encourages supervisors to assess banks' internal approaches to capital allocation and internal assessments of capital adequacy. It provides an opportunity for the supervisor to indicate where such approaches do not appear sufficient. Pillar 2 is also a way to focus supervisors on other means of addressing risks in a bank's portfolio, such as improving overall risk management techniques and internal controls.

The third pillar recognizes that market discipline has the potential to reinforce capital regulation and other supervisory efforts to ensure the safety and soundness of the banking system. Thus, the new accord proposes a wide range of disclosure initiatives, which are designed to make the risk and capital positions of a bank more transparent. As a bank begins to use the more advanced methodologies for market and operational risk, the new accord will require a significant increase in the level of disclosure. In essence, the trade-off for greater reliance on a bank's own assessment of capital adequacy is greater transparency. This pillar was subject to a recent redraft and consultation process (ended February 14, 2003); the new draft was in response to significant concerns raised about the January 2001 proposal.

Capital for Credit Risk

Under Basel II, banks must select one of three approaches to determine their capital for credit risk. The three approaches, from simplest to most complex, are: the standardized approach, the foundation IRB, and the advanced IRB.

Standardized Approach

The 1988 accord introduced the standardized risk-bucketing approach for setting the minimum regulatory capital requirement, which is still used in the United States today. The approach has been subject to criticism that it lacks sufficient risk sensitivity. The revised standardized approach under Basel II enhances the 1988 accord by providing greater, though still limited, risk sensitivity.

Key changes to create a more risk-sensitive framework include the refinement and addition of risk buckets, the introduction of external credit ratings, and a wider recognition of credit risk mitigation techniques. Risk weights are still determined by category of the borrower—sovereign, bank or corporate—but within each of these categories changes have been made to make the capital more reflective of the riskiness of the asset category. For example, the risk weight on mortgage loans has decreased from 50 percent to 40 percent and the risk weight on certain retail credits has moved from 100 percent to 75 percent. Risk weights for externally rated corporate credits, currently 100 percent, will range from 20 percent to 150 percent. Sovereign risk weights are no longer dependent upon whether a country is a member of the Organization for Economic Cooperation and Development ("OECD"), but rather on the external rating identified for the country.

The standardized approach is not likely to be implemented in the United States. U.S. supervisors believe that credit risk measured under the standardized approach of Basel II would generally not be appreciably different than that measured under current rules for most U.S. banks, and the marginal changes in capital requirements would not justify the cost of implementation.

Internal Ratings–Based Approach (Foundation and Advanced)

The IRB approach represents a fundamental shift in the committee's thinking on regulatory capital. It builds on internal credit risk rating practices used by some institutions to estimate the amount of capital they believe necessary to support their economic risks. In recent years, as a result of technological and financial innovations and the growth of the securities markets, leading banking institutions throughout the world have improved their measurement and management of credit risks. These developments have encouraged the supervisory authorities to devote greater attention to developing more risk-sensitive regulatory capital requirements, particularly for large, complex banking organizations.

Banks must meet an extensive set of stringent eligibility standards or "qualifying criteria" in order to use the IRB approach. Because the requirements include both qualitative and quantitative measures, national supervisors will need to evaluate compliance with them to determine which banks may apply the new framework. The requirements vary by both the type of exposure and whether the bank intends to use the simpler foundation IRB framework or the more advanced IRB framework. The requirements are extensive and cover a number of different areas, including rating system design, risk rating system operations, corporate governance, and validation of internal estimates. A brief sample of actual criteria include:

- The board of directors and senior management have a responsibility to oversee all material aspects of the IRB framework, including rating and probability of default ("PD") estimation processes, frequency and content of risk rating management reports, documentation of risk rating determinations, and evaluation of control functions.
- A one-year PD estimate for each grade must be provided as a minimum input.
- Banks must collect and store historical data on borrower defaults, rating decisions, rating histories, rating migration, information used to assign ratings, PD estimate histories, key borrower characteristics, and facility information.

As mentioned above, the requirements that a bank must meet are partially dependent upon which of the two IRB approaches a bank will use. The first methodology, called the foundation approach, requires fewer direct inputs by banks and provides several supervisory parameters that, in many cases, carry over from those proposed for the standardized approach. For a variety of reasons, the United States does not plan to introduce the foundation approach in its regulations. The second approach, the advanced IRB approach, allows banks much greater use of their internal assessments in calculating the regulatory capital requirements. This flexibility is subject to the

constraints of prudential regulation, current banking practices and capabilities, and the need for sufficiently compatible standards among countries to maintain competitive equality among banks worldwide.

There are four key inputs that are needed under IRB, for both the foundation and advanced approaches. The first element is the probability of default ("PD") of a borrower; the bank is required to provide the PD in both the foundation and the advanced approaches. The second piece is the estimate of loss severity, known as the loss given default ("LGD"). The final two elements are the amount at risk in the event of default or exposure at default ("EAD") and the facility's remaining maturity ("M"). LGD, EAD, and M are provided by supervisors in the foundation approach, but must be provided by banks operating under the advanced approach (subject to supervisory review and validation). For each exposure, the risk weight is a function of PD, LGD, and EAD.

The IRB approach envisions internal rating systems that are two-dimensional. One dimension focuses on the borrower's financial capacity and PD estimates that quantify the likelihood of default by the borrower, independent of the structure of the facility. The other dimension takes into account transaction-specific factors such as terms, structure, and collateral. These characteristics would determine the second dimension, i.e., the LGD. Implicit in this treatment is the assumption that when a borrower defaults on one obligation, it will generally default on all its obligations. (This assumption is relaxed with the IRB treatment of retail portfolios.)

Calculating the capital charge under the IRB approach involves several steps. The first of these steps is the breakdown of the bank's portfolio into five categories: corporate, retail, bank, sovereign, and equity. The IRB rules differ to varying degrees across these portfolios. As a result, the IRB capital charge is calculated by category, with the PD, LGD, and EAD inputs potentially differing across these categories. Supervisory approval is needed before banks can use the IRB approach for any of the five categories. The minimum requirements described above were written to apply across these five types of exposure. The IRB approaches are most developed for portfolios of exposures to corporates, banks, and sovereigns.

Another important step is the determination by the bank of the PDs for its loan-grading categories. The PD of an exposure is the one-year PD associated with the borrower grade, subject to a floor of 0.03 percent (excluding sovereigns). The determination of PDs for borrowers supported by guarantees or credit derivatives is more complex. Banks under the advanced approach would use their internal assessments of the degree of risk transfer within supervisory defined parameters, while those under the foundation approach would use the framework set forth in the new credit risk mitigation provisions. Overall, the PD must be "grounded in historical experience and empirical evidence," while being "forward looking" and "conservative." A reference definition of default has been developed for use in PD estimation and internal data collection of realized defaults.

Once the PD has been established, banks must then establish the dimensions of LGD ("loss severity") based on collateral and M. Under the foundation approach, M is assumed to be 2.5 years. There are several options that may be selected for the advanced approach, but in general, M is defined as the greater of one year or the remaining effective maturity in years.

After the bank determines the PDs and LGDs for all applicable exposures, these combinations can be mapped into regulatory risk weights. The risk weights, which are calibrated to include coverage for both expected and unexpected losses, are expressed as a continuous function, which provides maximum risk sensitivity and flexibility in accommodating diverse bank risk rating systems. The minimum capital charge is then determined by multiplying the risk weight by the amount expected to be outstanding at the time of default (EAD), and by 8 percent.

A final step in this process involves the ongoing review by the supervisors of the systems used to develop the IRB capital charge. Periodically, supervisors will need to validate these systems and review the internal controls that provide the foundation for the IRB approach. In addition, supervisors will also have to consider, under Pillar 2, whether the amount of capital generated by the IRB approach is commensurate with the bank's risk profile.

Implementation of the IRB Approach

In addition to the requirement that a bank meet the qualifying or eligibility criteria, the new accord requires that banks using the IRB approach run parallel systems for one year before implementation. This means that a bank planning to implement the IRB approach in December 2006 will actually have to begin calculating results as of December 2005 while continuing to run its current systems.

Adjustments to the Capital Charge for Credit Risk

There are additional considerations that banks may have to factor in when determining the capital charge for credit risk. These additional considerations will further adjust required capital, outside of the requirements of the different approaches to credit risk. The two primary adjustments that might be made to the credit risk charge are for credit risk mitigation and asset securitization.

Credit Risk Mitigation

The new accord provides a measure of capital relief for certain qualifying risk-mitigating techniques used by banks. However, it is important to note that the credit risk mitigation proposals in the new accord are generally only directly relevant to the standardized or foundation IRB approaches, which are not likely to be used in the United States. In the advanced IRB approach, credit risk mitigation must meet certain qualitative requirements, such as legal certainty, but there are no specific proposals for adjusting the capital requirement for transactions that include credit risk mitigation techniques. It is assumed that any credit risk mitigation efforts will be factored into the PDs and LGDs assigned by the bank.

With that caveat in mind, the section on credit risk mitigation in the new accord attempts to provide rough approximations of the risk reduction attributable to various forms of collateralized credit exposures, guarantees, credit derivatives, and on-balance-sheet netting arrangements. The committee has proposed a conceptual approach to these risk mitigation techniques that, while recognizing their risk reduction benefits, attempts to capture the additional risks posed by such transactions.

The credit risk mitigation proposal provides both a simple and a comprehensive approach to dealing with collateral. The proposal expands the range of eligible collateral from that recognized in Basel I. It also discusses the appropriate treatment for maturity mismatches between the credit risk mitigant and the underlying credit exposure. The proposal introduces haircuts, which the bank may estimate, to cover the market price and foreign exchange volatility that may be inherent in the mitigant. The proposal allows banks to greatly reduce the capital requirements for exposures with large amounts of high quality collateral. There are strict quantitative and qualitative factors that must be met in order for a bank to be permitted to use its own haircut estimates. The proposal encourages the use of credit risk mitigation by expanding the type of collateral, guarantors, and transaction structures that are recognized for capital reduction. Different types of credit risk mitigation techniques pose different levels of additional risk; the proposal incorporates flexibility that recognizes these differences and adjusts the capital treatment accordingly.

Asset Securitization

Asset securitization is clearly an important issue in the United States, as the securitization market is significantly greater than the securitization market of any other Basel member country. The Basel Committee believes that it is important to construct a more comprehensive framework to better reflect the risks inherent in the many forms of asset securitizations, including traditional and synthetic forms.

The securitization framework in the new Basel Accord applies generally when there is a transaction that involves the stratification or tranching of credit risk. The committee has developed securitization approaches for both standardized and IRB banks. The level of complexity is significantly higher for IRB banks. The framework tries to focus on the economic substance of the transaction, rather than its legal form.

Under the proposal for the treatment of securitizations by standardized banks, the capital charge is generally determined by multiplying the amount of the securitization exposure by the risk weight mapped to the long- and short-term rating categories. Off-balance-sheet exposures are subject to a conversion factor before the appropriate risk weight is applied. The proposal does allow for some recognition of credit risk mitigants provided on securitization exposures, but that recognition is permitted only when the bank meets a series of stringent criteria.

Banks that have adopted the IRB approach for credit risk are required to use one of two methods for determining capital requirements for securitization exposures. One method is the supervisory

formula approach ("SFA"), under which capital is calculated through the use of five bank-supplied inputs: the IRB capital charge on the underlying securitized exposures (as if held directly on the bank's balance sheet); the tranche's credit enhancement level and thickness; the pool's effective number of loans; and the pool's exposure-weighted average loss given default. The second method is known as the ratings-based approach ("RBA"). Under this approach, capital is determined by multiplying the amount of the exposure by the appropriate asset-backed security risk weights, which depend on external rating grades, short- or long-term. Granularity of the pool and the level of seniority of the position are also considered.

The securitization proposal is one of the newest pieces of the accord and its impact on the industry is not yet fully known. In the latest QIS exercise, banks were asked for the first time to provide data on the relative impact of the proposals. Due to a number of questions about the proposal, the QIS results did not provide entirely reliable results, and it appears that more work is needed to make the proposal more understandable for banks.

Operational Risk

One of the most significant changes in the new accord is the proposal for an operational risk charge. It is expected to represent, on average, 10–15 percent of the total minimum regulatory capital charge. The framework is based upon the following operational risk definition: the risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events.

The committee has proposed three approaches to calculate the operational risk charge, which represent a continuum of increasing sophistication and risk sensitivity. The basic indicator approach ("BIA") is the simplest of the three approaches; the capital charge is determined by taking an alpha factor decided by the committee and multiplying it by an indicator, gross income. The next approach is known as the standardized approach and is similar to the BIA, but breaks out gross income into business lines. Because there is no compelling link between these measures and the level of operational risk, the United States does not plan to utilize the BIA or the standardized approach to determine the capital charge for operational risk.

The committee has made the most significant changes to the advanced approach since it was originally introduced in January 2001. At that time, the committee envisaged a single, very prescriptive advanced approach for operational risk, similar to credit risk. However, after numerous comments from the industry, the committee made substantive changes in the proposal to reflect the evolutionary nature of the operational risk framework. The committee recognized that, unlike credit risk, there are very little data and no internal systems specifically designed to target operational risk; instead, banks and supervisors rely primarily on internal controls to deal with a myriad of banking risks that cannot be as readily quantified as credit and market risks.

The committee considered the comments and analyzed the state of the art of operational risk and developed what is known as the advanced measurement approaches (“AMA”). Rather than prescribing one methodology, the AMA will allow banks the option of designing the operational risk measurement framework that best suits their institution, subject to some broad criteria. The criteria will be the key to achieving a certain level of consistency and comparability among institutions, as well as providing a margin of comfort to supervisors who must assess these differing systems. The criteria currently identified in the new accord include the need for internal and external data, scenario analysis, consideration of business environment and internal control factors, and an adjustment for qualitative factors. Banks may also, under the AMA, consider the impact of risk mitigation (such as insurance), again subject to certain criteria set to ensure that the risk mitigants are effective.

Temporary Capital Floors

Two floors that have been established for the Basel II framework. In the first year of implementation, the total capital requirement cannot fall below 90 percent of the result the bank would have had under the current (1988) accord; in the second year, that floor drops to 80 percent.

Remarks by John D. Hawke, Jr., Comptroller of the Currency, before the Institute of International Bankers, on the proposed revisions to the Basel Capital Accord, Washington, D.C., March 3, 2003

Last week, I testified before a House of Representatives subcommittee on the proposed revisions to the Basel Capital Accord—Basel II, as we call it—and Basel II is what I'll be speaking to you about this morning. Over the past several months, there has been a great surge of interest in the news from the picturesque Swiss city that not too long ago was better known for its museums and medieval cathedral than for the pronouncements of the central bankers and bank supervisors who have been gathering there for decades. The financial press is full of the latest Basel news and rumors—the cottage industry of Basel-watchers could now fill a large office building—and financial institutions are hastening to get their views on the record in the hope that there may still be time to influence the Basel process. Let me assure you that there is still time—but the clock is ticking away.

The growing interest in Basel II comes as the Basel Committee on Bank Supervision and its various task forces and working groups gear up for a last push to achieve a new Capital Accord. Indeed, the year since I last visited with the Institute of International Bankers was an unusually eventful and productive one for the Basel Committee, and so I should like to begin with a summary of just what has occurred during this period.

At its July 2002 meeting, members of the committee reached agreement in principle on a number of important issues relating to Pillar I—the provisions prescribing a minimum regulatory capital charge. As you know, Pillar I offers financial institutions three major options for calculating capital:

- The standardized approach—essentially, a set of refinements to the old risk buckets—which provides for the use of external ratings in certain circumstances and gives some weight to risk mitigation devices;
- 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; and
- The "advanced IRB" approach, which bases capital calculations on the bank's own supervisory-validated models, including bank-calculated PDs and LGDs.
- In each of the three approaches there would be a calculation for determining an assignment of capital to cover operational risk.

These Pillar I options—and the manner in which they would be applied and implemented—had long been among the most problematic elements of the Basel II proposals. That's why the agreements that came out of the committee's July meeting were so important. We agreed on:

- Creation of a new IRB risk-weight curve that should provide a more risk-sensitive treatment of certain revolving retail exposures, including many credit card exposures.
- The need for banks using the "advanced IRB" approach to take account of a loan's remaining maturity when determining regulatory capital, while allowing national supervisors to exempt smaller domestic borrowers from this requirement.
- New elements of the corporate and retail IRB frameworks and a standardized approach designed to provide reduced capital requirements for loans to small- and medium-sized enterprises (SMEs) under the new accord.
- The need for flexibility in the capital treatment of operational risk, which I'll return to in a moment.
- A plan to narrow the gap between the amounts of capital required in the foundation and advanced IRB approaches.

Another key milestone achieved during 2002 was the launch of the committee's third Quantitative Impact Study, known as QIS–3. When the results of QIS–3 are reported to the committee later this year, we should have some idea of how the latest version of the Basel II proposal may impact bank capital—although I should hasten to say that there are some shortcomings in QIS–3 and I have some serious reservations about the reliability of QIS–3 as a basis for calibrating the new accord.

The committee agreed to an aggressive timetable for the remaining actions leading to the adoption of Basel II. The plan calls for issuance of the third consultative paper (CP–3) in May of this year, with a three-month comment period to follow; adoption of Basel II by the committee in December 2003; and full implementation of the new accord by December 2006.

All of this represents good progress—far greater than many critics of the process thought possible. The committee and its various working groups, under the strong and intelligent leadership of Bill McDonough, have achieved impressive results under difficult circumstances. But we're not there yet. Problems—intractable and consequential problems—remain. Much as we would all like to declare victory and move on to other things, it is imperative that we forthrightly come to terms with these problems rather than trying to minimize their importance in the rush to an accord—an accord that will undoubtedly govern the financial landscape for many years to come.

I'd like to spend my remaining time with you this morning discussing a few of what I believe are the major unresolved issues that confront the Basel Committee.

Calibration

As I said a moment ago, one of the key concerns for the committee in Basel II is to assure that the new framework does not result in a significant decrease in the aggregate level of capital in the banking system. This is, in my view, more a political rather than an economic concern. After all, the very purpose of Basel II is to have capital rules that better reflect actual risk, and a more sophisticated and accurate measurement of risk might well result in a lowering of capital. To be sure, bank supervisors are inclined to believe that more capital is always better, and we would be concerned if Basel II resulted in a lowering of capital that was not clearly related to risk. But we are also aware that there can be adverse consequences for governmental requirements for too much capital—an impairment of the competitiveness of our banks and a misallocation of resources. From a political point of view, of course, there is a strong likelihood that Basel II might be viewed with a jaundiced eye by legislators if it resulted in an appreciable lowering of capital—particularly since the new process will be based on the banks' own assessments of risk. On the other hand, the committee wants to induce banks to make the sizeable investments in new risk management systems that will be required to make an internal ratings-based approach feasible and acceptable, and it has held out the prospect of reduced capital as such an inducement. It remains to be seen whether we are up to this kind of prestidigitation—simultaneously allowing large banks to reduce their capital while keeping the level of capital in the system undiminished. As F. Scott Fitzgerald once observed, "the test of a first-rate intelligence is the ability to hold two opposed ideas in the mind at the same time, and still retain the ability to function." There is no question but that the Basel Committee is comprised of first-rate intelligences.

To accomplish these apparently inconsistent goals, the committee has proposed the use of a capital floor requirement in the revised accord. Under this approach, there will be a single overall capital floor for the first two years following implementation of the new accord. This floor will be based on calculations using the rules of the existing accord. Beginning the first year following implementation, minimum regulatory capital at individual banks would not be permitted to fall below 90 percent of the current minimum required level, and in the second year, the minimum would be 80 percent of this level. Preliminary analysis suggests that these minimum capital requirements may prove binding on a number of U.S. institutions.

The OCC's position on the proper calibration of the Basel capital rules has been consistent. We do not believe that a reduction in minimum regulatory capital requirements for certain institutions is necessarily an adverse feature of Basel II. Such an outcome is only acceptable, however, if the reduction is based on a regulatory capital regime that has validity and integrity and appropriately reflects the degree of risk in that bank's positions and activities. Until we have better evidence that Basel II meets that standard, the OCC will be reluctant to allow national banks to materially lower their current capital levels.

Operational Risk

No Pillar I issue has generated more controversy than the proposed provision for operational risk as a separate and distinct component of minimum regulatory capital. We define "op" risk as the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events.

Since the issuance of CP–1 in June 1999, there have been two competing views on the regulatory treatment of operational risk. Some have argued that op risk is sufficiently quantifiable to be treated similarly to credit risk and market risk and to be included in the Pillar 1 charge. Others maintain that an evaluation of op risk is inherently judgmental, inhering as it does in the quality of an institution's internal control systems, thus supporting a Pillar II approach under which supervisors would focus on a qualitative evaluation of such systems. The OCC has consistently advocated a Pillar II approach for op risk, rather than the more formulaic approach of Pillar I. Unfortunately, I have not been successful in persuading my committee colleagues to adopt that position.

Nonetheless, the committee's approach to op risk has changed significantly—and for the better, in my judgment—since CP–1. The current op risk proposal offers three options, reflecting a continuum of increased sophistication and risk sensitivity. The most sophisticated of these options, the so-called Advanced Measurement Approach ("AMA"), affords considerable flexibility to financial institutions in developing an op risk management process best suited to its business, control environment, and risk culture. The AMA tries to balance this need for flexibility with the establishment of broad standards for the identification, measurement, management, control, and mitigation of operational risk to ensure consistent application.

Whether these improvements are sufficient to bridge what we see as the fundamental differences between credit and market risk, on the one hand, and operational risk on the other, is another question. Banks assume credit and market risk in the expectation of financial return; op risk, by contrast, is an unwanted by-product of normal business activity.

Banks make provision for operational risk through a variety of risk management tools. They build internal controls of varying degrees of robustness, develop audit capabilities, purchase insurance—and allocate capital. As the U.S. banking agencies develop the domestic capital rules, qualifying criteria, and supervisory guidance for op risk, supervisors must ensure that implementing regulations and policies appropriately reflect the full range of management choices in addressing this risk.

Complexity

The Basel committee sought to realize an ambitious set of goals in the new accord. We hoped to integrate all we have learned over the years about capital regulation and risk in a single, logically consistent package. We hoped to recognize the technological and conceptual advances in the science of risk management since the adoption of Basel I and to provide incentives for bankers

to make use of these advances. We wanted to supplement the risk judgments of supervisors with those of the marketplace and of bankers themselves and ensure that the guidelines supervisors produce are relevant to the changes—structural changes, portfolio changes, and management changes—that have occurred in the international banking environment.

In one respect, the result of such an ambitious undertaking was probably predictable. The process has generated a product of vast complexity—putting to shame the U.S. Internal Revenue Code, long the world's record holder for complexity. Thousands of pages of task force and working group papers, years in the making, have given rise to hundreds of pages of rules, guidelines, and standards saturated with arcane mathematical formulae. They're not written by or for bankers—or for that matter, by or for conventional bank examiners. They're written for mathematicians and economists—"quants."

When I have complained in the Basel committee about the complexity problem, my colleagues have roundly admonished me. "We live in a complex world," they say. "Don't quibble if we try to fashion capital rules that reflect that complexity." But with great respect for my colleagues, the complexity we have generated goes far beyond what is reasonably needed to deal with the intricacies of sensible capital regulation. It reflects, rather, a compulsion to close every possible loophole, to dictate every detail, and to exclude to the maximum extent possible any opportunity for the exercise of judgment or discretion by those applying and overseeing the application of the new rules. In short, it reflects much more a commitment to prescriptiveness than a mere recognition of the complexity of today's banking business.

This complexity has a price. Most obviously, it will impose a heavy cost burden on bankers, who have to design systems and educate staff to deal with the complex new rules. It may also have a cost in terms of credibility and public acceptance, for if legislators, customers, and market participants cannot penetrate the new rules, can we expect them nonetheless to love and respect them?

Finally, it may have a cost in terms of competitive equality, and this is what concerns me most. Bank supervision varies significantly from one country to another in approach, intrusiveness, and quality. Is it realistic to think that an enormously complex set of rules will be applied in an even-handed way across a broad spectrum of supervisory regimes? For example, the OCC has as many as 30 or 40 full-time resident examiners in our largest banks. They are intimately involved as supervisors in watching the banks' operations and judging the banks' compliance with a myriad of laws, rules, and guidelines. Some other countries may send examiners in once a year to comparably sized institutions, or may put heavy reliance on the oversight of outside auditors. It's fair to ask, I think, in which regime 800 pages of detailed, prescriptive capital rules are more likely to be robustly enforced? The Basel Committee has not undertaken to set standards of supervision for member countries. Yet the attainment of competitive equity among internationally active banks is a bedrock principle of Basel II. Can we really achieve competitive equality without addressing disparities in supervision—particularly when we are operating on the assumption that the complex new rules we're writing will be applied in an evenhanded way throughout the world?

I cannot resist recalling words that seem peculiarly relevant to this effort. In the 1780s, as Americans engaged in a great debate on the principles that should underlie their new government, one of the most original of our thinkers on that subject (and later president), James Madison, contributed an important insight. Popularly elected governments do not automatically command popular confidence, Madison observed. “It will be of little avail to the people if laws are made by men of their choice, if the laws be so voluminous that they cannot be read, or so incoherent that they cannot be understood.”

Certainly what has come out of Basel has been voluminous; whether it is incoherent I shall leave for others to decide—although I frankly confess that much of it boggles my mind. But in light of some of the criticisms I’ve heard, I think it would be well to consider whether we’re not approaching that point of perfect impenetrability—as with our tax code—that makes honest compliance difficult, if not impossible.

Each of the problems I have outlined deserves serious consideration by the Basel committee—and by everyone who will be affected by what comes out of its deliberations. Until the final accord is inked, the Basel committee must remain open to new ideas and new solutions, even if that involves some further slippage in the timetable for bringing the accord to a conclusion. Congress is playing a key role—as it should—in ensuring that the interests of U.S.-based institutions—and U.S. citizens—with respect to Basel II are properly understood and safeguarded.

Most of all, we’re counting on continued input from the banks that will have to live under the new Basel regime—and pay most of the costs associated with it. I assure you that we will take your comments with the utmost seriousness—now and during the formal notice and comment process. The OCC, which has been invested by Congress with the statutory duty and authority to fix capital requirements for national banks will not give its final agreement to Basel II until we have fully and objectively considered all the comments we receive. And we will not sacrifice good public policy to the dictates of an arbitrary time schedule. If, after reviewing the views of commenters, we determine that changes to the Basel proposal are necessary, we will insist upon such changes. The integrity of the process is crucial if Basel II is to achieve the goals we set out to achieve—for now and for years to come.

Since we began the process of revising Basel I, the OCC’s position has been firm and unequivocal. This is a tremendously important endeavor, and we strongly support its objectives. But Basel II must work in practice as well as theory; it must provide supervisors with sufficient flexibility to accommodate differences among financial institutions; and it must work in a way that avoids placing banks at a competitive advantage compared to other financial services providers. In advocating these broad policy goals, the OCC has looked at the issues independently as on operational risk. And while we have not always prevailed when we have had differences, I believe our efforts make it more likely that we’ll eventually get a workable new Basel agreement —one that all concerned parties can live with and prosper under.

Remarks by John D. Hawke, Jr., Comptroller of the Currency, before the Independent Community Bankers of America, on plain English financial disclosures, Orlando, Florida, March 4, 2003

I've long believed that bank supervisors have a special responsibility when community banks are concerned—not just because of your importance to your customers and the local economies you serve but also because community banks tend to be especially susceptible to the burdens of supervisory policies and actions. That's why the Office of the Comptroller of the Currency ("OCC") takes so seriously the need to develop supervisory policies that are sensible, constructive, and supportive of community banks. The Independent Community Bankers of America ("ICBA") is one of our principal sounding boards on issues of community bank supervision, and I'm delighted to be with you once again to discuss some important issues of mutual concern.

At the outset, let me repeat some points I have shared with you before. While the OCC is sometimes thought of as the "large bank" regulator, the fact is that community banks make up an enormously important part of our jurisdiction. Of the 2,100 banks we supervise, close to 2,000, or 92 percent, are under $1 billion in assets. Almost 1,000 of these—or 46 percent of all the banks we supervise—are under $100 million in size. Thirteen hundred of our examiners—about 80 percent of our total workforce—are community bank specialists, and most live in or near the communities whose banks they work with. Our assistant deputy comptrollers, who make 90 percent of the supervisory decisions affecting their banks, average more than 20 years of supervisory experience. Each year this highly talented group of people conducts literally hundreds of outreach events for community banks around the country, and we in Washington regularly meet with dozens of delegations of community bankers. In short, the OCC has a huge commitment to community banking. Beyond these institutional concerns, I personally believe that the nation's community banks are an essential foundation of our financial system, and I want to see community banks flourish and prosper.

Of course, my old friend Ken Guenther and the ICBA leadership have long provided community bankers with effective and forthright representation in Washington, and they are always there, looking over our shoulders, highlighting issues of particular importance to community banks and reminding us of the importance of weighing the costs against the benefits of new regulations as we write them and implement them.

That the laws and regulations that govern banking are burdensome and costly is a proposition I suspect will get no argument from this audience. Scholars, industry groups, and government agencies have studied the question from almost every angle, and their studies invariably come to the same conclusion: regulation—particularly what we refer to as "compliance" regulation—constitutes a significant and growing burden for banks of all sizes, a burden that falls with disproportionate weight on the smallest banks. Where large banks may have dozens of lawyers and other specialists working in their compliance shops—parsing regulations and advisories, drafting

forms, following a myriad of court and agency rulings and interpretations, and dealing with examiners—those tasks may be a part-time responsibility for one person in many of your banks. Yet you have to understand and comply with the very same laws and rules as the largest banks.

The sharpest increase in regulatory burden has occurred in the area of consumer-oriented legislation. Since 1968, more than two dozen such laws have gone on the books, with the Truth-in-Lending Act ("TILA") leading the way. Others followed in rapid succession: the Fair Credit Reporting Act, the Equal Credit Opportunity Act, the Real Estate Settlement Procedures Act ("RESPA"), the Community Reinvestment Act ("CRA"), the Home Owners Protection Act, the Home Mortgage Disclosure Act, the Consumer Leasing Act, the Electronic Fund Transfer Act, the Truth in Savings Act, the Fair Debt Collection Act, to name only a few—and, most recently, the privacy provisions of the Gramm–Leach–Bliley Act ("GLBA").

The costs of complying with these laws, and the regulations promulgated to implement them, are substantial. In 1991, according to one study, those costs may have exceeded 12 percent of bank noninterest expenses. And this figure doesn't take into account the hundreds of millions of dollars that are spent annually by the supervisory agencies monitoring and measuring bank compliance with consumer regulations, or the hundreds of millions more spent examining for safety and soundness—costs that are directly or indirectly passed on to banks and taxpayers generally.

Statistical analyses lend credence to the point I made at the start—that compliance regulation is particularly onerous for community banks, which don't enjoy the economies of scale that are available to larger banks. A 1977 study, for example, showed that, for banks in the under-$10 million category, the cost of regulation per million dollars of assets was nearly twice what it was for banks with between $10 and $25 million in assets. Every subsequent study—and there have been many, of varying sophistication—has come to the same conclusion. But we didn't need teams of economists to tell us that.

What may be less immediately apparent is that the costs of bank regulation are spread over the broad economy. We have credible studies showing that regulation constitutes a significant barrier to the entry of new banking firms, that it reduces competition among financial providers, and that it discourages innovation and creativity in the development of new financial services. All of this imposes burdens whose impact is felt well beyond the financial sector.

Yet it must be emphasized that bank regulation is an unavoidable necessity. Banking is not like other businesses. It was the first regulated business in America, and for a long time it was the only one. Banks are critical to the health of our economy, they operate our payments system, and they provide crucial financial services to the communities they serve. In recognition of their enormously important role, banks are the beneficiaries of a federal safety net and a system of deposit insurance. Avoidance of bank failure is a major objective of government policy. The rationale for bank regulation was inarguable 200 years ago, and it's inarguable today.

Of course, the vast majority of compliance laws are of more recent vintage. It's important to remember, however, that these laws—and the burdens they've created—were not enacted in a vacuum. Almost without exception they were responsive to abuses in the financial marketplace that the banking industry had proved unable or unwilling to correct on its own. In many cases, these abuses were engaged in by a relatively small number of banks, but they were abuses nevertheless. It is a simple fact of political life that legislators will respond to the conduct of the worst actors and will generally do so with laws that affect the business of all, including the best.

One need only recall—to cite just a few examples—the impossible welter of incompatible approaches to interest rate calculation that had been used by financial institutions or the frustration that customers sometimes faced in getting billing errors corrected, or the discrimination on grounds of race or gender that some borrowers faced, or the abusive practices used by some unscrupulous collection agents, or the epidemic of "redlining" that contributed to the decline of so many inner-city neighborhoods, to understand why legislators found appeal in these laws. No doubt, TILA and CRA impose burdens on financial institutions, but it cannot be denied that they were responsive to real abuses.

To be sure, much good has come from these compliance laws. There is little doubt, for example, that the financial marketplace is fairer and more rational than it was a generation ago, especially for women and minorities and other previously neglected groups. Since the advent of standardized annual percentage rate ("APR") disclosures, consumers have been able to understand the true cost of credit and to do the kind of comparison-shopping that was always difficult before Truth in Lending and Truth in Savings went into effect. Shopping for a credit card became simpler when consumers could turn for information on interest rates, grace periods, and the like to the so-called Schumer Box on the issuer's solicitation. And while obtaining a mortgage loan and seeing it through to closing can still be something of an ordeal, there's far greater transparency about the process—and the costs associated with it—since TILA, RESPA, and their cohorts became the law of the land.

Certainly we've come a long way since the wild and wooly days when caveat emptor was the only real protection available to the financial consumer. Yet there's also plenty of evidence that we could be doing better—and getting a better return on the large investment in time and money that goes toward maintaining a fair and open marketplace for financial services through compliance regulation.

Many people take it for granted—indeed, take it as an article of faith—that simply because a particular set of disclosures is required by law, it must be valuable and important. It's significant that most of the evidence we have to the contrary is anecdotal. Many of us who don't read the pages of disclosures that accompany loan or new account applications or credit card statements assume that others aren't reading them either. We know about the frustration of trying to wade through paragraph upon dense paragraph of legalese. We hear stories—stories that seem quite plausible—about settlement agents impatiently suggesting that a real estate closing might have to

be rescheduled for a later date if the borrower insisted on reading all the disclosures. Legend has it that a large national bank conducted its own nonscientific survey by inserting a line of fine print somewhere in the middle of a lengthy disclosure document offering $100 to any customer that brought the item into a branch—and that not a single customer did.

The question of efficacy in our system of financial disclosures has a more troubling dimension as well. Despite the prevalence of disclosure as a cure for abuse, there is still much of what many people would see as shortsighted decision-making by financial consumers. Those who believe that many consumers don't always act in their own self-interest watch people paying payday lenders fully disclosed APRs that may reach 500 percent or more, and they conclude that mere disclosure is not enough and that more stringent substantive regulation is needed.

Of course, one needs to be careful here. After all, a free society gives people the freedom to make bad choices as well as wise ones. There is sometimes a troubling tendency to believe that just because someone is not wealthy, he or she may not be smart enough to be trusted to act in their own best interest.

I happen to believe, on the contrary, that people with limited means are more likely to make choices that are economically sensible for them. To be sure, people with limited means may not have the same access to financial products as more prosperous customers, and they may in some cases present greater risks that translate into higher costs. Assuring fair and nondiscriminatory access to credit and other financial services is of course a critically important objective of government policy.

Nonetheless, there is an important question whether our consumer protection and disclosure laws effectively provide individuals with the information they need to make informed personal choices. I believe that they often don't. Unreadable, unfathomable, and costly disclosures may be no better—and they're possibly worse—than no disclosures at all. Unfortunately many of the disclosures that fill our mailboxes and settlement packages fall into the "unreadable and unfathomable" category. Yet the costs to financial institutions to provide these disclosures may nonetheless be enormous.

The truth is, it would be remarkable if our consumer disclosures were effective, considering how little attention we've paid to making them effective. In contrast to the multitude of industry and academic studies that have appeared over the years on the cost of our regulations and disclosures, very little has been done to assess their *efficacy*, let alone to weigh the benefits against the cost burdens of compliance.

I'm aware of just a handful of exceptions to this general rule. In the mid-1970s, when Ken Guenther and I were very young colleagues at the Federal Reserve, a study was performed that focused on "information overload"—the concern that TILA disclosures were so extensive that they actually interfered with the ability of consumers to get the information they really needed. These concerns gave rise to the Truth in Lending Simplification Act of 1980. Significantly, the Simplifi-

cation Act took up more pages in the statute books than Congress needed when it enacted TILA in the first place. Suffice it to say, this well-intentioned effort did not result in a more effective, less costly disclosure regime.

In 1996, the Federal Reserve and the U.S. Department of Housing and Urban Development were directed by Congress to prepare recommendations for reform of TILA and RESPA disclosures. A year later, the two agencies submitted their report—a report that, with appendices, ran well over 100 pages.

The study found many technical problems with the existing disclosure regime, and it issued more than a dozen specific recommendations for improvement. It noted that consumers in mortgage loan transactions are often required to pay various fees to their lender *before* the lender is required to provide the required disclosures, giving the borrower an incentive to go through with the transaction regardless. The agencies pointed out that RESPA "good faith estimates" often turn out to be incomplete and inaccurate—almost invariably to the disadvantage of the borrower. And they recommended an expansion in the definition of the finance charge to assure that all costs the consumer is required to pay to close the loan were reflected in the APR.

Some of these recommendations await action by Congress; others have already been adopted under the two agencies' rulemaking authority.

Yet only in passing did this comprehensive study even touch upon what may be a more fundamental flaw in the existing TILA and RESPA disclosures—their sheer oppressive weight, their inscrutability, the confusion or cynicism they engender among the consumers to whom they are given. Nor did the study come to grips with a critical basic question—a question that could be raised about almost all compliance regulation. Are the benefits being delivered to consumers worth the costs being imposed on the industry? Or, to put it in more positive terms, can we improve the effectiveness and value of these laws and at the same time relieve financial institutions of some of the deadweight costs of compliance?

These are critically important questions, because the costs of compliance are not a free good. It must be assumed that most, if not all, of these costs are passed on to consumers. They become, in effect, part of the cost of credit and other financial products and services—costs that the intended beneficiaries must themselves bear.

I believe that legislators and policymakers need the answers to these questions, and the inquiry should not be approached on an ideological basis. It should be very pragmatic. Are we getting our money's worth? More specifically,

- Do the laws in question maximize the ability of consumers to understand the relative costs, benefits, and limitations of financial transactions by providing key information in a clear, easily understandable way?

- Do they maximize the ability of consumers to make informed and appropriate decisions based on the information they've received?
- What in fact are the costs of compliance? What magnitude of resources are devoted to compliance by banks, and what are the costs incurred by supervisors in implementing and overseeing compliance?

To answer these questions, I believe we need an independent, professional, well-funded research effort that would not only survey and document the costs of compliance regulation, both for banks and for regulators, but would analyze whether consumers are getting the most user-friendly and effective protections we can offer. I am convinced we can do better in serving the interests of consumers, and do it more simply and at less of a cost burden.

I know there's a better way, because we've seen it in action.

The U.S. Food and Drug Administration ("FDA") had a voluntary nutritional labeling program for packaged foods as early as the 1970s. But in the face of evidence that this framework wasn't meeting the growing public interest in the nutritional content of packaged foods—or rising health concerns about the American diet—the FDA decided to switch to a new arrangement. It's significant that the FDA decision to adopt a mandatory system of uniform labeling predated the passage of federal legislation; for the most part, the Nutritional Labeling and Education Act of 1990 called for changes that the FDA had already initiated under its rulemaking authority.

Four years later, the now familiar "nutrition facts" panels began to appear on food packages throughout the country. Finally consumers had—in simple, readable form—the right kind of reliable, relevant, and consistent information about what they were buying and consuming. And they had it at a critical time—before they made a purchase. If they choose to make unwise dietary decisions nonetheless—and certainly the new information has proved to be no panacea from a public health standpoint—it's not because the information they need to make sound decisions at the supermarket isn't available to them.

Four years from conception to rollout may seem like a long time. But this was time well spent. The FDA took pains to bring all interested parties—industry, public health experts, consumer groups, and regulators—into the process. Consumers were intimately involved from the start. Extensive task-based testing was performed to establish what consumers were looking for and how they intended to use the information; different disclosure formats were developed, refined, and tested, focusing on ease of use and accuracy. Consumers were then surveyed on their views of the label design. Was it legible? Easy to use? Did consumers understand what was being presented? And did it serve its intended purpose?

Enough said "yes" to give us the "nutrition facts" format we have today. The acceptance and the accolades it's won—including the coveted Presidential Design Achievement Award—speak for themselves.

I believe that every regulator in America can learn from the FDA experience. It should certainly encourage us to reconsider the way we've gone about developing our disclosure regime for financial institutions. We have to start by talking to the people for whom the disclosures are designed to learn more about their needs and how those needs are best met. We have to do more research, more testing, more consulting with end users, and more validating to ensure that our disclosures produce positive results and not simply more waste and frustration.

Fortunately, we may have an opportunity at hand for a new beginning in the design and implementation of financial disclosures to consumers.

As you well know, Title V of the Gramm–Leach–Bliley Act created privacy standards that financial institutions must meet to protect their customers' personal information—and, at the same time, required financial institutions to inform consumers about how those standards were being met. These requirements have led to disclosures that, at their worst, embody all that's wrong with our current approach. Today's privacy disclosures are long, dense, complex—and, if the anecdotal evidence is to be believed, likely to wind up in the trash without having been read. While a major objective of the new law was to give consumers the ability to "opt out" with regard to the sharing of their personal information with third parties, it takes enormous fortitude—and, seemingly, a graduate-level education—to unravel the language that instructs consumers on how to accomplish this.

We can't place the blame on financial institutions for the unwieldiness of our privacy disclosures. After all, Congress left them with little discretion in determining what belongs in privacy disclosures—and left the regulators with very little time to develop appropriate standards. The FDA took four years. In our case, seven financial regulatory agencies were expected to compose their differences and produce privacy standards in six months.

Congress was quite explicit in requiring that the disclosures include discussion of the kinds of information that the financial institution collects, the categories of persons to whom the information is or may be disclosed, and the policies and practices of the institution with respect to disclosing the nonpublic personal information of those who are no longer customers of the institution. Additionally, the disclosure must explain the policies that the institution has to protect the confidentiality and security of the nonpublic personal information.

I defy anyone to convert that mass of information into a form that would fit on the side of a cereal box.

But there may be a better approach—a "layered" approach under which consumers would receive a "short-form" privacy disclosure with a few basic facts presented in large, boldface type. This disclosure would provide only the basic information—such as the fact that the institution shares the consumer's information with third parties for marketing purposes, and that the consumer has

the right to block such sharing arrangements. But it would also advise consumers about where to turn—with a phone number or a Web site address, for example—to obtain a more detailed disclosure with all of the information required by GLBA.

We believe that this approach would meet both the letter and the spirit of the law. For surely it was not the intent of Congress in enacting privacy legislation to leave consumers more baffled and frustrated than before. Nor were the GLBA privacy provisions intended to embroil financial institutions in a costly paper exercise that adds burden without benefit.

As I said, this is only a concept—and only a start. Clearly, there is much work to be done in moving toward the more consumer-centric approach to disclosure pioneered by FDA. We still know too little about the kinds of financial information that consumers need and want. The basic research in this area remains to be done. But I believe that our concept could take us an important step toward a more efficacious regime of financial disclosure.

* * *

Financial institutions tend to see consumer regulation as an unavoidable fact of life—as a burden to be endured. Yet it can be much more than that, as the food industry's experience with the FDA proves. Food manufacturers entered the new disclosure era not quite kicking and screaming but with a healthy skepticism. They soon discovered, however, that better nutritional labeling could work to their competitive advantage. By learning what consumers wanted—products with less fat or cholesterol, for example—they were able to reformulate existing products and develop new products that met the evolving demands of the marketplace.

The message for bankers should be clear: figure out what consumers want and give it to them. That basic rule of commerce applies to financial services as much as it does to the food industry. Compete on the basis of openness. If banks provide clearer and more relevant information—and brag about it—they'll be better able to tailor financial products that meet consumer tastes and preferences, build customer loyalty, and draw new customers into the fold.

In that sense, we should start viewing disclosure not as a burden, but as a competitive opportunity. It's a view I would encourage all bankers to embrace.

Remarks by John D. Hawke, Jr., Comptroller of the Currency, before the Centre for the Study of Financial Innovation, on the proposed revisions to the Basel Capital Accord, London, England, March 13, 2003

It is an honor and a pleasure to be with the Centre for the Study of Financial Innovation ("CSFI") as it celebrates 10 years of distinguished service to the financial community. The roster of your officers, sponsors, and trustees—as well as the impressive list of CSFI publications—makes it self-evident why the organization enjoys the reputation it does. I particularly want to express my appreciation to Sir Brian, Minos Sombanakis, and Andrew Hilton, for the invitation to speak as well as for this evening's fine hospitality.

When I alluded to your "distinguished service to the financial community," I was obviously not referring to "service" in the same sense one might use the term in a gathering of back-office consultants or software developers. What CSFI provides is quite different—and extraordinarily important in an age when polemics and self-interest masquerade as solemn truth. What CSFI gives us is judgment we can trust, perspective we can apply, and forthright analysis that is indispensable to our understanding of the pressing policy issues of the day.

For internationally active banks, their supervisors, and those who try to make sense of it all, no public policy issues matter more than those currently on the table at Basel. In the United States, Basel II has recently attracted a great deal of attention from banks and policy makers following a Congressional hearing in mid-February at which I expressed concerns with the proposal.

It has certainly been a difficult journey for the members of the Basel Committee and the various working groups and task forces from the central banks and supervisory agencies that are so heavily involved in the Basel process. We have been at it for nearly four years now, and will be at it for some time longer—at least until the end of 2003.

With respect for the kind of perspective that informs so much of CSFI's work, I thought that I would step back and look at Basel II in the context of the history of capital regulation. In what ways does Basel II draw on the experiences of the past—and to the extent that it is leaving experience behind and breaking new ground, what kinds of issues may it be raising?

One needn't go back too far—the late 1970s would do—to find a time when many bank supervisors believed they could easily get along with no formal rules on capital. Experience had taught them that such simple ratios as capital to assets and capital to total deposits were not very useful and that supervisory judgment was a far better tool than mathematical ratios. I recall asking the head of supervision at the Federal Reserve years ago how much capital was enough, and he answered, "I can't tell you, but I know it when I see it"—a response that sounded eerily like that of a late U.S. Supreme Court Justice who was asked to define obscenity.

In any case, bank supervisors of a generation ago were reluctant to place too much faith in fixed capital ratios, partly because they feared giving rise to a false sense of security—or insecurity—about the safety and soundness of the banking system, and partly because the idea that formulaic ratios should carry any decisive weight in an assessment of a bank's condition offended their sense of professionalism. It had taken many decades to overcome the view of the bank examiner as an accounting clerk with enforcement powers—people who might be depended upon to find shortages in the till or moribund loans still being treated as viable, but not much else. In place of that image, a shiny new one was evolving of bank supervisors, whose expertise in banking and finance was matched only by their intuition, discretion, and ability to look beyond the raw numbers to discern the true condition of the institutions under their responsibility.

Not surprisingly, therefore, in the United States the initiative for a return to capital ratios as a supervisory mainstay came not from bank supervisors themselves but rather from lawmakers reacting to the rather abrupt deterioration of the U.S. banking system during the late 1970s. Postmortems on several high-profile failures revealed that the industry's capital-to-assets ratio had been eroding for some time, although it was never definitively established that more capital would have averted or significantly ameliorated the crisis. Regardless, in response to congressional pressure, the regulatory agencies, including the Office of the Comptroller of the Currency ("OCC"), adopted blunt regulatory capital requirements.

As the regulators had predicted, problems quickly cropped up. First, by each adopting its own requirements for regulatory capital, the agencies inevitably found themselves in conflict with one another. That generated restrained dispute among the regulators and the advocates for their respective points of view. But more importantly, it led regulated institutions to engage in a new form of regulatory arbitrage, since it was a simple matter to move to the charter that offered the most permissive approach to capital. In the international arena, it also created invidious distinctions among institutions competing across borders, affording a competitive advantage to those whose home country supervisors took a more lenient approach to capital.

Congress took steps to deal with the domestic ramifications of the problem in several legislative enactments. In 1978 it created the Federal Financial Institutions Examination Council, with a mandate to achieve greater uniformity among the supervisory agencies. In the International Lending Supervision Act of 1983, it required the U.S. banking agencies to do what they had already done voluntarily, if reluctantly, in regard to capital policy, and in 1984, the Federal Reserve ("Fed"), the Federal Deposit Insurance Corporation ("FDIC"), and the OCC agreed to revise their new capital-adequacy guidelines to establish common capital standards for all banking organizations.

The goal of creating a more level playing field for financial institutions—and promoting more consistent supervisory treatment of those institutions—was one of the central objectives of the

Basel Committee from the time of its inception in 1974, and it remains one of its overriding objectives today. By the mid-1980s, the committee had turned its attention to the development of common capital standards for all internationally active banks.

But the Basel process took off in a different direction from where the United States had started under congressional mandate—and it produced very different results. France, the United Kingdom, and Germany had adopted risk-based capital standards starting in the late 1970s, reflecting the industry shift toward higher risk assets and off-balance-sheet activities. This approach involved less prescription and more discretion on the supervisors' part than the more rigid, formulaic approach that U.S. supervisors had objected to but adopted nonetheless under pressure. The European approach became the starting point for work on an international capital accord—and, with minor exceptions, its end result.

The Basel Accord set forth capital standards that U.S. supervisors were well satisfied with—capital standards that not only went a long way toward harmonizing international practice, but that also carved out an important role for supervisory judgment and expertise in determining how much capital a particular institution required, given its risk profile.

If the Basel principals thought that the publication of their work marked the final word on the subject, however, they were mistaken. First, at least in the United States, the adoption of the Basel Accord represented no definitive ratification of the philosophy it embodied. Indeed, the Basel approach scarcely survived the U.S. banking crisis that was already under way when the accord was adopted. In the light of mounting losses and near insolvency of the federal deposit insurance fund, supervisory discretion—the underlying approach of Basel—was increasingly viewed as a euphemism for forbearance, which even some U.S. bank supervisors, under the spotlights, conceded had helped to create and prolong the crisis. In the FDIC Improvement Act of 1991, Congress acted to strip away some of that discretion. Putting strong new emphasis on "prompt corrective action"—that is, a mandate to supervisors to force remedial steps, including recapitalization, when capital levels fall—Congress hard-wired a set of capital trigger points in an effort to limit discretion and to prevent forbearance by the banking agencies—not recognizing that since the supervisors retained the power to assay what the level of capital actually is, any effort to force action based on specific capital levels was not likely to eliminate discretion from the process.

It's unclear which strain in the current philosophical duality is responsible for the industry's impressive current capital strength. However, some bankers have since spoken of their experiences during the crisis of a decade ago as a personal turning point that convinced them never again to split hairs over the risk weight of a given asset and to build capital well beyond regulatory minimums to enable them to weather any foreseeable contingency.

Looking back from today's perspective, the original Basel Accord—Basel I—may be viewed as charmingly unsophisticated, comprised, as it was, of a handful of prefabricated "risk buckets." Two things became clear before long: first, that these rather coarsely structured "buckets" had

little to do with real risk, and, second, that it was a simple matter to arbitrage from one bucket to another. These realizations helped to give birth to Basel II.

The authors of Basel II established a noble and ambitious set of goals for themselves: to integrate all that we have learned about capital regulation and risk over the years in a single, logically consistent package; to accommodate, if not resolve, the chronic tension between prescription and supervisory discretion; to recognize the technological and conceptual advances in the science of risk management, and to provide incentives for bankers to make use of those advances; to fine-tune our current risk ratings in a way that makes them more sensitive, more discriminating, and more forward-looking; to supplement the risk judgments of supervisors with those of the marketplace and of bankers themselves; and to ensure that the regulations we produce are relevant to the massive changes that have occurred in international banking—structural changes, portfolio changes, and management changes—since Basel I.

I assume that this audience is reasonably familiar with the key features of Basel II, but at the risk of being tedious, let me briefly outline the structure. The new approach would be built on three "pillars"—the first, a set of formulas for determining regulatory capital; 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:

- The "standardized" approach—essentially, a set of refinements to the old risk buckets, which provides for the use of external ratings in certain circumstances, and gives some weight to risk mitigation devices.
- 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.
- The "advanced IRB" approach, which bases capital calculations on the bank's own supervisory-validated models, including bank-calculated PDs and LGDs.

In each of the three approaches there would be a separate calculation for determining an assignment of capital to cover operational risk. In measuring their operational risk, banks can choose between a basic approach, a standardized approach that looks at individual business lines, and an advanced measurement approach ("AMA").

I suppose in one respect the result of such an ambitious undertaking might have been predictable. The process has generated a lengthy and complex product, as the Committee has sought to develop a risk-based rule that could be applied to banks around the world with varying degrees of sophistication. Part of the complexity of the most recent consultative paper (CP–2), which will be

reflected in the soon to be released CP–3, is simply the consequence of there being so many different components of the rule, and thus a variety of possible permutations.

When I have complained in the Basel Committee about the complexity of the paper, I am roundly admonished by my colleagues. “We live in a complex world,” they say. “Don’t quibble if we try to fashion capital rules that reflect that complexity.” But with great respect for my colleagues, the complexity we have generated goes far beyond what is reasonably needed to deal with the intricacies of sensible capital regulation. It reflects, rather, a desire to close every possible loophole, to dictate every detail, and to exclude to the maximum extent possible any opportunity for the exercise of judgment or discretion by those applying and overseeing the application of the new rules. In short, it reflects much more a commitment to prescriptiveness than a mere recognition of the complexity of today’s banking business. To be sure, much of the complexity also reflects the myriad compromises negotiated in the drafting process. And therein lies the greatest obstacle to simplification, for almost any effort to simplify runs the danger of being viewed as having the potential to upset compromises that have been hammered out.

This complexity has a price. Most obviously, it will impose a heavy cost burden on bankers, who have to design systems and educate staff to deal with the complex new rules. It may also have a cost in terms of credibility and public acceptance, for if legislators, customers, and market participants cannot penetrate the new rules, can we expect them nonetheless to love and respect them?

Finally, it may have a cost in terms of competitive equality, and this is what concerns me most. Bank supervision varies significantly from one country to another in approach, intrusiveness, and quality. Is it realistic to think that an enormously complex set of rules will be applied in an evenhanded way across a broad spectrum of supervisory regimes? For example, the OCC has as many as 30 to 40 full-time resident examiners in our largest banks. They are intimately involved as supervisors in watching the banks’ operations and judging the banks’ compliance with a myriad of laws, rules, and guidelines. Some other countries may send examiners in once a year to a comparably sized institution, or may examine such an institution thoroughly only every five or six years, or may put heavy reliance on the oversight of outside auditors.

It’s fair to ask, I think, in which regime hundreds of pages of detailed, prescriptive capital rules are more likely to be robustly enforced. The Basel Committee has not undertaken to set standards of supervision for member countries. Yet the attainment of competitive equity among internationally active banks is a bedstone principle of Basel II. Can we really achieve competitive equality without addressing disparities in supervision—particularly when we are operating on the assumption that the complex new rules we’re writing will be applied in an evenhanded way throughout the world?

As a practical matter, particularly given the rigorous schedule set by the committee, I think it is unrealistic to think that we will see significant simplification in the next iteration of the proposal. I would count it a major achievement, nonetheless if we were able to do no more than simplify the *articulation* of the proposal.

I cannot resist recalling words that seem peculiarly relevant to this effort. In the 1780s, as Americans engaged in a great debate on the principles that should underlie their new government, one of the most original of our thinkers on that subject (and later president), James Madison, contributed an important insight. Popularly elected governments do not automatically command popular confidence, Madison observed. "It will be of little avail to the people if laws are made by men of their choice, if the laws be so voluminous that they cannot be read, or so incoherent that they cannot be understood." Certainly what has come out of Basel has been voluminous; whether it is incoherent I shall leave for you to decide—as you try to make your way through it.

So where do we go from here? The committee has reaffirmed its intention to release a third consultative paper for comment in early May, with a view toward issuing a final document by year-end. While some have argued that we should scrap the whole Basel II process and go back to the drawing board, or even adopt an entirely new approach, that is not going to happen. There is enormous momentum being generated by Basel Committee members, and by the central bank governors who comprise the Bank for International Settlements, to move ahead with the current approach on the current timetable.

In the United States, the three bank regulatory agencies (Federal Reserve, FDIC, and OCC) have jointly agreed to three steps to simplify our implementation of Basel II.

First, we will make available to U.S. banks only the advanced IRB and the advanced measurement approach to operational risk. The U.S. agencies will likely propose for notice and comment a Basel II-based regime incorporating the advanced IRB approach for credit risk, the AMA for operational risk, and the internal ratings approach for market risk. The underlying strategy is that banks would realize lower capital charges as they moved up the scale of sophistication and would thus have an incentive to make the investment in systems required to make such a movement.

Second, we will apply Basel II only to our large internationally active banks. We do not intend to apply it to the thousands of smaller community banks we have in the United States. While other banks in the United States can apply to come under Basel II, we anticipate that at the outset only a very few will do so—although we also anticipate that market forces will drive some of them in this direction. We expect these two actions will make it easier for us to develop a draft U.S. regulation, which will in effect be a subset of Basel II, and by limiting the number of banks coming under Basel, it will help focus these key banks on the proposal during the comment period, which we expect to undertake this summer.

Third, in drafting the proposed U.S. capital framework, we will use a combination of regulatory language and supervisory guidance to "translate" the objectives and principles of Basel II into terminology and a framework consistent with the U.S. approach to capital regulation. We expect the U.S. rule will require at least as much capital as a literal interpretation of Basel II; at the same time, we will seek to write regulations and guidance that can be understood by both our large banks and by the line bank supervisors enforcing the new capital rule—mindful that we are required to articulate all our regulations in "plain English."

In the United States, our Congress is just beginning to focus on this subject, and is considering what its role should be in the process. While to date the heavy lobbying has been related to the handling of operational risk, there is still a possibility, in my view, that Congress could be energized by some of the large internationally active banks, if they are discontented with the terms of Basel II in its final iteration, or with its impact on their required capital; or by smaller banks claiming that they will suffer a competitive inequity because they don't have access to the potential capital reductions offered the large banks. Members have been particularly insistent that when U.S. regulators translate Basel II into specific regulatory language, which will then be published for public comment, that process must have real integrity—that is, the banking agencies must give serious consideration to the comments they receive, and, if they find some problems, must resolve those issues or bring them back to Basel for further consideration. Let me reaffirm that the OCC and the other U.S. banking agencies cannot sign off on a final Basel II framework until we have weighed the final product in the light of all the comments we receive and have determined that we can implement the new rules in a way that does not compromise safety and soundness or the competitive strength of our banking system. We expect that other countries will go through a similar process with their banks and may also identify substantive issues.

One "safety valve" in the process is the Accord Implementation Group ("AIG") the committee has formed. The AIG will be a continuing subset of the committee that will address problems encountered during the implementation phase, with the potential for mitigating unforeseen difficulties.

The Office of the Comptroller of the Currency has from the outset argued strongly and consistently that Basel II must work in practice as well as in theory; that it must provide supervisors with sufficient flexibility to accommodate differences among financial institutions; and that it must work in a way that avoids placing banks at a competitive disadvantage compared to other financial services providers. In advocating these broad policy goals, the OCC has staked out its own independent positions, as on operational risk. And while we have not always prevailed, I believe that our efforts make it more likely that we'll eventually get a workable new Basel agreement—an agreement that all concerned parties can live with and prosper under.

One final word on timing. The Basel Committee, under the strong and intelligent leadership of Bill McDonough, has wisely set time frames as a means of disciplining itself, and we will work earnestly within the committee in an effort to achieve that schedule. We need to be sure, however, that we get it right. We have taken on a huge task for ourselves as supervisors, and we are confronting our banks with imposing new challenges and cost burdens. The new rules will govern banking for many years to come, and we need to keep the long view in mind, even as we press ahead.

In that endeavor, we have counted on the support and assistance of CSFI and look forward to continued collaboration with you on Basel II—and beyond.

Remarks by Julie L. Williams, First Senior Deputy Comptroller and Chief Counsel, before the Financial Services Regulatory Conference, on the OCC, the national bank charter, and current issues facing the national banking system, Washington, D.C., March 17, 2003

Early in *The Tempest,* one of Shakespeare's characters advises that "What's past is prologue,"[1] meaning, in that context, that events of the past provide guidance for a present-day course of action. Much the same could be said for many of the most significant issues facing the Office of the Comptroller of the Currency (OCC) and national banks today. The mission of the agency and the essence of the powers and the character of the national bank charter are deeply rooted in the circumstances that gave rise to the creation of both the agency and national banks in 1863. As the OCC celebrates its 140th anniversary this year, that past provides the principles that define the OCC's contemporary role and the characteristics and legal status of the national bank charter.

Prologue[2]

Banks have never been particularly popular American institutions, and in the early days of this country, banks that operated under a broad grant of national authority may have been most unpopular of all. Thomas Jefferson spoke for many of his time when he said that "banking institutions are more dangerous than standing armies." American history buffs will recall that even George Washington was opposed to an American standing army, so Jefferson's comment was saying quite a lot.

Yet even Jefferson did not believe that the country could afford to dispense with banks altogether. In fact, America needed banks even more than Britain did, for the United States was a young, undeveloped, and far-flung country noticeably lacking in the great private accumulations of liquid wealth with which England was blessed. In order to mobilize capital in such a place, banks were essential to create and facilitate the flow of money.

In 1791, at the urging of Alexander Hamilton, the first Secretary of the Treasury, Congress created the First Bank of the United States—America's first venture into the area of central banking. When the bank's 20-year charter expired, the bank expired with it. But a crumbling economy led lawmakers five years later to create the Second Bank of the United States, which proved no more popular than the first. And state-chartered banks, of which there were well over a hundred by 1816, took advantage of that unpopularity by encouraging state legislatures to pass a variety of discriminatory laws, hoping to rein in, if not destroy, the sometimes overbearing Second Bank.

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[1] *The Tempest,* II, I, 257.

[2] Special thanks to Jesse Stiller, OCC special advisor for Executive Communications, for much of the content of this section.

Maryland's contribution to this state effort was an annual tax of $15,000 levied against the Baltimore branch of the Second Bank of the U.S. When the bank refused to pay, it was successfully sued in state court. In the name of its cashier, J.W. McCulloch, the Second Bank appealed that verdict to the U.S. Supreme Court.

What emerged was one of the landmark judicial decisions in our history. Speaking for a unanimous Supreme Court, Chief Justice Marshall declared constitutional Congress' creation of a national bank and declared unconstitutional Maryland's attempt to weaken it through taxation. On the first point, Marshall elaborated the view of federal power associated with Alexander Hamilton, an expansive view based on a strong union.

On the second point, regarding Maryland's attack on the Second Bank, Marshall invoked the Supremacy Clause—paragraph 2 of Article VI—holding that the Constitution of the United States, and the laws promulgated under it, are the law of the land and carry a presumption of supremacy over the states. "The States," Marshall affirmed, "have no power, by taxation or otherwise, to retard, impede, burden, or in any manner control the operations" of any agency created by lawful exercise of federal authority.

But, the states could still send elected representatives to Washington to accomplish the same end by federal legislation or presidential authority, and under President Andrew Jackson, legislation to extend the life of the Second Bank was vetoed.

With the loss of this centralizing and stabilizing influence, the U.S. banking system stumbled into disarray. Indeed, it was hardly a system at all, because standards and practices varied enormously from state to state. In states like Indiana and New York, new bank organizers were required to have real capital, and their operations were subject to some degree of government supervision. But in many states, banks could organize without a dollar's capital to their name, and supervision was virtually nonexistent. That permitted the shadiest of operators to enter the field—and dominate it in some states.

The currency of the country consisted of notes issued by those banks, and the practice of issuing bank notes with no or inadequate real assets backing them up became a national scandal and a huge burden on interstate commerce, which needed a reliable, nationally accepted currency. To keep redemption-minded note-holders at a safe distance, shady bank operators became experts at evasion, moving their hole-in-the-wall offices to frontier backwaters "where only the wildcats roamed." The term "wildcat banking" has its source in this experience.

Today, we would probably characterize such a situation, when a customer provides value and receives in return an instrument of uncertain and possibly dubious value, as a consumer protection problem. But in the mid-1800s, the lack of uniformity in the value of currency was a great flaw in our banking system before the Civil War, because it gave rise to confusion and uncertainty—two major obstacles to economic development.

This situation cried out for a remedy, and the Civil War provided the catalyst for a new system to deal with it. The Office of the Comptroller of the Currency was created to charter and supervise a new system of national banks, which would serve as the instruments of a uniform and sound national currency and help finance the Civil War.

When the Comptroller chartered a new national bank, a portion of the bank's paid-in capital was required to be used to purchase U.S. Treasury securities, which not only filled the Union's coffers but which were pledged as backing for a new species of circulating notes issued by the banks with the Comptroller's approval. Because these new national banks were to be subject to uniform federal supervision, with capital in the form of government securities, their circulating notes would hold a stable value and could be used, reliably, from state to state. The design of the new national banks thus solved the safety and soundness problem that plagued many state banks and, at the same time, addressed the fraud and deception that resulted from the issuance of notes of dubious value by many state banks.

But, in creating a system of national banks, Congress was not only aiming to solve an immediate problem. By establishing a national banking system, and creating the Office of the Comptroller of the Currency to oversee it, Congress also erected a framework for change, growth, integrity, and expansion of the business of banking, under the Comptroller's supervision, designed to support and foster the nation's economic development. As Carter Golembe put it in one of his famous commentaries: "The responsibility of the Office carries with it, in addition to safety and soundness considerations, the need for the Comptroller to assure that the national banking system is healthy, vigorous, competitive, profitable, innovative, and capable of serving in the best possible manner the banking needs of its customers."

This history—my prologue—helps to explain three defining characteristics of national banks and the national banking system, which are so important in the financial marketplace today:

1) The dynamic powers of national banks to engage in the business of banking, as that business evolves over time;

2) The role and responsibilities of the OCC as the charterer, supervisor, and regulator of national banks; and

3) The National Bank Act's preemption of state laws that would seek to direct or control activities of national banks that are authorized under federal law.

The Powers of National Banks

The long-range goals of Congress for the national banking system—supporting a stable national currency, financing commerce, acting as private depositories, and generally supporting the nation's economic growth and development—required a type of bank that was not just safe and

sound, but whose powers were dynamic and capable of evolving, so that national banks could perform their intended roles, well beyond the aftermath of the Civil War. Key to these powers is language set forth at 12 USC 24(Seventh), which provides that national banks are authorized to exercise

> all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes. . . .

Congress had modeled this authority on the bank charter authorized by the New York Free Banking Act, a type of charter that the New York courts explicitly had found to possess flexible and adaptive powers. Shortly before enactment of the National Bank Act, the New York Court of Appeals described the dynamic nature of the New York bank charter, stating that "[t]he implied powers [of a bank] exist by virtue of the grant [to do the banking business] and are not enumerated and defined; because no human sagacity can foresee what implied powers may in the progress of time, the discovery and perfection of better methods of business, and the ever-varying attitude of human relations, be required to give effect to the express powers."[3]

The specifications of certain banking activities that were contained in the New York banking laws, (and subsequently copied into the National Bank Act), were "eminently useful," but "not indispensable," according to the court in that case. Based on this lineage, in construing the National Bank Act the OCC typically looks to the objectives in addition to simply the mechanics of the act, approaching the statute, as one commentator put it, as "an architect's drawing and not a set of specifications."[4] As a result, the powers of national banks to engage in the business and banking and activities that are "incidental" thereto have been continually updated and consistently interpreted by the OCC—and accepted by the courts—as evolutionary; capable of developing and adjusting as needed to support the evolving financial and economic needs of the nation.

Any doubt concerning this characterization of the powers of national banks was settled with the Supreme Court's decision in NationsBank v. Variable Annuity Life Insurance Co. ("VALIC") in which the Court expressly held that the "business of banking" is not limited to the enumerated powers in 24(Seventh) and that the Comptroller has discretion to authorize activities beyond those specifically enumerated in the statute.[5] In the same decision, the Court also reiterated a previous admonition that the Comptroller's determinations regarding the scope of permissible national bank activities pursuant to this authority should be accorded great deference, stating emphatically

[3] *Curtis* v. *Leavitt,* 15 N.Y. 9 (1857).

[4] Harfield, "The National Bank Act and Foreign Trade Practices," 61 *Harvard Law Review* 782 (1948).

[5] *NationsBank of North Carolina* v. *Variable Annuity Life Insurance Co.,* 513 US 251.

that "it is settled that courts should give great weight to any reasonable construction of a regulatory statute adopted by the agency charged with enforcement of that statute. The Comptroller of the Currency is charged with the enforcement of banking laws to an extent that warrants the invocation of this principle with respect to his deliberative conclusions as to the meaning of these laws."[6]

So, today, national banks operate pursuant to federal authority contained in a federally granted charter; that authority is recognized as flexible and adaptable to serve changing customer and business needs and desires, and the OCC is uniquely authorized to define and refine the content of the business of banking in order to enable national banks to best serve those changing needs on a safe and sound basis.

The Role and Responsibilities of the OCC as Supervisor of National Banks

The OCC's authority to regulate, supervise, and examine national banks is extensive, and in many respects, exclusive. The latter feature is not always popular with state authorities, but the scope of the OCC's exclusive "visitorial" power is firmly grounded in the National Bank Act and its history.

At the beginning of the national banking system, both proponents and opponents of the new system expected that it would supersede the existing system of state banks.[7] Given this anticipated impact on state banks and the resulting diminution of control by the states over banking in

[6] *Clarke* v. *Securities Industry Assn.,* 479 US 388, 403–404 (1987) (quoting *Investment Company Institute* v. *Camp,* 401 US 617, 626–627.

[7] Representative Samuel Hooper, who reported the bill to the House, stated in support of the legislation that one of its purposes was "to render the law [Currency Act] so perfect that the State banks may be induced to organize under it, in preference to continuing under their State charters." Congressional Globe, 38th Congress 1st Session 1256 (March 23, 1864). While he did not believe that the legislation was necessarily harmful to the state bank system, he did "look upon the system of State banks as having outlived its usefulness. . . ." Id. Opponents of the legislation believed that it was intended to "take from the States . . . all authority whatsoever over their own State banks, and to vest that authority . . . in Washington. . . ." Congressional Globe, 38th Congress, 1st Session 1267 (March 24, 1864) (statement of Representative Brooks). Representative Brooks made that statement to support the idea that the legislation was intended to transfer control over banking from the states to the federal government. Given that the legislation's objective was to replace state banks with national banks, its passage would, in Representative Brooks' opinion, mean that there would be no state banks left over which the states would have authority. Thus, by observing that the legislation was intended to take authority over state banks from the states, Representative Brooks was not suggesting that the federal government would have authority over state banks; rather, he was explaining the bill in a context that assumed the demise of state banks. Representative Pruyn opposed the bill stating that the legislation would "be the greatest blow yet inflicted upon the States. . . ." Congressional Globe, 38th Congress, 1st Session 1271 (March 24, 1864). See also John Wilson Million, "The Debate on the National Bank Act of 1863," 2 *Journal of Political Economy* 251, 267 (1893–94) regarding the Currency Act. ("Nothing can be more obvious from the debates than that the national system was to supersede the system of state banks.").

general,[8] proponents of the national banking system were concerned that states would attempt to undermine it. Remarks of Senator Sumner, addressing the prospect of state taxation of national banks, illustrate the sentiment of many legislators of the time. He said, "[c]learly, the bank must not be subjected to any local government, state or municipal; it must be kept absolutely and exclusively under that Government from which it derives its functions." [9]

The allocation of any supervisory responsibility for the new national banking system to the states would have been inconsistent with this need to protect national banks from state interference. Congress, accordingly, established a federal supervisory regime and vested responsibility to carry it out in the newly created OCC. Congress granted the OCC the broad authority "to make a thorough examination of all the affairs of [a national] bank,"[10] and solidified this federal supervisory authority by vesting the OCC with exclusive "visitorial" powers over national banks. These provisions assured, among other things, that the OCC would have comprehensive authority to examine all the affairs of a national bank and protected national banks from potential state hostility by establishing that the authority to examine national banks is vested *only* in the OCC, unless otherwise provided by federal law.[11]

Courts have consistently recognized the distinct status of the national banking system and the limits placed on state involvement in national bank supervision and regulation by the National Bank Act. The Supreme Court stated in one of the first cases to address the role of the national banking system that "[t]he national banks organized under the [National Bank Act] are instruments designed to be used to aid the government in the administration of an important branch of the public service. They are means appropriate to that end."[12]

[8] See, e.g., *Tiffany* v. *National Bank of the State of Missouri,* 85 US 409, 412–413 (1874) ("It cannot be doubted, in view of the purpose of Congress in providing for the organization of national banking associations, that it was intended to give them a firm footing in the different states where they might be located. It was expected they would come into competition with state banks, and it was intended to give them at least equal advantages in such competition. . . . National banks have been national favorites. They were established for the purpose, in part, of providing a currency for the whole country, and in part to create a market for the loans of the general government. It could not have been intended, therefore, to expose them to the hazard of unfriendly legislation by the states, or to ruinous competition with state banks."). See also B. Hammond, *Banks and Politics in America from the Revolution to the Civil War,* 725–34 (1957); P. Studenski and H. Krooss, *Financial History of the United States,* 155 (1st ed., 1952).

[9] Congressional Globe, 38th Congress, 1st Session, at 1893 (April 27, 1864). See also *Anderson* v. *H&R Block,* __ F.3d __, 2002 US App. LEXIS 5978, at 15–16 (No. 01–11863, April 3, 2002) ("congressional debates amply demonstrate Congress's desire to protect national banks from state legislation. . . .").

[10] Act of June 3, 1864, c. 106, § 54, 13 Stat. 116, codified at 12 USC 481.

[11] Writing shortly after the Currency Act and National Bank Act were enacted, then-Secretary of the Treasury, and formerly the first Comptroller of the Currency, Hugh McCulloch observed that "Congress has assumed entire control of the currency of the country, and, to a very considerable extent, of its banking interests, prohibiting the interference of State governments. . . ." Congressional Globe, 39th Congress, 1st Session, Misc. Doc. No. 100, at 2 (April 23, 1866).

[12] *Farmers' and Mechanics' National Bank* v. *Dearing,* 91 US 29, 33 (1875).

Subsequent opinions of the Court have been equally clear about national banks' distinct role and status.13 For example, in Guthrie v. Harkness,14 the Supreme Court stated that "Congress had in mind, in passing this section [section 484] that in other sections of the law it had made full and complete provision for investigation by the Comptroller of the Currency and examiners appointed by him, and, authorizing the appointment of a receiver, to take possession of the business with a view to winding up the affairs of the bank. It was the intention that this statute should contain a full code of provisions upon the subject, and that no state law or enactment should undertake to exercise the right of visitation over a national corporation. Except in so far as such corporation was liable to control in the courts of justice, this act was to be the full measure of visitorial power."15

The Supreme Court also has recognized the clear intent on the part of Congress to limit the authority of states over national banks precisely so that the nationwide system of banking that was created in the Currency Act could develop and flourish. For instance, in *Easton v. Iowa,*[16] the Court stated that the National Bank Act "has in view the erection of a system extending throughout the country, and independent, so far as the powers conferred are concerned, of state legislation which, if permitted to be applicable, might impose limitations and restrictions as various and as numerous as the States. . . . If [the states] had such power it would have to be exercised and limited by their own discretion, and confusion would necessarily result from control possessed and exercised by two independent authorities."[17]

The Court, in *Farmers*' *and Mechanics*' *Bank,* similarly found that "States can exercise no control over [national banks] nor in any wise affect their operation, except in so far as Congress may see proper to permit." Any thing beyond this is "an abuse, because it is the usurpation of power which a single State cannot give."[18]

[13] See *Marquette National Bank* v. *First of Omaha Service Corp.,* 439 US 299, 314–315 (1978) ("Close examination of the National Bank Act of 1864, its legislative history, and its historical context makes clear that, . . . Congress intended to facilitate . . . a 'national banking system.'" (Citation omitted)); *Franklin National Bank of Franklin Square* v. *New York,* 347 US 373, 375 (1954) ("The United States has set up a system of national banks as Federal instrumentalities to perform various functions such as providing circulating medium and government credit, as well as financing commerce and acting as private depositories."); *Davis* v. *Elmira Savings Bank,* 161 US 275, 283 (1896) ("National banks are instrumentalities of the Federal government, created for a public purpose, and as such necessarily subject to the paramount authority of the United States").

[14] 199 US 148 (1905).

[15] Id. at 159.

[16] 188 US 220 (1903).

[17] Id. at 229, 231-232.

[18] *Farmers' and Mechanics' Bank,* 91 US at 34 (citation omitted).

Consistent with the need for a uniform system of laws and uniform supervision that would foster the nationwide banking system, courts have interpreted the OCC's visitorial powers expansively. The Supreme Court in Guthrie noted that the term "visitorial" as used in section 484 derives from English common law, which used the term "visitation" to refer to the act of a superintending officer who visits a corporation to examine its manner of conducting business and enforce observance of the laws and regulations (citing First National Bank of Youngstown v. Hughes19).20 "Visitors" of corporations "have power to keep them within the legitimate sphere of their operations, and to correct all abuses of authority, and to nullify all irregular proceedings." The Guthrie Court also specifically noted that visitorial powers include bringing "judicial proceedings" against a corporation to enforce compliance with applicable law.21 Thus, section 484 establishes the OCC as the exclusive regulator of the business of national banks, except where otherwise provided by federal law.

Congress recently affirmed the OCC's exclusive visitorial powers with respect to national banks operating on an interstate basis in the Riegle–Neal Interstate Banking Act of 1994 ("Riegle–Neal").22 Although Riegle–Neal makes interstate branches of national banks subject to specified types of laws of a "host" state in which the bank has an interstate branch (except when federal law preempts the application of such state laws to national banks), the statute then makes clear that even where the state law is applicable, authority to enforce the law is vested in the OCC.23

Federal Preemption of State Laws Under the National Bank Act

The OCC's exclusive visitorial authority complements principles of federal preemption, to accomplish the objectives of the National Bank Act. Again, the subject of preemption may not be popular in some quarters, but it flows directly from the Supremacy Clause of the U.S. Constitution,24 which provides that federal law prevails over any conflicting state law, and has long been

[19] 6 F. 737, 740 (6th Circuit 1881), appeal dismissed, 106 US 523 (1883).

[20] Guthrie, 199 US at 158. See also *Peoples Bank* v. *Williams,* 449 F. Supp. 254, 259 (Western District of Virginia 1978) (visitorial powers involve the exercise of the right of inspection, superintendence, direction, or regulation over a bank's affairs).

[21] Enforcement through judicial proceedings was the most common—and perhaps exclusive—means of exercising the visitorial power to enforce compliance with applicable law at the time section 484 was enacted into law. Administrative actions were not widely used until well into the 20th century. Thus, by vesting the OCC with exclusive visitorial power, section 484 vests the OCC with the exclusive authority to enforce, whether through judicial or administrative proceedings.

[22] Pub. L. 103–328, 108 Stat. 2338 (September 29, 1994).

[23] See 12 USC 36(f)(1)(B) ("The provisions of any State law to which a branch of a national bank is subject under this paragraph shall be enforced, with respect to such branch, by the Comptroller of the Currency.").

[24] U.S. Constitution Article VI, clause 2 ("This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.").

recognized with respect to authority granted national banks under the National Bank Act. An extensive body of judicial precedent has developed over the 140 years of existence of the national banking system, explaining and defining the standards of federal preemption of state laws as applied to national banks.25 Together, federal preemption and the OCC's exclusive visitorial authority are defining characteristics of the national bank charter, and constitute one of the essential distinctions between the national banking system and the system of state-chartered and state-regulated banks that comprise the other half of our "dual banking system."

As described above, Congress established the national banking system in 1863 as a means of achieving the economic policy objectives of the United States, including furnishing a stable and reliable national currency through national bank circulating notes, and promoting the nationwide availability of private credit and sound banking services vital to economic development and opportunity though soundly operated and rigorously supervised banks. With the National Bank Act, Congress built a banking system intended to be nationwide in scope, built upon banks whose powers were intended to be uniform, established under federal law, regardless of where in the nation they were doing business. As the Supreme Court noted in Deitrick, Receiver v. Greaney,26 "[t]he National Bank Act constitutes 'by itself a complete system for the establishment and government of National Banks.'" In an earlier case, the Supreme Court stated that "[n]ational banks are instrumentalities of the federal government, created for a public purpose, and as such necessarily subject to the paramount authority of the United States. It follows that an attempt, by a state, to define their duties or control the conduct of their affairs is absolutely void, wherever such

[25] See, e.g., *Barnett Bank of Marion County, N.A.* v. *Nelson,* 517 US 25, 26, 32, 33 (1996) ("grants of both enumerated and incidental 'powers' to national banks [are] grants of authority not normally limited by, but rather ordinarily pre-empting, contrary state law." States may not "prevent or significantly interfere with the national bank's exercise of its powers."); *Franklin National Bank,* 347 US at 378–379 (1954) (federal law preempts state law when there is a conflict between the two; "The compact between the states creating the Federal Government resolves them as a matter of supremacy. However wise or needful [the state's] policy, . . . it must give way to contrary federal policy."); *Anderson National Bank* v. *Luckett,* 321 US 233, 248, 252 (1944) (state law may not "infringe the national banking laws or impose an undue burden on the performance of the banks' functions" or "unlawful[ly] encroac[h] on the rights and privileges of national banks"); *First National Bank* v. *Missouri,* 263 US 640, 656 (1924) (federal law preempts state laws that "interfere with the purposes of [national banks'] creation, tend to impair or destroy their efficiency as federal agencies or conflict with the paramount law of the United States."); *First National Bank of San Jose* v. *California,* 262 US 366, 368–369 (1923) ("[National banks] are instrumentalities of the federal government. . . . [A]ny attempt by a state to define their duties or control the conduct of their affairs is void, whenever it conflicts with the laws of the United Sates or frustrates the purposes of the national legislation, or impairs the efficiency of the bank to discharge the duties for which it was created."); *McClellan* v. *Chipman,* 164 US 347, 358 (1896) (application to national banks of state statute forbidding certain real estate transfers by insolvent transferees would not "destro[y] or hampe[r]" national bank functions); *First National Bank of Louisville* v. *Commonwealth of Kentucky,* 76 US (9 Wall.) 353, 362–63 (1870) (national banks subject to state law that does not "interfere with, or impair [national banks'] efficiency in performing the functions by which they are designed to serve [the Federal] Government"); *Association of Banks in Insurance, Inc.* v. *Duryee,* 270 F.3d 397, 403–404 (6th Circuit 2001) ("The Supremacy Clause 'invalidates state laws that "interfere with, or are contrary to," federal law.' . . . A state law also is pre-empted if it interferes with the methods by which the federal statute was designed to reach th[at] goal.") (citations omitted).

[26] 309 US 190, 194 (1939).

attempted exercise of authority expressly conflicts with the laws of the United States, and either frustrates the purpose of the national legislation or impairs the efficiency of these agencies of the Federal government to discharge the duties, for the performance of which they were created."27

This independence from state direction and control both recognizes the essentially federal character is national banks and protects them from conflicting local laws that may undermine the uniform, nationwide character of the national banking system. Indeed, the Supreme Court has consistently held that subjecting national banks' exercise of their federally authorized powers to state regulation or supervision would be inconsistent with the system that Congress designed.28 The Court also has recognized that because national banks are federal creations, state law aimed at regulating national banks and their activities applies to national banks only when Congress directs that result,29 and "the States can exercise no control over them, nor in any wise affect their operation, except in so far as Congress may see proper to permit."30

The Court's decisions also have agreed that Congress was concerned not just with the application of certain states' laws to individual national banks but also with the application of multiple states' standards, which would undermine the uniform, national character of the powers of national banks throughout the system. This point was highlighted by the Supreme Court in *Talbott* v. *Silver Bow County Commissioners* where the Court stressed that the "entire body of the Statute respecting national banks emphasize that which the character of the system implies—an intent to create a national banking system co-extensive with the territorial limits of the United States, and with uniform operation within those limits. . . ."31 A similar point was made by the Court in the Easton case, which stressed that the national banking system was "a system extending throughout the country, and independent, so far as the powers conferred are concerned, of state legislation

[27] Davis, 161 US at 283.

[28] See, e.g., *Marquette Nat. Bank of Minneapolis,* 439 US at 314–315 ("Congress intended to facilitate a 'national banking system.'"); *First National Bank of San Jose,* 262 US 366, 369 (1923) (national banks are instrumentalities of the federal government; "any attempt by a State to define their duties or control the conduct of their affairs is void, whenever it conflicts with the laws of the United States or frustrates the purpose of national legislation or impairs the efficiency of the bank to discharge the duties for which it was created.").

[29] Of course, Congress may specifically require the application of state law to national banks for certain purposes. See, e.g., 12 USC 92a(a) (the extent of a national bank's fiduciary powers is determined by reference to the law of the state where the national bank is located). Congress may also, more generally, establish standards that govern when state law will apply to national banks' activities. See, e.g., 15 USC 6701 (codification of section 104 of the Gramm–Leach–Bliley Act, which establishes standards for determining the applicability of state law to different types of activities conducted by national banks, other insured depository institutions, and their affiliates). In such cases, the OCC applies the law or the standards that Congress has required or established.

[30] *Farmers' & Mechanics' National Bank,* 91 US at 33–34.

[31] *Talbott* v. *Silver Bow County Commissioners,* 139 US 438, 443 (1891).

which, if permitted to be applicable, might impose limitations and restrictions as various and as numerous as the States."32

This federal character has consistently informed the decisions of the Supreme Court when the Court has considered whether particular state laws apply to national banks. In a recent instance in which the Supreme Court had occasion to review the federal constitutional foundations of the national banking system, the Court concluded that, because of the federal status and purpose of national banks, national bank powers are not normally limited by state law.[33]

In sum, operating under a broad and potent grant of enumerated powers and such "incidental powers as shall be necessary to carry on the business of banking," national banks were designed from the outset to carry on their business under uniform federally granted powers, uniform federal supervision, and uniform, federally set standards.

While this means that the national banking system and the state banking system are distinct—indeed that difference is the essence of the dual banking system that we highly value today—the distinct character of the national banking system definitely does not mean that national banks operate with lesser standards or less rigorous oversight than generally applicable to state banks. While state laws necessarily will vary state-by-state, national banks are subject to rigorous standards and supervision, administered from the federal level, that applies uniformly to their business, wherever and in whatever form, they conduct it.

The OCC thus bears a heavy responsibility as administrator of the national banking system. The national banking system portion of the dual banking system is designed and premised on the OCC carrying out multiple responsibilities that trace to the agency's origins: ensuring the safety and soundness of the national banking system, overseeing the standards by which national banks operate, and assuring that national banks are playing an appropriate role in the national economy. In this mix, the safety and soundness of national banks is of obvious importance, but so too is the fairness and integrity national banks display in conducting their business. As Judge Posner of the Seventh Circuit observed in Central National Bank of Mattoon v. U.S. Department of the Treasury, "[national] banks are [the Comptroller's] wards, and his only wards; if they fail in droves, he will be blamed."[34] And so too is the Comptroller responsible if national banks commit modern-day versions of the customer frauds and deception that plagued the pre–Civil War banking scene. And so too will he be criticized if national banks fail to provide products and services that support a healthy, stable, and growing economy.

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[32] *Easton,* 188 US at 229, 231–232.

[33] *Barnett Bank of Marion County, N.A.* v. *Nelson,* 517 US 25, 32 (1996) (the history of the legal concept of national bank powers "is one of interpreting grants of both enumerated and incidental 'powers' to national banks as grants of authority not normally limited by, but rather ordinarily pre-empting, contrary state law").

[34] 912 F 2.2d 897, 905 (7th Circuit 1990).

The OCC's Place in the Dual Banking System and the Tripartite Banking Agency Regulatory System[35]

The OCC carries out these duties from a somewhat unusual status within the federal government. The original decision to create the OCC as an independent agency was a landmark step, and it was one that reflected Congress's understanding of the importance of bank supervision in the nation's overall economic scheme. While formally a "bureau" of the Treasury Department—indeed, until the 1970s, the Comptroller's offices were actually housed within the main Treasury building in Washington—the OCC has always enjoyed considerable operational autonomy. Although appointed by the President with Senate confirmation, the President cannot remove the Comptroller before the expiration of the statutory five-year term without providing to the Senate in writing a statement of his reasons for doing so. Wisely, many administrations have recognized that sound supervision and regulation of the banking system is a responsibility that should not be politicized.

Today, supervision of the U.S. banking industry is split between the OCC for national banks and the Federal Reserve and the FDIC dividing up federal-level supervision of state banks. As already mentioned, at the time of creation of the national banking system, most in Congress apparently hoped for, or at least anticipated, the elimination of state-chartered banks and believed that the offer of easy conversion to the national charter would provide sufficient incentive for state banking to liquidate itself. But the lagging pace of voluntary conversions led Congress to adopt the Marshall dictum so nicely expressed in the *McCulloch* case—"the power to tax is the power to destroy." It imposed a "death tax" on the notes of state banks, a tax that congressional backers promised would be every bit as effective in driving out state banks as an outright ban, which was also considered.

They were wrong. State banking was able to adapt simply by substituting deposit-taking for note-issuing and by taking advantage of state regulations deliberately tailored to permit them to engage in many activities deemed too risky for national banks. The dual banking system was thus born. Reflecting the country's basic ambivalence about banking and the use of national power, a less confrontational Congress then reconciled itself over time to a dual banking system rather than a unified one, embracing a more benign view of state banking as a legitimate expression of state sovereignty and a source of salutary competition for national banks.

Dual banking made for a complicated regulatory system that would soon grow more complicated. Today we entrust the Federal Reserve and the Federal Deposit Insurance Corporation with significant responsibilities for state bank supervision. State-chartered banks, in addition to their state supervisors, each have one primary federal bank supervisor—the FDIC if it's a state-chartered bank that is not a member of the Federal Reserve system (membership is optional for all state banks and mandatory for most OCC-supervised national banks), and the Federal Reserve if the state bank is a Fed member.

[35] Thanks again to Jesse Stiller for much of the content of this section.

We are sometimes asked to explain why this complicated regulatory structure arose—and why we have not attempted systematically to simplify it. The question of origins has a relatively straightforward answer and takes us back to a theme from the beginning of these remarks—Americans' ambivalence toward banking institutions, their suspicion of concentrated political authority, and their belief that establishing multiple and competing government bureaucracies would serve to check their ambitions and excesses. Thus, when the Federal Reserve System was created in 1914—becoming the second federal agency with a bank supervisory mission—Congress simply layered it on top of the existing supervisory structure and parceled supervisory authority between the new Fed and the OCC. The same pattern held in 1933, when the FDIC—the third of the federal banking agencies—was created.

Why has this system persisted? Perhaps because it has produced some valuable benefits, albeit inadvertently. Competition can be a good thing in the public as well as private sector, and competition among the banking agencies challenges each agency to excel. Our system shows that competition among regulatory agencies can be a force to enhance the quality of supervision, and help prevent any one regulator from becoming unduly rigid. As Ken Lewis, chairman and chief executive officer of Bank of America, said in a speech just last week, "[w]e don't always think of competition as a desirable aspect of regulation, but in our industry it has worked well. Healthy competition among the agencies leads to market-inspired innovation. . . ."

Issues of the Day at the OCC

As we celebrate the OCC's 140th anniversary this year, many of the most significant issues facing the OCC and national banks today have their roots in essential characteristics of the national bank charter and the OCC's fundamental responsibilities as administrator of the national banking system.

Preemption and visitorial powers. Today, the original design of the national bank charter and national banking system is the source of preemption and visitorial powers issues in connection with many facets of national banks' operations. In recent years, national banks have encountered state and municipal efforts to limit the amount of fees that national banks may charge—such as ATM fees—and have argued in response that such restrictions are preempted under the National Bank Act, since the authority of national banks to do business under federal law necessarily includes the ability to charge for, and make a profit on, the products and services the banks provide.

Because of the value of being able to operate under uniform national standards, preemption is an important characteristic of the national bank charter, and some nonbank companies, such as payday lenders, have even tried to enter into contracts with national banks whereby the banks would book the payday loans originated through the payday company's facilities, enabling the nonbank company to conduct that aspect of its business through the national charter and prompting the company then to claim that its activities enjoyed federal preemption as if it were a national bank. While the OCC has been supportive of national banks when preemption issues arise, it has vigorously opposed such "rent-a-charter" arrangements.

The lending authorities of national banks also have raised preemption issues in connection with state restrictions on the interest rates that national banks may charge and state limitations on other terms and conditions of extensions of credit by national banks. State and local limitations and restrictions on loan terms contained in "anti-predatory lending" legislation and ordinances have raised preemption questions that the OCC is now considering. At the same time, in order to assure that national banks do not directly or indirectly participate in abusive or predatory lending practices, the OCC has issued two advisory letters setting out the factors that national banks should take into account in developing polices and standards for their operations to enable them to avoid such practices.

With respect to permissible interest rates, national banks operate under a standard set by federal law, 12 USC 85, which references state law in part but does not completely defer to it. Twice in the last decade, issues concerning the nature of national banks' authority under that section have been addressed by the Supreme Court. The second instance is a case now pending before the High Court, which will be argued at the end of April.

Closely related to preemption, issues concerning the scope of the OCC's exclusive visitorial powers to supervise and examine national banks have arisen recently in connection with activities national banks conduct through "operating subsidiaries." Under OCC regulations, national bank operating subsidiaries conduct their activities pursuant to the same authorization, terms, and conditions that apply to the conduct of those activities by their parent national bank and are subject to state law only to the extent of their parent bank. Recent state efforts to examine and regulate mortgage lending "op subs" of national banks has led to litigation that is currently pending in California.

Safety and soundness and bank capital. One of the original objectives of the OCC, establishing a nationwide system of uniformly sound banking institutions, is highly relevant to the OCC's supervisory responsibilities today, as the fragile economy continues to present challenges for banks of all sizes. High corporate and consumer leverage and stressed real estate conditions in several markets persist. Credit weakness continues to be centered primarily in corporate portfolios. Yet, improved credit risk management practices, a strong capital base, and diversified earnings have enabled banks to continue to post record earnings despite the adverse credit conditions. Notably, an important component of the earnings diversification that helps enhance national banks' soundness today results from decisions in years past by the OCC to recognize new types of activities and risk management techniques as permissible for national banks as part of the dynamic and evolving nature of the business of banking.

We also continue to refine our supervisory tools. The OCC's "Project Canary" is a groundbreaking initiative to develop computer-based analytical products to support early risk identification and evaluation at national banks. Examiners are integrating "Canary" tools (i.e., analytical programs) into their bank supervision. Senior staff will use the "Canary" data to supplement analyses from other sources to develop an ongoing assessment of risk in the national banking system.

National banks can even access the Canary analysis of their own institution through the OCC's "National BankNet" Internet-based network for national banks.

Credit quality issues resulting from softness in the economy make it particularly important that bank capital is robust. Exactly what constitutes adequate capital—particularly for the larger, internationally active banks—is currently under review on an international basis. The Basel Committee on Banking Supervision, as a forum for international cooperation on bank supervision, is undertaking a major revision of its 1988 Capital Accord. Initiatives in 2003 will include issuance of its latest proposal for public comment. The OCC and other U.S. financial regulators expect to issue an advance notice of proposed rulemaking to enable the industry to formally comment of the details of the proposal this summer.

Privacy and customer treatment. The historically grounded responsibilities of the OCC to oversee the integrity of national banks' operations have a present-day incarnation in the highly visible topic of customer privacy. Today, privacy issues test the balance between customer concerns regarding protection of their nonpublic information and banks' desire to utilize such information to manage and control their risk as well as to market financial services.

Privacy-related issues will be in the spotlight in 2003 for several reasons. First is the scheduled expiration, on December 31st, of various preemption provisions of the Fair Credit Reporting Act. Second is a set of consumer concerns involving particular privacy-related issues such as identity theft and obnoxious, often dinnertime-disturbing, telemarketing practices. And third may be the generally agreed poor quality of the privacy notices that consumers have received in the last several years pursuant to the new privacy standards contained in the Gramm–Leach–Bliley Act. I say that the quality of the notices is generally agreed to be poor, not because banks have not been trying hard to do a good job. They have. Unfortunately, the requirements of the law are complex, and the agencies, in promulgating the privacy regulations, didn't make them any easier.

OCC Comptroller Jerry Hawke recently took aim at this very issue in a speech he delivered earlier this month. He said that "unreadable, unfathomable, and costly disclosures may be no better—and they're probably worse—than no disclosures at all." He particularly singled out privacy disclosures as an area that could be improved with a layered approach under which consumers would receive a short-form with a few basic facts presented in a simple standardized format. "This disclosure," he said "would provide the basic information—such as the fact that the institution shares the consumer's information with third parties for marketing purposes and that the consumer has the right to block such sharing arrangements. But it would also advise consumers about where to turn—with a phone number or a Web site address, for example—to obtain a more detailed disclosure with all the information required by the Gramm–Leach–Bliley Act."

In recent years, the OCC also has taken a pioneering position to protect national bank customers against unfair treatment, by using our enforcement authority under section 8 of the Federal Deposit Insurance Act to enforce section 5 of the Federal Trade Commission Act. Section 5 declares

unfair and deceptive acts and practices in or affecting commerce to be unlawful but assigns enforcement of the act with respect to banks to the federal banking agencies. We are the only federal banking agency that, in recent years, has taken enforcement actions to combat unfair and deceptive practices using our cease-and-desist powers.

PATRIOT Act and Sarbanes–Oxley Implementation. The PATRIOT Act has established a formidable arsenal of new standards to combat facilitation of financing of terrorist activities. The OCC has worked extensively as part of interagency efforts to adopt implementing regulations and continues to support the act's objectives though ongoing supervision of banks' anti-money-laundering systems, including terrorist financing controls, and PATRIOT Act compliance.

We also are implementing, when appropriate, the new requirements of the Sarbanes–Oxley Act. This means some additional rulemaking activity, but even more importantly, Sarbanes–Oxley has heightened sensitivities to issues of operational integrity and sound corporate governance. In addition to what the new law may require, we, and the banking industry, are keeping a closer watch on how banks identify, assess, and address activities or transactions that pose reputation risk to the bank.

Another corporate governance issue of particular interest to us is assuring that the reputation and interests of national banks within financial conglomerates are properly respected and maintained. While a typical conglomerate, made up of multiple corporations, might be able to ignore the legal entity distinctions of the companies in the corporate family, when one of the members of the family is a federally insured bank, the situation is quite different. Banks enjoy particular government-derived benefits, such a federal deposit insurance, and they are also subject to special protections, such as the transaction-with-affiliates standards of section 23A and 23B of the Federal Reserve Act. Equally important, banks' reputation for soundness and integrity is a priceless asset. We intend to make sure that it is not tarnished.

Conclusion

This journey from the roots of the national banking system, to the present-day issues we face at the OCC, provides context for how we face those issues—and the future. The national banking system is a unique asset of the U.S. financial system and valuable pillar of our national economy. At the OCC, our responsibilities for overseeing the system are in fact, multi-dimensional, as Carter Golembe put it—"to assure that national banks are safe and sound, competitive and profitable, and capable of serving in the best possible manner the banking needs of their customers."

Statement of Julie L. Williams, First Senior Deputy Comptroller and Chief Counsel, before the U.S. House Subcommittee on Financial Institutions and Consumer Credit of the Committee on Financial Services, on relieving the regulatory burden on the financial services industry, Washington, D.C., March 27, 2003

Statement required by 12 USC 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.

Introduction

Chairman Bachus, Ranking Member Sanders, and members of the subcommittee, I appreciate this opportunity to appear before you again to discuss with you ways in which we can reduce unnecessary regulatory burden on America's banking system, and to express the views of the Office of the Comptroller of the Currency ("OCC") on H.R. 1375, the Financial Services Regulatory Relief Act of 2003 ("FSRR Act"). Let me also thank Congresswoman Capito for again sponsoring a bill that includes sensible and appropriate regulatory burden relief for national banks and other financial institutions.

Many of the provisions in the FSRR Act were also in H.R. 3951, the financial services regulatory relief legislation that was prepared for floor action in the House last year after being reported by the Committee on Financial Services. I want to thank the committee for including almost all of the items suggested by the OCC in these bills. In addition to the provisions that were in H.R. 3951, the FSRR Act also includes some important new amendments that will advance the goal of reducing unnecessary burdens and costs on our nation's banks.

Effective bank supervision demands that regulators achieve a balance between promoting and maintaining the safety and soundness of the banking system and fostering banks' ability to conduct their business profitably and competitively. This is only possible if banks are free from burdensome constraints that are not necessary to further the purposes of the banking laws or to protect safety and soundness. Unnecessary burdens drive up the costs of doing business for banks and their customers and prevent banks from effectively serving the public. Periodic review of the banking statutes and regulations is an essential means of ensuring that banks are not needlessly encumbered by requirements that are no longer appropriate for today's banking environment.

The OCC has a continuing commitment to review its regulations and make changes, consistent with safety and soundness, to enable banks to keep pace with product innovation, new technologies, and changing consumer demand. We constantly reassess the effectiveness and efficiency of our supervisory processes to focus our efforts on the institutions and activities that present the greatest risks and to reduce unnecessary burdens on demonstrably well-run banks. An exciting new development in this regard is the OCC's new "E-corp" system, which enables national banks

to file their corporate applications electronically. Using National BankNet, the OCC's Internet-based system for national banks, national banks can now file new branch and branch relocation applications electronically. We will be adding more applications to the system on a rolling basis.

In addition, we also are currently working with the other banking agencies to prepare for the regulatory review required under section 2222 of the Economic Growth and Regulatory Paperwork Reduction Act of 1996. Section 2222 requires the Federal Financial Institutions Examination Council and each federal banking agency to conduct a review of all regulations every 10 years to identify outdated, unnecessary regulatory requirements. We and the other federal banking agencies have identified our teams for this project and our work is already under way.

However, the results that Congress can achieve today by removing or reducing regulatory burden imposed by federal statutes can be broader and more far-reaching than regulatory changes that we can make under the current law. The FSRR Act contains a number of important provisions that will help banks remain profitable and competitive by eliminating unnecessary burden. My testimony will highlight several of these provisions.[1]

The FSRR Act also contains provisions that further our ability to promote and maintain the safety and soundness of the banking system. I will mention a few of these provisions in my testimony. I will also take this opportunity to briefly discuss our suggestions to improve some of the provisions in the FSRR Act and our recommendations for additional changes that you may wish to consider as the legislation advances.

National Bank Provisions

The FSRR Act contains several provisions that would streamline and modernize aspects of the corporate governance and interstate operations of national banks. The OCC strongly supports these provisions.

For example, section 101 of the act relieves a restriction in current law that impedes the ability of national banks to operate as "Subchapter S" corporations. The National Bank Act currently requires all directors of a national bank to own at least $1,000 worth of shares of that bank or an equivalent interest in a bank holding company that controls the bank. The requirement means that all directors must be shareholders, making it difficult or impossible for some banks to comply with the 75-shareholder limit that defines eligibility for treatment as a Subchapter S corporation. These banks are thus ineligible for the benefit of Subchapter S tax treatment, which avoids a double tax on the bank's earnings. Community banks suffer most from this result.

Section 101 authorizes the Comptroller to permit the directors of banks seeking Subchapter S status to satisfy the qualifying shares requirement by holding a debt instrument that is subordinated

[1] A detailed section-by-section review of the provisions of Title I, IV, and VI of the FSRR Act that are relevant to the OCC's responsibilities is attached to this testimony as an appendix.

to the amounts owed by the bank to its depositors and general creditors. The holding of such an instrument would not cause a director to be counted as a shareholder for purposes of Subchapter S. The subordinated liability has features resembling an equity interest, however, since the directors could only be repaid if all other claims of depositors and nondeposit general creditors of the bank were first paid in full, including the claims of the FDIC, if any. The new requirement would thus ensure that directors retain the requisite personal stake in the financial soundness of their bank, but yet would allow the bank to take advantage of Subchapter S tax treatment.

Similarly, section 102 of the act eliminates a requirement in current law that precludes a national bank from prescribing, in its articles of association, the method for election of directors that best suits its business goals and needs. Unlike most other companies and state banks, national banks cannot choose whether or not to permit cumulative voting in the election of their directors. Instead, current law requires a national bank to permit its shareholders to vote their shares cumulatively. Section 102 provides that a national bank's articles of association may permit cumulative voting. This amendment would conform the National Bank Act to modern corporate codes and provide national banks with the same corporate flexibility available to most corporations and state banks.

An important new provision that was added to FSRR Act is section 110. This provision is strongly supported by the OCC and clarifies that the OCC may permit a national bank to organize in any business form, in addition to a "body corporate." An example of an alternative form of organization would be a limited liability national association, comparable to a limited liability company. The provision also clarifies that the OCC's rules will provide the organizational characteristics of a national bank operating in an alternative form, consistent with safety and soundness. Except as provided by these organizational characteristics, all national banks, notwithstanding their form of organization, will have the same rights and privileges and be subject to the same restrictions and enforcement authority.

Allowing a national bank to choose the business form that is most consistent with the banks' business plans improves the efficiency of a national bank's operations. For example, if the OCC should permit a national bank to organize as a limited liability national association, this may be a particularly attractive option for community banks. The bank may then be able to take advantage of the pass-through tax treatment for comparable limited liability entities under certain tax laws and eliminate double taxation under which the same earnings are taxed both at the corporate level as corporate income and at the shareholder level as dividends. Some states currently permit state banks to be organized as unincorporated limited liability companies ("LLCs") and the Federal Deposit Insurance Corporation (FDIC) recently adopted a rule that allows certain state bank LLCs to qualify for federal deposit insurance. This amendment would clarify that the OCC can permit national banks to organize in an alternative business form, such as an LLC.

Section 401 of the act also simplifies the requirements that apply to a national bank that wishes to expand interstate by establishing branches de novo. Under the Riegle–Neal Interstate Bank-

ing and Branching Efficiency Act of 1994, interstate expansion through bank mergers generally is subject to a state "opt-out" that had to be in place by June 1, 1997. Under the time frames set by the statute, interstate bank *mergers* were permissible in all 50 states as of September 2001. By contrast, de novo *branching* still requires states to pass legislation to affirmatively "opt-in" to permit out-of-state banks to establish new branches in the state. Some states have done so, generally conditioning such de novo branching on reciprocal de novo branching being allowed by the home state of the bank proposing to branch in such a state.

The effect of current law is to require that, in many cases, banks must structure artificial and unnecessarily expensive transactions in order to establish a new branch across a state border—which in some cases, is simply across town in a multi-state metropolitan area. Section 401 repeals the requirement that a state must adopt an express "opt-in" statute to permit the de novo branching form of interstate expansion for national banks and contains parallel provisions for state member and nonmember banks. Both state and national banks and their customers would benefit significantly by this change, which would permit a bank to freely choose which form of interstate expansion is most efficient for its needs and customer demands. In today's Internet age, when customers can communicate remotely with banks located in any state, restrictions on where a bank may establish "branch" facilities to directly serve customers are an unnecessary legacy from a protectionist era that detract from healthy competition and customer service.

Federal Branches and Agencies of Foreign Banks

The OCC also licenses and supervises federal branches and agencies of foreign banks. federal branches and agencies generally are subject to the same rights and privileges, as well as the same duties, restrictions, penalties, liabilities, conditions, and limitations and laws that apply to national banks. Thus, federal branches and agencies will benefit equally from the provisions in the FSRR Act that reduce burden on national banks. Branches and agencies of foreign banks, however, also are subject to other requirements under the International Banking Act of 1978 (IBA) that are unique to their organizational structure and operations in the U.S. as an office of a foreign bank. The FSRR Act also includes provisions amending the IBA that are intended to reduce certain unnecessary burdens on federal branches and agencies. We are supportive of these efforts. However, we believe that one of the provisions can be improved to achieve the full benefits of burden reduction and to preserve national treatment with national banks.

Section 107 provides that the OCC can set the capital equivalency deposit (CED) requirements for a federal branch or agency as necessary to protect depositors and other investors and to be consistent with safety and soundness. However, that amount cannot be less than the amount required by a state for a state-licensed branch or agency in which the federal branch or agency is located. This approach is a substantial improvement over the inflexibility of the current law. However, the CED requirements could be made even more risk-focused. The OCC has provided the committee with an alternate that allows the OCC, after consultation with the Federal Financial Institutions Examination Council, to adopt regulations allowing the CED to be set on a risk-based

institution-by-institution basis. Such an approach would more closely resemble the risk-based capital framework that applies to both national and state banks.

Information Sharing With Foreign Supervisors

A new provision added to the bill will be particularly helpful to the OCC and the other banking agencies in negotiating information-sharing agreements with foreign supervisors. Section 610 clarifies that the OCC, Federal Reserve Board, FDIC, and Office of Thrift Supervision ("OTS") cannot be compelled to disclose information obtained from a foreign regulator under an information-sharing agreement, or pursuant to other lawful procedures, if public disclosure of the information would cause the foreign authority to violate foreign law. However, nothing in this provision would allow the agency to withhold information from Congress or prevent the agency from complying with a court order in an action commenced by the United States or the agency. This clear statement in the law will facilitate information sharing and will provide foreign supervisors with assurances that public disclosure of confidential supervisory information will be limited in cases in which such disclosures will violate foreign laws.

Safety and Soundness Provisions

The FSRR Act also contains a number of provisions that further the objective of promoting and maintaining the safety and soundness of the banking system. One of the most important of these provisions is section 405, which expressly authorizes the federal banking agencies to enforce written agreements and conditions imposed in writing in connection with an application or when the agency imposes conditions as part of its decision not to disapprove a notice, *e.g.,* a Change in Bank Control Act (CBCA) notice.

This provision also would supersede recent federal court decisions that conditioned the agencies' authority to enforce such conditions or agreements on a showing that the nonbank party to the agreement was "unjustly enriched." Section 405 also contains a valuable measure that clarifies that controlling parties and affiliates of banks many not evade their capital commitments to the bank through bankruptcy. These changes will enhance the safety and soundness of depository institutions and protect the deposit insurance funds from unnecessary losses. Finally, as stated earlier, this section also clarifies the banking agencies' authority to impose and enforce conditions in connection with the agency's decision not to object to a CBCA or other notice.

The act also contains another provision that promotes safety and soundness by providing the federal banking agencies with greater flexibility to manage resources more efficiently and deal more effectively with problem situations. Current law mandates that most banks be examined on-site on prescribed schedules. This can, in certain circumstances, interfere with the ability of the banking agencies to concentrate their supervisory oversight on the most problematic institutions. Section 601 of the bill would permit the agencies, when necessary for safety and soundness purposes, to adjust their mandatory examination schedules to concentrate resources on particularly troubled or risky institutions.

We also recommend that we and the other banking agencies have more flexibility in assigning our examiners to particular institutions. To further that goal, the banking agencies worked together to develop an amendment that broadly addresses particular ethical issues facing our examiners and we thank the committee for including this provision in section 613 of the bill. Current law provides that criminal penalties may be imposed on a federal bank examiner who examines a bank from which the examiner receives an extension of credit, including a credit card issued by that institution. The financial institution that extends such credit to the examiner also is subject to criminal penalties. This limits the flexibility of the OCC and the other banking agencies to assign examiners to particular institutions or examination teams, even if the extension of credit is on the bank's customary terms and the examiner's skills or expertise would contribute materially to the examination.

Section 613 provides that the federal financial institutions regulatory agencies, including the federal banking agencies, may grant exemptions from the prohibition to their examiners by regulation or on a case-by-case basis if an extension of credit would not affect the integrity of the examination. The agencies must consult with each other in developing regulations providing for the exemptions and case-by-case exemptions only may be granted after applying certain specific factors. In addition, the amendment expressly provides that examiners may have credit cards without disqualification or recusal, but subject to the safeguard that the cards must be issued under the same terms and conditions as cards issued to the general public.

Section 603 of the FSRR Act also improves the federal banking agencies' ability to keep bad actors out of our nation's depository institutions. This provision gives the federal banking agencies the authority to prohibit a person convicted of a crime involving dishonesty, breach of trust, or money laundering from participating in the affairs of an uninsured national or state bank or uninsured branch or agency of a foreign bank without the consent of the agency. Under current law, the ability to keep these bad actors out of depository institutions applies only to insured depository institutions. Section 611 further would amend the law to provide the Federal Reserve Board with the authority to keep persons convicted of these offenses from participating in the affairs of a bank holding company or its nonbank subsidiaries, or an Edge or Agreement corporation. To further strengthen this authority, we recommend that this provision be expanded to clarify that the federal banking agencies also can prohibit these persons from participating in the affairs of nonbank subsidiaries of the banks that we supervise.

Two other important new provisions have been added to the FSRR Act to promote safety and soundness. These provisions were developed on an interagency basis by the federal banking agencies and, in my testimony last year, I recommended that these provisions be included in the bill.

First, under current law, independent contractors for insured depository institutions are treated more leniently under the enforcement provisions in the banking laws than are directors, officers, employees, controlling shareholders, or even agents for the institution or shareholders, consultants, and joint venture partners who participate in the affairs of the institution ("institution-af-

filiated parties"). To establish that an independent contractor, such as an accountant, has the type of relationship with the insured depository institution that would allow a federal banking agency to take action against the accountant for a violation of law, breach of fiduciary duty, or an unsafe or unsound banking practice, the banking agency must show that the accountant "knowingly and recklessly" participated in such a violation. This standard is so high that it is extremely difficult for the banking agencies to take enforcement actions against accountants and other contractors who engage in wrongful conduct. Section 614 of the FSRR Act removes the "knowing and reckless" requirement to hold independent contractors to a standard that is more like the standard that applies to other institution-affiliated parties.

Second, section 409 amends the CBCA to address issues that have arisen for the banking regulators when a stripped-charter institution (i.e., an insured bank that has no ongoing business operations because, for example, all of the business operations have been transferred to another institution) is the subject of a change-in-control notice. The agencies' primary concern with such CBCA notices is that the CBCA is sometimes used as a way to acquire a bank with deposit insurance without submitting an application for a de novo charter and an application for deposit insurance. In general, the scope of review of a de novo charter application or deposit insurance application is more comprehensive than the statutory grounds for denial of a notice under the CBCA. There also are significant differences between the application and notice procedures. In the case of an application, the banking agency must affirmatively approve the request before a transaction can be consummated. Under the CBCA, if the federal banking agency does not act to disapprove a notice within certain time frames, the acquiring person may consummate the transaction. In the case of a CBCA notice to acquire a stripped-charter institution, acquirers are effectively buying a bank charter without the scope of review that the law imposes when applicants seek a new charter, even though the risks presented by the two sets of circumstances may be substantively identical. To address these concerns, section 409 of the FSRR Act expands the criteria in the CBCA that allow a federal banking agency to extend the time period to consider a CBCA notice so that the agency may consider business plan information and would allow the agency to use that information in determining whether to disapprove the notice.

Additional Suggestion To Improve Information Sharing

Another item that we recommend be included in the bill is an amendment that would permit all of the federal banking agencies—the OCC, FDIC, OTS, and the Federal Reserve Board—to establish and use advisory committees in the same manner. Under current law, only the Board is exempt from the public disclosure requirements of the Federal Advisory Committee Act (FACA). The OCC, FDIC, and OTS, however, also supervise insured depository institutions and these institutions and their regulators have the same need to share information and to be able to conduct open and frank discussions about important supervisory and policy issues. Because of the potentially sensitive nature of this type of information, the public meeting and disclosure requirements under FACA could inhibit the supervised institutions from providing the OCC, FDIC, or OTS with their candid views. Our amendment would enhance the free exchange of information

between all depository institutions and their federal bank regulators with resulting safety and soundness benefits.

Bank Parity with Special Provisions for Thrifts

Finally, I note that the bill contains provisions providing beneficial treatment to federal thrifts in areas where there is no reason to particularly distinguish federal thrifts from national banks or state banks. These provisions include section 213 (federal court diversity jurisdiction determined only on the basis of where an institution has its main office, eliminating consideration of where it has its principal place of business) and section 503 (eliminating geographic restrictions on thrift service companies). Similar issues may exist with respect to some of the other sections. The nature of these provisions is such that, if they are considered appropriate by the subcommittee, there is no basis not to make them applicable to banks as well as thrifts.

Conclusion

Once again, Mr. Chairman, on behalf of the OCC, I thank you for your leadership in pursuing this legislation. As I have indicated, the OCC supports the act and believes that many of its provisions will go far to promote the objectives I have described today. In the areas in which we have recommended that you consider additional improvements, we would be pleased to work with your staff to develop appropriate legislative language for the subcommittee's consideration.

I am pleased to have had this opportunity to provide our views on this important initiative, and I would be happy to answer any questions you may have.

APPENDIX: H.R. 1375: The Financial Services Regulatory Relief Act of 2003

Summary and Comments of the Office of the Comptroller of the Currency on Titles I, IV, and VI

Title I—National Bank Provisions

Section 101. National Bank Directors

Summary: This section would amend section 5146 of the Revised Statutes of the United States (12 USC 72) to provide more flexible requirements regarding director qualifying shares for national banks operating, or seeking to operate, as Subchapter S corporations. The National Banking Act currently requires all directors of a national bank to own "shares of the capital stock" of the bank having an aggregate par value of at least $1,000, or an equivalent interest, as determined by the Comptroller, in a bank holding company that controls the bank. The amendment would permit the Comptroller to allow the use of a debt instrument that is subordinated to the interests of depositors, the Federal Deposit Insurance Corporation (FDIC), and other general creditors to satisfy the qualifying shares requirement for directors of national banks seeking to operate in Subchapter S status.

OCC comments: The OCC supports this change to the law. The requirement in current law creates difficulties for some national banks that operate in Subchapter S form. It effectively requires that all directors be shareholders, thus making it difficult or impossible for some banks to comply with the 75-shareholder limit that defines eligibility for the benefit of Subchapter S tax treatment, which avoids double tax on the bank's earnings. Such a subordinated debt instrument would have features resembling an equity interest, since the directors could only be repaid if all other claims of depositors and nondeposit creditors of the bank were first paid in full, including the FDIC's claims, if any. It would thus ensure that directors retain their personal stake in the financial soundness of the bank. However, the holding of such an instrument would not cause a director to be counted as a shareholder for purposes of Subchapter S.

Section 102. Voting in Shareholder Elections

Summary: This section would amend section 5144 of the Revised Statutes of the United States (12 USC 61). Section 5144 imposes mandatory cumulative voting requirements on all national banks. This law currently requires that, in all elections of national bank directors, each shareholder has the right to (1) vote for as many candidates as there are directors to be elected and to cast the number of votes for each candidate that is equal to the number of shares owned, *or* (2) cumulate his or her votes by multiplying the number of shares owned by the number of directors to be elected and casting the total number of these votes for only one candidate or allocating them in any manner among a number of candidates. This amendment would permit a national bank to

provide in its articles of association which method of electing its directors best suits its business goals and needs and would provide the OCC with authority to issue regulations to carry out the purposes of this section.

OCC comments: The OCC supports this change to national banking law. The Model Business Corporation Act and most states' corporate codes provide that cumulative voting is optional. This amendment would conform this provision of the National Bank Act to modern corporate codes and would provide national banks with the same corporate flexibility available to most state corporations and state banks.

Section 103. Simplifying Dividend Calculations for National Banks

Summary: This section would amend section 5199 of the Revised Statutes of the United States (12 USC 60) to simplify the formula for calculating the amount that a national bank may pay in dividends. The current law requires banks to follow a complex formula that is unduly burdensome and unnecessary for safety and soundness. The proposed amendment would retain certain safeguards in the current law that provide that national banks (and state member banks)[1] need the approval of the Comptroller (or the Federal Reserve Board (FRB) in the case of state member banks) to pay a dividend that exceeds the current year's net income combined with any retained net income for the preceding two years. For purposes of the approval requirement, these federal regulators would retain the authority to reduce the amount of a bank's "net income" by any required transfers to funds, such as a sinking fund for retirement of preferred stock.

OCC comments: The OCC supports this amendment. The amendment would reduce burden on banks in a manner that is consistent with safety and soundness. Among other things, the amendment would ensure that the OCC (and the FRB for state member banks) will continue to have the opportunity to deny any dividend request that may deplete the net income of a bank that may be moving towards troubled condition. Importantly, the amendment would not affect other safeguards in the National Bank Act (12 USC 56). These provisions generally prohibit national banks from withdrawing any part of their permanent capital or paying dividends in excess of undivided profits except in certain circumstances.

Moreover, other safeguards, such as Prompt Corrective Action, have been enacted in the last 10 years that provide additional safety and soundness protections for all insured depository institutions. The proposed amendment would not affect the applicability of these safeguards. These additional safeguards prohibit any insured depository institution from paying any dividend if, after that payment, the institution would be undercapitalized (see 12 USC 1831o (d)(1)).

[1] See 12 USC 324 and 12 CFR 208.5 generally applying the national bank dividend approval requirements to state member banks.

Section 104. Repeal of Obsolete Limitation on Removal Authority of the Comptroller of the Currency

Summary: This provision amends section 8(e)(4) of the Federal Deposit Insurance Act (FDIA) (12 USC 1818(e)(4)) relating to the procedures for the removal of an institution-affiliated party (IAP) from office or participation in the affairs of an insured depository institution. With respect to national banks, current law requires the OCC to certify the findings and conclusions of an Administrative Law Judge to the FRB for the FRB's determination as to whether any removal order will be issued. This amendment would remove this certification and FRB approval process and allow the OCC directly to issue the removal order with respect to national banks.

OCC comments: The OCC supports this amendment. This present system stems from historical decisions made by Congress on circumstances that are no longer applicable. Originally, the role of the OCC in removal cases was to certify the facts of the case to the FRB. The FRB then made the decision to pursue the case and made the final agency decision. At that time, the Comptroller was a member of the FRB and therefore participated in the FRB's final removal decision. However, Congress later removed the Comptroller from the FRB and gave the OCC the authority to issue suspensions and notices of intention to remove.

All of the federal banking agencies, except the OCC, may remove a person who engages in certain improper conduct from the banking business. In the case of the OCC, the determination of whether to remove an individual from a national bank (and thus from the banking business) is made by the FRB. This amendment would give the Comptroller the same removal authority as the other banking agencies to issue orders to remove persons who have been determined under the statute to have, for example, violated the law or engaged in unsafe or unsound practices in connection with an insured depository institution. Like the other banking agencies, the Comptroller should make these decisions about persons who engage in improper conduct in connection with the institutions for which the Comptroller is the primary supervisor. This is a technical change to streamline and expedite these actions and has no effect on a person's right to seek judicial review of any removal order. The FRB also supports this amendment.

Section 105. Repeal of Intrastate Branch Capital Requirements

Summary: This provision would amend section 5155(c) of the Revised Statutes of the United States (12 USC 36(c)) to repeal the requirement that a national bank, in order to establish an intrastate branch in a state, must meet the capital requirements imposed by the state on state banks seeking to establish intrastate branches.

OCC comments: The OCC supports this technical amendment to repeal the obsolete capital requirement for the establishment of intrastate branches by national banks. This amendment passed the House on October 9, 1998 in Section 306 of H.R. 4364, the Depository Institution Regulatory Streamlining Act of 1998, and was also included in later legislation introduced in the House. This requirement is not necessary for safety and soundness. Branching restrictions are already imposed

under other provisions of law to limit the operations of a bank if it is in troubled condition. See 12 USC 1831o(e) (prompt corrective action).

Section 106. Clarification of Waiver of Publication Requirements for Bank Merger Notices

Summary: This section would amend sections 2(a) and 3(a)(2) of the National Bank Consolidation and Merger Act (12 USC 215(a) and 215a(a)(2), respectively) concerning the newspaper publication requirement of a shareholder meeting to vote on a consolidation or merger of a national bank with another bank located within the same state. This change would clarify that the publication requirement may be waived by the Comptroller in the case of an emergency situation *or* by unanimous vote of the shareholders of the national or state banks involved in the transaction.

This amendment does not affect other requirements in the law. The current law also requires that the consolidation or merger must be approved by at least a 2/3 vote of the shareholders of each bank involved in the transaction. In addition, the shareholders of the banks generally must receive notice of the meeting by certified or registered mail at least 10 days prior to the meeting. These provisions are not changed.

OCC comments: The OCC supports this amendment. The amendment would clarify the intent of the statute and remove any ambiguity as to its meaning.

Section 107. Capital Equivalency Deposits for Federal Branches and Agencies of Foreign Banks

Summary: This section would amend section 4(g) of the International Banking Act of 1978 (IBA) (12 USC 3102(g)) with respect to the Comptroller's authority to set the amount of the capital equivalency deposit (CED) for a federal branch or agency. The CED is intended to ensure that assets will be available in the U.S. for creditors in the event of liquidation of a U.S. branch or agency. The current CED statute that applies to foreign banks operating in the United States through a federal license may impose undue regulatory burdens without commensurate safety and soundness benefits. These burdens include obsolete requirements about where the deposit must be held and the amount of assets that must be held on deposit. As a practical matter, the IBA sets the CED at 5 percent of total liabilities of the federal branch or agency and provides that the CED must be maintained in such amount as determined by the Comptroller. As a result, federal branches and agencies often must establish a CED that is larger than the capital that would be required for a bank of corresponding size or for a similar size state-chartered foreign branch or agency in major key states.

Section 107 provides that the OCC can set the CED requirements for a federal branch or agency as necessary to protect depositors and other investors and to be consistent with safety and soundness. However, that amount cannot be less than the amount required by a state for a state-licensed branch or agency in the state in which the federal branch or agency is located.

OCC comments: Section 107 represents a substantial improvement over the inflexibility of current law; however, the CED standards could be made even more risk-focused. Last year and again this year the OCC provided the committee with an amendment that allows the OCC, after consultation with the Federal Financial Institutions Examination Council (FFIEC), to adopt regulations allowing the CED to be set on a risk-based institution-by-institution basis. Such an approach would more closely resemble the risk-based capital framework that applies to national and state banks. The FRB has no objections to the OCC's amendment.

Section 108. Equal Treatment for Federal Agencies of Foreign Banks

Summary: This section would amend section 4(d) of the IBA (12 USC 3102(d)) to provide that the prohibition on uninsured deposit-taking by federal agencies of foreign banks applies only to deposits from U.S. citizens or residents. As a result, a federal agency would be able to accept uninsured foreign source deposits from non-U.S. citizens. State agencies of foreign banks may accept uninsured deposits from parties who are neither residents nor citizens of the United States, if so authorized under state law. However, due to slight language differences in the IBA, the D.C. Circuit Court of Appeals has held that federal agencies cannot accept any deposits, including those from noncitizens who reside outside of the United States. *Conference of State Bank Supervisors* v. *Conover,* 715 F.2d 604, 623 (D.C. Cir. 1983).

OCC comments: The OCC supports this amendment. This amendment would allow federal agencies to accept the limited uninsured foreign source deposits that state agencies may accept under the IBA. As a result, the amendment would repeal an unnecessary regulatory burden that has competitively disadvantaged federal agencies and prevented them from offering the same services to foreign customers that may be offered by state agencies. Because these deposits are not insured, this amendment does not pose any risks to the deposit insurance fund.

Section 109. Maintenance of a Federal Branch and a Federal Agency in the Same State

Summary: This section would amend section 4(e) of the IBA (12 USC 3102(e)) to provide that a foreign bank is prohibited from maintaining both a federal agency and a federal branch in the same state only *if* state law prohibits maintaining both an agency and a branch in the state. Current law prohibits a foreign bank from operating both a federal branch and a federal agency in the same state notwithstanding that state law may allow a foreign bank to operate both types of offices.

OCC comments: The OCC supports this change. According to the legislative history of the current provision, this prohibition was included in the IBA to maintain parity with state operations. However, today some states permit foreign banks to maintain both a branch and agency in the same state. Florida law permits a foreign bank to operate more than one agency, branch, or representative office in Florida (see Fla. Stat. Ann. 663.06). Other states, such as Connecticut, also may permit a foreign bank to have both a state branch and a state agency (see Conn. Gen. Stat.

Ann. 36a–428). This amendment would repeal an outdated regulatory burden in current law and permit a foreign bank to maintain both a federal branch and a federal agency in those states that do not prohibit a foreign bank from maintaining both of these offices. This change would enhance national treatment and give foreign banks more flexibility in structuring their U.S. operations.

Section 110. Business Organization Flexibility for National Banks

Summary: This section would amend the Revised Statutes of the United States (12 USC 21 et seq.) to clarify the Comptroller's authority to adopt regulations allowing national banks to be organized in different business forms. Notwithstanding the form of organization, however, all national banks would continue to have the same rights and be subject to the same restrictions and requirements except to the extent that differences are appropriate based on the different forms of organization.

OCC comments: The OCC strongly supports this amendment. This amendment would reduce burden on national banks and allow them to choose among different business organizational forms, as permitted by the Comptroller, and to select the form that is most consistent with the their business plans and operations so that it may operate in the most efficient manner. Certain alternative business structures may be particularly attractive for community banks. For example, if the Comptroller should permit a national bank to be organized as a limited liability national association and establish the characteristics of such a national bank, the bank then may be able to take advantage of the pass-through tax treatment for comparable limited liability entities under certain tax laws and eliminate double taxation under which the same earnings are taxed both at the corporate level as corporate income and at the shareholder level as dividends.

Some states currently permit state banks to be organized as unincorporated limited liability companies (LLCs) and the FDIC recently adopted a rule that will result in certain state bank LLCs being eligible for federal deposit insurance. Clarifying that national banks also may be organized in alternative business forms will provide a level playing field.

Section 111. Clarification of the Main Place of Business of a National Bank

Summary: This section would amend two sections in the Revised Statutes of the United States (12 USC 22 and 81). The amendment would replace obsolete language that is used in these two sections with the modern term "main office."

OCC comments: The OCC supports these technical amendments. The change to 12 USC 22 would clarify that the information required to be included in a national bank's organization certificate is the location of its *main office*. The change of 12 USC 81 would clarify that the general business of a national bank shall be transacted in its *main office* and in its branch or branches. Both statutes currently use obsolete terms to describe a main office of a national bank.

Title IV—Depository Institution Provisions

Section 401. Easing Restrictions on Interstate Branching and Mergers

Summary: This section would amend section 5155(g) of the Revised Statutes of the United States (12 USC 36(g)), section 18(d)(4) of the FDIA (12 USC 1828(d)(4)), section 9 of the Federal Reserve Act (12 USC 321), and section 3(d)(1) of the Bank Holding Company Act (BHCA) (12 USC 1842(d)(1)) to ease certain restrictions on interstate banking and branching. Under the Riegle–Neal Interstate Banking and Branching Efficiency Act of 1994 (Riegle–Neal Act), an out-of-state national or state bank may establish a de novo branch in a state only if that state has adopted legislation affirmatively "opting in" to de novo branching. This amendment would repeal the requirement that a state expressly must adopt an "opt-in" statute to permit the de novo branching form of interstate expansion.

In addition, the Riegle–Neal Act permits a state to prohibit an out-of-state bank or bank holding company from acquiring an instate bank that has not been in existence for up to five years. This amendment also would repeal the state age requirement.

Also, the amendment would amend the FDIA to authorize consolidations or mergers between an insured bank and a noninsured bank with different home states and amend national banking law relating to consolidations or mergers between noninsured national banks and other noninsured banks with different home states.

OCC comments: The OCC supports the changes to the law to remove the restrictions on interstate de novo branching. Enactment of this amendment should enhance competition in banking services with resulting benefits for bank customers. Moreover, it will ease burdens on banks that are planning interstate expansion through branches and would give banks greater flexibility in formulating their business plans and in making choices about the form of their interstate operations.

Under the Riegle–Neal Act, interstate expansion through bank mergers generally is subject to a state "opt-out" that had to be in place by June 1, 1997. While two states "opted out" at the time, interstate bank *mergers* are now permissible in all 50 states. By contrast, de novo *branching* by banks requires states to pass legislation to affirmatively "opt-in" to permit out-of-state banks to establish new branches in the state. This requires banks in many cases to structure artificial and unnecessarily expensive transactions in order for a bank to simply establish a new branch across a state border. However, federal thrifts are not similarly restricted and generally may branch interstate without the state law "opt-in" requirements that are imposed on banks.

In addition, the OCC supports the amendments that would repeal the state age requirement. This additional limitation on bank acquisitions by out-of-state banking organizations is no longer necessary if interstate de novo branching is permitted.

Section 402. Statute of Limitations for Judicial Review of Appointment of a Receiver for Depository Institutions

Summary: This provision would amend section 2 of the National Bank Receivership Act (12 USC 191) and section 11(c)(7) of the FDIA (12 USC 1821(c)(7)) to provide for a 30-day period to judicially challenge a determination by the OCC to appoint a receiver for a national bank under the National Bank Receivership Act or by the FDIC to appoint itself as receiver under the FDIA under certain conditions. Current law generally provides that challenges to a decision by the OTS to appoint a receiver or conservator for an insured savings association or the FDIC to appoint itself as receiver or conservator for an insured state depository institution must be raised within 30 days of the appointment. 12 USC 1464(d)(2)(B), 1821(c)(7). There is, however, no statutory limit on a national bank's ability to challenge a decision by the OCC to appoint a receiver of an insured or uninsured national bank.[2] As a result, the general six-year statute of limitations for actions against the United States applies to the OCC's receiver appointments. See *James Madison, Ltd.* v. *Ludwig,* 82 F.3d 1085 (D.C. Cir. 1996).

Moreover, under the FDIA, there are some circumstances under which FDIC may be appointed or appoint itself as receiver or conservator for an insured depository institution that are not specifically subject to the general 30-day judicial review period. As a technical matter, the amendment also would harmonize these provisions in the FDIA with the general 30-day rule.

Finally, the amendment would provide that the changes made in the statute of limitations under these provisions applies with respect to conservators, receivers, or liquidating agents appointed on or after the date of enactment of the new law.

OCC comments: The OCC supports this amendment to national banking law. This amendment passed the House on October 9, 1998 in Section 304 of H.R. 4364, the Depository Institution Regulatory Streamlining Act of 1998, and was also included in later legislation introduced in the House. The six-year protracted time period under current law severely limits the OCC's authority to manage insolvent national banks that are placed in receivership by the agency and the ability of the FDIC to wind up the affairs of an insured national bank in a timely manner with legal certainty. (In the case of an insured national bank that is placed in receivership by the OCC, the FDIC must be appointed the receiver.) This amendment would make the statute of limitations governing the appointment of receivers of national banks consistent with the time period that generally applies to other depository institutions. The amendment would not affect a national bank's ability to challenge a decision by the OCC to appointment a receiver, but simply require that these challenges must be brought in a timely manner and during the same time frame that generally applies to other depository institutions.

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[2] Under current law, there is a 20-day statute of limitations for challenges to the OCC's decision to appoint a *conservator* of a national bank. 12 USC 203(b)(1).

Section 403. Reporting Requirements Relating to Insider Lending

Summary: This provision would amend section 22(g) of the Federal Reserve Act (12 USC 375a) and section 106(b)(2) of the Bank Holding Company Act Amendments of 1970 (12 USC 1972(2)) to eliminate certain reporting requirements concerning loans made to insiders. Specifically, the reports that would be eliminated are—

1) The report that must be filed with a bank's board of directors when an executive officer of the bank obtains certain types of loans from another bank that exceeds the amount the officer could have obtained from his or her own bank,

2) The supplemental report a bank must file with its quarterly call report identifying any loans made to executive officers during the previous quarter, and

3) An annual report filed with a bank's board of directors by its executive officers and principal shareholders regarding outstanding loans from correspondent banks.

OCC comments: The OCC supports these amendments. Nothing in these amendments affects the insider lending restrictions that apply to national banks or the OCC's enforcement of those restrictions. Moreover, the OCC believes that it will continue to have access to sufficient information during the examination process to review a national bank's compliance with the insider lending laws. Under the OCC's regulations, national banks are required to follow the FRB's regulations regarding insider lending restrictions and reporting requirements (see 12 CFR 31.2). The FRB's regulations require member banks to maintain detailed records of all insider lending. In addition, the OCC has the authority under 12 USC 1817(k) to require any reports that it deems necessary regarding extensions of credit by a national bank to any of its executive officers or principal shareholders, or the related interests of such persons.

Section 404. Amendment to Provide an Inflation Adjustment for the Small Depository Institution Exception under the Depository Institution Management Interlocks Act

Summary: This provision would amend section 203(1) of the Depository Institutions Management Interlock Act (DIMIA) (12 USC 3202(1)). Under current law, generally a management official may not serve as a management official of any other nonaffiliated depository institution or depository institution holding company if (1) their offices are located or they have an affiliate located in the same MSA, or (2) the institutions are located in the same city, town, or village, or a city, town, or village that is contiguous or adjacent thereto. For institutions of less than $20 million in assets, the SMSA restriction does not apply. The amendment would increase the current $20 million exemption to $100 million.

OCC comments: The OCC supports this amendment. This $20 million cap has not been amended since the current law was originally enacted in 1978. However, the asset size of FDIC-insured commercial banks between 1976 and 2000 has increased over five fold. Depository institutions of all sizes will continue to be subject to the city, town, or village test.

Section 405. Enhancing the Safety and Soundness of Insured Depository Institutions

Summary: This provision would add a new section to the FDIA (12 USC 1811, et seq.) to provide that the federal banking agencies may enforce the terms of (1) conditions imposed in writing in connection with an application, notice, or other request, and (2) written agreements. The amendment also would clarify the existing authority of the FDIC as receiver or conservator to enforce written conditions or agreements entered into between insured depository institutions and IAPs.

Finally, the amendment would amend section 18(u) of the FDIA (12 USC 1828(u)). This section of the law provides that certain transfers to depository institutions to bolster their capital cannot be reversed under the Bankruptcy Code or other law if the affiliate or controlling shareholder making the transfer later becomes bankrupt. The amendment would delete the requirement that the insured depository institution had to be undercapitalized at the time of the transfer for the transfer to be protected under this provision.

OCC comments: The OCC supports these changes to the law. This amendment enhances the safety and soundness of depository institutions and protects the deposit insurance funds from unnecessary losses. This amendment is intended to reverse some court decisions that question the authority of the agencies to enforce such conditions or agreements against institution-affiliated parties (IAP) without first establishing that the IAP was unjustly enriched. In addition, the amendment would clarify that a condition imposed by a banking agency in connection with the nondisapproval of a notice, e.g., a notice under the Change in Bank Act, can be imposed and enforced under the FDIA. Finally, the OCC also supports the change to section 18(u) of the FDIA. The amendment enhances safety and soundness by protecting the capital of insured depository institutions.

Section 406. Investments by Insured Savings Associations in Bank Service Companies Authorized

Summary: This section would amend the Bank Service Company Act (12 USC 1861, et seq.) to allow an insured savings association to be an investor in a bank service company. Under current law, a bank service company must be owned by one or more insured *banks* and, thus, a savings association cannot invest in these entities. In addition, this provision would amend section 5(c)(4)(B) of the Home Owners' Loan Act (HOLA) (12 USC 1464(c)(4)(B)) to provide that a federal savings association may invest in a service company under HOLA if the company is owned by state and federal *depository institutions*. Under current law, a federal savings association may invest in a service company under HOLA only if the corporation is organized under the laws of the state in which the association's home office is located and the corporation is owned only by state and federal *savings associations* having their home offices in such state. Another provision in this bill, Section 503, would amend HOLA to eliminate the geographic limits on service companies authorized under that law and, thus, would no longer require that the company must be located in the investors' home state.

OCC comments: The OCC does not object to section 406, but suggests that if, under section 503, geographic limits on thrift service companies are eliminated, geographic restrictions on bank service companies should similarly be lifted.

Section 407. Cross Guarantee Authority

Summary: This section would amend section 5(e)(9)(A) of the FDIA (12 USC 1815(e)(9)(A)) to provide that, for purposes of determining liability of commonly controlled depository institutions for FDIC losses, institutions are commonly controlled if they are controlled by the same company. Under current law, institutions are only commonly controlled if controlled by the same "depository institution holding company." Such a holding company includes only a bank holding company or savings and loan holding company. However, if the subsidiary institution is, for example a credit card bank or a trust company, it is not a "bank" for purposes of the BHCA. Because the holding company is not a bank holding company, there is no cross guarantee liability under current law.

OCC comments: The OCC supports this amendment, which would correct a gap in the current law to ensure that cross guarantee liability applies equally to any company that controls more than one insured depository institution.

Section 408. Golden Parachute Authority and Nonbank Holding Companies

Summary: This section would amend section 18(k) of the FDIA (12 USC 1828(k)) to clarify the FDIC's authority to limit golden parachute payments or indemnification payments made by any company that controls an insured depository institution. Similar to the provision summarized in Section 407, current law only applies to "depository institution holding companies."

OCC comments: The OCC also supports this amendment to correct a gap in the law.

Section 409. Amendments Relating to Change in Bank Control

Summary: This section would amend the Change in Bank Control Act (CBCA) in section 7(j) of the FDIA (12 USC 1817(j)) to expand the criteria that would allow a federal banking agency to extend the time period to consider a CBCA notice. Under the CBCA, a federal banking agency must disapprove a CBCA notice within certain time frames or the transaction may be consummated. Initially, the agency has up to 90 days to issue a notice of disapproval. The agency may extend that period for up to an additional 90 more days if certain criteria are satisfied and this amendment provides for new criteria that would allow an agency to extend the time period under this additional up to 90-day period. The new criteria that an agency could use to extend the time period can provide the agency more time to analyze the future prospects of the institution or the safety and soundness of the acquiring party's plans to sell the institution or make changes in its business operations, corporate structure, or management. Moreover, the amendment would permit the agencies to use that information as a basis to issue a notice of disapproval.

OCC comments: The OCC supports this amendment, which is jointly recommended by the federal banking agencies. This amendment will address issues that have arisen for the banking regulators when a stripped-charter institution (i.e., an insured bank that has no ongoing business operations because, for example, all of the business operations have been merged into another institution) is the subject of a CBCA notice. The agencies' primary concern with such CBCA notices is that the CBCA is sometimes used as a way to acquire a bank with deposit insurance without submitting an application for a de novo charter and an application for deposit insurance. In general, the scope of review of a de novo charter application or deposit insurance application is more comprehensive than the statutory grounds for the denial of a notice under the CBCA. There are also significant differences between the application and notice procedures. In the case of an application, the banking agency must affirmatively approve the request before a transaction can be consummated. Under the CBCA, if the federal banking agency does not act to disapprove a notice within certain time frames, the acquiring person may consummate the transaction. In the case of a CBCA notice to acquire a stripped-charter institution, acquirers are effectively buying a bank charter without the requirement for prior approval and without the scope of review that the law imposes when applicants seek a new charter, even though the risks presented by the two sets of circumstances may be substantively identical. Section 409 expands the criteria in the CBCA that allows a federal banking agency to extend the time period to consider a CBCA notice so that the agency may consider the acquiring party's business plans and the future prospects of the institution and use that information in determining whether to disapprove the notice.

Title VI—Banking Agency Provisions

Section 601. Waiver of Examination Schedule in Order to Allocate Examiner Resources

Summary: This section would amend section 10(d) of the FDIA (12 USC 1820(d)) to provide that an appropriate federal banking agency may make adjustments in the examination cycle for an insured depository institution if necessary for safety and soundness and the effective examination and supervision of insured depository institutions. Under current law, insured depository institutions must be examined by their appropriate federal banking agencies at least once during a 12-month period in a full-scope, on-site examination unless an institution qualifies for the 18-month rule. Small, insured depository institutions with total assets of less than $250 million and that satisfy certain other requirements may be examined on an 18-month basis rather than a 12-month cycle. The amendment would permit the banking agencies to make adjustments in the scheduled examination cycle as necessary for safety and soundness.

OCC comments: The OCC supports this amendment. It would give the appropriate federal banking agencies the discretion to adjust the examination cycle of insured depository institutions to ensure that examiner resources are allocated in a manner that provides for the safety and soundness of insured depository institutions. For example, as deemed appropriate by a federal banking agency, a well-capitalized and well-managed bank's examination requirement for an annual or

18-month examination could be extended if the agency's examiners were needed to immediately examine troubled or higher risk institutions. This amendment would permit the agencies to use their resources in the more efficient manner.

Section 602. Interagency Data Sharing

Summary: This section would amend the FDIA (12 USC 1811, et seq.). The amendment would provide that a federal banking agency has the discretion to furnish any confidential supervisory information, including a report of examination, about a depository institution or other entity examined by the agency to another federal or state supervisory agency and to any other person deemed appropriate. Similar changes are also made to the Federal Credit Union Act.

OCC comments: The OCC supports this provision. This provision will give the other federal banking agencies parallel authority to share confidential information that was given to the FRB in Section 727 of the Gramm–Leach–Bliley Act (GLBA). We note, however, that this provision is discretionary and nothing in this provision would compel a banking agency to disclose confidential supervisory information that it has agreed to keep confidential pursuant to an information sharing or other agreement with another supervisor. See also Section 610.

Section 603. Penalty for Unauthorized Participation by Convicted Individual

Summary: This section would amend section 19 of the FDIA (12 USC 1829) to give the federal banking agencies the authority to prohibit a person convicted of a crime involving dishonesty, breach of trust, or money laundering from participating in the affairs of an uninsured national or state bank or uninsured branch or agency of a foreign bank without the consent of the agency. Under current law, the ability to keep these bad actors out of depository institutions applies only to *insured* depository institutions. Section 611 also would amend 12 USC 1829 to give the FRB the authority to keep persons convicted of these offenses from participating in the affairs of a bank holding company or its nonbank subsidiaries, or an Edge or Agreement corporation.

OCC comments: The OCC supports these changes to the law. This amendment will help to provide for the safe and sound operations of uninsured, as well as insured, institutions. We recommend, however, that the provision be clarified so that the federal banking agencies also may prevent a person convicted of such offenses from participating in the affairs of nonbank subsidiaries of depository institutions.

Section 604. Amendment Permitting the Destruction of Old Records of a Depository Institution by the FDIC After the Appointment of the FDIC as Receiver

Summary: This provision would amend section 11(d)(15)(D) of the FDIA (12 USC 1821(d)(15)(D)) to modify the record retention requirement of old records that must be maintained by the FDIC after a receiver is appointed for a failed insured depository institution. Under current law, the FDIC must preserve all records of a failed institution for six years from the date

a receiver is appointed. This requirement is not dependent on the actual age of the records at the time the receiver is appointed. After the six-year period, the FDIC may destroy any unnecessary records, unless directed to retain the records by a court or a government agency or otherwise prohibited from destroying the records by law. The amendment would permit the FDIC to destroy unnecessary records that are 10 or more years old on the date the receiver is appointed unless prohibited from doing so by a court, a government agency, or law.

OCC comments: The OCC supports this change and recommends that a similar provision be included in national banking law. The OCC appoints receivers for all national banks, both insured and uninsured. The FDIC only is required to accept the appointment for insured national banks. Thus, a receiver for an uninsured national bank would not be the FDIC. Adding a similar provision to national banking law also would clarify for a receiver of a national bank, other than the FDIC, that these outdated records may be destroyed.

Section 605. Modernization of FDIC Recordkeeping Requirement

Summary: This section would amend section 10(f) of the FDIA (12 USC 1820(f)) to provide that the FDIC may retain records in electronic or photographic form and that such documents shall be deemed to be an original record for all purposes, including as evidence in court and administrative proceedings.

OCC comments: The OCC supports this amendment and recommends that it be expanded to apply to all of the federal banking agencies.

Section 606. Clarification of Extent of Suspension, Removal, and Prohibition Authority of Federal Banking Agencies in Cases of Certain Crimes by Institution-Affiliated Parties

Summary: This provision would amend section 8(g) of the FDIA (12 USC 1818(g)) to clarify that the appropriate federal banking agency may suspend or prohibit IAPs charged with or convicted of certain crimes (including those involving dishonesty, breach of trust, or money laundering) from participating in the affairs of *any* depository institution and not only the institution with which the party is or was last affiliated. The amendment would also clarify that the section 8(g) authority applies even if the IAP is no longer associated with any depository institution at the time the order is considered or issued or the depository institution with which the IAP was associated is no longer is existence.

Under current law, if an IAP is charged with such a crime, the suspension or prohibition will remain in effect until the charge is finally disposed of or until terminated by the agency. If the individual is convicted of such a crime, the party may be served with a notice removing the party from office and prohibiting the party for further participating in the affairs of a depository institution without the consent of the appropriate federal banking agency. Before an appropriate federal banking agency may take any of these actions under section 8(g), the agency must find

that service by the party may pose a threat to interests of depositors or impair public confidence in a depository institution. The statute further provides that an IAP that is suspended or removed under section 8(g) may request a hearing before the agency to rebut the agency's findings. Unless otherwise terminated by the agency, the suspension or order of removal remains in effect until the hearing or appeal is completed. Current law, however, applies only to the depository institution with which the IAP is associated. Similar amendments are made to the Federal Credit Union Act.

OCC comments: The OCC supports the amendment to the FDIA. This amendment will help to ensure that, if a federal banking agency makes the required findings, the agency has adequate authority to suspend or prohibit an IAP charged with or convicted of such crimes from participating in the affairs of any depository institution.

Section 607. Streamlining Depository Institution Merger Application Requirements

Summary: This section would amend the Bank Merger Act (BMA) (12 USC 1828(c)). The amendment would provide that the responsible agency in a merger transaction, which is generally the federal banking agency that has the primary regulatory responsibility for the resulting bank, must request a competitive factors report only from the attorney general, with a copy to the FDIC. Under current law, this report must be requested from all of the other federal banking agencies but the other agencies are not required to file a report.

OCC comments: The OCC supports this amendment. It appropriately streamlines the agencies' procedures in processing BMA transactions.

Section 608. Inclusion of Director of the Office of Thrift Supervision in List of Banking Agencies Regarding Insurance Customer Protection Regulations

Summary: This provision would amend section 47(g)(2)(B)(i) of the FDIA (12 USC 1831x(g)(2)(B)(i)) to add OTS to the list of the federal banking agencies that must jointly make certain determinations before certain state customer protection laws may be preempted. Under current law, OTS is one of the federal banking agencies that are required to adopt the federal regulations that would provide the basis for the preemption determination but is not included in the list of agencies that must make the preemption determination.

OCC comments: The OCC does not object to this provision.

Section 609. Shortening of Post-Approval Antitrust Review Period with the Agreement of the Attorney General

Summary: This provision would amend section 11(b)(1) of the BHCA (12 USC 1849(b)(1)) and section 18(c)(6) of the BMA (12 USC 1828(c)(6)) to permit the shortening of the post-approval waiting period for certain bank acquisitions and mergers. Under current law, the post-approval waiting period generally is 30 days from the date of approval by the appropriate federal banking agency. The waiting period gives the attorney general time to take action if the attorney general

determines that the transaction will have a significant adverse effect on competition. The waiting period under both the BHCA and BMA, however, may be shortened to 15 days if the appropriate banking agency and the attorney general agree that no such effect on competition will occur. The proposed amendment would shorten the mandatory 15-day waiting period to five days.

OCC comments: The OCC supports this change. It will give the banking agency and the attorney general more flexibility to shorten the post-approval waiting period as appropriate for those transactions that do not raise competitive concerns. If such concerns exist, the 30-day waiting period will continue to apply. This change will not affect the waiting periods for transactions that involve bank failures or emergencies. In those cases, the statute already provides for other time frames.

Section 610. Protection of Confidential Information Received by Federal Banking Regulators from Foreign Banking Supervisors

Summary: This section would amend section 15 of the IBA (12 USC 3109) to add a provision that ensures that the FRB, OCC, and FDIC cannot be compelled to disclose information obtained from a foreign supervisor if public disclosure of this information would be a violation of foreign law and the U.S. banking agency obtained the information pursuant to an information sharing arrangement with the foreign supervisor or other procedure established to administer and enforce the banking laws. The banking agency, however, cannot use this provision as a basis to withhold information from Congress or to refuse to comply with a valid court order in an action brought by the United States or the agency.

OCC comments: The OCC supports this provision. This amendment would provide assurances to foreign supervisors that the banking agencies cannot be compelled to disclose publicly confidential supervisory information that the agency has committed to keep confidential, except under the limited circumstances described in the amendment. This authority is similar to the authority provided to the Securities and Exchange Commission under the securities laws (15 USC 78q(h)(5)). Some foreign supervisors have been reluctant to enter into information sharing agreements with U.S. banking agencies because of concerns that the U.S. agency may not be able to keep the information confidential and public disclosure of the confidential information provided could subject the supervisor to a violation of its home country law. This amendment will be helpful to ease those concerns and will facilitate information sharing agreements that enable U.S. and foreign supervisors to obtain necessary information to supervise institutions operating internationally.

Section 611. Prohibition on the Participation in the Affairs of Bank Holding Company or Edge Act or Agreement Corporations by Convicted Individual

Summary: This section also would amend section 19 of the FDIA (see also Section 603). It will give the FRB the authority to prohibit a person convicted of an offense involving dishonesty, breach of trust, or money laundering from participating in the affairs of a bank holding company, its nonbank subsidiaries, or an Edge or Agreement Corporation without the consent of the FRB.

OCC comments: The OCC supports expanding the banking agencies' authority to keep bad actors out of our financial firms. We recommend, however, that the provision be clarified so that the federal banking agencies may prevent persons convicted of such offenses from participating in the affairs of nonbank subsidiaries of depository institutions.

Section 612. Clarification that Notice after Separation from Service May Be Made by an Order

Summary: This section would amend section 8(i)(3) of the FDIA (12 USC 1818(i)(3)) to clarify that, when a federal banking agency takes an enforcement action against an IAP who has resigned or is otherwise separated from an insured depository institution, the agency can take such action by notice *or* issuing an order.

OCC comments: The OCC supports this technical clarification to the law. Enforcement actions under 12 USC 1818 generally provide that actions against IAPs can be taken in the form of a notice or an order and this amendment clarifies that the same is true for actions against IAPs under this provision of 1818.

Section 613. Examiners of Financial Institutions

Summary: This section would amend sections 212 and 213 of title 18 of the United States Code (18 USC 212, 213). Current law provides that criminal penalties may be imposed on a federal bank examiner who examines a bank from which the examiner receives an extension of credit, including a credit card issued by that institution. The financial institution that extends such credit to the examiner also is subject to criminal penalties. The amendment would provide that the federal financial institutions regulatory agencies, including the federal banking agencies, may grant exemptions from the prohibition in the law to their examiners by regulation or on a case-by-case basis if an extension of credit would not likely affect the integrity of the examination. The agencies must consult with each other in developing regulations providing for the exemptions and case-by-case exemptions only may be granted after considering certain specific factors. In addition, the amendment expressly provides that examiners may obtain any credit card without disqualification or recusal, but subject to the safeguard that the cards must be issued under the same terms and conditions as cards issued to the general public.

OCC comments: The banking agencies worked together to develop this amendment. Current law limits the flexibility of the OCC and the other banking agencies to assign examiners to particular institutions or examination teams, even if the extension of credit is on the bank's customary terms and the examiner's skills or expertise would contribute materially to the examination. This amendment would clarify and update the law to permit the agencies to grant appropriate exemptions to the prohibition on extending credit while continuing to ensure that the integrity of our examiners is not compromised.

Section 614. Parity in Standards for Institution-Affiliated Parties

Summary: This section would amend section 3(u)(4) of the FDIA (12 USC 1813(u)(4)) to remove the "knowing and reckless" requirement to hold independent contractors to a standard that is more like the standard that applies to other IAPs. Under current law, independent contractor IAPs are treated more leniently under the enforcement provisions in the banking laws than are directors, officers, employees, controlling shareholders, or even agents for the institution or shareholders, consultants, and joint venture partners who participate in the affairs of the institution. To establish that an independent contractor, such as an accountant, has the type of relationship with the insured depository institution that would allow a federal banking agency to take action against the accountant as an IAP for a violation of law, breach of fiduciary duty, or an unsafe or unsound banking practice, the banking agency must show that the accountant "knowingly and recklessly" participated in such a violation. This amendment would strike the "knowing and reckless" requirement.

OCC comments: The federal banking agencies jointly recommend this amendment. The knowing and reckless standard in the current law is so high that it is extremely difficult for the banking agencies to take enforcement actions against accountants and other contractors who engage in wrongful conduct. The amendment will strengthen the agencies' enforcement tools with respect to accountants and other independent contractors.