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Speeches and Congressional Testimony

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Remarks by John D. Hawke, Jr., Comptroller of the Currency before the American Academy in Berlin, on Basel II, December 15, 2003

Basel II: A Brave New World for Financial Institutions?

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

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

I think it's quite appropriate that we discuss this subject in this splendid building, which I'm told was once the home of the eminent banker Hans Arnhold. Bankers have long been among the most international—and indispensable—of business people. When the absolute monarchs of centuries ago felt overwhelmed by the financial burdens of maintaining armies and appearances, they turned to private bankers. Indeed, the power of bankers came to rival—and in some cases to surpass—that of the sovereigns they served. It was the Duc de Richelieu, prime minister under Louis XVIII, who was supposed to have observed, "there are six great powers in Europe: England, France, Russia, Austria, Prussia, and Baring Brothers." These may have been the words of an obsequious loan-seeker or those of a resentful debtor. But they also were not that far from the literal truth.

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

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

While the international integration of banking and financial markets has been a source of enormous strength to the world economy, it also exposed it to vulnerabilities from unexpected sources. The 1974 failure of the Bankhaus Herstatt—a modest sized bank that I'm sure would not have appeared on any global problem bank list, had one existed—sent shock waves through the financial sector, demonstrating that weakness in the banking system or the supervisory regime in a single country may have the potential to cause disruption not only within that country but also internationally. Herstatt became a catalyst for the G–10 nations to establish the Basel Committee a year later, with a view to promoting common standards and best practices of prudential supervision, and assuring that no internationally active banking establishment should escape competent supervision.

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

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

The shortcomings in Basel I have been recognized for a number of years. Principal among them is that it established capital requirements that were only remotely related to actual risks, and that were susceptible to significant arbitrage. Moreover, since Basel I the banking industry has become exceedingly more complex. Increasing use has been made of sophisticated funding tools, such as securitizations, and of complex derivatives to reduce capital requirements and to hedge and manage risk, and the state of the art of risk measurement and modeling has advanced very significantly.

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

sues. The most recent consultative paper—CP–3—runs more than 200 pages, and is mind-numbing in its complexity.

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

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

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

1) The "standardized" approach—essentially, a set of refinements to the Basel I risk buckets—which provides for the use of external ratings in certain circumstances, and gives some weight to risk mitigation devices.

2) The "foundation internal ratings–based (IRB)" approach, which sets forth a methodology for using a bank's own internal risk rating system, including its calculated probabilities of default (PD), as a base for calculating capital, using a factor for loss given default (LGD) provided by supervisors.

3) The "advanced IRB" approach, which bases capital calculations on the bank's own supervisory-validated credit risk rating systems, including bank-calculated PDs and LGDs.

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

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

For one thing, the committee has devoted significant attention to the interests of non-G–10 countries. Not only has the "standardized" approach been formulated with the intention of making it suitable for use by less complex banks in less developed economies throughout the world, but the committee itself has engaged in increased outreach to and consultation with banking authorities in these countries.

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

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

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

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

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

Finally, I am concerned that the Basel II process does not mesh well with the traditional U.S. approach to rulemaking. Indeed, much of the criticism that has been aimed at the United States in recent months reflects a lack of understanding of both our supervisory process and our domestic rulemaking process.

Because the very purpose of the American Academy in Berlin is to foster international understanding and the sharing of differing points of view, I'd like to use this occasion to discuss three of the major issues on which our views—and I speak now solely for the OCC—have caused some consternation among our colleagues and as to which some elaboration may contribute to international understanding. They are complexity, scope of application, and timing and process.

Complexity

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

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

But complexity has more insidious implications for the goal of competitive equality in light of the vast differences in the nature of bank supervision among the countries participating in Basel II. The OCC has full-time resident teams of examiners on-site in our largest banks—as many as 35 or 40 at the largest. Supervision of these banks is truly continuous. In some of the other member countries comparably sized banks may be visited by examiners only every other year, or even less frequently. In some countries much of the responsibility for supervision is relegated to outside auditors. A recent OCC survey showed that we have by far the lowest ratio of banking assets per supervisory staff member of any G–10 country—perhaps the best indicator of a supervisory system's capacity to assure compliance with supervisory mandates. Can anyone reasonably assume that a mandate of the complexity of Basel II will be applied with equal forcefulness across such a broad spectrum of supervisory regimes? I am tremendously concerned that, given such disparity and the complexity of the mandate, banks in our system could be placed at a serious competitive disadvantage.

I recognize that this argument may prove too much—that if complex rules cannot be evenly applied across a broad variety of supervisory regimes, then how can we expect more discretionary rules to be evenly applied? The answer, of course, is to put greater emphasis on the attainment of parity among supervisory regimes. Uniformity of application and competitive quality will remain

elusive goals, irrespective of the prescriptiveness of the rules, so long as we have wide variations in the nature and content of supervision itself.

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

Scope of Application

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

The latter approach was a clear choice for us. We defined the scope of application of Basel II by setting dollar thresholds of asset size and international exposures, and by that means identified about 10 banks that we would treat as mandatorily subject to Basel II. We also made the judgment that these banks had sufficiently substantial resources and sophistication to move immediately to the advanced IRB approach, and thus we saw no useful purpose to be served by offering our banks the option of using either the foundation IRB or standardized approaches.

We will permit, but not require, other U.S. banks to apply the advanced approaches of Basel II, under the same standards that must be met by the group of mandatory banks. To borrow a phrase from our British colleagues at the FSA [Financial Services Authority], our approach to those banks will be one of "no compulsion, no prohibition." Our expectation is that a number of banks in the next tier below the 10 mandatory banks, whether or not "internationally active," would likely seek supervisory approval to become "Basel II" banks, for a variety of reasons. We estimate that the mandatory Basel banks plus those that we expect to opt in to Basel II will account for close to 99 percent of the foreign exposures of all U.S. banks. Thus, we believe we are completely in harmony with the intent of Basel II.

Some have been critical of the United States for refusing to subject our smaller banks to even the standardized approach—particularly some of those countries that intend to apply Basel II to all of their banks. They seem to suggest that it is hypocritical of the United States, as a Basel Commit-

tee member, to participate in the promulgation of capital standards intended to be usable by the rest of the world while refusing to apply those standards to its own banks.

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

It may well be that in some countries, simply by reason of their size or geography, many smaller banks might be considered to be internationally active, and, therefore, properly includable within the scope of Basel II. We also appreciate that the European Union may decide, in the name of pan-European uniformity, that Basel II should apply to all banks in the EU, and we certainly respect that decision. But, in joining in the work of the Basel Committee we did not surrender our discretion to supervise our banking system in the way that we deem most appropriate, and just as we do not criticize those countries that have opted for a regime of supervision much less demanding than ours, we think it inappropriate for us to be criticized for the choice of supervisory approaches that we make with regard to our small, non–internationally active banks.

Timing and Process

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

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

But my personal view is that we cannot afford to ignore substantial issues, or to sweep recognized problems under the rug, simply to be able to issue a document by some target date. It is far more important to get the new accord *right* than to get it done on some predetermined schedule.

One clear lesson we should have learned over the past five years is that this is an exceedingly complicated and difficult process, and that new issues tumble out of the deliberations at every turn. Indeed, even though we resolved some major issues at the last meeting of the committee in Madrid, we have encountered new issues in the implementation of that resolution. Moreover, in the committee's announcement following the Madrid meeting several other issues were identified that remain to be resolved. Our work, to date, on those issues makes quite clear that we still have some difficult choices ahead.

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

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

Given the complexity of this issue—which, in fairness, was not simply overlooked by the committee, but put on a back burner in order to move ahead on other fronts—would involve significant delay. Yet, at least one trade group that has been vociferous in its criticism of the committee's failure to move to full modeling has been equally vociferous in urging the committee to act expeditiously in adopting Basel II. I do not see how we can have it both ways.

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

When we responded to these comments by urging the committee to make changes we were accused by some of trying to "renegotiate the deal"—a charge that seemed to me to betoken a fundamental misunderstanding of not only the committee's process, but the U.S. domestic process as well. CP–3 was *not*, of course, a "deal"; it was a proposal—a significantly incomplete proposal, at that. The very purpose of soliciting comments was to identify potential problem areas, and the EL–UL issue stood out like a sore thumb. Indeed, the alacrity with which the committee agreed to

a change in this area reflected its own recognition that a change was required. The most significant reservations related to concerns about what such a change might imply for the timetable.

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

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

Second, we in the United States have expressed the intention to conduct a fourth quantitative impact study, or QIS, based on the final Basel document. While the committee conducted QIS–3 late last year, I believe that study had significant shortcomings—not the least of which was that CP–3 was seriously incomplete at the time. Moreover, there was virtually nothing in the way of supervisory validation of the process by which the banks participating in the study made their estimates of capital impact. It was essentially a unilateral process that did not reflect the kind of rigorous oversight role that supervisors would play when Basel II actually goes into effect. I do not believe that any responsible bank supervisor can or should make a judgment about the impact of Basel II on the capital level of the banks it supervises, based on QIS–3. And that means that at present we have really no sound basis, whatsoever, for assessing capital impact. I would hope that the committee, itself, would see the wisdom of conducting its own QIS–4, but, whether it does or not, we intend to do so.

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

Let me turn for a moment to the role of our Congress in this process. Over the course of the Basel II process we have provided informal briefings to congressional staff on the progress of the effort, but it has only been fairly recently—as the committee's proposals have become more fully fleshed out—that members of Congress have engaged significantly on the specifics of the proposal. This is in marked contrast, I should say, to some of the other member countries, such as

Germany, where legislators have been involved in influencing, even dictating, some of the positions of their representatives from the very outset of the Basel process.

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

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

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

This has obvious implications for the future course of Basel II. As I have said, we have given the committee a commitment to work diligently toward the goal of producing a "final" version of the accord by mid-year 2004. However, no one should underestimate the difficulty of the issues that remain to be resolved or the very high potential for new issues emerging, as we move forward. QIS–4, which will follow the committee's definitive paper, will be an especially important event for us, since it should give us a far clearer picture of how Basel II is going to impact the capital of our banks. Should QIS–4 lead us to project that there might be wide or unwarranted swings in the capital of our banks, either up or down, that will present us with a very significant decision point, and we would feel compelled to bring that concern back to the committee.

I am much more skeptical about the currently stated goal of achieving implementation of Basel II by the end of 2006. There is a staggering amount of work confronting both us and our banks before Basel II can be implemented, and I am absolutely confident, based on past experience, that, as we move into the implementation phase, we will uncover a myriad of issues not previously thought of or addressed. The committee has established an Accord Implementation Group composed of highly qualified supervisors to address implementation issues, and the work of that group will be of enormous importance, as we move ahead. Once again, I believe it is far more important that we get these decisions right than that we adhere to some preestablished schedule,

and while I fully understand the anxieties and pressures that have come to bear with respect to the promulgation of Basel II, I think there should be far less concern about the actual date of implementation. It is obviously premature to address the implementation date, but I would simply observe that having at least another year of data upon which to base the models that our banks will be using should be viewed as a strong plus.

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When the Basel Committee on Banking Supervision was founded nearly three decades ago, its goal was to develop standards, guidelines, and principles that its member countries would implement in ways best suited to their unique national arrangements—political as well as supervisory. That approach, based on the spirit of consultation, respect for sovereign differences, and recognition of the limitations of the committee's authority as a consultative body, has been one of the committee's great strengths over the years. In tackling the formidable challenges of bringing a new capital accord to fruition, we should draw as much as possible upon those strengths and those experiences.

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

Remarks by Julie L. Williams, Chief Counsel and First Senior Deputy Comptroller, before the Consumer Federation of America 15th Annual Consumer Financial Services Conference, on preemption, Washington, D.C., December 5, 2003

Let me first extend my sincere thanks to Steve Brobeck and the Consumer Federation of America for inviting me to take part in this 15th Annual Consumer Financial Services Conference. I am honored to be here, and I truly appreciate that you have asked me to address a very timely topic—"Financial Services Regulation: What Should Be the Role of the States?" I also welcome the chance for some give-and-take after these prepared remarks.

This is an opportunity to address some very important issues—and, I believe, some key misperceptions—that have arisen in connection with positions of the Office of the Comptroller of the Currency concerning the application of state laws to national banks, and the role of state authorities in enforcing those laws.

At the heart of these issues are constitutional principles of federal preemption. We are acutely aware that, in many quarters, the very concept of preemption is unpopular. In some respects, the fact that federal preemption arises from the federal charter of national banks seems to put us, inescapably, at odds with some state authorities. This is unfortunate, because the OCC and the states do not have fundamentally different goals.

We probably do, however, have different ways of getting to them, consistent with our different sources of statutory authority and our respective authorities thereunder. But, that does *not* mean that we cannot work together.

To start, it is helpful to provide just a bit of background on the issue of federal preemption of state law in the context of the operations of national banks. But notwithstanding this beginning, I want to give away the ending:

- Standards of federal preemption applicable to activities of national banks are derived from the Supremacy Clause of the U.S. Constitution and are well established.
- Those standards have repeatedly been reaffirmed by the courts.
- The OCC did not invent preemption and we are not the only ones that can assert it.
- Sparring over the *extent* of federal preemption of state laws applicable to operations of national banks is counterproductive.
- Protection of consumers can be maximized if states and the OCC look for ways to spread their oversight to provide the most efficient, broadest coverage for consumers.

Let me now turn to a little background. The constitutional doctrine of preemption, which holds that federal authorities prevail over conflicting restraints or conditions imposed by state laws, is a subject that has been addressed by successive generations of legal scholars going back to the 19th century.

The OCC has issued many preemption rulings over its 140-year history, but it has never done so except after careful study, and scrupulous consideration of Supreme Court precedents and the intent of Congress. Importantly, the latter includes recognition of the original intent of Congress to establish a *uniform*, nationwide system of federally chartered financial institutions. That intent was first reflected in the National Currency Act of 1863, repeatedly elaborated and reaffirmed by subsequent Congresses, and upheld in a remarkably consistent and supportive series of Supreme Court rulings.

It is also material in the present context to recall the considerations that prompted Congress and President Lincoln to create the national banking system in 1863. It was part of a broader vision of economic development and financial stability, designed to put an end to the monetary confusion, disunion, and the pervasive sense that America had, until then, failed to deliver the goods, so to speak, for too many of its people.

The national banking system, along with other enactments of that period, including the Pacific Railroad Act, the Land-Grant Colleges Act, and lots more, were integral parts of a plan to deliver on America's economic promise. Integral to our mission then—and today—is assuring that national banks' standards of operation are of the highest caliber. This includes not just their financial stability, but also the integrity with which they conduct their business and deal with their customers. Some recent history in this regard is instructive.

Thirty years ago, the OCC established a consumer affairs division, reporting directly to the Comptroller.

The OCC was the first federal banking agency to conduct regular, separate, full-scope consumer examinations, using specially trained consumer examination specialists, and to produce consumer examination manuals and policy guidelines for bankers. That was in 1976.

Also in 1976, the OCC implemented a consumer-complaint information system to track complaints systematically. That early attempt to assemble a consumer database has evolved into our world-class Customer Assistance Group, headed by our Ombudsman, who reports directly to the Comptroller.

Where we have found that national banks have engaged in abusive practices, we have not only acted with dispatch to end those practices, but have also used every legal and supervisory tool available—and have developed new tools—in order to secure restitution to consumers and penalize the institutions involved.

We have pioneered the use of section 5 of the Federal Trade Commission (FTC) Act as a basis to take enforcement action where we found instances of unfair or deceptive practices by national banks.

In August of this year, the OCC entered into a formal agreement that required a national bank in Oregon to refund various credit card fees to customers.

Several weeks ago, we announced a precedent-setting agreement that requires the complete reimbursement of fees and interest charged by a Texas national bank in a series of abusive loans that we considered "unfair" within the meaning of the FTC Act.

We have thwarted payday lenders in their "rent-a-charter" designs to use national banks as a cover for evading state consumer protection laws.

We have taken the lead in raising concerns about abusive practices in connection with so-called "bounce protection products" and in urging the other federal banking agencies to adopt standards to address those practices.

And, we have issued the most comprehensive supervisory guidance ever issued by any federal banking agency, defining and describing predatory lending and warning banks about the supervisory consequences of engaging, directly or indirectly, in such practices.

Just last month, the OCC joined the Securities and Exchange Commission, the Labor Department, and the New York State Attorney General in taking a series of actions against the Arizona-based Security Trust Company, N.A., which had participated in mutual-fund late trading and market-timing schemes. In announcing the actions, New York Attorney General Eliot Spitzer praised the OCC and the other federal agencies for their "excellent assistance and cooperation," noting that "coordination by regulators is imperative" and "this case shows how that can be accomplished."

In light of all this, you need to appreciate why it's so frustrating to the hundreds of dedicated consumer and community development specialists, compliance examiners, and attorneys at the OCC—and to all of us who work with them and support them—to hear our motives impugned or our commitment or competence in regard to consumer protection questioned. It is regrettable that this type of allegation and innuendo seems to have become standard fare, disparaging the efforts of federal regulators to carry out their responsibilities under federal law.

For example, in the case of the Texas national bank and its illegal loans that I mentioned a moment ago, not only did an organization that had taken strenuous exception to our view of preemption of state predatory lending laws *not* come out in support of our enforcement actions, but actually used the occasion to criticize us further.

That kind of sniping is unconstructive—and it is surely unproductive for consumers.

Unfortunately, the fact that we at the OCC are responsible for administering a system of *national* banks, operating under *national* standards, has led some to suggest that we and state authorities have different *goals* regarding fair treatment of bank customers and high integrity of bank conduct. That is simply not so.

We implement different statutory authorities, and thus we may have different approaches. For the OCC, our approach reflects, as it must, the fact that we administer a system composed of federally chartered entities whose powers and the restraints on them flow from federal law. That being the case, certain results follow under doctrines of federal preemption. But make no mistake: our fundamental goals are the same.

Misperceptions persist, however, and they seem to turn us into adversaries when we should be allies. That is a terrible waste. Instead of dissipating energy and resources, there is a way that states could be combining efforts with the OCC and leveraging resources to combat abusive financial providers.

Continuing an adversarial approach drains resources as well as good will —resources that all of us must husband carefully. Given the budget difficulties many states face, protracted legal battles over jurisdiction would seem harder and harder to defend at a time when some of them are reportedly considering the possibility of discharging convicted felons in order to cut costs.

Indeed, there has even been a proposal to impose a surcharge on each loan transaction—it sounds like the borrowers' version of a gas tax—to establish a special enforcement fund to augment state budgets for consumer protection activities. Surely there is a better approach than charging consumers extra to ensure that they are treated fairly.

Yet, in contesting for the ability to subject national banks to various state laws—laws that the courts repeatedly have held to be preempted as applied to national banks—states are spending time and money that *could* be directed at practices by entities—unlike banks—that are not already subject to comprehensive regulation.

The OCC has adopted special procedures to expedite referrals of consumer complaints regarding national banks from state attorneys general and state banking departments, and we have offered to enter into formal information-sharing agreements with the states to formalize these arrangements. Recently we concluded the first of these arrangements, with the Office of Consumer Credit Regulation of the State of Maine. We hope that this is the first of many.

By coordinating our resources and working cooperatively with the states, the OCC and the states can cover more ground. We can maximize the benefit to consumers, help to close loopholes in existing consumer protection laws, and better target those financial providers who prey on vulnerable members of our society.

We are committed to those goals. We stand ready to work with the states to achieve them.

Thank you.

Remarks by Mark A. Nishan, Chief of Staff and Public Affairs, before the Midwest National Bank Conference, on preemption, St. Louis, Missouri, October 9, 2003

St. Louis is one of America's friendliest and most sophisticated cities—a city that's long made a proud contribution to America's growth and greatness. I do have one regret, though: my good friend Larry Beard and his OCC colleagues here in our Central District have been so preoccupied with organizing this conference and making sure that it's a valuable conference for you, that they've pretty much left me to my own devices after hours, and that means I've missed some of the best of what St. Louis has to offer. Larry, I'll take that rain check—and I promise you, I *will* be back to collect.

Speaking of rain checks, this is an especially fine time of the year if you happen to be a baseball fan whose team is in the playoffs, with dreams of the World Series dancing in your head. For the rest of us—and I'm speaking here as a longtime New York Mets fan, who feels your pain—it's a time to embrace a longer and more philosophical view of sports and the world. It's the test of how seriously you mean what you used to tell your kids, that what really matters is how you play the game—that the pride you take in what you do means more than the numbers you put up on the board.

Whether you think that's just another cliché—or a rule that guides your every day—one thing, I think, *is* beyond dispute. In any competitive business, whether it's baseball or banking, the team that's consistently successful is likely to be the team that has focused most consistently and resolutely on fundamentals. I've long believed that what separates the leaders from the followers in this industry is the degree to which they have internalized the three "Cs": controls, customers, and culture.

I'm referring, of course, to a rigorous environment of internal controls; a strong customer service orientation; and, perhaps most important in this day and age, an organizational culture that stresses high ethical standards and accountability.

That third "C" may be the most fundamental of all. And yet, there's evidence that inadequate attention to the ethical dimensions of organizational culture has been responsible for some of the setbacks that banks have lately suffered in their external relations—setbacks that have had profound *practical* consequences for banking in America.

People are sometimes amazed when I tell them that it wasn't all that long ago or all that uncommon for the average American to put the average banker on a pedestal usually reserved for the average baseball superstar. But it's a fact. People used to look up to bankers as paragons of integrity, high moral character, and incorruptibility.

But to a considerable degree—and most regrettably—that's not the way it is anymore. The industry's reputation has fallen, and pride in the banking profession has fallen with it. That concerns us at the OCC. And, I know it concerns you.

One reflection of the industry's diminished prestige is the surge in the number—and noisiness—of the attacks on banks. State and local legislatures around the country have enacted, or are considering enacting, new laws to regulate various aspects of the business; state law enforcement officials are making dramatic headlines announcing large dollar settlements; federal regulators are issuing regulations and guidance; consumer activists are leveling broadside barbs; and committees of Congress are holding hearings and conducting investigations aimed at determining whether new federal laws are needed to curb abusive practices.

I find this curious. Given the impressive performance of the banking system during a time of such widespread uneasiness in the general economy, this is a time when you might have expected public confidence in the industry—which has helped to prop up the economy—to be at an all-time high. Instead, the opposite seems to be the case.

Certainly these attacks take a heavy toll. They hurt morale and make it harder to attract bright young people into the industry, thus compromising its future prospects. It hurts retention, too. We've even heard some bankers question their decision to choose the career in the first place—or, worse, to decide that the career is no longer worth the trouble. When an experienced and knowledgeable banker takes his or her talents to another line of work not because there's any great desire to leave, but because there seems to be no other way of recapturing that essential pride and self-respect, it's deeply unfortunate for all concerned.

But at worst, criticism of the sort that has lately befallen the industry can have a direct affect on your ability to run your business. It can result in new regulatory burdens and costs, new constraints on your relationship with your customers, and new limitations on the kinds of products and services you offer.

An *interesting* question is, "what has emboldened the industry's critics to take the offensive in this way?" The *practical* question is what the industry can do to counteract this criticism—and what it can do to bolster that important sense of pride.

I suspect that the industry's public relations problems may be partly the result of guilt by association. There are plenty of unsavory characters in the financial services business, and always have been. But, increasingly, they're offering products that look like those traditionally offered by banks, and vice versa. As the lines between financial services providers become blurred, it may be more difficult for financial consumers to differentiate among them, and banks are more likely to be tarred by the same unsavory reputation that has clung to their nonbank, less supervised—in some cases, unsupervised—competitors.

Certainly the motives of the industry's critics may also be called into question, and it would be easy to conclude that bankers have merely been scapegoats or stalking horses for people with political ambitions. Of course, kicking banks around has been something of a national pastime at least since the days of Andrew Jackson, and so it would be easy to conclude that politics is what this latest round of bank bashing has largely been all about.

But, we draw that conclusion at our peril, for it ignores some of the underlying problems for which banks and other financial providers bear more than a passing responsibility. History teaches that when Congress acts to pass regulatory legislation dealing with financial institutions, it's almost always in response to real abuses that have been festering over a long period of time—time that financial providers could have used productively—but didn't—to implement remedial steps on their own. That the banking industry has sometimes been its own worst enemy in this regard is a truth that unfortunately cannot be denied.

Back in the 1960s, for example, banks and other lenders utilized so many different and incompatible methods for computing interest rates that consumers, trying to comparison shop, didn't stand a chance. There was plenty of public outrage—and plenty of opportunity for the industry to clean up its act—but no one was willing to take the lead. So Congress did—not because it wanted to, but again, because the industry left it with no choice. The result was the Truth in Lending Act of 1968. The industry has been living with it—and other laws like it—ever since.

Arguably, all of the consumer protection laws with which you're so familiar could have been avoided, or at least softened, with some proactive industry self-policing. The point is, it's not too late to start—because the steps the industry takes today to demonstrate leadership—to weed out industry abuses, protect consumers from the actions of a misguided few, defend the industry's reputation, and develop standards of good practice—are the steps that might spare it from the Truth in Lending Acts of the future.

That's essentially the message Comptroller Jerry Hawke delivered last month to the ABA conference in Hawaii. Perhaps some of you were there to hear him. You have to admire Jerry—and I would be among his biggest admirers even if he weren't my boss. He's been a leader in this industry for four decades. When it comes to bank regulation, he's pretty much seen it and done it all. In all those years, from his various positions in the government and private sector, in literally hundreds of speeches and dozens of articles, he's been exhorting the industry to clean house in its own interest. For many of those years, he was a lonely voice in the wilderness. And through it all, he never lost hope that the industry would see the light and take the steps that would set it free to better serve the banking public.

Now there are signs that his patience and persistence may at last be paying off.

At the ABA convention, he called for the creation of a new committee on banking standards and practices, to be composed of a group of the most respected people in the industry, whose job it would be to articulate and promote the adoption of principles of fair dealing and best practices.

The initial reaction—not only from ABA—has been promising. Many people have expressed interest in Jerry's idea, and we're hoping that interest is followed by action. Although we have no illusion that the path to salvation runs through any committee, this could be an important step toward reversing the tide of regulatory measures that has lately been threatening the industry.

In the final analysis, however, the responsibility for fair and ethical conduct—and for the consequences of that conduct—rests not with a trade group or with some faceless entity we call the "industry." The responsibility rests with the hundreds of thousands of individual bankers and bank employees who come to work in its offices each and every day. Their actions—your actions—will determine whether Congress, state legislators, regulators, consumer advocates, state attorneys general, and the public—turn the focus elsewhere or keep the spotlight squarely on the banking community.

Needless to say, we're delighted and encouraged by the favorable response to the Comptroller's proposal. But, I can understand that there might be some skepticism about this "heal thyself" approach. Some will say that we're expecting too much of human nature; that a value system that encourages businesses to be innovative and to push the envelope cannot be reconciled with the kind of internal restraint that our approach requires; and that only a punitive remedy with teeth, imposed by government, can ever succeed in preventing and rooting out abusive practices.

Yet, we also know that some financial organizations are chronic abusers while some banks have operated for decades—even tens of decades—without ever having their reputation besmirched. What sets them apart? I believe that takes us back to our third "C"—a culture of ethics and accountability, nurtured and reinforced by senior managers over time.

As the Comptroller said in Hawaii, "the ultimate protection for all of our banks, and for the people responsible for running them, is to instill in all employees a dedication to the highest standards of fairness and ethical dealing; to make clear that no loan, no customer, no profit opportunity, is worth compromising those standards for; and to take swift and decisive corrective action where those standards are violated."

That's all any one banker can do to uphold the industry's standards—and to bolster that pride.

For me, the words "high standards and pride" have always triggered a mental association with the national bank charter, and I trust that many of you feel as strongly about that as I do—or some of you wouldn't be here today. We keep getting unsolicited letters from bankers telling us how much the national charter means to them, and one very recently from a community banker in Indiana whose views, I think, are worth quoting at some length in the current context.

This banker said that he'd always viewed the national charter as a "value proposition." "The cost [in assessments] may be higher" and the OCC's exams were "much tougher than [those of] state regulators," but "I saw great value in having . . . highly qualified examination personnel assist[ing] by pointing out best practices and challenging my thought processes. They are a

resource that we consult frequently." And as for the result, "I am certain that we would not be as successful today if we had decided to go the state charter route."

Obviously, this is one satisfied national banker.

I mention this not to toot our own horn, but because this banker's experience seems relevant to my earlier observation on history and human nature. I daresay that those who are pessimists about the human condition—who believe that people will always take the paths of quick gratification and least resistance if they're allowed to—would have trouble figuring out how the national banking system managed to survive and thrive for these past 140 years.

From their perspective, it makes no sense that capitalists would opt to pay more—twice as much, in some instances—for the privilege of more rigorous government scrutiny when they could easily pay a lot less and avoid the inconvenience of having a government inspector looking over their shoulders. Yet, at last count, 2,100 national bankers were making what we might call the inexpedient choice, and many quite happily and successfully, if that Indiana community banker is to be believed.

That should give us hope that banks and the groups that represent them might yet rise to the leadership challenges spelled out in Hawaii by Comptroller Hawke.

An interesting sidebar to all this is that the congressional founders of the national banking system were themselves worried that bankers would take the expedient course every time if given the choice. Their response was to try to deny bankers the choice. That's why they considered abolishing state banks outright and then, in 1865, passed the so-called "death tax" on state bank notes, which was intended to accomplish the very same goal. Only by eliminating state banks, with their notoriously lax—and low cost—examinations, the founders believed, could a banking system, built on advanced principles of safety and soundness be sustained. So much for the notion that Congress "created" the dual banking system.

It's one of those historical ironies that the national banking system succeeded, even though what the system's founders considered to be the essential condition for its success—a single high standard of bank supervision, with no options or opportunities for evasion—was never achieved. It has succeeded, in that sense, for one reason only: because national bankers have been wise enough to figure out that in bank supervision, as in all things, there's no free lunch.

The national charter offers pride of membership in a select club and it offers value that comes from rigorous examinations that assess the safety and soundness of your institution and test the quality of your systems and your judgment. But it also offers more. And no attribute of the charter has garnered more attention of late than the immunity it provides from most state laws that would interfere or prevent a national bank from engaging in an authorized activity.

I bring this up because there's been a lot of sound and fury of late from what can only be called

a cabal of state supervisors and state attorneys general, suggesting that the OCC's invocation of the preemption power represents some novel and dangerous assault on the dual banking system, the separation of powers, the ability of the states to protect consumers, and who knows what else. Each of these allegations, I believe, is wholly without merit.

The charge that our actions are incompatible with the dual banking system is particularly baseless, and we'll soon be releasing a paper that will consider that argument in considerable detail. We plan to send you a copy, along with one of the Comptroller's speeches on the subject, in the very near future.

In the meantime, let me make a couple of points that our critics have conveniently overlooked about preemption. The first pertains to *why* the OCC occasionally preempts state laws. Preemption is simply the means by which national banks are enabled to operate under the uniform national standards that Congress intended from the very outset of the national banking system. When the states attempt to impose their legislative and enforcement authority over national banks, it's the states that are actually violating the intent of Congress.

I would couch the second point in the form of a question. Which side in the preemption controversy embodies the true spirit of the dual banking system? The essence of dual banking, after all, is choice: charter choice, choice in supervisory philosophy, regulatory approach, and so forth. When choice ceases to exist, then the system will be dual in name only.

Yet, by attempting to impose their laws on national banks, the states that do so are not only violating nearly two hundred years of constitutional precedent, which holds federal creations immune from such interference; they are also obliterating distinctions that make the dual banking system meaningful.

I cannot guarantee that these efforts on the states' part will fail. I can say that they have consistently failed in the past. Over the past seven years, in fact, only once has an OCC preemption determination been overturned in court—and that one, the *Barnett* decision, was itself overturned by the Supreme Court of the United States.

Of one thing I *can* assure you: no effort to interfere with you in the proper exercise of your authority as a national bank will go unanswered. We will challenge—with all of the resources available to us—any attempt to interfere with your serving your customers within the limits of federal law. That is our solemn commitment to you.

So, I would say again that it's a great day to be in St. Louis. And we're working to make sure that it's *always* a great day to be a national banker in America.