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Let me begin by thanking Andrew Hilton and CSFI for inviting me here this evening. These roundtables provide an excellent forum for the open discussion of the critical issues facing the financial sector today, and I applaud the independent thinking that the CSFI brings to these events.

Tonight I would like to discuss one of the most significant recent developments in the financial sector – the Basel II capital accord – which has certainly generated its fair share of controversy and taken quite a few years to get where we are now. In the U.S., a draft Notice of Proposed Rulemaking has at long last been released. Publication of the proposal will mark the final stage in our consultative process, in which comments are widely solicited, seriously evaluated, and in some cases intensely debated prior to the formulation of final implementing regulations. While this marks an important milestone, I can't help but be reminded of the famous Churchill line about this being not even the beginning of the end, but perhaps the end of the beginning. More prosaically, while much work has been done, much work remains before we have an up-and-running, fully supervised, and fully reliable Basel II risk-based capital regime.

Why We Are Where We Are

Tonight, I want to discuss why we are where we are with Basel II, and where we hope to go from here. Let me begin by focusing on three basic principles guiding our work on which there is broad consensus. First, our existing Basel I risk-based capital regime is deficient. The relatively simplistic framework underlying these rules has become increasingly incompatible with the increasing complexity of the activities pursued by our largest banks. The ham-handed risk weighting "buckets" overstate some risks, understate others, and, in other cases, simply fail to capture risks altogether. That combination creates inappropriate and even perverse risk-taking incentives that can and often do run at cross-purposes to supervisory objectives.

Second, given the types of risk in which our most sophisticated banks engage, improvement in risk measurement and risk management is imperative. Whether through enhancements to control structures, expansion of data gathering, or upgrading of modeling capabilities, risk management practices in banks are evolving rapidly. This is a logical and necessary reaction to changes in today's financial marketplace.

Third, the last line of defense against risk in any risk management process is capital – those funds held to absorb unexpected loss.

Mindful of these three principles, bank supervisors have sought to establish a much more rigorous relationship among risk, risk management, and capital in our regulatory and supervisory structure. It was this challenge that led the Basel Committee to the development of Basel II.

I strongly agree with the thrust of the Basel II approach. The continued safety and soundness of our banking system demands that we move away from our current simplistic risk-based capital system to one that substantially enhances risk management and more closely aligns capital with risk. I say this not because economists have dreamed up complex capital models in an academic exercise that attracts kudos from quantitative experts. Instead, I say it as the head of an agency that supervises institutions holding multiple hundreds of billions of dollars in assets– in some cases more than a trillion dollars – that take substantial levels of calculated risks as financial intermediaries to provide enormous amounts of funding fuel for our economy. These institutions no longer rely on simple capital measures when they put their equity at risk in ever more complex activities on an increasingly broad scale. They can't afford to, and neither can we. Instead, they have, at varying rates, developed much more rigorous risk management and risk modeling systems and controls to measure and manage their risk and allocate their capital. We as regulators have sought to move in the same direction in our supervisory approach, and for precisely the same reasons.

Let me offer one short anecdote to illustrate just how much the world has changed. Several months ago, the OCC hosted a workshop on credit risk modeling that was targeted not just at "quants," but also at managers who must rely on credit risk models in their day-to-day business. The workshop was not focused on Basel II, which of course has a credit risk model at its core, but was instead framed more generally to address the use of credit risk models in a variety of contexts. To my surprise, this "workshop" attracted four hundred participants, and not just from banks, but from all parts of the financial services industry and even from some commercial companies. This was very palpable evidence that business focus on credit risk modeling as a core business and risk management strategy has increased exponentially in the last ten years.

It is in this context that I believe the advanced approaches of Basel II constitute a sound conceptual basis for the development of a regulatory capital regime for large internationally active banks. In particular, Basel II funnels the internal credit assessments of individual banks through a single model – designed and maintained by the regulators, not the industry. That process produces capital charges that allow regulators to make "apples to apples" comparisons of risk-taking at covered banks, even though banks' own credit rating systems provide the inputs to the supervisory model. Perhaps most important, by tying regulatory capital to risk management, Basel II establishes powerful incentives for all covered banks to build and maintain state-of-the-art risk management processes that are consistent with industry best practices – and that will accrue to the benefit of banks and supervisors alike. Indeed, at a cost of hundreds of millions of dollars, a number of banks have already made significant improvements in their risk management processes in anticipation of Basel II implementation. In short, I believe the

Basel II approach will enhance the long-term safety and soundness of our banking system.

Now, saying that we support the Basel II approach is not the same thing as saying that we have crafted a perfect proposal to implement that approach. Earlier this year, the U.S. agencies issued an analysis of Quantitative Impact Study 4, or "QIS-4," as it is commonly known. This study sought to assess the impact of Basel II in the initial form proposed by the U.S. banking agencies in 2004, even though banks have not yet built the substantial systems necessary to implement such a proposal. As you will recall, the QIS-4 results showed both a material reduction in capital and a significant dispersion of results across institutions and portfolios. Aggregated over all QIS-4 participants, the decrease in minimum required capital compared to existing standards was over 15 percent, with a median drop of 26 percent.

Two weeks ago, the Basel Committee provided information on the results of QIS-5, which included the U.S. QIS-4 results. In many respects, the outcome of the international QIS exercise was similar to that found in the U.S., although at somewhat reduced levels. Like QIS-4, QIS-5 evidenced material dispersion and declines in minimum capital requirements. As the May 24th press release from the Basel Committee indicated, minimum required capital of QIS-5 participant banks declined on average by 6.8%, but unlike QIS-4, that result took into account the increase in credit risk capital requirements generated by the 1.06 scaling factor, so the difference between the results of QIS-4 and QIS-5 are more similar than they first appear.

Analysis of QIS results suggests that a multitude of factors contributed to the overall drop and dispersion in capital requirements. Institutions are at widely varying stages of development of the advanced credit and operational risk systems and processes required by Basel II. Also, the QIS exercises were carried out without definitive rules and guidance establishing supervisory expectations, and without ongoing supervisory oversight and disclosure.

Perhaps the most interesting area of analysis of the QIS results relates to the effect of changes in economic conditions on capital requirements under Basel II. The current Basel I framework is not sensitive to economic conditions, requiring institutions to hold the same amount of capital in good times and bad, regardless of whether the state of the economy presents increased risk of loss. In contrast, bank internal ratings and parameter estimates underlying the Basel II framework are sensitive to economic conditions. Most supervisors and industry participants expect that, because of this enhanced sensitivity, minimum risk-based capital requirements under Basel II for certain wholesale and retail portfolios could rise or fall by more than 20 percent, "peak-to-trough," over a normal economic cycle.

This raises some interesting questions. Will regulators really be comfortable with significant declines in minimum required capital after sustained periods of economic growth? If so, will there be adequate time to increase capital to higher levels when the cycle turns and a bigger capital buffer is necessary to absorb losses? Conversely, in

prolonged periods of economic stress, will Basel II call for continued increases in minimum required capital that could restrict an institution's ability to provide adequate credit to the economy – in layman's terms, a "credit crunch"? Should regulators consider using discretion afforded by Pillar 2 of Basel II to adjust minimum required capital levels to dampen the effect of changes in economic conditions? If so, what would be the standard or baseline for making such changes? But if such a judgmental determination were made, wouldn't that undermine the fundamental integrity of Pillar 1?

Good questions, all, and ones that we supervisors will continue to discuss as the Basel process moves forward. Certainly, the relatively benign economic environment prevalent when the QIS studies were conducted resulted in lower minimum risk-based capital requirements than would have been observed had the studies been conducted during a more stressful economic period. Nevertheless, an individual bank's capital ratios and equity position under Basel II will be a function of many features, some of which are not sensitive to prevailing economic conditions. It remains to be seen whether the particular effect of economic conditions, by itself, will be sufficiently significant to require additional regulatory adjustments in the future. This is an issue worthy of continued focus and discussion.

In sum, there are a number of factors that contributed to the sharp decline and dispersion of capital levels in the QIS results, and these will undoubtedly change with the implementation of a final Basel II rule. Nevertheless, I want to be clear about our view of the final QIS-4 results: if a final rule were to produce the same type of sharp decline and dispersion, that outcome would plainly be unacceptable to the U.S supervisory agencies. In light of that conclusion, the agencies have grappled with the issue of what to do to address the results of QIS-4. Last September, we concluded that more study of the conceptual underpinnings of the Basel II framework would yield little additional practical benefit. Instead, we decided that the questions raised by QIS-4 can only be fully answered by observing live Basel II systems that are based on a definitive set of agency rules and are subject to meaningful supervisory validation and scrutiny. That means continuing to move toward implementation, but in ways that recognize and attempt to address QIS-4 concerns. Let me mention five such ways.

First, some adjustments have already been made to the draft Notice of Proposed Rulemaking, although such adjustments have not changed the fundamental parameters of the previous Basel II approach.

Second, as the result of comments received on the NPR, the agencies will undoubtedly make further changes to the proposal before it is finalized, some of which will surely address QIS-4 concerns.

Third – and this is critically important, I believe – the U.S. agencies have insisted on stringent safeguards during the initial implementation or transition period of a final Basel II rule. These implementation safeguards consist of (1) delaying the adoption of Basel II for one year, (2) extending the transition period following adoption to three years, and (3) strictly limiting potential reductions in capital requirements during that transition period through a system of simple and conservative capital floors. Why are these safeguards so

important? Because they will allow banks adequate time to build fully compliant risk management and risk-based capital systems, and they will allow the agencies to analyze implementation of these systems in a fully supervised environment where sharp regulatory capital declines are not permitted. That, in turn, will enable supervisors to determine whether fully supervised, up-and-running systems using the new risk-based capital requirements result in capital charges that accurately reflect differences in risk within and among banks, which is, of course, the fundamental objective of Basel II.

Fourth, we will maintain the leverage ratio – our equity-to-asset ratio – as a fundamental capital backstop for unanticipated risks faced by banks, including the risk that Basel II at times may not work as intended.

Finally – and this is perhaps the most important safeguard of all – if the agencies conclude during the transition period that the fully implemented Basel II rule does not adequately reflect risk, or results in unacceptable declines in capital requirements like what we observed in QIS-4, then we have committed to make further changes to address those problems to fulfill our safety and soundness responsibilities.

Implementation Issues

Let me turn briefly to implementation issues, which loom larger as we move closer to the effective date for Basel II. Supervisors have long recognized that this new Framework would require more cooperation and coordination than the current regime. The actions of the Basel Committee, and especially its Accord Implementation Group, have attempted to address that need. But, while the Basel Committee is a coordinating mechanism for national supervisors, it is the individual supervisors who will continue to have the legal responsibility to oversee the activities of institutions operating within their respective jurisdictions. And given the differences in national systems, there are practical limits on the ability of any multilateral group to fully address home/host issues.

As a result, I believe the most effective means to resolve such issues under Basel II is the method most effectively used today: bilateral discussions between different national supervisors in the context of an individual bank. The U.S. banking agencies have had great success working with banks and foreign supervisors to address home/host issues in the past, and we have every confidence that such success will continue under Basel II. Indeed, U.S. supervisors and our foreign counterparts have already begun working to coordinate our respective roles in the oversight of individual companies under a Basel II regime. As it relates specifically to the UK, I am confident that the outstanding working relationship the OCC has had in the past with the FSA will continue in ways that will enable us to work through Basel II home/host issues.

Next Steps

So, where does the U.S. plan to go from here? The Agencies have jointly developed a draft Notice of Proposed Rulemaking, which was made publicly available by the Federal Reserve to begin public discussion of that critical document. The OCC and OTS delivered the draft NPR to the Office of Management and Budget as part of a required economic impact analysis of the rulemaking. We expect to hear back from OMB on their

work shortly. In addition, related materials, including proposed supervisory guidance on both credit risk and operational risk, will also be released for public comment in the coming months. Taken together, these substantial materials will provide a detailed statement of precisely what the U.S. agencies intend with respect to implementation of Basel II. That will be followed by a significant comment period, during which I expect we will receive a significant number of comments and suggestions, which of course we will take into account before moving to any final rule.

That leads me to our parallel rulemaking regarding changes to the risk-based capital rules for U.S. institutions that will not be subject to Basel II. That is, because regulations must be tailored to the size, complexity, and risk profile of banking institutions, we have long recognized that the mandatory application of Basel II advanced approaches should be limited to large complex institutions. But we also recognize the need to provide a meaningful alternative to our current risk-based capital rules for smaller, less complex domestic banks – an alternative that increases sensitivity to risk without the massive complexity of Basel II. Our Basel IA initiative is intended to address this need, as well as competitive equity issues raised by adoption of Basel II. The U.S. Agencies have already laid out a conceptual basis for the new approach in an Advanced Notice of Proposed Rulemaking with respect to Basel IA, with the comment period concluding in January of this year. Based on the comments we have received, the agencies expect to move to the next step, a Notice of Proposed Rulemaking, in the next several months. I continue to believe that it is very important that the public be able to compare, contrast, and comment on definitive proposals for both Basel II and Basel IA during overlapping comment periods.

Let me conclude. The OCC has frequently been a critic of the Basel II Framework, and the agency has worked hard in the past to make important changes that we thought made sense. That role will continue. But it is also true that, at critical points in the process, the OCC has supported moving forward towards implementation. Why? Because in terms of safety and soundness, which is the very heart of the OCC's mission, Basel II is moving in the right direction to address the increasingly large and complex risks of our largest banks. We may not have the details right yet, and we will surely make changes as we go forward. But so long as we have adequate safeguards in place as we do so, I believe we should push ahead.

Thank you very much.