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Before The
Subcommittee On Domestic and International Monetary Policy, Trade and Technology
of the
Committee on Financial Services
of the
United States House of Representatives

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Chairman King, Congresswoman Maloney and members of the Subcommittee, I am pleased to have this opportunity to present the views of the OCC on the Basel Committee's proposed revisions to the 1988 Capital Accord. It is essential that Congress have the opportunity to express its views on any regulatory changes that could affect the operations and competitiveness of our banking system, and the Subcommittee is to be commended for its initiative in this regard.

For the past few years, the Basel Committee, of which the OCC is a permanent member, has been working to develop a more risk sensitive capital adequacy framework to replace the 1988 Basel Accord. The Committee has established a target of December 2003 for adoption of a revised Accord (Basel II). Accordingly, the OCC and the other U.S. banking agencies have already begun the process of considering revisions to the current U.S. capital regulations through our domestic rulemaking process. That means publishing proposed revisions for public comment and carefully considering the comments we receive.

Let me assure the Subcommittee that 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 determined through this notice and comment process that any changes to our domestic capital regulations are reasonable, practical and effective.

Despite the enormous effort and great progress made by the Basel Committee, serious questions remain about some aspects of the Basel II framework. I would like to highlight four such issues for the committee – issues that must be resolved before Basel II can be considered as final.

The first issue is complexity.

One of the goals of Basel II is to encourage financial institutions to improve their own ability to assess and manage risk, and for supervisors to make use of bank self-assessments in setting regulatory capital. But before we can do that, banks have to demonstrate that their systems – and the capital determinations that flow from them – are reliable.

Thus, Basel II sets detailed and exacting standards for rating systems, control mechanisms, audit processes, data systems and other internal bank processes. This has led to a proposal of immense complexity – greater complexity, in my view, than is reasonably needed to implement sensible capital regulation. I believe we must avoid the tendency to develop encyclopedic standards for banks, which minimize the role of judgment or discretion by banks applying the new rules and of supervisors overseeing the new rules.

Moreover, Basel II must be written in a manner that is understandable to the institutions that are expected to implement it, as well as to third parties. It is imperative that the industry and other interested parties understand the proposed regulatory requirements and all supervisory expectations if they are to provide a meaningful assessment of the proposal and its effects.

The second issue is competitive equality.

We need to think carefully about the effects of Basel II on the competitive balance between domestic banks and foreign banks; between banks and non-banks; and between large, internationally active banks in the U.S. and the thousands of other domestic banks.

In the United States, we have a sophisticated, hands-on system of bank supervision. For example, the OCC has full-time teams of resident examiners on site at our largest banks -- as many as 30 or 40 examiners at the very largest. In other countries, by contrast, supervisors may rely less on bank examiners and more on outside auditors to perform certain oversight functions. Given such disparities in the methods of supervision, it seems to us inevitable that an enormously complex set of rules will be applied much more robustly under our system than in many others. Thus, the complexity of the rules alone will tend to work a competitive disparity.

There is also a concern about the potential effect of Basel II on the competitive balance between large and small banks. As it is likely to be implemented in the U.S., Basel II would result in a bifurcated regulatory capital regime, with the largest banks subject to Basel II-based requirements and all other banks subject to the current capital regime.

We expect that banks subject to Basel II will experience lower capital requirements in some lines of business (such as mortgage lending) than banks that remain under the 1988 Accord. This may put smaller "non-Basel" banks at a competitive disadvantage when competing against the large banks in these same product lines. We should avoid adoption of a capital regime that might have the unintended consequence of disrupting our current banking structure of small, regional, and large banks, and take steps to mitigate the adverse effects on the competitive balance between our largest and other banks.

Finally, for many banks, the principle source of competition is not other insured depository institutions, but non-banks. This situation is especially common in businesses such as asset management and payments processing. While differences in regulatory requirements for banks and non-banks exist today, many institutions have voiced concern that implementation of Basel II may exacerbate those differences to the disadvantage of depository institutions.

The third issue is 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 component of minimum regulatory capital. The OCC supports the view that there should be an appropriate charge for operational risk. But I have also consistently argued before the Basel Committee that the determination of an appropriate charge for operational risk should be the responsibility of bank supervisors, under Pillar 2, rather than being calculated using a formulaic approach under Pillar 1. I regret to say that I have not been able to persuade the Committee to adopt this approach.

Basel's operational risk proposal has changed considerably since it was first introduced. The current operational risk proposal, especially the option of the Advanced Measurement Approach (AMA), which the OCC helped develop, is a significant improvement over earlier proposals. 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. Nonetheless, the OCC believes that more work needs to be done to develop guidelines for the appropriate capital treatment of operational risk proposal.

Calibration

It has been an explicit goal of the Basel Committee that the revised Accord be capital neutral. In other words, the aim is to maintain the overall capital of the banking industry at levels approximately equivalent to those that exist under the present Basel Accord.

To ensure that overall capital in the banking system does not fall, the Committee has proposed the use of a minimum overall capital floor for the first two years following implementation of the new Accord.

While the OCC supports a temporary capital floor, it does not believe that a reduction in minimum regulatory capital requirements for certain institutions is, in and of itself, an undesirable outcome. A drop in required capital is acceptable if the reduction is based on a regulatory capital regime that reflects the degree of risk in that bank's positions and activities. But we are not yet at the point where we can make a really confident judgment about the impact of Basel II on capital levels. QIS-3, the latest qualitative impact study, was based on an incomplete proposal and was applied by the banks without any of the validation or control that would be present when the new regime is in full force. Thus an effort to calibrate new capital requirements based on QIS-3, must confront great uncertainty. This uncertainty further illustrates the importance of moving cautiously before we incorporate Basel II into our domestic capital rules.

Conclusion

As I indicated earlier, the OCC strongly supports the objectives of Basel II – a more risk-sensitive and accurate capital rule for large institutions. This summer, the OCC and the other banking agencies expect to seek notice and comment from all interested parties 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 conduct a full and thorough consideration of the proposal.

If we determine through our rulemaking process that changes to the Basel proposal are necessary, we will press the Basel Committee to make changes. And we further reserve our right to assure that any final U.S. regulation applicable to national banks reflects any necessary modifications. Given the importance of this proposal, 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 both in theory as well as in 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.