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One doesn't need to be a macroeconomic guru to know how much reliance we have put on the consumer in the effort to get our economy on the road to a solid recovery. Accounting for two-thirds of the U.S. economy, consumer spending largely determines its fate. Over the past two years, the consumer's readiness to spend, despite rising unemployment and global unrest, has kept this recession mild and the economy afloat. If consumers continue to spend, business investment should revive and recovery should proceed. If the consumer suddenly becomes cautious, then we might be in for a much more difficult and prolonged recovery.

As we put more and more emphasis on consumers, the Consumer Bankers Association is again front and center. This is not an unfamiliar role for an organization whose members have helped so many ordinary Americans enjoy the extraordinary fruits of our industrial economy. In recent years, CBA and its members have been in the vanguard of the effort to help the industry adjust to the responsibilities and opportunities presented by the Community Reinvestment Act—an effort in which this conference has come to play a major part. And CBA has been a catalyst for industry efforts to tackle the persistent problem of financial illiteracy, helping consumers to develop the basic financial skills and obtain the information they need to make informed choices and keep them out of the clutches of the financial predators.

Now the banking industry faces a new challenge, and CBA members will once again have a critical role to play. America is changing.

Of course, change is nothing new for Americans. It's been the driver of our technological, economic, and social progress. But changes in our nation's ethnic composition have the potential to alter the banking industry profoundly—for better or worse.

There have been times in our past when demographic shifts were so massive and abrupt that they were the dominant political reality of the day. In the decade between 1841 and 1850, for example, the population of the United States grew by approximately six million. More than one third of those new Americans were immigrants, and, of that group, numbering roughly two million, half were from Ireland. The bulk of this influx settled in and around New York City, Boston, and Philadelphia, where, almost overnight, the Irish became a social and political force to be reckoned with. No one could miss their impact.

It would take far greater numbers than that to have an equivalent impact on the America of 2003. There are vastly more of us to begin with, and we are dispersed over a far wider area, than were the Americans of a century and a half ago.

But the most recent census reports tell a story that's no less dramatic—and certainly no less consequential for the banking industry. In 1990 one of every five Americans was a member of a minority group. In 2000, it was one in four. And by 2025—two decades from now—projections tell us it will be nearly two in five. Today almost 50 of the largest U.S. cities are "majority minority." The list of cities in which non-Hispanic whites went from being a majority to a minority during the 1990s includes Milwaukee, Boston, Philadelphia, and St. Louis. Nineteen other cities would have lost population during the decade if not for the growth in the Hispanic population.

But suburban and rural areas are also feeling the effects of this transformation, in largely unprecedented ways. The Hispanic populations in Mississippi and Wisconsin more than doubled during the 1990s, and some of the most dramatic growth in Asian and Hispanic populations has occurred in suburban counties where these ethnic groups had been most unfamiliar. Indeed, last year I visited community organizations in Kansas City, Kansas, at the geographic heart of the United States—where a strong influx of Hispanics had led local support organizations to devote significant attention to their interests. This is not a Kansas City that Dorothy and Toto would recognize today.

The U.S. banking industry has enjoyed tremendous success in meeting the needs of the America that we have *been.* It is no exaggeration to say that the industry's future success hinges on its ability to meet the needs of the nation we are in the process of *becoming.*

It's not just the future of the banking system that's at stake. The industry's interests and those of our economy have always been intertwined. All Americans benefit when their banks function profitably and well. By the same token, if the industry should fail to meet the challenge of the new demographics, all Americans—even those who are not bank customers today—will feel the effects. Indeed, those who are not your customers will feel those effects most of all.

To be candid about it, this is an area in which the industry has in the past had mixed success. We've noticed a certain reluctance to launch the kind of concerted outreach that developing these new markets requires. Indeed, this reluctance may stem from the recognition that cosmetic changes or targeted advertising alone won't suffice for banking organizations to make significant inroads into minority markets. It takes commitment up and down the organization, and to this point some banks have decided—shortsightedly, I believe—that the returns weren't worth the investment.

But while many banks have shown some reluctance to enter, nonbank competitors have been consolidating their foothold in minority markets. The phenomenal expansion of payday lenders, check cashers, rent-to-own operators and other such fringe providers in primarily minority communities is not only a competitive threat to U.S. commercial banks, it's a significant obstacle for

members of minority groups in their bid to achieve economic security and a genuine stake in their communities.

For all that, the sheer growth of minority banking markets means that there are still plenty of opportunities to go around—and still time for financial institutions to make up for their late start in taking advantage of them.

Nowhere are the opportunities more bountiful—and the potential payoff to financial institutions, their minority customers, and economic growth more promising—than in the area of home ownership.

The housing market has been one of the few bright spots in the economy over the past several years. Rising housing sales and prices have helped offset declines in other areas, especially in the stock market, while lower interest rates and the refinancing wave have put billions of dollars back in people's pockets. Nearly one million new homes were sold in 2002—the highest number on record—and the average sales price was nearly ten percent higher than it was two years earlier. But in order to sustain this level of activity, we need to reach out to new customers in new markets.

Consider this: while the U.S. home ownership rate hit nearly 68 percent in 2000, the rates for African-Americans and Hispanics remained well below 50 percent. This gap represents approximately $600 billion-worth of home mortgages waiting to be made. And there's no end in sight: predictions are that between now and the year 2100, nearly 60 percent of all first-time homebuyers will be young minorities and immigrants.

Or consider the opportunities that are still going begging for banks to establish mutually profitable relationships with minority businesses. The fundamentals are certainly there: the entrepreneurial spirit is alive and well in many minority communities, and those who live in those communities have money to spend—more money than is usually assumed to be the case. New studies conducted in diverse cities such as New York, Houston and Washington, D.C., by Social Compact, a nonprofit coalition of corporate leaders, show that minority communities are typically undercounted, both as to size of their populations and their purchasing power. That can perpetuate a vicious cycle: merchants assume that low-income communities can't support retail investment, so they invest elsewhere; and with few local retail outlets, residents must travel to obtain goods and services, spending funds that would otherwise stay put in the community.

Businesspeople who understand the economic potential of minority communities are often frustrated by a lack of start-up and working capital and micro business financing. Surveys tell us that while three-quarters of all businesses rely on bank credit to finance growth, only two-thirds of minority-owned businesses did. The other third relied on personal debt—typically high-interest, unsecured credit card debt. Another recent study of female ethnic entrepreneurs—and women are a major source of business initiative in those communities—highlighted the greater difficulty they face in obtaining conventional financing compared to their non-minority peers—twice as difficult for African American businesswomen as for Caucasians.

Finally, it's clear that there's a demand for retail financial services in minority communities that is being met today by providers other than banks. Ten million households—nearly 10 percent of U.S. households—are unbanked, and more than 60 percent of those are minority households. African-Americans and Hispanics were *seven times* more likely *not* to have checking accounts than Caucasian respondents. And we know something about the revenues that nonbanks generate: $60 billion a year by check cashing outlets; at least $10 billion a year by payday lenders; over $3 billion a year by pawnshops; nearly $5 billion a year by rent-to-own operators. According to one estimate, the annual earnings of consumers without bank accounts amount to $500 billion. It should go without saying that numbers of this magnitude can be ignored by the banking industry only at its peril.

The people who patronize nonbank fringe providers should be *your* customers. And in some communities, where banks have demonstrated the requisite creativity and commitment to the development of these markets, they are. What are these banks doing that the rest of the industry could be doing, too? That's a question that deserves an answer, and, in the next few minutes, I'd like to share some of the lessons that can be drawn from experience and industry "best practices" in serving ethnic banking markets.

Let me begin by telling you what experience demonstrates *won't* work.—at least not in isolation. As I said at the outset, a bank's decision to make itself a felt presence in minority markets isn't a decision to be made casually. Nor is it one that a bank's marketing department is capable of executing on its own. It can't be accomplished merely by printing new brochures or running ads on Spanish-language radio, for example. Those steps can be important parts of an effective overall market-building strategy, but that strategy has to encompass a commitment throughout the company, from the very senior-most levels down to the branch management. It has to involve product development, portfolio management, community affairs, human resources, and more.

It has to reach outside the bank, as well. One of the things we've discovered is that the banks that are most successful in ethnic markets are the banks that have patiently researched the needs and characteristics of the market and developed local partnerships. One banker spent two years personally getting to know the community he was planning to target—and learning enough Spanish to enable him to communicate with his customers and employees. Other bankers have entered alliances with non-profit, community-based organizations, not only to speed the process of establishing name recognition in the community but also to provide services, such as financial literacy education, that the bank may not be equipped to deliver itself. And we know from our research and experience how crucial such training can be, especially to first-time homeowners and small business people.

Understanding the particular financial needs of ethnic communities is obviously a crucial component of any bank that hopes to succeed in them. A bank moving into such a community for the first time might assume that the same menu of product and services that works at its non-minority branches will work there. But bankers with experience in these communities have sometimes

found that trying to market their whole product line may detract from effectively marketing what those customers need most. That includes, obviously, low-cost checking, deposit, and debit accounts, home mortgages, small business and consumer loans, and other products that are a normal part of most Americans' financial lives. I have long advocated that banks make wider use of technology, especially through the promotion of direct payroll deposit and the offering of electronic account access, to deliver banking services to low-income Americans at prices they can afford.

I've heard it argued that lower-income people are unfamiliar—and uncomfortable—with technology, and that they may not have personal computers in their homes. I'm afraid that at times this may reflect a rather patronizing attitude that confuses income level with intelligence. But it overlooks two important facts. First, you don't have to own a computer to be comfortable using one. Indeed, many people who spend their workdays gazing at a computer monitor choose not to have a computer at home, whether they can afford one or not. If they are permitted to use their office computer for personal purposes, they have ready access to financial services on the Internet. And even if they are not so permitted, computers are readily accessible in a variety of other locations, such as libraries and Internet cafes. When it comes to technology, you don't have to be an owner to be an accomplished user.

The second point that deserves emphasis relates yet again to the demographics of minority banking markets. Today fully 45 percent of the Hispanic population in America consists of children nine years of age and younger. Even if their parents are unfamiliar with computers, these young people—the banking customers of tomorrow—aren't. Computers are ubiquitous, and they appear everywhere kids congregate—in schools, shopping malls, and entertainment arcades. It's important to the banks that hope to serve these future customers that they're able to communicate with them technologically as well as verbally. The banking customer of the future will already be experienced at using the Internet for a wide variety of functions, and it is very likely to *expect* that he or she will be able to conduct banking transactions by computer. Over-the-counter banking will be a horse-and-buggy methodology to them.

It's also important that the menu of banking products include those that address the unique needs of minority populations. In some immigrant and minority neighborhoods, the act of transferring funds abroad is almost as common as cashing a check. Nearly $10 billion a year is wired to Mexico alone each year. And some innovative banks, recognizing this, have made low-cost wire-transfer services the centerpiece of account relationships with immigrant customers. For the customer, the savings can be substantial; for the bank, it can become the foundation of long-term, profitable relationships.

Aesthetics count, too—sometimes in ways that are not always apparent. Those of us who study such things have long wondered why people continue to patronize check-cashing establishments when there is a bank branch next door, offering the same services frequently for lower fees, or

even no fees at all. And increasingly our research leads us back to intangible factors, such as bank tellers (or ATMs) that may not speak the customers' language or an unwelcoming business environment in which customers feel out-of-place.

What we do know is that the banks that have achieved some success in minority communities have typically not only staffed their teller windows and desks with employees drawn from the neighborhood, but have also tried to cultivate a look and a feel that are reassuring to those whom they'd like to see walking through their doors. Their décor reflects the culture of the local population; their business hours reflect the working schedules of their customers; they provide play areas and extra chairs in the lobby to accommodate larger families-in-waiting; the signage is multilingual.

To succeed in minority communities, in other words, banks have to work to make themselves a good fit—and good neighbors.

It's time to sum up. Change always presents challenge—and opportunity for those who are positioned to respond to it. The changing face of America will challenge us in many ways in the coming years, but if the patterns of the past hold up—as I expect they will—the primary result of the demographic changes I've been discussing will be that we're culturally and materially enriched.

Some businesses may decide that they can safely ignore these changes and carry on as before. But for a broad-based industry like banking—an industry with a statutory mandate to serve—that option does not exist. The industry's responsibilities to its multiple constituencies—employees, shareholders, existing customers—as well as its responsibilities under the law—cannot be fulfilled if it fails to respond to the needs of *all* Americans.

Fortunately, this is not uncharted terrain, and while there are no hard and fast rules for success in minority banking markets, we have had enough experience to have greatly improved the odds against failure. In my remarks this morning, I have tried to bring some of those lessons to light. Bankers must be receptive to innovation in product development and consumer relations. They must recognize that traditional marketing and product delivery approaches don't yield the same results in minority markets that they do in traditional ones. And they must work to develop and leverage strategic relationships with organizations that operate in the communities they seek to serve. That's particularly important in light of the distance that the industry has to make up to be truly competitive in minority communities.

The OCC will continue to take very seriously its responsibility to call the industry's attention to opportunities to serve and prosper, and to disseminate best practices to that end. The Consumer Bankers Association has long been a valued partner in that effort. We're counting on your to continue supplying the leadership that will assure the industry 's ability to meet the challenges of tomorrow—just as it has met the challenges of the past.

Remarks by John D. Hawke, Jr., Comptroller of the Currency, before the Exchequer Club, on the U.S. bank regulatory structure and predatory lending and preemption, Washington, D.C., April 16, 2003

Forty-three years ago, I arrived in Washington from New York City, fresh out of law school, to serve a clerkship on the U.S. Court of Appeals. Washington has been my home ever since.

Washington has obviously changed over those four decades, but one thing hasn't changed: every time someone new encounters our Byzantine structure of financial regulation, they immediately want to overhaul it. As a result, we have seen almost a score of studies, commissions, proposals, and reorganization plans put forward over the past three or four decades.

Yet, as sensible and thoughtful as these initiatives may have been, they have uniformly failed to get any traction. Just why this is so is the main topic I want to discuss with you today. And if that doesn't get your pulse racing, I want to finish up with a few comments on another current topic—predatory lending and preemption.

So let me start by posing this question: why has there been so much chatter about our bank regulatory structure?

The answer to this is obvious: the current bank regulatory structure offends all of our aesthetic and logical instincts. It's complicated; it's irrational; it probably has inefficiencies; and it takes a great deal of explaining. It's a product of historical accident, improvisation, and expediency, rather than a methodically crafted plan. It reflects the accretion of legislative enactments, each passed at a very different time—and under very different circumstances—in our history.

Given all of these criticisms over the years, it's fair to ask why we have not seen any change in the structure. It's certainly not for trying. Major efforts were put forth in the Reagan and Clinton administrations to rationalize the structure, but they never got very far off the ground. Yet in a number of foreign countries—the United Kingdom and Japan, for example—we have seen in recent years the creation of strong, independent financial supervisory agencies, with consolidated jurisdiction over financial firms. Why haven't we been as enlightened?

There are a variety of very compelling reasons, I believe.

First, the system works. While it is far from perfect, at its best it works extremely well. A variety of formal mechanisms and external pressures have caused the agencies to work quite well together. To be sure, there are examples of interagency rivalry, turf protection, and even inconsistency that arise from time to time, but on the whole the agencies have recognized the need to work together, to avoid inconsistencies, and to respect one another's jurisdictions and responsibilities. We clearly have an example of a system that doesn't work at all in theory, but works well in practice.

Moreover, studies conducted over the years by the General Accounting Office and others have repeatedly deflated the proposition that huge savings would accrue from regulatory restructuring. Instead, researchers have concluded that while there are some redundancies and extra costs associated with multiple agencies, those costs are located primarily in such back-office functions as human resources and information technology, rather than in front-line supervision, where the lion's share of agency resources are spent. Accordingly, the savings that might be realized from restructuring would likely be quite modest.

Second, there has never been a public constituency for change. Neither the banking industry itself—which has learned to cope with and take advantage of the current structure—nor advocacy or interest groups that are stakeholders in the system have mounted any case for change. And experience tells us that logic alone will generally not be enough of a catalyst for major reform legislation; a public and political constituency is almost always necessary.

But apart from these considerations, there have been, and continue to be, two major reasons why regulatory restructuring has not gained more momentum. The role of the Federal Reserve (Fed) and the FDIC (Federal Deposit Insurance Corporation) is one; the impact on state banking systems is the other. Time after time, well-meaning proposals for change have run into the intractable reality of having to deal with those concerns.

Right at the outset of any consideration of restructuring one must confront the question of what role the Federal Reserve should play in bank supervision. While the Fed's role as a supervisor was quite modest until the expansion of its bank holding-company jurisdiction in 1970, the Fed has long and successfully argued that it must have a major presence in bank supervision in order to obtain a "window" into the banking system as an adjunct to its monetary policy and payments system responsibilities. Yet countries around the world—Great Britain, Japan, and now China, chief among them—have chosen to move precisely in the opposite direction, concluding that the central bank cannot provide objective, independent bank supervision while discharging its monetary responsibilities at the same time. Who's right? More importantly, what's right for the United States? My personal view is that we have it about right as it is—although I believe very strongly that bank supervision must focus on safety and soundness concerns, and that bank supervisors should not be looked to for the conduct of macroeconomic policy.

The role of the FDIC in the supervisory framework is another perennial issue. The FDIC's role in insuring deposits and resolving failed banks has provided it with a strong argument for involving itself in the supervision of banks. But does the FDIC's legitimate interest in minimizing losses to the deposit insurance fund constitute justification for pervasive and continuous involvement in day-to-day supervision of banks that are not in the problem categories? Even more fundamentally, is the FDIC's paramount interest in minimizing losses—with the aversion to risk that interest encourages—consistent with the responsibilities of balanced supervision?

To be sure, some would resolve these conflicts by transferring all bank supervisory jurisdiction to the Fed or the FDIC. In fairness, I don't think either of those agencies has seriously suggested

this. Without putting too fine a point on it, I'll just say that I do not share this view. It would probably be immodest of me to expand on that at this time.

It is obvious, I think, that the present distribution of bank supervisory authority creates some burdens for banks, not the least of which is having to contend with visitations by examiners from different agencies, frequently duplicating—or ignoring—one another's work. I believe this is a concern that needs continual attention, for if there was anything that might galvanize the industry to support restructuring, it is likely to be the annoyance and burden of such supervisory duplication.

Finally, there is the question of how any plan to rationalize bank supervision would comport with a strong dual banking system. If the federal bank supervisory agencies were consolidated into a single independent agency, as many scenarios envision, with the federal supervision of state banks being performed by the same agency that supervises national banks, charter choice might be rendered all but meaningless. Banks' ability to select the system of supervision they deemed best suited to their needs would be curtailed. Disparities in powers between state and national banks would become untenable with a single federal agency presiding over both types of institutions, and the pressure for uniformity would be very strong.

Perhaps the most significant question would be how such an agency would be funded. Today, national banks bear virtually all of the costs of their supervision, while state banks bear only about 20 percent of their supervision costs—the portion attributable to that supervision carried out by the states themselves. As we are all aware, this disparity arises because the Fed and the FDIC, with virtually bottomless pockets, subsidize the state banks they supervise by absorbing all of the costs of their federal supervision. This inequity could not possibly be perpetuated if all federal bank supervision were vested in a single independent agency that didn't have the resources of the Fed or the FDIC. Such an agency would either have to be supported by appropriations—which would be a bad idea, in my view—or it would have to assess all of the banks it supervised. Even if the agency for unified supervision were the Fed or the FDIC, it is inconceivable that the present subsidy for supervision costs could be limited to state banks. Since many supervisors of state banks—at both the state and federal levels—have a pathological fear that equalizing supervisory fees would cause massive conversions from state to national charter, it is not surprising that they have opposed regulatory consolidation.

I recognize that some may view these remarks as a ringing endorsement of maintaining the status quo. That is not my intention. I share the intellectual interest in structural rationalization that the advocates exhibit. But I think that any proposal, no matter how logical it might appear, must address the fundamental political obstacles I've been discussing before we spend a lot more time spinning our wheels over still another iteration of an idea that is showing distinct signs of age.

Now let me turn briefly to two related subjects that are stirring up a lot of comment these days: predatory lending and preemption. First, I want to state emphatically that there is no question that predatory lending is a real concern. We have ample evidence that people in many areas are being stripped of the equity in their homes by a certain subspecies—and I use that term in its most pejorative sense—of subprime lenders, overwhelmingly unregulated nonbanks. Some 20 states have undertaken initiatives to address predatory lending, either through statute or regulation. In a case that's drawn considerable attention, a Georgia statute imposes severe restrictions on so-called "high-cost" mortgage loans, requiring lenders who offer them to comply with a range of substantive and procedural requirements.

Unfortunately, the passage of these laws has led to considerable uncertainty about their applicability to national banks, which, as you know, operate under a longstanding constitutional immunity from state laws that purport to regulate the manner in which they conduct their banking business—an immunity repeatedly reaffirmed by the Supreme Court of the United States, tracing back to the mid nineteenth century. The Office of Thrift Supervision has already determined that the Georgia law is inapplicable to federally chartered savings institutions and their operating subsidiaries, and the OCC is now reviewing comments submitted in response to a request for a determination of that law's applicability to national banks.

Unfortunately, the legal disputation over preemption tends to distract us from the real question: how best to deal with the problem of predatory lending in our communities, while ensuring that adequate credit remains available on reasonable terms to mortgage customers at all income levels. The nuances of preemption theory are unlikely to mean much to borrowers who either have been burned by predatory lenders or denied credit in the first place.

I have several concerns about the across-the-board approach that has been adopted, with the best of intentions, by some states. First, it would inevitably add significant costs to banks that operate in many jurisdictions, since they would have to bear the costs and risks of complying with innumerable local laws—costs that would ultimately be reflected in the cost of credit. But even more of a concern is that such laws may actually have the effect of making credit harder to come by for those who may most need it and deserve it.

Evidence increasingly suggests this might already be happening. Fannie Mae recently announced that it would not purchase mortgage loans subject to the New York state and Georgia anti-predatory laws—a decision that will undoubtedly cause some contraction in credit availability to subprime borrowers.

Recent analysis by economists, one of whom has been on the OCC staff, of anti-predatory-lending laws in Chicago, Philadelphia, and North Carolina bears out this fear. In Chicago, a municipal law that applied primarily to banks had the effect of driving more subprime mortgage lending into the nonbank sector, which is precisely where predatory practices are most prevalent. And

a Philadelphia law that applied to *all* financial services providers had the effect of reducing the availability of subprime mortgage money generally. Similarly, it appears that the North Carolina law decreased the availability of subprime credit in the state.

Subprime credit is *not* the equivalent of predatory credit. Indeed, the growth of our subprime credit market has made legitimate credit available to families that may previously not have had access to credit. Thus, any law that causes responsible lenders to exit the subprime market must be viewed as problematic.

I think that the OCC has a better approach. Rather than focusing on the features of particular loan *products,* we focus on abusive *practices*—on preventing them in the first place, attacking them out where they're found to exist, and providing restitution to those who have been victimized by them.

Our emphasis on prevention has taken the form of comprehensive guidance—the only such guidance that's been produced by *any* of the federal banking agencies—instructing national banks on how to avoid engaging in abusive or predatory practices. Rigorous, ongoing supervision and oversight by OCC examiners is designed to make certain that this guidance is followed. But when it's not, we have not hesitated to use our enforcement authority to combat unsafe, unsound, unfair, or deceptive practices. Indeed, OCC enforcement actions have resulted in refunds totaling hundreds of millions of dollars to consumers.

I believe that the OCC's approach to predatory lending not only provides an effective remedy where abusive conduct has been found, but avoids the overbroad and unintended adverse effects of one-size-fits-all laws.

Quite apart from the question whether state and local laws threaten the unintended consequences of encouraging bank lenders to exit the subprime lending market, there is the question whether such laws can constitutionally apply to national banks. Since we presently have under consideration a request for a preemption determination with respect to the Georgia law, I will not discuss that issue directly. Suffice it to say that preemption is a doctrine with almost 200 years of history and constitutional precedent behind it. It is not an issue as to which we have a broad range of discretion.

Statement of John D. Hawke, Jr., Comptroller of the Currency, before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, on the proposed revisions to the 1988 Basel Capital Accord ("Basel I"), Washington, D.C., June 18, 2003, with attachment

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, 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). I welcome the efforts of the subcommittee to focus attention on these critical issues. The health of the U.S. commercial banking system is a critical element to a strong economy. Thus, it's essential that any regulatory changes that might affect the condition and competitiveness of our banking system be fully understood and carefully evaluated 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 applicable to internationally active commercial banks in all of the G–10 countries, and it 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.

By the late 1990s, it became evident 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 a meaningful measure of the risks faced by large, internationally active banks or the capital they should hold against those risks.

Consequently, 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 committee's first draft document, "Consultative Paper No. 1" (CP–1), was issued in June 1999. It laid the groundwork for the new capital adequacy framework (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 more detailed, CP–2 still left a number of key issues unaddressed and unresolved. The committee's most recent paper, "Consultative Paper No. 3" (CP–3), which I will discuss today, was issued on April 29 of this year.

As work on these consultative papers has progressed, the Basel Committee also has attempted to gauge the impact of its proposals on the required capital levels of banking institutions through a series of quantitative impact studies. In May, the committee published the results of the most recent assessment, the third quantitative impact study (QIS–3). While the committee concluded that the results were generally in line with the objectives of Basel II, the QIS–3 data still do not provide a sufficiently reliable estimate of the likely regulatory capital requirements for banks subject to Basel II. More work in this area is clearly warranted and I will discuss this later in my testimony.

The Basel Committee has outlined an aggressive timeline for the remaining actions leading to the adoption of Basel II. As a consequence, the U.S. banking agencies, the agencies responsible for the maintenance of capital adequacy standards for U.S. financial institutions, are faced with a daunting task. While we will work earnestly in this effort, the timeline should be seen as a means to an end, not an end in itself. As will be highlighted in my testimony, basic principles of safety and soundness demand that the banking agencies have a more complete understanding of the consequences of this proposal on the overall capital levels of affected institutions, the competitive effects on our financial system, and associated compliance costs and burdens before moving forward to finalize this proposal.

Our current primary focus in this effort is the development of U.S. implementing regulations and policies. As I will discuss later, the OCC and the other U.S. banking agencies will soon issue for comment proposed revisions to U.S. risk-based capital regulations to reflect the primary components of Basel II. 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 begin implementing a final Basel II framework until we have conducted whatever cost-benefit and impact analyses that are required, and 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. We made this point quite clearly to our Basel Committee colleagues before we agreed to go forward with CP–3. Indeed, many of them will also have to go through their own internal domestic processes before they can adopt the Basel II framework.

Current Basel Proposal

The Basel Committee deserves considerable credit for its articulation of Basel II in CP–3. The proposal is still exceedingly complex, but CP–3 is a clearer presentation of inherently difficult material than its predecessors. This is an important step, since regardless of the complexity of the proposal, it is important that the industry and other interested parties have a clear understanding of the proposed accord.

The attachment to this written statement provides a summary of the substantive provisions contained in CP–3. As before, this iteration of the proposed new accord has 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 tradeoff 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, Basel II 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 comply fully with these requirements. The importance of this rulemaking makes this comment process particularly critical to our success. Thus, we welcome this process as a means for positive contribution to this deliberative effort. We believe that the solicitation and assessment of comments is a critical step in determining the feasibility, effectiveness, and expected consequences of Basel II and related domestic capital regulations.

Next month, the U.S. banking agencies expect to jointly 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 will be largely based on CP–3 and will provide a description of proposed revisions to current capital regulations, while seeking comment on outstanding or contentious issues associated with the proposal. The ANPR will also request information on the cost of implementing the proposal, and will seek comment on the competitive implications in both domestic and international markets for banks of all sizes. In conjunction with the ANPR, the banking agencies will also issue for comment draft supervisory guidance articulating general supervisory expectations for banks seeking to implement Basel II–compliant methodologies for the advanced measurement approach (AMA) to operational risk and advanced IRB for corporate credits. Recognizing that CP–3 is a complex document, we understand the importance of providing U.S. banks an opportunity 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, the ANPR and draft guidance will provide a meaningful forum for a full discussion of Basel II.

After assessing comments generated during the ANPR process, the U.S. banking agencies will consider a complete cost analysis in accordance with applicable rulemaking requirements, including the standards of Executive Order 12866, discussed below, and will develop specific regulatory language for a joint Notice of Proposed Rulemaking (NPR). Again, the banking industry and other interested parties will have an opportunity to comment on this fully articulated proposal before any revisions to our capital regulations are finalized.

Let me now 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 United States expects to set forth in the ANPR proposed criteria for identifying which banks in the United States will be subject to the new accord. Despite language in the 1988 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, consistent with the focus of the Basel Capital Accord on banks that compete in the global market place, we will propose applying Basel II concepts 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 II–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 policies, 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 may 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. It is important to note that U.S. implementation actions do not contemplate changes to many fundamental aspects of our regulatory/supervisory process, including a focus on regular on-site supervision, our prompt corrective action rules, and our minimum leverage ratio for capital adequacy. As described more fully in the attachment, the U.S. agencies will propose for notice and comment a Basel II–based regime incorporating only the advanced IRB approach for credit risk, the AMA for operational risk, and the internal models approach for market risk.

We are also very cognizant that in connection with this, or any rulemaking, existing requirements may compel preparation of detailed analysis of the costs, benefits, and other effects of our regulations, depending on threshold determinations of whether the rulemaking in question triggers the substantive requirements of particular statutes or Executive Orders. Relevant requirements are set forth in the Regulatory Flexibility Act (RFA), the Unfunded Mandates Reform Act of 1995 (UMRA), and Executive Order 12866 (EO 12866). Issuance of the ANPR will help us identify and determine costs, benefits, and other effects of the proposed rulemaking, for purposes of complying with these requirements.

Timing

As I noted early on in my testimony, the Basel Committee timeline presents a daunting task to both the U.S. banking agencies and the banking industry. While it is clearly necessary to move forward in addressing the acknowledged deficiencies in the current Basel Capital Accord, the banking agencies must better understand the full range and scale of likely consequences before finalizing any proposal. The list provided below identifies the milestones the OCC must meet under the current Basel II timeline. Each step is critical in a prudential consideration of Basel II in the United States:

- *Consideration of comments received by the Basel Committee on CP–3.* The comment period on this document concludes on July 31.
- *Finalization, issuance, and consideration of comments on the U.S. ANPR.* Based on current estimates, the notice and comment period will run from July to October.
- *Finalization, issuance, and consideration of comments on supervisory guidance on corporate IRB and AMA methodologies.* Based on current estimates, the notice and comment period will run from July to October.

- *Development, issuance, and consideration of comments on supervisory guidance on other substantive aspects of Basel II–based regulations, especially including retail IRB.* Based on current estimates, the agencies hope to commence solicitation of comment on this guidance by year-end 2003.

- *Participation in the Basel Committee's consideration of Basel II.* Under the current timeline, the committee is to consider approval of Basel II in December of this year.

- *Development, issuance, and analysis of results of additional agency efforts to evaluate the prospective effects of Basel II implementation.* EO 12866 may compel the OCC and OTS to undertake such analysis prior to the issuance of a Notice of Proposed Rulemaking (NPR). Even without regard to this requirement, however, it is essential that we have a reliable estimate of the impact of Basel II on the capital and competitive position of U.S. banks.

- *Development, issuance, and consideration of comments on the U.S. NPR.* This document would only be issued after the Basel Committee finalizes its consideration of Basel II. If the existing timeline is maintained, solicitation of comment on the NPR would commence no earlier that the first quarter of 2004.

- *Development and issuance of a U.S. final rule and supervisory guidance.* Again, assuming the present timeline is maintained, our best estimate for the issue date of a final rule implementing Basel II is the third or fourth quarter of 2004.

- *Completion of all necessary supervision-related steps to implement Basel II–based regulations in advance of the presently proposed December 2006 effective date.* Most significantly, the agencies need to determine whether each bank subject to Basel II–based regulations has appropriate systems and procedures in place to qualify for using the A–IRB and AMA.

Status of Basel Proposal—Outstanding Issues

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 former chairman, William McDonough. The OCC firmly supports the objectives of Basel II. These objectives 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. Nonetheless, much of that conceptual basis has not been tested in practice in any manner approaching the magnitude of Basel II. We continue to be concerned about the potential for unintended or unanticipated consequences of the Basel II proposals.

Implementation Challenges

At its foundation, the Basel II proposals permit qualifying institutions to calculate their minimum risk-based capital requirements by reference to their own internal systems and methodologies.

While it is the hallmark of Basel II, a greater alignment of internal risk assessment with minimum regulatory capital derived through internal models represents a radical departure from our existing regulatory capital framework. As we will highlight in the ANPR and accompanying guidance, this reliance on internal risk assessment systems mandates changes in the way we structure our capital regulations and, in certain important respects, how we conduct our supervisory activities. The fundamental question for the banking agencies in assessing Basel II is the issue the OCC has previously identified—whether the regime will work in practice, as well as theory, as the basis for a regulatory capital regime.

For bank supervisors and other external stakeholders to be in a position to rely on a bank's internal process in the establishment of regulatory capital requirements, there must be a high degree of confidence that regulators can establish and enforce appropriate risk measurement and management standards consistently across the banks subject to a Basel II–based regime. The challenge for supervisors is to create a verifiably accurate system that appropriately balances the need for flexibility, to promote continued improvement in risk management practices, with the need for objective standards, to ensure consistency in application across institutions and supervisors, both foreign and domestic.

The capital rule we implement must respect the evolutionary nature of risk management. As regulators, we must acknowledge that we are still in the relatively early days of model-based credit and operational risk measurement and management, and we must recognize the inevitability of further innovation and improvements in this area. This respect for the evolutionary nature of this discipline must then be reconciled with the need for objective standards to ensure consistency in application. Much of the detail and complexity within Basel II derives from the need to establish more objective expectations for bank rating systems, control mechanisms, audit processes, data systems, and other internal determinations of risk by individual banks. In many cases, this has led to the establishment of supervisory standards in areas previously left to management discretion or supervisory judgment.

Not surprisingly, the regulatory community has struggled with the establishment of these standards. Failing to achieve the proper balance for these often conflicting objectives while moving forward with the radically different Basel II–based regime can have dramatic consequences. If our regulation and supervisory process is overly flexible, bank internal calculations of capital adequacy may prove insufficient, non-comparable, or both. If we err on the other extreme, we establish an excessively prescriptive supervisory regime that stifles innovation, imposes undue regulatory burden, and inappropriately narrows the role of judgment.

This need to carefully balance dramatically opposed objectives, together with the significant uncertainties that still exist about the practical feasibility of these proposed changes to the Capital Accord, raise doubts about the achievability of the time frame established by the Basel Committee.

Competitive Equality

A stated goal of the Basel Committee in developing Basel II was that "the Accord should continue to enhance competitive equality." Realistically, we are not yet in a position to assess definitively the full range of consequences from the implementation of Basel II, including its effect on competitive equality in the global financial marketplace. There are risks 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, the very complexity of the rules themselves calls this objective into question. 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 such 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 assessing 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 years, or may put heavy reliance on the oversight of outside auditors.[1]

It's fair to ask, I think, in which type of supervisory regime detailed, prescriptive capital rules are more likely to be robustly and reliably 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?

Another principle source of competition for many banks 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 exacer-

[1] See Daniel E. Nolle, "Bank Supervision in the U.S. and the G–10: Implications for Basel II," *RMA Journal,* June 2003.

bate the current differences. These concerns have been mainly focused on the effects on competition from the application of the operational risk proposal and the enhanced disclosures required under Pillar 3.

Finally, 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.[2] Industry comments were overwhelmingly 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, and it is one of the areas on which we will seek guidance in our ANPR. There are several concerns in this regard. First, banks using a Basel II–based regime may have a lower minimum capital requirement, allowing those banks to grow and compete more aggressively with smaller banks for both assets and liabilities. To be sure, banks subject to the new Basel II requirements will incur very significant systems and compliance costs in preparing for the new regime. These concerns are discussed in more detail in the "Calibration" section below. Moreover, banks using a Basel II–based regime may have significantly higher or lower marginal regulatory capital charges than non-Basel banks for some types of loan products, resulting in potential pricing differentials. While Basel II might enable larger banks to compete more effectively for high-quality credits, it could also result in larger concentrations of lower quality credits in smaller institutions. Finally, the potential implications on industry consolidation are simply not known. 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 seriously concerned if, as an unintended consequence of the implementation of Basel II, we significantly alter the structure of banking in the United States.

Calibration

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

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

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.

In order to gauge its success in meeting that objective, the Basel Committee attempted to measure the impact of its proposals on the required capital levels of banking institutions through several quantitative impact studies. On May 5, 2003, the committee published an overview of the results of its most recent assessment, the third quantitative impact study (QIS–3). On the basis of QIS–3 results, the committee concluded that the aggregate results were generally in line with the objectives established for Basel II.

Unfortunately, the QIS–3 data do not provide a reliable estimate of the likely regulatory capital requirements for banks subject to Basel II. Banks encountered several practical impediments to providing accurate estimates of the effect of the proposals on their measured ratios; thus, the estimated risk-based capital ratios were subject to a substantial margin of error. For example, in many cases, existing bank systems were not able to produce the data requirements necessary for inputs required by the new accord. In some areas, the QIS–3 instructions were not sufficiently clear or were misinterpreted, and in other cases, the proposals were still in flux as banks were completing the survey. Most important, QIS–3 was completed without the rigorous supervisory validation and oversight that would occur when the proposal actually takes effect.

A key concern is that focusing on the overall results of the QIS–3 exercise masks the wide dispersion of results for individual institutions. In the United States, measured against current risk-weighted assets, the use of advanced approaches yielded results that ranged from a decrease in regulatory capital requirements of 36 percent to an increase of 43 percent. Similarly broad dispersions are found in a great many of the underlying components that make up the total capital requirement. While some dispersion of results in a truly more risk-sensitive framework would be expected, we are not convinced that the wide ranges indicated by QIS–3 can be explained by relative differences in risk among institutions; it appears that comparability of QIS–3 results among different institutions may be severely lacking.

Finally, the quantitative studies that have been done to date have been based on unilateral inputs from the participating banks. We and other supervisors have had only very limited ability to review the veracity of the results. I want to be clear that we have no reason to believe that U.S. banks did not make every effort to provide results as accurate as possible given the constraints they were operating under. Nonetheless, it is certainly conceivable—I would say highly likely—that the results might change significantly, and not necessarily in any particular direction, when all the intricacies of real-world implementation come into play. It seems fair to assume that banks will have fewer incentives to take conservative stances and greater incentives to exploit any loopholes or gray areas in the final rules; the extent to which these effects might be offset (or exceeded by) greater supervisory oversight is unknown.

Notwithstanding the significant uncertainties noted above, it presently appears that the required capital levels of some U.S. institutions could drop significantly, even taking into account the temporary minimum floor capital requirements, discussed in the attachment. The OCC does not believe that some 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. Given the fact that relevant bank systems and procedures are still in development, the OCC is not yet in a position to make that determination as it relates to Basel II. As such, 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.

The OCC expects that an additional quantitative study will be necessary after the Basel Committee's work on Basel II is completed. Ideally, this should take the form of another global study by the Basel Committee itself—*i.e.,* a QIS–4. However, even if the Basel Committee does not undertake such a study, I believe that it is absolutely essential that the U.S. agencies do so prior to the adoption of final implementing regulations. I strongly believe that we cannot responsibly adopt final rules implementing Basel II until we have not only determined with a high degree of reliability what the impact will be on the capital of our banks, but we have made the judgment that the impact is acceptable and conducive to the maintenance of a safe and sound banking system in the United States.

Conclusion

As I have indicated, the OCC firmly supports the objectives of Basel II—a more risk-sensitive and accurate capital regime. However, in light of the issues that been identified with the current iteration of Basel II, the U.S. banking agencies must now determine how best to proceed on this critically important issue. I believe the following are essential elements in the agencies' consideration of Basel II implementation within the United States.

First, the agencies need to move forward with the solicitation of comments on a Basel II–related ANPR and associated guidance. That is the most effective mechanism to a have full and complete consideration of the proposal from all interested parties. The solicitation of comments on a proposed regulatory and supervisory structure for Basel II implementation will also permit supervisors to tangibly assess the feasibility of the proposal.

Second, the agencies need to undertake additional steps to evaluate the costs, benefits, and other effects of the proposal before moving forward with any final regulatory action. Frankly, we simply need additional information to reasonably address the numerous issues, concerns, and uncertainties associated with Basel II implementation. We must better understand the likely consequences of this proposal on overall capital levels of affected institutions, the competitive effects on our financial system, and associated compliance costs and burdens. In determining the appropriate additional steps, the agencies should consider the obligations imposed under EO 12866, the

other statutory requirements for consideration of costs and impact, lessons learned from QIS–3, and perhaps, a U.S. version of QIS–4.

Third, as I have consistently reiterated, if we determine through this process that changes to the Basel II proposal are necessary, the U.S. agencies must pursue those changes, both domestically and in the Basel Committee. In this regard, the U.S. agencies should not foreclose consideration of alternative proposals that address the acknowledged deficiencies of the 1988 Accord but that do not constitute such a radical departure from our existing regulatory capital framework.

Fourth, the overarching consideration for supervisors in moving forward on Basel II is the need to act in accordance with our primary mission—to ensure the continued maintenance of a robust and safe and sound banking system. We need to "incent" banks to continue to better measure and manage the full panoply of risks they face and to make use of new and evolving risk management practices. We must also ensure that prudential consideration of safety and soundness principles remain paramount.

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 implementation of a final Basel II framework until we have fully considered all comments received during our notice and comment process. 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 (the committee) has been developing the new accord over the past five years. During that time, three full-scale consultative papers (June 1999, January 2001, and April 2003) 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 New Basel Capital Accord (Consultative Document), which is out for comment until July 31; the document can be found on the 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 in to 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.

The current structure of the accord has been influenced by the results of several quantitative impact studies (QIS), the most recent of which was completed in December 2002. Approximately 20 U.S. banks participated in the QIS exercise in December and the results have been factored into the most recent version of the accord. Changes were made in several areas including the treatment of retail credits, specialized lending, securitization, and operational risk.

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 bank's portfolio, such as improving 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 tradeoff for greater reliance on a bank's own assessment of capital adequacy is greater transparency. This pillar has been subject to numerous changes as the committee has worked to balance the need for robust disclosure with a recognition of the proprietary and confidential nature of some of the information.

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 35 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 introducing more risk-sensitive regulatory capital requirements, particularly for large, complex banking organizations.

Banks must meet an extensive set of 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 PD of a borrower; the bank is required to provide the PD in both the foundation and the advanced approaches. The second input 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 (including commercial real estate), 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 exposures.

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 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. 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 most of the credit risk mitigation proposals in the new accord are 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. In addition, specific proposals related to maturity mismatches and backtesting requirements of certain model results are applicable to the advanced IRB approach. Otherwise, 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 collateral. 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 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 adopt the IRB approach for credit risk are generally 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: 1) the IRB capital charge on the underlying securitized exposures (as if held directly on the bank's balance sheet); 2) the tranche's credit enhancement level and 3) thickness; 4) the pool's effective number of loans; and 5) the pool's exposure-weighted average loss given default (LGD). 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 potential impact on the industry is still being assessed. In the December 2002 QIS exercise, banks were asked for the

first time to provide data on the relative impact of the proposals. The QIS results did not provide entirely reliable results. However, the committee has responded to some of the concerns raised during the QIS process by making changes to the securitization framework. One key change was the introduction of a simpler approach for liquidity facilities.

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. This includes legal risk, but excludes strategic and reputational risks.

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. The committee has introduced an Alternative Standardized Approach to address some of the concerns raised by the results of the December 2002 QIS exercise; this is not a separate approach, but rather a modification to the Standardized Approach. 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 (including the Alternative 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, and consideration of business environment and internal control 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 act as an effective capital-replacement tool.

Temporary Capital Floors

Two floors have been established for the Basel II framework. In the first year of implementation, an institution's required minimum level of regulatory risk-based capital cannot be less than 90 percent of the minimum level of capital that would be required under the agencies' general risk-based capital rules. In the following year, an institution's minimum level of regulatory risk-based capital cannot be less than 80 percent of the minimum amount required under the agencies' general risk-based capital rules.

Statement of John D. Hawke, Jr., Comptroller of the Currency, before the Subcommittee on Financial Institutions and Consumer Credit, of the U.S. House of Representatives Committee on Financial Services, on the proposed revisions to the 1988 Basel Capital Accord ("Basel I"), Washington, D.C., June 19, 2003, with attachment

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, Congressman Sanders, 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). I welcome the efforts of the subcommittee to focus attention on these critical issues. The health of the U.S. commercial banking system is a critical element to a strong economy. Thus, it's essential that any regulatory changes that might affect the condition and competitiveness of our banking system be fully understood and carefully evaluated 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 applicable to internationally active commercial banks in all of the G–10 countries, and it 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.

By the late 1990s, it became evident 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 a meaningful measure of the risks faced by large, internationally active banks or the capital they should hold against those risks.

Consequently, 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 committee's first draft document, "Consultative Paper No. 1" (CP–1), was issued in June 1999. It laid the groundwork for the new capital adequacy framework (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 more detailed, CP–2 still left a number of key issues unaddressed and unresolved. The committee's most recent paper, "Consultative Paper No. 3" (CP–3), which I will discuss today, was issued on April 29 of this year.

As work on these consultative papers has progressed, the Basel Committee also has attempted to gauge the impact of its proposals on the required capital levels of banking institutions through a series of quantitative impact studies. In May, the committee published the results of the most recent assessment, the third quantitative impact study (QIS–3). While the committee concluded that the results were generally in line with the objectives of Basel II, the QIS–3 data still do not provide a sufficiently reliable estimate of the likely regulatory capital requirements for banks subject to Basel II. More work in this area is clearly warranted and I will discuss this later in my testimony.

The Basel Committee has outlined an aggressive timeline for the remaining actions leading to the adoption of Basel II. As a consequence, the U.S. banking agencies, the agencies responsible for the maintenance of capital adequacy standards for U.S. financial institutions, are faced with a daunting task. While we will work earnestly in this effort, the timeline should be seen as a means to an end, not an end in itself. As will be highlighted in my testimony, basic principles of safety and soundness demand that the banking agencies have a more complete understanding of the consequences of this proposal on the overall capital levels of affected institutions, the competitive effects on our financial system, and associated compliance costs and burdens before moving forward to finalize this proposal.

Our current primary focus in this effort is the development of U.S. implementing regulations and policies. As I will discuss later, the OCC and the other U.S. banking agencies will soon issue for comment proposed revisions to U.S. risk-based capital regulations to reflect the primary components of Basel II. 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 begin implementing a final Basel II framework until we have conducted whatever cost-benefit and impact analyses that are required, and 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. We made this point quite clearly to our Basel Committee colleagues before we agreed to go forward with CP–3. Indeed, many of them will also have to go through their own internal domestic processes before they can adopt the Basel II framework.

Current Basel Proposal

The Basel Committee deserves considerable credit for its articulation of Basel II in CP–3. The proposal is still exceedingly complex, but CP–3 is a clearer presentation of inherently difficult material than its predecessors. This is an important step, since regardless of the complexity of the proposal, it is important that the industry and other interested parties have a clear understanding of the proposed accord.

The attachment to this written statement provides a summary of the substantive provisions contained in CP–3. As before, this iteration of the proposed new accord has 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 tradeoff 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, Basel II 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 comply fully with these requirements. The importance of this rulemaking makes this comment process particularly critical to our success. Thus, we welcome this process as a means for positive contribution to this deliberative effort. We believe that the solicitation and assessment of comments is a critical step in determining the feasibility, effectiveness, and expected consequences of Basel II and related domestic capital regulations.

Next month, the U.S. banking agencies expect to jointly 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 will be largely based on CP–3 and will provide a description of proposed revisions to current capital regulations, while seeking comment on outstanding or contentious issues associated with the proposal. The ANPR will also request information on the cost of implementing the proposal, and will seek comment on the competitive implications in both domestic and international markets for banks of all sizes. In conjunction with the ANPR, the banking agencies will also issue for comment draft supervisory guidance articulating general supervisory expectations for banks seeking to implement Basel II–compliant methodologies for the advanced measurement approach (AMA) to operational risk and advanced IRB for corporate credits. Recognizing that CP–3 is a complex document, we understand the importance of providing U.S. banks an opportunity 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, the ANPR and draft guidance will provide a meaningful forum for a full discussion of Basel II.

After assessing comments generated during the ANPR process, the U.S. banking agencies will consider a complete cost analysis in accordance with applicable rulemaking requirements, including the standards of Executive Order 12866, discussed below, and will develop specific regulatory language for a joint Notice of Proposed Rulemaking (NPR). Again, the banking industry and other interested parties will have an opportunity to comment on this fully articulated proposal before any revisions to our capital regulations are finalized.

Let me now 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 United States expects to set forth in the ANPR proposed criteria for identifying which banks in the United States will be subject to the new accord. Despite language in the 1988 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, consistent with the focus of the Basel Capital Accord on banks that compete in the global market place, we will propose applying Basel II concepts 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 II–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 policies, 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 may 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. It is important to note that U.S. implementation actions do not contemplate changes to many fundamental aspects of our regulatory/supervisory process, including a focus on regular on-site supervision, our prompt corrective action rules, and our minimum leverage ratio for capital adequacy. As described more fully in the attachment, the U.S. agencies will propose for notice and comment a Basel II–based regime incorporating only the advanced IRB approach for credit risk, the AMA for operational risk, and the internal models approach for market risk.

We are also very cognizant that in connection with this, or any rulemaking, existing requirements may compel preparation of detailed analysis of the costs, benefits, and other effects of our regulations, depending on threshold determinations of whether the rulemaking in question triggers the substantive requirements of particular statutes or Executive Orders. Relevant requirements are set forth in the Regulatory Flexibility Act (RFA), the Unfunded Mandates Reform Act of 1995 (UMRA), and Executive Order 12866 (EO 12866). Issuance of the ANPR will help us identify and determine costs, benefits, and other effects of the proposed rulemaking, for purposes of complying with these requirements.

Timing

As I noted early on in my testimony, the Basel Committee timeline presents a daunting task to both the U.S. banking agencies and the banking industry. While it is clearly necessary to move forward in addressing the acknowledged deficiencies in the current Basel Capital Accord, the banking agencies must better understand the full range and scale of likely consequences before finalizing any proposal. The list provided below identifies the milestones the OCC must meet under the current Basel II timeline. Each step is critical in a prudential consideration of Basel II in the United States:

- *Consideration of comments received by the Basel Committee on CP–3.* The comment period on this document concludes on July 31.
- *Finalization, issuance, and consideration of comments on the U.S. ANPR.* Based on current estimates, the notice and comment period will run from July to October.
- *Finalization, issuance, and consideration of comments on supervisory guidance on corporate IRB and AMA methodologies.* Based on current estimates, the notice and comment period will run from July to October.

- *Development, issuance, and consideration of comments on supervisory guidance on other substantive aspects of Basel II–based regulations, especially including retail IRB.* Based on current estimates, the agencies hope to commence solicitation of comment on this guidance by year-end 2003.

- *Participation in the Basel Committee's consideration of Basel II.* Under the current timeline, the committee is to consider approval of Basel II in December of this year.

- *Development, issuance, and analysis of results of additional agency efforts to evaluate the prospective effects of Basel II implementation.* EO 12866 may compel the OCC and OTS to undertake such analysis prior to the issuance of a Notice of Proposed Rulemaking (NPR). Even without regard to this requirement, however, it is essential that we have a reliable estimate of the impact of Basel II on the capital and competitive position of U.S. banks.

- *Development, issuance, and consideration of comments on the U.S. NPR.* This document would only be issued after the Basel Committee finalizes its consideration of Basel II. If the existing timeline is maintained, solicitation of comment on the NPR would commence no earlier that the first quarter of 2004.

- *Development and issuance of a U.S. final rule and supervisory guidance.* Again, assuming the present timeline is maintained, our best estimate for the issue date of a final rule implementing Basel II is the third or fourth quarter of 2004.

- *Completion of all necessary supervision-related steps to implement Basel II–based regulations in advance of the presently proposed December 2006 effective date.* Most significantly, the agencies need to determine whether each bank subject to Basel II–based regulations has appropriate systems and procedures in place to qualify for using the A–IRB and AMA.

H.R. 2043

Mr. Chairman, you and some of your colleagues have introduced H.R. 2043, a bill that would establish an interagency committee, the United States Financial Policy Committee (USFPC). The USFPC would be chaired by the Secretary of the Treasury, and its other members would be the Comptroller of the Currency, and the chairmen of the Federal Reserve Board and the FDIC. Broadly speaking, the purpose of this committee would be to develop uniform U.S. positions on issues before the Basel Committee and require the banking agencies, in consultation with the Secretary of the Treasury, to evaluate the impact of the proposed accord, taking into account certain specific factors, including the costs associated with implementation of the accord and its competitive effects. In cases where a uniform position could not be reached, the position of the Secretary of the Treasury would be determinative.

Mr. Chairman, we understand—and we share—your desire to make sure that the banking agencies adopt a uniform approach and that the impact of Basel II is well understood before it is

adopted. However, we do not believe legislation is needed to compel that result. As I have already discussed, the next key step in the United States is the rulemaking process. That process is subject to requirements, including those contained in the statutes and the executive order that I mentioned earlier, that we believe will address the key concerns underlying the proposed legislation.

In this regard it is important to note that the rulemaking process is already an interagency process involving all the banking agencies in joint rulemaking. While we have not all agreed on every issue, the interagency approach has been very collaborative, and I am confident we will be able to work out any remaining differences in pursuit of our mutual objective.

As noted earlier, we are under an obligation to consider the costs and competitive effects of proposals like Basel II. This evaluation of the impact of Basel II involves factors similar to that proposed under H.R. 2043. Specifically, EO 12866 requires the OCC and OTS to provide specific information to OMB's Office of Information and Regulatory Affairs (OIRA), including an assessment of the costs and benefits of the regulatory action, if the agency or OIRA determines that a proposed regulation is a "significant regulatory action." A "significant regulatory action" is defined to include a rule that may have an annual effect on the economy of $100 million or more, or have a material adverse effect on the economy, a sector of the economy, productivity, jobs, or several other factors. The RFA [Regulatory Flexibility Act] requires an agency to consider whether a rule will have a "significant economic impact" on a "substantial number" of small businesses, including, of course, small banks. The UMRA [Unfunded Mandates Reform Act of 1995] requires an agency to prepare a written statement if a proposed or final rule includes a "federal mandate," that is, a federally imposed requirement that may, among other things, result in private sector expenditures for compliance of $100 million or more in any one year. If a written statement is required under the UMRA, it would include a qualitative and quantitative assessment of the anticipated costs and benefits of the federal mandate and, to the extent feasible, estimates of its effect on the international competitiveness of U.S. goods and services.

Status of Basel Proposal—Outstanding Issues

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 former chairman, William McDonough. The OCC firmly supports the objectives of Basel II. These objectives 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. Nonetheless, much of that conceptual basis has not been tested in practice in any manner approaching the magnitude of Basel II. We continue to be concerned about the potential for unintended or unanticipated consequences of the Basel II proposals.

Implementation Challenges

At its foundation, the Basel II proposals permit qualifying institutions to calculate their minimum risk-based capital requirements by reference to their own internal systems and methodologies.

While it is the hallmark of Basel II, a greater alignment of internal risk assessment with minimum regulatory capital derived through internal models represents a radical departure from our existing regulatory capital framework. As we will highlight in the ANPR and accompanying guidance, this reliance on internal risk assessment systems mandates changes in the way we structure our capital regulations and, in certain important respects, how we conduct our supervisory activities. The fundamental question for the banking agencies in assessing Basel II is the issue the OCC has previously identified—whether the regime will work in practice, as well as theory, as the basis for a regulatory capital regime.

For bank supervisors and other external stakeholders to be in a position to rely on a bank's internal process in the establishment of regulatory capital requirements, there must be a high degree of confidence that regulators can establish and enforce appropriate risk measurement and management standards consistently across the banks subject to a Basel II–based regime. The challenge for supervisors is to create a verifiably accurate system that appropriately balances the need for flexibility, to promote continued improvement in risk management practices, with the need for objective standards, to ensure consistency in application across institutions and supervisors, both foreign and domestic.

The capital rule we implement must respect the evolutionary nature of risk management. As regulators, we must acknowledge that we are still in the relatively early days of model-based credit and operational risk measurement and management, and we must recognize the inevitability of further innovation and improvements in this area. This respect for the evolutionary nature of this discipline must then be reconciled with the need for objective standards to ensure consistency in application. Much of the detail and complexity within Basel II derives from the need to establish more objective expectations for bank rating systems, control mechanisms, audit processes, data systems, and other internal determinations of risk by individual banks. In many cases, this has led to the establishment of supervisory standards in areas previously left to management discretion or supervisory judgment.

Not surprisingly, the regulatory community has struggled with the establishment of these standards. Failing to achieve the proper balance for these often conflicting objectives while moving forward with the radically different Basel II–based regime can have dramatic consequences. If our regulation and supervisory process is overly flexible, bank internal calculations of capital adequacy may prove insufficient, non-comparable, or both. If we err on the other extreme, we establish an excessively prescriptive supervisory regime that stifles innovation, imposes undue regulatory burden, and inappropriately narrows the role of judgment.

This need to carefully balance dramatically opposed objectives, together with the significant uncertainties that still exist about the practical feasibility of these proposed changes to the Capital Accord, raise doubts about the achievability of the time frame established by the Basel Committee.

Competitive Equality

A stated goal of the Basel Committee in developing Basel II was that "the Accord should continue to enhance competitive equality." Realistically, we are not yet in a position to assess definitively the full range of consequences from the implementation of Basel II, including its effect on competitive equality in the global financial marketplace. There are risks 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, the very complexity of the rules themselves calls this objective into question. 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 such 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 assessing 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 years, or may put heavy reliance on the oversight of outside auditors.[1]

It's fair to ask, I think, in which type of supervisory regime detailed, prescriptive capital rules are more likely to be robustly and reliably 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?

Another principle source of competition for many banks 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 exacer-

[1] See Daniel E. Nolle, "Bank Supervision in the U.S. and the G–10: Implications for Basel II," *RMA Journal,* June 2003.

bate the current differences. These concerns have been mainly focused on the effects on competition from the application of the operational risk proposal and the enhanced disclosures required under Pillar 3.

Finally, 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.[2] Industry comments were overwhelmingly 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, and it is one of the areas on which we will seek guidance in our ANPR. There are several concerns in this regard. First, banks using a Basel II–based regime may have a lower minimum capital requirement, allowing those banks to grow and compete more aggressively with smaller banks for both assets and liabilities. To be sure, banks subject to the new Basel II requirements will incur very significant systems and compliance costs in preparing for the new regime. These concerns are discussed in more detail in the "Calibration" section below. Moreover, banks using a Basel II–based regime may have significantly higher or lower marginal regulatory capital charges than non-Basel banks for some types of loan products, resulting in potential pricing differentials. While Basel II might enable larger banks to compete more effectively for high-quality credits, it could also result in larger concentrations of lower quality credits in smaller institutions. Finally, the potential implications on industry consolidation are simply not known. 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 seriously concerned if, as an unintended consequence of the implementation of Basel II, we significantly alter the structure of banking in the United States.

Calibration

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

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

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.

In order to gauge its success in meeting that objective, the Basel Committee attempted to measure the impact of its proposals on the required capital levels of banking institutions through several quantitative impact studies. On May 5, 2003, the committee published an overview of the results of its most recent assessment, the third quantitative impact study (QIS–3). On the basis of QIS–3 results, the committee concluded that the aggregate results were generally in line with the objectives established for Basel II.

Unfortunately, the QIS–3 data do not provide a reliable estimate of the likely regulatory capital requirements for banks subject to Basel II. Banks encountered several practical impediments to providing accurate estimates of the effect of the proposals on their measured ratios; thus, the estimated risk-based capital ratios were subject to a substantial margin of error. For example, in many cases, existing bank systems were not able to produce the data requirements necessary for inputs required by the new accord. In some areas, the QIS–3 instructions were not sufficiently clear or were misinterpreted, and in other cases, the proposals were still in flux as banks were completing the survey. Most important, QIS–3 was completed without the rigorous supervisory validation and oversight that would occur when the proposal actually takes effect.

A key concern is that focusing on the overall results of the QIS–3 exercise masks the wide dispersion of results for individual institutions. In the United States, measured against current risk-weighted assets, the use of advanced approaches yielded results that ranged from a decrease in regulatory capital requirements of 36 percent to an increase of 43 percent. Similarly broad dispersions are found in a great many of the underlying components that make up the total capital requirement. While some dispersion of results in a truly more risk-sensitive framework would be expected, we are not convinced that the wide ranges indicated by QIS–3 can be explained by relative differences in risk among institutions; it appears that comparability of QIS–3 results among different institutions may be severely lacking.

Finally, the quantitative studies that have been done to date have been based on unilateral inputs from the participating banks. We and other supervisors have had only very limited ability to review the veracity of the results. I want to be clear that we have no reason to believe that U.S. banks did not make every effort to provide results as accurate as possible given the constraints they were operating under. Nonetheless, it is certainly conceivable—I would say highly likely—that the results might change significantly, and not necessarily in any particular direction, when all the intricacies of real-world implementation come into play. It seems fair to assume that banks will have fewer incentives to take conservative stances and greater incentives to exploit any loopholes or gray areas in the final rules; the extent to which these effects might be offset (or exceeded by) greater supervisory oversight is unknown.

Notwithstanding the significant uncertainties noted above, it presently appears that the required capital levels of some U.S. institutions could drop significantly, even taking into account the temporary minimum floor capital requirements, discussed in the attachment. The OCC does not believe that some 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. Given the fact that relevant bank systems and procedures are still in development, the OCC is not yet in a position to make that determination as it relates to Basel II. As such, 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.

The OCC expects that an additional quantitative study will be necessary after the Basel Committee's work on Basel II is completed. Ideally, this should take the form of another global study by the Basel Committee itself—*i.e.,* a QIS–4. However, even if the Basel Committee does not undertake such a study, I believe that it is absolutely essential that the U.S. agencies do so prior to the adoption of final implementing regulations. I strongly believe that we cannot responsibly adopt final rules implementing Basel II until we have not only determined with a high degree of reliability what the impact will be on the capital of our banks, but we have made the judgment that the impact is acceptable and conducive to the maintenance of a safe and sound banking system in the United States.

Conclusion

As I have indicated, the OCC firmly supports the objectives of Basel II—a more risk-sensitive and accurate capital regime. However, in light of the issues that been identified with the current iteration of Basel II, the U.S. banking agencies must now determine how best to proceed on this critically important issue. I believe the following are essential elements in the agencies' consideration of Basel II implementation within the United States.

First, the agencies need to move forward with the solicitation of comments on a Basel II–related ANPR and associated guidance. That is the most effective mechanism to a have full and complete consideration of the proposal from all interested parties. The solicitation of comments on a proposed regulatory and supervisory structure for Basel II implementation will also permit supervisors to tangibly assess the feasibility of the proposal.

Second, the agencies need to undertake additional steps to evaluate the costs, benefits, and other effects of the proposal before moving forward with any final regulatory action. Frankly, we simply need additional information to reasonably address the numerous issues, concerns, and uncertainties associated with Basel II implementation. We must better understand the likely consequences of this proposal on overall capital levels of affected institutions, the competitive effects on our financial system, and associated compliance costs and burdens. In determining the appropriate additional steps, the agencies should consider the obligations imposed under EO 12866, the

other statutory requirements for consideration of costs and impact, lessons learned from QIS–3, and perhaps, a U.S. version of QIS–4.

Third, as I have consistently reiterated, if we determine through this process that changes to the Basel II proposal are necessary, the U.S. agencies must pursue those changes, both domestically and in the Basel Committee. In this regard, the U.S. agencies should not foreclose consideration of alternative proposals that address the acknowledged deficiencies of the 1988 Accord but that do not constitute such a radical departure from our existing regulatory capital framework.

Fourth, the overarching consideration for supervisors in moving forward on Basel II is the need to act in accordance with our primary mission—to ensure the continued maintenance of a robust and safe and sound banking system. We need to "incent" banks to continue to better measure and manage the full panoply of risks they face and to make use of new and evolving risk management practices. We must also ensure that prudential consideration of safety and soundness principles remain paramount.

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 implementation of a final Basel II framework until we have fully considered all comments received during our notice and comment process. 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 (the committee) has been developing the new accord over the past five years. During that time, three full-scale consultative papers (June 1999, January 2001, and April 2003) 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 New Basel Capital Accord (Consultative Document), which is out for comment until July 31; the document can be found on the 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 in to 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.

The current structure of the accord has been influenced by the results of several quantitative impact studies (QIS), the most recent of which was completed in December 2002. Approximately 20 U.S. banks participated in the QIS exercise in December and the results have been factored into the most recent version of the accord. Changes were made in several areas including the treatment of retail credits, specialized lending, securitization, and operational risk.

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 bank's portfolio, such as improving 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 tradeoff for greater reliance on a bank's own assessment of capital adequacy is greater transparency. This pillar has been subject to numerous changes as the committee has worked to balance the need for robust disclosure with a recognition of the proprietary and confidential nature of some of the information.

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 35 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 introducing more risk-sensitive regulatory capital requirements, particularly for large, complex banking organizations.

Banks must meet an extensive set of 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 PD of a borrower; the bank is required to provide the PD in both the foundation and the advanced approaches. The second input 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 (including commercial real estate), 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 exposures.

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 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. 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 most of the credit risk mitigation proposals in the new accord are 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. In addition, specific proposals related to maturity mismatches and backtesting requirements of certain model results are applicable to the advanced IRB approach. Otherwise, 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 collateral. 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 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 adopt the IRB approach for credit risk are generally 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: 1) the IRB capital charge on the underlying securitized exposures (as if held directly on the bank's balance sheet); 2) the tranche's credit enhancement level and 3) thickness; 4) the pool's effective number of loans; and 5) the pool's exposure-weighted average loss given default (LGD). 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 potential impact on the industry is still being assessed. In the December 2002 QIS exercise, banks were asked for the

first time to provide data on the relative impact of the proposals. The QIS results did not provide entirely reliable results. However, the committee has responded to some of the concerns raised during the QIS process by making changes to the securitization framework. One key change was the introduction of a simpler approach for liquidity facilities.

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. This includes legal risk, but excludes strategic and reputational risks.

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. The committee has introduced an Alternative Standardized Approach to address some of the concerns raised by the results of the December 2002 QIS exercise; this is not a separate approach, but rather a modification to the Standardized Approach. 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 (including the Alternative 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, and consideration of business environment and internal control 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 act as an effective capital-replacement tool.

Temporary Capital Floors

Two floors have been established for the Basel II framework. In the first year of implementation, an institution's required minimum level of regulatory risk-based capital cannot be less than 90 percent of the minimum level of capital that would be required under the agencies' general risk-based capital rules. In the following year, an institution's minimum level of regulatory risk-based capital cannot be less than 80 percent of the minimum amount required under the agencies' general risk-based capital rules.

Remarks by Julie L. Williams, First Senior Deputy Comptroller and Chief Counsel, before the OCC Alumni Association, on an historical perspective on current issues facing the national banking system, Washington, D.C., May 14, 2003

It is remarkable how many of the significant issues facing the OCC and national banks today have their roots—and their answers—in fundamental characteristics of the national bank charter and the original design of the national banking system. So, I thought, what could be a better topic for remarks to a group of OCC alumni? I'm going to talk about three of those issues today:

- What activities may national banks conduct as part of, or incidental to, the "business of banking"?
- To what extent do national banks operate under uniform national standards and when do state laws apply to their activities?
- And, if a state law applies to a national bank, who enforces it?

Earlier this year, I prepared a paper on "The OCC, the National Bank Charter, and Current Issues Facing the National Banking System,"[1] which described the origins of banking in the United States and the circumstances leading up to the creation of the national banking system and establishment of the Office of the Comptroller of the Currency (OCC) in 1863. I believe that Bob Serino has provided many of you with a copy of that paper as your "homework" assignment in preparation for today's lunch, and it goes into considerably more detail than I will confront you with as a luncheon speaker. As the paper recounts, the Civil War did, in fact, provide the catalyst for establishing a new system of national banks that were capitalized in a manner that aided the federal government in financing the Civil War. That financing role occurred because new national banks, upon being chartered by the Comptroller, were required to use a portion of their paid-in capital to purchase U.S. Treasury securities. The money received by the Treasury, in turn, was used to fund the Union efforts in the war.

But the design of the national banking system evidences creation of more than just a financing arm for the government's war effort. In an extraordinary step for the time, President Lincoln sought an entirely new system of federally chartered, but privately owned enterprises, whose powers and responsibilities were established under federal law, whose duration could be perpetual, and which were made subject to uniform federal supervision by a new federal regulator. The Treasury securities that new national banks were required to buy were pledged as backing for a new species of circulating notes issued by the banks with the Comptroller's approval. With capital

[1] "The OCC, the National Bank Charter, and Current Issues Facing the National Banking System," presented to the Financial Services Regulatory Conference, March 17, 2003, Washington, D.C. [Available in the *Quarterly Journal,* Vol. 22, No. 2 (June 2003) and on the Web at http://www.occ.treas.gov/QJ/QJ.htm/QJ22-2/3-SpeechesTestimony.pdf.]

in the form of government securities, these circulating notes were designed to be a new national currency that would hold a stable value and could be used, reliably, across the nation.

Thus, from the very outset, national banks were unique federal enterprises. It was envisioned that they would be located throughout the country, and that wherever located, they would exercise a uniform set of federal powers, under federal standards of operation, and federally mandated capitalization, with a federal supervisor overseeing all of the foregoing. Regardless of their short-term role in Civil War finance, this was a system of financial institutions designed to far outlast the aftermath of the war, with attributes that would enable them to play a powerful and evolving role in the national economy.

A vital attribute of national banks' ability to play this role was how their powers were—and, perhaps as importantly, were not—defined.

The Powers of National Banks —What is the "Business of Banking?"

The centerpiece for powers of national banks 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. . . ."

It is stunning, but it was deliberate, that this central source of national bank powers is contained in just these 53 words. Congress 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, in a case called *Curtis* v. *Leavitt,* 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."[2]

According to the court, the specifications of certain permissible banking activities in the New York banking laws, (and subsequently copied into the National Bank Act), were "eminently useful," but "not indispensable." Put more directly, banks' permissible activities were not limited to just the activities listed in the statute. Based on this lineage, in determining what activities are permissible for national banks, the OCC typically looks to both the literal language and the

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

objectives of the act, approaching the statute, as one commentator picturesquely put it, as "an architect's drawing and not a set of specifications."[3] The result is that, in effect, the content of the powers of national banks has been continually under construction under the careful administration of the OCC for 140 years. In this role, the OCC consistently has viewed the powers of the national bank charter as fundamentally evolutionary, capable of developing and adjusting as needed to support the changing financial and economic needs of the nation and bank customers of all types.

Any doubt concerning the validity of this approach 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, within reason, to authorize activities beyond those specifically enumerated in the statute.[4] 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 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."[5]

The OCC makes its decisions concerning the content and boundaries of permissible national bank activities carefully and systematically, using a framework of analyses that looks both to the vitality of the national bank charter in the environment in which it is then operating, and the safety and soundness considerations associated with the proposed new activity. For example, in determining whether an activity is part of the business of banking, the OCC considers whether the activity is a contemporary functional equivalent or logical outgrowth of a recognized permissible banking function, whether the activity benefits customers and/or strengthens the bank, and whether the risks of the activity are similar to the type of risks already assumed by banks. In evaluating whether an activity is "incidental" to banking, the OCC will look to whether the activity facilitates the operation of the bank as a business enterprise, whether it enhances the efficiency and quality of the content or delivery of banking services or products, and whether it optimizes the use and value of a bank's facilities and competencies, or enables the bank to avoid economic waste in its banking franchise.

A glance at recent installments of the OCC's *Interpretations and Actions* publication reflects how these progressive standards have enabled national banks of all sizes to engage in new activities that contribute importantly to their ability to remain competitive and serve changing needs of their customers—new technology-based products and services, new types of advisory and con-

[3] Harfield, "The National Bank Act and Foreign Trade Practices," 61 Harv. L. Rev. 782 (1948).

[4] *NationsBank of North Carolina* v. *Variable Annuity Life Insurance Co.,* 513 U.S. 251 (1995).

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

sulting services, and new risk mitigation and risk management techniques for themselves and their customers, are just a few examples. Indeed, one reason for national banks' strength and strong earnings in current, less-than-ideal economic conditions is the diversification of their earnings that has resulted from decisions by the OCC to recognize new types of activities and new risk management techniques as part of the dynamic and evolving nature of the business of banking.

Preemption

Preemption, in the context of national banks, is an often misunderstood and mischaracterized question. Fundamentally, national bank preemption issues raise the same question: to what extent are national banks, as federally created and federally supervised enterprises able to operate under *federal standards?* Individual skirmishes concerning displacement of particular state laws miss the key point: preemption is a 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. Resistance to preemption is essentially resistance to the uniform standards inherent in a national system.

While the subject of preemption may not be popular in some quarters, principles of preemption flow directly from the Supremacy Clause of the United States Constitution,[6] which provides that federal law prevails over any conflicting state law, and has long been 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.[7]

[6] U.S. Const. Art. VI, cl. 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.").

[7] *See, e.g., Barnett Bank of Marion County, N.A.* v. *Nelson,* 517 U.S. 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 U.S. 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 U.S. 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 U.S. 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 U.S. 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 U.S. 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 U.S. (9 Wall.) 353, 362–63 (1870)

Together, the uniformity of powers and operating standards that result from federal preemption, coupled with the OCC's exclusive visitorial authority, which I will discuss in a moment, are defining characteristics of the national bank charter. Together, they constitute 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."

Ironically, many opponents of preemption are also fervent defenders of the "dual banking system." I have to confess to being perplexed when I hear state authorities on the one hand embracing as sacrosanct the "dual banking system," while at the same time criticizing national banks for taking advantage of the very characteristics of the national bank charter that distinguish national and state banks and make the system "dual." Similarly, the dual banking system is sometimes praised because of the *variety* of activities that may be allowed in different states, and for that reason the state banking component of the dual banking system is touted by its supporters as providing laboratories for innovation. It should be noted, however, that the attribute of the state system that is being extolled is the potential state-by-state *diversity* of standards applicable to state banks. That's fine. But it makes no sense then to criticize the other half of the dual banking system—national banks—for seeking uniform, *national* standards of operation, consistent with the *national* character of their charter.

Preemption is simply the legal theory that enables national banks to operate nationwide, under the uniform national standards, subject to the oversight of a federal regulator, just as Congress originally intended. As the Supreme Court noted in 1939, in *Deitrick, Receiver* v. *Greaney,*[8] "[t]he National Bank Act constitutes 'by itself a complete system for the establishment and government of National Banks.'" In a much earlier case, decided in 1896, 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 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."[9]

This independence from state direction and control both recognizes the essential federal character of 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 consistently has held that subjecting national banks' exercise of their federally authorized powers to state regula-

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(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 Cir. 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).

[8] 309 U.S. 190, 194 (1939).

[9] *Davis* v. *Elmira Savings Bank,* 161 U.S. 275, 283 (1896).

tion or supervision would be inconsistent with the system that Congress designed.[10] 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,[11] and, as the court said in 1875, "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."[12]

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 1891, in *Talbott* v. *Silver Bow County Commissioners* when 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. . . ."[13] A similar point was made by the court 100 years ago, in 1903, in *Easton* v. *Iowa,* 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 which, if permitted to be applicable, might impose limitations and restrictions as various and as numerous as the States."[14]

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.[15]

[10] *See, e.g., Marquette Nat. Bank of Minneapolis,* 439 U.S. at 314–315 ("Congress intended to facilitate a 'national banking system.'"); *First National Bank of San Jose,* 262 U.S. 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.").

[11] 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.

[12] *Farmers' & Mechanics' National Bank* v. *Dearing,* 91 U.S. 29, 33–34 (1875).

[13] *Talbott* v. *Silver Bow County Commissioners,* 139 U.S. 438, 443 (1891).

[14] *Easton* v. *Iowa,* 188 U.S. 220, 229, 231–232 (1903)(emphasis added).

[15] *Barnett Bank of Marion County, N.A.* v. *Nelson,* 517 U.S. 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").

Visitorial Powers

Closely related to preemption, the OCC's authority to regulate, supervise, and examine national banks is extensive, and in many respects, exclusive. This authority, referred to in old English common law terminology as "visitorial powers," has recently given rise to issues with state authorities on several fronts, including whether the scope of the OCC's exclusive visitorial powers applies to national bank 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 on this point that is currently ongoing in California. I am happy to report that, just last week, the federal district court in California upheld our regulations on this point and agreed with our position that the OCC has exclusive visitorial authority over national bank operating subsidiaries to the same extent as it has that authority over their parent national bank.

As has recently been the case in California, some state authorities have balked at recognizing the scope of the OCC's exclusive visitorial powers. Suggestions have been offered that the OCC's visitorial powers contain an unwritten distinction between safety and soundness and consumer protection laws and that the OCC's exclusive visitorial authority should be read as limited to safety and soundness issues. Even more remarkably, others have suggested that the ability of *states* to regulate *national banks* is a fundamental tenet of the dual banking system.

These suggestions lack support, and the latter assertion, in particular, has things utterly backward. Differences in national and state bank powers and in supervision and regulation of national and state banks are not inconsistent with the dual banking system; they are the defining characteristics of it. To the extent that state authorities resist or try to blur those distinctions, their actions, not the

[16] 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." Cong. Globe, 38th Cong. 1st Sess. 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. . . ." Cong. Globe, 38th Cong., 1st Sess. 1267 (March 24, 1864) (statement of Rep. Brooks). Rep. 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 Rep. 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, Rep. 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. Rep. Pruyn opposed the bill stating that the legislation would "be the greatest blow yet inflicted upon the States. . . ." Cong. Globe, 38th Cong., 1st Sess. 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.")

actions of the OCC, dilute the character of the dual banking system. Familiarity with a little bit of history helps a lot to understand this point in the context of the issue of visitorial powers.

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.[16] Given this anticipated impact on *state* banks and the resulting diminution of control by the states over banking in general,[17] proponents of the national banking system were concerned that states would attempt to undermine it. Remarks of Senator Sumner in 1864, the first year of the national banking system, 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."[18]

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,"[19] 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.[20]

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[17] *See, e.g., Tiffany* v. *National Bank of the State of Missouri,* 85 U.S. 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 & H. Krooss, *Financial History of the United States,* 155 (1st ed. 1952).

[18] Cong. Globe, 38th Cong., 1st Sess., at 1893 (April 27, 1864). *See also Anderson* v. *H&R Block,* __ F.3d __, 2002 U.S. 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").

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

[20] 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. . . ." Cong. Globe, 39th Cong., 1st Sess., Misc. Doc. No. 100, at 2 (April 23, 1866).

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. For example, in *Guthrie* v. *Harkness,*[21] 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.[22]

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. As the court stated in *Easton* v. *Iowa,*[23] 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."[24]

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."[25]

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.

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[21] 199 U.S. 148 (1905).

[22] *Id.* at 159.

[23] 188 U.S. 220 (1903).

[24] *Id.* at 229, 231–232 (emphasis added); *see also Marquette National Bank* v. *First of Omaha Service Corp.,* 439 U.S. 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 U.S. 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 U.S. 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").

[25] *Farmers' and Mechanics' National Bank* v. *Dearing,* 91 U.S. 29, 34 (1875).

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. *Hughes*[26]).[27] "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.[28] Thus, section 484 establishes the OCC as the exclusive regulator of the business of national banks, except where otherwise provided by federal law.

Congress affirmed the OCC's exclusive visitorial powers recently with respect to national banks operating on an interstate basis in the Riegle–Neal Interstate Banking Act of 1994 (Riegle–Neal).[29] Although Riegle–Neal clarifies that interstate branches of national banks are subject to specified types of laws of a "host" state in which the bank has an interstate branch to the same extent as a bank based in that state, potentially including consumer protection laws—except when federal law preempts the application of such state laws to national banks—the statute then makes crystal clear that even where the state law is applicable, authority to enforce the law is vested in the OCC.[30]

While all this means that the national banking system and the state banking system are distinct—indeed the differences that I've discussed are at the very heart of the "dual" character 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 and the resources of state supervisors necessarily will vary state-by-state, national banks are subject to rigorous standards and systemic supervision, administered from the federal level, that applies uniformly to their business, wherever and in whatever form, they conduct it.

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[26] 6 F. 737, 740 (6th Cir. 1881), *appeal dismissed,* 106 U.S. 523 (1883).

[27] *Guthrie,* 199 U.S. at 158. *See also Peoples Bank v. Williams,* 449 F. Supp. 254, 259 (W. D. Va. 1978) (visitorial powers involve the exercise of the right of inspection, superintendence, direction, or regulation over a bank's affairs).

[28] 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.

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

[30] *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.").

We are recognized for our "sophisticated credit examination and risk management capabilities" by leaders in the banking industry,[31] and we have taken a leadership role in ensuring that the business practices of national banks are of the highest caliber. We not only have a progressive approach to bank powers to enable national banks to better serve their customers through new products and services and new technology, we also have taken a pioneering position to ensure national bank customers are treated fairly by using our cease-and-desist powers to prevent unfair or deceptive practices. National bank customers, as well as national banks themselves, are the beneficiaries of our regulatory and supervisory efforts.

We recognize that the OCC 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 national banks' operations, 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. Dept. of the Treasury,* "[national] banks are [the Comptroller's] wards, and his only wards; if they fail in droves, he will be blamed."[32] And so too will the Comptroller's office be criticized if national banks fail to conduct their operations fairly and with integrity. And so, too, will the OCC be blamed if national banks fail to provide products and services that support a healthy, stable, and growing economy.

Conclusion

This journey from the roots of the national banking system, to the present-day issues we face at the OCC, provides context and the foundation 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 in one of his famous commentaries—"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."

Thank you very much.

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[31] Kenneth Lewis, Chairman and Chief Executive Officer, Bank of America, "Regulatory Reform for the American People," presented to the FDIC Symposium on The Future of Financial Regulation, March 13, 2003.

[32] 912 F 2.2d 897, 905 (7th Cir. 1990).

Remarks by Julie L. Williams, First Senior Deputy Comptroller and Chief Counsel, before the Risk Management Association's Retail Risk Management Conference, on regulatory concerns about certain retail banking practices, Chicago, June 3, 2003

I am sure all your speakers begin their remarks by telling you how happy they are to be addressing you. I am no different in that respect, but I am particularly sincere in saying that, because this speech provides an opportunity to knit together several important subjects in the retail banking arena: the significance of the retail banking business today and some particular concerns we have with how it is being conducted; how those concerns interact with broader supervisory and regulatory policy perspectives of the OCC; and thoughts on potential consequences for the industry of the convergence of questionable retail banking practices with our supervisory and policy concerns and objectives.

We are talking about an enormously important segment of the banking business today. The consumer accounts for no less than two-thirds of all U.S. economic activity, and it's widely agreed that the extent to which consumer confidence bounces back—as it appears to be doing—after its recent decline, will go far in determining the magnitude and duration of the economy's recovery.

Consumer attitudes and behavior are also of profound importance to the banking system—and always have been. But consumer behavior now affects the financial services industry more directly than ever before. During the past two decades, the growth in loans to individuals—and the declining prominence of commercial and industrial loans—have been perhaps the most dramatic of the many changes that have occurred in bank portfolios. At the same time, banks have grown increasingly reliant on noninterest income, derived increasingly from their retail customers. In 1983, banks earned nearly $9 in interest income for every dollar of noninterest income. In 2001, the ratio was down to less than three to one.

So while unemployment rates, wage growth, housing prices, household debt burden, and other consumer-related measures have always been full of meaning for banks, they have never had a more immediate bearing on the industry's bottom line than they do today.

Given this reliance, one might assume that banks would be bending over backwards to cultivate and retain their retail customers. Indeed, some are—and the effort is usually well rewarded. But we have observed too many banks engaging in retail banking practices that are hard to defend, either from consumer protection or safety and soundness perspectives. Bankers who invent new fees to impose on consumer transactions, or who arbitrarily raise their existing fees, or who engage in fine-print sleight-of-hand about how those fees are calculated and applied, risk alienating customers and driving them into the arms of nonbank competitors.

The loss of retail customers *en masse* would be a serious blow to any business that depends upon them as much as depository institutions do today. But taking those customers for granted—or be-

ing insensitive to *their* needs and interests—presents additional risks to the industry. When retail customer practices by some institutions are abusive, unsavory, unfair, deceptive or unsafe, and unsound, those practices may provoke a legislative response—or a reaction from bank regulators—that will affect all the institutions engaged in that line of business. The result might be a loss of flexibility by all, and costly new burdens on an entire banking sector. And, in the broadest sense, consumer-unfriendly banking practices are counterproductive to the country's economic recovery.

I know that last point might strike some as a stretch. But when we were checking the latest report on consumer attitudes from the University of Michigan, we happened upon another report prepared by researchers at the same institution, which concluded that customer satisfaction was *the* most important leading indicator of consumer spending—more important than income changes and consumer confidence *combined.*

Think about that for a moment. If these researchers are right, then the *quality* of the interaction between consumers and merchants does more to determine whether that consumer keeps coming back for more—and continues to do his or her part to fuel the economy—than anything else. In other words, it appears that for a significant percentage of the American public, unpleasant, unproductive, or disillusioning retail experiences can have a chilling effect on future spending—depriving the economy of the stimulus from which it would otherwise benefit.

These macroeconomic considerations buttress the case for vigorous supervision of retail banking activities—for the benefit of banks *and* their customers—and for prompt and decisive supervisory intervention when we find patterns of conduct incompatible with safety and soundness, as well as with the letter and the spirit of consumer protection laws.

Unfortunately, questionable practices are not rare—especially in the credit card business, which generates more customer complaints than any other retail banking activity. That's been the case since the OCC began collecting and tabulating customer complaints relating to national banks in the late 1990s. But consumers with credit-card–related complaints have become more vociferous—and the issues they raise more serious—over the past several years.

Certainly the OCC has taken these complaints seriously—and has acted vigorously to combat the abuses that we discover. In 2000, we investigated charges that Providian National Bank was engaging in unfair and deceptive credit card marketing practices—practices that affected literally hundreds of thousands of customers. To resolve that dispute, Providian entered into a consent decree that not only assured that the practices we cited would come to a halt, but also provided hundreds of millions of dollars in restitution to customers who had suffered harm. In the last half of 2001, we arrived at similar consent decrees with two other national banks found to have engaged in "unfair and deceptive" practices in their credit card operations. And a fourth national bank whose business was predominantly credit-card–related was closed early in 2002 after its unsafe and unsound practices depleted its capital.

These actions, I think, demonstrated our strong commitment to protecting consumers, to upholding the reputation, as well as the safety and soundness of the national banking system, and to safeguarding the public interest. Yet, as already noted, there was continuing and growing evidence—reported both by consumers and our examiners—that the problems that I've just mentioned—and the practices that gave rise to them—were becoming sufficiently pervasive industry-wide to warrant a more comprehensive and systematic response.

That's why the OCC, along with the Federal Reserve, FDIC, and OTS, last year began to develop guidance focusing on account management practices for credit card lending—issues with safety and soundness as well as consumer protection implications. And this past January, the agencies issued new guidance intended to address those problems. The guidance is significant both for what it says, and because the agencies had to issue it in the first place. I'll talk about each of these points in turn.

The guidance aimed "to ensure that financial institutions conduct credit card lending in a safe and sound manner by establishing sound account management, risk management, and loss allowance practices." And it spelled out our specific expectations in each area of concern: credit line management, overlimit practices, minimum payments and negative amortization, workout and forbearance practices, and income recognition and loss allowance practices.

Our concern about **credit line management** stemmed from the growing number of card issuers extending and expanding credit without sufficient consideration of the cardholders' ability to repay. In some cases, having established a profitable relationship with a borrower, lenders have gone on to increase credit lines or to issue additional cards, including store-specific private label cards and affinity relationships cards, without considering how such extensions might affect that relationship or overextend the borrower's financial capabilities. It's not unheard of for institutions to offer additional cards even to borrowers who have *already* started to experience repayment problems.

The interagency guidance makes clear that lenders must manage credit line assignments and increases responsibly, using proven credit criteria. We expect institutions to test, analyze, and document line-assignment and line-increase criteria, and to establish and strengthen internal controls capable of determining the impact of additional credit lines on repayment capability.

Overlimit practices have been another matter of concern. We have found that account management practices that don't control the authorization or provide for timely repayment of overlimit amounts may significantly increase the credit risk profile of the portfolio—especially in the case of subprime accounts, where liberal overlimit tolerances and inadequate repayment requirements can magnify the high risk exposure to the lender.

The guidance stresses the importance of careful management of overlimit accounts, to ensure that bankers are able to identify, measure, manage, and control the risks associated with them. It puts

banks on notice to restrict over limit accounts, particularly those that are subprime, and to subject them to appropriate policies and controls.

As regulators, we understand the competitive pressures under which banks operate today. And we understand why banks might see it as advantageous to adopt policies designed to maintain outstanding balances. But some institutions have crossed an important line: they've reduced minimum payment-due amounts on their cards to the point that they fall short of covering all finance charges and fees assessed during the billing period, so that the outstanding balance continues to grow through negative amortization. At the very least, minimum payments set at that level make very little progress in reducing the amount owed.

But such **minimum payment and negative amortization** practices also cross a regulatory line, as our guidance makes explicit. First, reduced minimum payments may have the effect (if not the intent) of masking declining credit quality and borrower impairment. Second, they dig borrowers into an ever deeper hole, requiring increasingly more difficult measures if borrowers are ever to pay their way out of debt.

For those reasons, we expect financial institutions to require minimum payments that will amortize the current balance over a reasonable period of time. Low minimum payments, especially when they result in negative amortization, are not consistent with the principle that consumer loans should be repaid within a reasonable period of time. As the guidance states, negative amortization, inappropriate fees, and other practices can compound or protract consumer debt and disguise portfolio performance. These practices raise safety and soundness concerns and are subject to examiner criticism.

Although it's only been in effect for several months, the guidance has already produced several positive results. It's promoted a greater understanding of the credit risk inherent in overlimit accounts, and has led to a strengthening of overlimit practices. It has generated a useful dialogue with the industry on the adequacy of minimum payments; some institutions that had inordinately reduced their minimums are in the process of raising minimum payments back in line with the industry. It has encouraged the adoption of improved income recognition and loss allowance practices, particularly for uncollectible accrued interest and fees.

But, as important as the content of the guidance is the fact that the guidance had to be issued in the first place. Allow me to elaborate on some lessons to be learned from this development.

At the OCC, we support the ability of national banks to conduct the banking business authorized under their federal charter, including the products they are allowed to offer and the fees they are allowed to charge for them. This assuredly does not mean, however, that we will tolerate abusive or sly consumer banking practices by national banks. We expect national banks to treat their customers fairly and to exhibit the highest standards of integrity in all their business operations. Given the importance of consumer banking business these days, this should be a business imperative. But, where banks fail to do so, we have, and we will take action.

In general, our approach has been to address particular *practices* by particular national banks. Typically, we have tackled unfair, deceptive, unsafe, or unsound practices on an institution-specific basis. We recognize that differences in conduct require different sanctions and solutions, and that, on the other hand, different banks could have different, but nevertheless appropriate ways of dealing with a particular consumer issue. Our system of comprehensive supervision of national banks enables us to address—and not overreact to—problems we identify. And, we have believed that approaching *practices* through our supervisory process enables us to more effectively deal with the circumstances presented by each bank, and to design solutions customized to the practices, operations, and risks presented by each bank.

What is notable about the account management guidance issued earlier this year is that it represents a departure from this approach. More telling is the reason why. To be blunt, some players in the industry have been tone-deaf on key issues. Despite the concerns we have expressed informally, despite the obvious importance of the consumer business segment, some industry participants have looked for any excuse to cut corners in customer treatment and drift to the lowest common denominator of account management practices. Banks should not need to have regulators instruct them on how to fairly treat their customers or fairly present their financial performance. Indeed, in today's post-Enron, post–Sarbanes–Oxley environment, managers of companies of all types should be bending over backwards to assure that presentation of their financial information best reflects the economic substance of their business. The fact that the agencies had to issue the account management guidance reflects a failure to "get it."

At the very least, enlightened self-interest should lead bankers to embrace best practices and condemn any outliers for not doing the same. The history of consumer regulation and legislation teaches a valuable lesson here: when some institutions persist in not "getting it," the consequences ultimately are felt by all institutions, when regulators—or Congress—react by setting comprehensive standards that apply to all.

Applying this lesson in the context of the account management guidance is important, because other issues remain, and to the extent the relevant industry continues not to "get it," the industry invites another response from regulators that the industry may well not like. On the question of minimum payments, for example, our guidance did not specify what might be a "reasonable period of time" for an outstanding balance to be amortized. That raises the question of whether the regulatory agencies should impose a limit on the amortization period or require disclosure of the length of time to repay the indebtedness if only the minimum payments are made.

Second, the guidance dealt with the question of negative amortization in the context of minimum payments. But, it can well be argued that negative amortization is a practice that should simply be eliminated. The question is how to do that. A minimum payment that is quite sufficient to amortize the debt alone might be inadequate if overlimit and late fees are added to the financed amount. That would leave financial institutions with two unpalatable choices: either raise the minimum amount or reduce fees.

Third, there are unresolved issues in connection with the repayment of overlimit amounts. Again, part of the problem is definitional: what constitutes "timely repayment" of such amounts, as called for in the guidance? Obviously, overlimit amounts should be subject to more stringent repayment requirements than the original balance. But having just undergone the process of writing and vetting comprehensive guidance, there is an understandable reluctance, on the parts of the industry and the agencies, to go through the process yet again if satisfactory results can be achieved instead through the supervisory process.

We believe that the supervisory process *can* produce satisfactory results. For the agencies' part, it requires that we clearly convey our expectations to management. In the coming weeks, our examiners will be doing just that. Whether we wind up having to do more will depend on the industry's response. This is a time for bankers to "get it"—to demonstrate leadership of their own by reforming their account management practices.

The interagency guidance—and my remarks—have detailed issues arising in connection with credit card lending. But I want to emphasize I could have been talking about other areas of retail banking: payday lending, skip payment plans, debt protection plans, overdraft protection plans. Each of these banking products has come under different degrees of criticism. By and large, many of these are not inherently bad or abusive products, and no one would expect bankers to deliver them without being compensated for their effort. Indeed, over the years the OCC has *encouraged* national banks to look to fee income as a way to diversify their income stream, in order to even out the oscillations in interest income that were so long a source of industry instability. The impressive strength of the banking sector during these trying economic times suggests that this strategy has borne fruit.

But continuing long-term success requires that as bankers pursue more fee-based products and services and enhanced noninterest income, they do so with particular consideration of fairness to customers and fair presentation of their financial performance. Much hinges on the decisions bankers will make regarding the terms on which their retail products are offered and the clarity and integrity with which the performance of those retail products is presented.

You face some important crossroads now in several retail product areas. You have the opportunity to establish a solid foundation for the long-term profitability and success of those products. If you don't, you undermine that foundation, and you enhance the likelihood that regulators will conclude that we need to act, again.

It's up to you.

Thank you very much.

Remarks by Julie L. Williams, First Senior Deputy Comptroller and Chief Counsel, before the Risk USA 2003 Conference, on regulatory considerations in the evolution of risk management, Boston, June 10, 2003

I am delighted to be with you this morning and it's a particular honor to address this conference, which is deservedly described in your brochure as "North America's premier annual congress examining the latest innovations, trends, and methodologies for effective risk management and optimal derivatives trading." Having said that, I suspect many of you now may be wondering why one of your keynote speakers at such a conference is a bank regulator, and even worse, *a lawyer*. Regrettably, innovation and trend-setting are qualities not typically associated with either regulators or lawyers.

I hope I have a pleasant surprise in store for you. What I'll talk about this morning is the approach my agency—the Office of the Comptroller of the Currency (OCC)—has taken to the role of banks as financial intermediaries; how this approach has evolved; how it has enabled the national banks we regulate to become robust, vital and *successful and safe and sound* participants in the derivatives markets, and how we take supervisory and regulatory concerns into consideration when we evaluate proposals by national banks to engage in new facets of the derivatives business.

Brief Overview of Banks' Role in the Derivatives Business

At the risk of telling you some things you already know, allow me to provide a little background. First, my agency—the Office of the Comptroller of the Currency—does not print money; we regulate the national banking system, including most of our nation's largest, most complex and sophisticated banks. The largest of these banks are active participants in the derivatives business, and the growth of their business has been a significant component of the overall growth of derivatives markets.

Indeed, the phenomenal growth of derivatives has been one of the defining features of global capital markets over the past decade or two, and an increasingly important part of the commercial banking business worldwide. In 1990, total notionals held by U.S. banks was well under $10 trillion; in the first quarter of 2003, they stood at some *$61.4 trillion*, overwhelmingly in interest rate contracts. U.S. banks generated $3 billion in trading cash instruments and derivatives activities during that same three-month period—a tidy sum that reflects one of the better quarters in recent reporting time periods.

As bullish as these numbers are, they don't begin to tell the whole story. Indeed, for technical reasons, the actual profitability of derivatives trading is even greater than reflected in the reported numbers.

But for banks actively participating in the derivatives market—admittedly, still a relative handful—trading income is but one of the benefits they derive—icing on the cake, as it were. In a recent speech that deserved more attention than it received, Federal Reserve Board Chairman Alan Greenspan endorsed the view that much of the credit for the resilience of the financial system during the economic turbulence of past three years may belong to the improvements in risk measurement and management techniques in use at our leading banks. And of those improvements, he singled out the growing use of derivatives as of particular importance in assisting financial institutions in unbundling and managing financial risks. As a result, U.S. financial institutions were not only able to withstand the largest corporate defaults in history, and the largest sovereign default in history—Argentina—but are now poised to lend again as companies anticipate quickening demand for their products and services in a recovering economy. Derivatives, as a key risk management device, may thus have helped to play a decisive role in keeping the recent recession both shorter and milder than would otherwise have been the case.

Of course, derivatives continue to be controversial in some quarters. They haven't quite overcome the taint of association with Barings and Long Term Capital Management. Their complexity can be daunting. One investment banker famously observed that he had been "trying to explain [the subject] to my parents and my wife for nine years and they still don't understand it. I still have to assure my mother that what I do for a living is legal." Especially in inexperienced or unethical hands, the risks posed by derivatives are very real.

OCC's Approach to National Banks' Derivatives Activities

At the OCC, we have tried to view the derivatives business not in isolation, but rather as part of an overall approach to the business of banking, its safe and sound conduct, and the management of the risks associated with it. Banks are in the business of serving the needs of their customers, and the OCC has consistently taken the position that the national charter is a dynamic instrument for the delivery of bank products and services. When we authorize—indeed, before we authorize—national banks to undertake new banking activities, we also consider how those risks will be managed and mitigated. Banks are quintessential financial intermediaries and derivatives can play an important part in the risk-management strategies employed by financial institutions and their customers. Thus it was logical that banks would seek to enter the derivatives business, and as they did, it presented a new range of legal, regulatory, and supervisory considerations for the OCC.

We initially found national banks have authority to enter into derivatives, including swaps, options, and forwards, by looking to the nature of the investment on which the derivative was based. In those cases when national banks could own the underlying investment, we concluded banks may enter into derivatives with payments tied to the value of those investments. Based on these precedents, national banks were able to launch derivatives businesses that focused on management of interest rate and foreign exchange risks and price risk of particular precious metals.

Later, banks explored with the OCC the possibility of expanding their derivative business to include cash-settled derivatives based on the value of investments that banks generally cannot own, such as commodities (including oil, gas, and electricity) and certain securities (generally equities and some types of debt). Banks sought to provide customers with derivative products useful for managing risks of price fluctuations in those commodities or securities.

In reviewing these proposals, the OCC considered carefully the nature of the transactions and activities involved and determined that cash-settled derivatives with payments tied to the value of securities or commodities essentially involve exchanges of payments, similar to traditional banking activities. We also concluded that this line of business was fundamentally financial intermediation—a new form of banks' long-recognized role as financial intermediaries. I will have more to say about these precedents in a moment.

Today, as in the past, the OCC takes a favorable view of banks' efforts to conduct banking activities in new ways to respond to changing financial needs of customers. In this regard, we also support and *encourage* national banks in their well-established history of serving as leaders in the development of risk management and controls.

Legal Foundation for National Banks' Ability to Conduct Derivatives Activities

Now I get to the part where I explain how our legal positions actually have been constructive.

OCC legal precedents interpret banks' statutory authorities broadly, consistent with both the language and goals of the National Bank Act. We approach banking powers—guided by decisions of the U.S. Supreme Court—as not just the activities listed in the National Bank Act, but as including a more general authority to engage in the business of banking and incidental activities. Our precedents have permitted ever expanding and more sophisticated banking activities. At the same time, and of equal importance, we have developed supervisory guidance to ensure these activities are conducted safely and soundly and we have assembled a talented staff with outstanding expertise, who understand this business and take a risk-focused approach to applying that guidance to the banks they supervise.

Using the procedures, interpretations, and safeguards I have described, the OCC has permitted new and more efficient forms of hedging risk. Banks do not need to hedge each transaction, but can hedge on a portfolio basis to within appropriate risk limits.

The OCC also has permitted hedging with holdings that generally are not permissible for banks. Equity hedges are an example of this. Our decision to permit this new form of hedging was based on evidence from a national bank that conducting the hedges within the bank resulted in substantial savings and reduced operational and other risks arising from the bank's derivatives business. Our legal opinion was that the equity hedges are incidental to that business because they enable the bank to conduct the business more profitably and effectively.

Also permitted are new forms of settlement to allow banks to participate in a broader range of markets. Over the last year, the OCC issued two newsworthy rulings authorizing a national bank to engage in what appeared to be novel types of financial intermediation transactions. In the first case, a bank proposed to add transactions based on the price of electricity to its existing energy-related financial intermediation derivatives. In the second case, a bank proposed to expand its financial intermediation business to include customer-driven, electricity derivative transactions that involve transfers of title to electricity.

In both cases, however, there actually may have been less news than met the eye. The rulings were premised on a common set of assumptions—assumptions that have long been the foundation of our approach to bank powers generally.

First, we held that financial intermediation transactions involving commodities are authorized as part of the business of banking. We have previously recognized, in a variety of contexts, that commodity and commodity index derivatives are a modern form of traditional financial intermediation functions performed by banks. Based in part on that lineage, we have concluded that national banks may make payments to—or receive payments from—customers under commodity derivative contracts in the event of a gain or loss in a metal or energy product or index thereon. These derivative transactions thus have been recognized as permissible for national banks as a financial intermediation activity.

In these arrangements, national banks act as financial intermediaries between customers that want to manage risks resulting from the variations in the price of a particular commodity or commodity index. Customers do not deal directly with one another, but instead make payments to the intermediary bank. Under these authorities, the OCC has determined that national banks may engage in matched and unmatched commodity price index swaps, and manage and warehouse them on a portfolio basis.

Based on similar reasoning, we have permitted national banks to engage in various commodity-linked transactions involving oil, gas, other hydrocarbons, and metals. "Commodity-linked transactions" include making loans, taking deposits, and issuing debt instruments having terms related to commodity prices, sales, or indices, or measured in relation to the future; and entering into swaps, forwards, and other transactions relating to commodity prices and indices, or combinations thereof, in order to assist bank customers in managing their financial exposures.

The second assumption behind our recent approvals was that the electricity derivatives business is the functional equivalent of other commodity derivatives transactions that the OCC has previously determined are permissible for national banks. They are privately negotiated contracts between the parties to the transaction, individually tailored to the specific risk sensitivities of the customers. The parties agree to make payments based on the performance of a particular commodity or commodity index, whether the commodity is a hydrocarbon or a foodstuff.

Third, again, the OCC has long recognized that using derivatives to hedge against the risks associated with bank permissible activities is an integral part of those permissible banking activities. We have determined that national banks may hedge bank permissible commodity derivative transactions with *other* commodity derivatives, such as futures, and swaps and options and other over-the-counter instruments, when conducted in a safe and sound manner as provided in OCC guidance. Hence, as with other commodity derivatives, national banks may hedge bank-permissible electricity derivative transactions with electricity futures, and swaps and options and over-the-counter derivative instruments. Further, we have specifically endorsed the hedging of commodity transactions on a transaction-by-transaction or portfolio basis.

How Supervisory Considerations Intersect with Legal Standards

Perhaps most important, the approval I have described was predicated on the requirement that electricity derivatives—like all financial intermediation transactions that we approve—will be conducted in a safe and sound manner. That is, just because the proposed activity may closely resemble a previously approved activity does not mean that it will automatically qualify for approval itself. Such activities require sophisticated risk measurement and management capacities on the part of a bank, as well as qualified personnel, in order for the activity to operate in a safe and sound manner.

Thus, in order for us to reach the conclusion that the proposed activity was permissible for the bank, the bank was required to demonstrate to the OCC's satisfaction that it had established appropriate risk measurement and management processes—including board supervision, managerial and staff expertise, comprehensive policies and operating procedures, risk identification and measurement, and management information systems, as well as an effective risk control function. In other words, we did *not* reach a general conclusion that the activity was permissible for every national bank. We explicitly linked our conclusion about legal permissibility with our supervisory conclusion about the capacity and expertise of the particular bank to conduct the business in question.

But the Enron debacle and other events that led to the passage of the Sarbanes–Oxley Act reminded us that risk management is not just about financial exposure; it is also about reputation risk. There was time when some questioned why the OCC included "reputation risk" as one of the types of risks that we evaluate in our supervision of national banks. We don't hear that much any more. Certainly many shareholders would agree that events of the last two years have shown that an institution's corporate reputation has a significant economic value.

We recognize that when national banks engage in complex structured transactions involving derivatives, issues concerning the appropriateness of a transaction may arise. Thus, in our review of a bank's risk management approval process, we look to see how the bank evaluates that consideration, in other words, what it does to protect its good name in choosing the transactions it is willing to conduct and the parties with which it is willing to do business. We expect that banks

involved in complex structured transactions involving derivatives will subject those transactions to review and oversight through their risk management oversight process to ensure that transactions conform to the bank's standards of appropriateness and integrity.

We look to see if committees independent of the sponsoring business review the complex structured transactions. In addition, we look to see whether the bank has a process by which it will evaluate the purpose of a transaction to assess whether a client has attempted to achieve a financial statement objective that could be construed as materially misrepresenting its financial condition, even if in conformance with generally accepted accounting principles. And, where such could be the case, we look for an undertaking from the bank to take appropriate steps, including declining to participate in the transaction, or requiring its counterparty to make appropriate disclosures concerning the nature and impact of the transaction on the financial position, so that there will be no misperception of the transaction's purpose and effect.

Conclusion

As I have recounted, the derivatives markets play a vital role in the management and intermediation of risk in our financial system, and the participation of banks, in their natural role as financial intermediaries, has, and should continue to, grow. Whether and how much it does, will be influenced by whether regulators—or legislators or government officials—feel the need to intervene to affect the way the business is conducted. And that, in turn, will depend to an important extent on how well *you,* and other industry participants, help to ensure that, in your derivatives business, appropriate attention is paid to both financial and reputation risk.

What does all this presage for the future of banks as participants in this business? The OCC expects that national banks' role as financial intermediaries will continue to grow and evolve in response to customer financial risk management needs and market developments. We view these developments favorably. We support national banks' efforts to better serve customers with new and innovative products. We will continue to strive to take a risk-focused approach to our supervisory responsibilities. But one thing *we will insist on* is that this evolution of activities continues to be coupled with appropriate financial risk controls, and internal checks and balances to ensure that these activities are conducted with integrity and due regard for the bank's good name.

Thank you very much.

Remarks by Mark A. Nishan, Chief of Staff, before the Urban Financial Services Coalition, on improving financial literacy, Washington, D.C., May 29, 2003

It's a distinct and unexpected honor to address the Urban Financial Services Coalition—an organization that's literally been responsible for changing the face of the industry that we serve in our various capacities.

As you know, I'm standing in for Sam Golden, the OCC's Ombudsman, who's grounded at home in Houston, doing his bit to ensure that our agency's operational continuity is safeguarded during the current national security alert. I know that Sam is very disappointed that he's not able to join you today, and I know how much you'd have enjoyed hearing from him. But I'll do my best not to let you—or Sam—down.

After visiting with many of you last night, I already feel as though I'm in the presence of friends. We share many of the same goals, and none is more important—or challenging—than improving the state of financial literacy in our country.

There's no disputing that people who have been through well-designed and well-executed financial education programs are more likely to make sound economic choices, now and in their future. They are more likely to own their own homes and to keep them, with all of the social and economic advantages that go with homeownership. They're more likely to accumulate assets and less likely to be burdened by excessive debt.

As former Treasury Secretary Paul O'Neill said, "Ownership, independence, and access to wealth should not be the privilege of a few. They should be the hope of every American. And financial literacy is an essential tool to make that hope a reality."

The students who are with us today as participants in the coalition's asset-building program are taking important steps toward acquiring that tool—along with the skills to use it intelligently and productively.

When I was growing up on the streets of New York, financial literacy was something you picked up along the way—like a good stickball swing. No one taught you how to do it, least of all in school. We learned how to handle money—to the extent we *had* any—and learned about making financial decisions from our parents and from watching others either succeeding or failing in their financial lives.

It was a hit-or-miss proposition. And many missed—judging by the large numbers of people who might have possessed all the prerequisites for success, but who never had a chance to put them to use, for society's betterment and their own. That's because they were forever scrambling to pay the rent, put food on the table, and keep the bill collector at bay. I knew more than my share of

people who fit that description, and I'm sure you did, too.

I was more fortunate. Although by no means affluent, my parents, neither of whom went to college, were my role models. They taught me the importance of education and discipline, self-confidence and humility, responsibility, and modesty. They taught me to accumulate assets whose value would grow instead of more stuff that would never again be worth what it cost. Somehow—because I don't remember paying much conscious attention to their words—some of what they told me evidently sunk in.

Today, we would call the advice my parents gave me a recipe for wealth building. But as logical as it seemed then and as logical as it still seems today, it's probably harder for young people to live up to that ideal amidst today's runaway materialism than it was when I was growing up when there was a lot less "stuff" to be had. Today, the temptations to consume rather than save are everywhere.

On the other hand, as I mentioned, we didn't have the tools or the expertise available to us today, and in that respect, you who are still in high school have a leg up on us old-timers. It was not very long ago that "buyer beware" was the rule of the marketplace. Government assumed a very minimal rule in assuring fair play, and companies, including financial services companies, had only their consciences watching over them to keep them on the straight-and-narrow. For many, the lure of profit proved far stronger than the Golden Rule.

It's remarkable to reflect on how much has changed in this regard. First, financial institutions themselves have discovered the benefits—for themselves as well as for their customers—of taking a direct hand in sponsoring, organizing, and delivering financial literacy programs. According to surveys by the Consumer Bankers Association, nearly all banks contribute to the war on financial illiteracy in some way, with more than half serving as primary sponsors of the programs in which they participated.

I was delighted to see that national banks—those chartered and supervised by the OCC—rank prominently on the list of the Coalition's sponsors, which means that they are also actively supporting the financial literacy activities that we're honoring at this luncheon. Such activities have not only helped millions of Americans become smarter financial consumers, they have earned the banking industry tremendous respect and good will. It should serve to remind us that altruism in combination with self-interest can be a potent force for good.

The role of government has also been decisively transformed. Today, agencies like the OCC are active agents in the effort to protect consumers from abusive business practices and to arm consumers with the information they need to make intelligent financial decisions for their own benefit.

At the OCC, we do this in various ways. We do it by enforcing the laws that bar unfair or abusive practices. We do it by ensuring that regulated institutions make clear and complete disclosure of the terms governing financial relationships, as provided by law and regulation.

We do it by providing consumers with outlets for resolving disputes with their banks. We do it by providing both positive and negative incentives to financial institutions to offer products and services that meet community needs. We do it by encouraging banks to participate in financial literacy programs, as described above. And, last but not least, we do it by participating in those financial literacy programs ourselves.

As an example of that participation, I would mention the OCC's contribution to the cause of financial literacy through our relationship—of which Sam Golden is the OCC's sponsor—with the National Academy Foundation and its subsidiary, Academy of Finance.

The NAF, for those of you who may not be familiar with its work, is a nonprofit dedicated to preparing young people for careers in the fields of finance, travel and tourism, and information technology. And not just any young people: 95 percent of the academies are located in inner city high schools.

The OCC's partnership with NAF—and we are one of only four federal agencies to have formally entered into such a partnership—has been responsible for placing hundreds of students in internship opportunities at OCC offices around the country, as well as at the financial institutions that participate in the program. Those institutions are eligible to receive favorable consideration for their contributions under the Community Reinvestment Act.

But bankers tell us that currying favor with regulators is not the main reason why they participate in NAF programs. They do it because they believe it's good business to cultivate talented young people, to demonstrate their commitment to diversity, and to identify their employees of the future. I could not agree more. Good deeds and good business *can* go hand in hand.

Another way the OCC aids in the financial literacy effort is through our Customer Assistance Group, or CAG, which is co-located with the Office of the Ombudsman in Houston. The CAG's goal is to give national bank customers an impartial, sympathetic ear, and a place to turn when they have a problem or a complaint.

We often find that the problem is the result of simple misunderstanding, and when it is, we can usually facilitate a simple resolution. On other occasions, the bank may have failed to live up to its legal and regulatory responsibilities—usually inadvertently, but sometimes as a more deliberate matter. When that occurs, we instruct the bank to correct its practices. And when we see systematic patterns of neglect or abuse, we may make referrals to our examination and legal staff for follow-up action.

But the CAG serves another, less visible function that, to my mind, is just as important as the conflict- and dispute-resolution services we provide to bank customers. Larger financial institutions often commission extensive (and expensive) market research to provide them with feedback on how well they're meeting their customers' needs. What comes back to them can be invaluable.

Yet, the possibility of conflict of interest can never be ruled out. It stands to reason that if a bank has a serious customer-relations problem, bank contractors and employees may not be the best sources to consult about it.

The CAG gives banks another piece of the puzzle—and gives it to them straight, unfiltered and unvarnished. Customer complaint data offer banks an opportunity to identify and address potential and existing problems, and thus to avoid the consequences of problems that go undetected and uncorrected.

To cite just one example, when banks fail to take customer dissatisfaction seriously, they face reputation risk that can cost them dearly in customers and in the revenue those customers generate. That would probably not have been so serious decades ago, when commercial banks were primarily in the business of making commercial loans.

But today, as you know, commercial banks depend on interest and noninterest income from retail banking products far more than ever before. Banks have to work to maintain and expand their retail customer base, and information supplied by the OCC and CAG can be of great value in that enterprise.

We find it gratifying that many national banks have taken these lessons to heart. Banks throughout the country are discovering that it's good business to keep customers satisfied, because satisfied customers are much less likely to become someone *else's* customers.

- It's also good business to keep customers informed of changes in bank policies *beyond* minimum regulatory requirements.

- It's good business for banks to train bank employees so that they're able to provide clear explanations of bank policies when customers express confusion.

- It's good business for banks to make good-faith attempts to evaluate customer complaints on their merits—especially when the cost of resolving the complaint to the customer's satisfaction is less than the cost of fighting it.

- It's good business for banks to go the extra mile—beyond what the laws and regulations require—to safeguard the privacy of customer information, to maintain service fees at reasonable levels, and to steer clear of products and services that might be viewed as abusive.

- And, once again, it's good business for banks to join in the effort to make bank customers *smarter* consumers, through financial literacy programs.

Of course, while many banks have internalized these lessons, others haven't, and the OCC has taken decisive action against those few bad actors that give the rest of the industry a bad name. Utilizing our authority under banking law and the Federal Trade Commission Act, we have taken action against a number of institutions that engaged in false or deceptive practices, requiring them to desist from those practices and to provide restitution ranging into the hundreds of millions of dollars to customers who were harmed by those practices.

Obviously, government has an important role to play in policing the financial services marketplace, and I think that the OCC, over its 140-year history, has fulfilled that responsibility with considerable distinction.

But government cannot be everywhere, and most of us wouldn't want it to be. Ultimately, in a free society, we depend upon individuals to make sound and rational choices in their own best interest. For that we depend on individuals having skills and knowledge equal to our increasingly complex and demanding society.

That's where each of you—and the Coalition—come in. Working together, with the government and the private sector each playing their respective parts, we can make giant strides toward improving the financial literacy of all of our citizens—and in so doing, help build a more prosperous and more productive America.

Thank you.