

**Remarks of
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OCC Supervision in a Global Banking System

As always, it's a pleasure to be with you. Today I want to focus my remarks on some current policy issues that have international implications – specifically, where we are with Basel II in the U.S., as well as some thoughts on responses to recent market turmoil that will highlight some of the work of the Joint Forum. But to set that discussion in context, I'd like to begin with an observation: with global financial markets, a bank regulatory agency can't be effective if it focuses narrowly on domestic concerns. National borders are increasingly irrelevant to some of the most important issues we face, and effective policymaking has to take that into account.

So let me start by briefly sketching the many and varied areas of international involvement of the OCC. As the supervisor of *national* banks, the domestic U.S. activities of the OCC may be most prominent in the minds of those interested in banking and financial matters. But I suspect that the full scope of our perhaps less visible, international side will surprise even this internationally oriented audience.

International Activities of the OCC

The OCC has had a growing focus on international aspects of banking and bank supervision for some time. This is a trend I have actively encouraged since becoming Comptroller, because I believe it is a necessary and desirable direction for the agency.

In part, this is because of the international activity of the national banks we supervise. The largest national banks conduct business across a broad range of countries. These are truly global institutions, not just banks that happen to operate in a few overseas locations. OCC-supervised banks had 1.7 trillion dollars of foreign exposure on their books at the end of 2007, not to mention substantial additional off-balance-sheet exposure. That foreign exposure has been growing at more than 30 percent per year recently. Although most of the exposure is to developed countries, emerging market exposure has grown rapidly.

Some of the institutions the OCC supervises here in the U.S. are under foreign ownership. We supervise 30 national bank and trust companies that are foreign-owned, with more than 500 billion dollars in assets. And of course we supervise the activities of federally licensed branches and agencies of foreign banks. Currently, there are 48 of these – actually, as of today¹, I believe 49, because a new federal branch opened this morning – from 20 countries with combined assets of about 156 billion dollars.

The cross-border nature of the institutions we supervise is a prime driver of our international focus. But at an operational level, to be an effective supervisor in a global financial system, we maintain extensive relationships with our colleagues throughout the international supervisory community. These relationships take many forms.

One of the most obvious is that we meet regularly with banking supervisors from many countries. Often this is informal: our staff meet with counterparts to exchange views on key issues, to collaborate, to compare practices, and to share relevant information. At other times interaction is more formal, through structured bilateral meetings and through joint work with our colleagues in the Department of Treasury. The

¹ The recently approved branch of ICICI from India is scheduled to open on Monday March 3.

OCC also has an office in London that has operated out of the U.S. Embassy since 1974, and is dedicated to evaluating key risks present in national banks' European operations. When complex or stressful supervisory situations arise, there is simply no adequate substitute for the personal and professional working relationships we establish through these channels.

While the bulk of our international activity continues to be with the developed countries, we also pay close attention to key emerging markets, in countries such as Brazil, India, Russia, Mexico, and China. As one example, the OCC has a close and productive working relationship with Chinese banking supervisors. This is a valuable supervisory relationship that we have cultivated over the years in various ways, first with the People's Bank of China, and more recently with the China Banking Regulatory Commission, or CBRC, as well. OCC staff and officials – including the Comptroller – regularly travel to China to maintain and enhance our understanding of Chinese banking markets and issues. We, in turn, are pleased to receive regular visits from Chinese officials in exchange, and have hosted CBRC staff for extended periods through the OCC's international intern program. Similarly, the OCC actively engages with regional supervisory groups such as ASBA in Latin America and SEACEN in Southeast Asia.²

I'm proud of the role the OCC plays in helping to promote effective supervision around the world. We have an active technical assistance program that provides courses and other training opportunities to supervisors from many foreign countries. For example, last year approximately 72 supervisors from 29 countries took part in OCC courses on Operational Risk, Anti-Money Laundering and Combating the Financing of

² ASBA is the Asociacion de Supervisores Bancarios de las Americas; SEACEN stands for South East Asian Central Banks.

Terrorism, and Problem Bank Supervision. In addition to our own courses, OCC instructors assist the training efforts of regional supervisory bodies, the IMF, and others. This kind of international outreach strengthens the international financial system and helps promote a level playing field, something that I know is of particular importance to all of you.

As I suggested earlier, it may come as a surprise to some that the OCC is so heavily engaged internationally. After all, the vast majority of the banks we supervise in the national banking system have no direct international activity. But we recognize the undeniable fact I alluded to earlier: in a global financial system, many banking and financial issues are not confined within national borders, and therefore cannot be effectively addressed by any national supervisor in isolation. If we ignore this fact, we set ourselves up to fail. Issues of liquidity, governance, transparency, data security, or risk measurement and management have been, and continue to be, concerns around the world – concerns that, for that matter, are not unique to the banking sector.

Joint Forum

That last point is one of the main reasons I was especially pleased and honored last October to become Chairman for two years of the Joint Forum. As you may know, the Joint Forum brings together supervisors from the banking, insurance, and securities sectors from 13 major countries to address issues of mutual interest. For the past ten years, the Joint Forum has been at the forefront of various issues that cut across these three sectors. Among other topics, the group has tackled liquidity, business continuity, outsourcing, and corporate governance. The work produced by the Joint Forum is

frequently used by supervisors in individual countries when they formulate their own guidance.

Because of its composition and its mandate, the Joint Forum is uniquely positioned with regard to some of the most important international financial policy discussions right now. At this time, the Joint Forum has active workstreams on risk concentrations, credit-risk transfer products, customer suitability, and the supervision of financial conglomerates.

This work of the Joint Forum has assumed added significance and urgency in light of current market developments. The work on credit-risk transfer products, for example, provides a timely update to an earlier report on this topic done in 2005 by the Joint Forum – a report containing a number of recommendations that, if they had been followed more closely, might have helped all of us avoid some of the recent turmoil that has stemmed from some of these types of products, or at least have reduced the impact. While it is clear that credit-risk transfer instruments like credit default swaps and collateralized debt obligations will continue to play a valuable role in distributing risk more efficiently across financial markets, it also has become clear that they can create some troublesome risks of their own. Our work on the Joint Forum has been carefully considering a number of areas where we think practices could be improved, both in the industry and on the supervisory side.

For example, there have been large losses incurred by banks and other institutions that held senior and so-called “super-senior” tranches of subprime-mortgage related collateralized debt obligations – securities that were rated triple-A by the credit rating agencies but have performed very differently than triple-A rated corporate

securities. I believe that the rating agencies could and should do a much better job of differentiating the ratings with respect to these different types of securities. But events also have emphasized the point that good risk management – and good regulation, for that matter – should not become so dependent on third-party credit ratings that it loses sight of the fact that ratings as currently constructed only capture certain aspects of risk, while neglecting certain others that turn out to matter a great deal. I hope that the Joint Forum and its parent organizations will be in a position to say much more about this work, and its potential policy implications, very shortly.

These next two years promise to be an interesting time to chair the Joint Forum, and I'm pleased to have the opportunity to lead a group that, by its composition and mandate, is positioned to make a unique and valuable contribution to the tone and content of international policy discussions.

Basel II in the United States

The international nature of banking and financial issues is also why we continue to move forward with implementation of Basel II in the United States. I'm a supporter of the Basel II framework, because I believe the advanced approaches for credit and operational risk reflected in Basel II, and in the related U.S. rule, will give us a more risk sensitive and comprehensive approach to capital adequacy than our existing capital regulations. Basel II aligns minimum capital requirements much better with the risks at each institution, and encourages improvements in risk management.

Not only is Basel II a tangible step forward in linking capital requirements to risk, but the adoption of a common approach helps foster a level international playing field. It

is neither desirable to have, nor practical to expect, capital rules that are perfectly identical across countries – that would ignore some very real differences that exist in different national financial systems. But a common rulebook brings many benefits, so the U.S. banking agencies have gone out of their way to make our final U.S. rule as consistent as it can be with international standards. In this regard, the agencies also have committed to develop a rule based on the Standardized Approach in Basel II, which would then become available as an option for banks in the U.S. I expect that a proposed rule may be publicly released in the second quarter of this year.

The recent credit market disruptions have caused some to cast doubt on the entire Basel framework. In my view, these doubts are misplaced or overstated. But more important, I take significant comfort in the sensible and measured approach we have taken in the U.S., an approach that incorporates various transitional arrangements and prudential safeguards that will help us be sure the new standard works the way it's supposed to. These safeguards include a parallel run period that lasts at least four quarters but could be longer for individual institutions; during this period, banks have to show that their risk measurement and management processes meet stringent requirements as they compute minimum capital requirements under both the old and the new approaches. This parallel run experience will provide the basis for the OCC's initial Basel II qualification decisions.

Following initial qualification, a minimum three-year transition period begins, which permits U.S. supervisors to see a bank's Basel II systems in full operation. During that time, any potential reductions in capital requirements will be strictly limited through a system of simple and conservative capital floors. And of course, banks will continue to

be subject to the U.S. agencies' leverage ratio and Prompt Corrective Action requirements. If that sounds like belt and suspenders – it is, and appropriately so.

While I believe that the new capital rules are an important improvement in our risk-based capital requirements, I have also frequently pointed out that if we see unacceptable results during parallel run or the transition periods, we can and will identify and fix the shortcomings. In fact, the U.S. rule has been structured to allow us to make adjustments based on what we see during implementation, and to make those changes while the transition safeguards are still in effect.

Our willingness and ability to do just that is evident right now. The U.S. agencies, together with the Basel Committee and others, are reviewing the capital treatment of certain CDOs and securitizations to see if changes are warranted. For example, I find it difficult, in light of recent events, to look at the seven percent risk weight on senior tranches of granular CDOs without wondering if some modifications are needed. These securities have a relatively high proportion of systematic risk, particularly where pieces of securitizations have been re-securitized. We may need to consider taking steps – possibly including imposing higher minimum capital requirements – to account for the fact that default rates under stress are likely to be higher than would be the case for other exposures with similar average default probabilities.

In the meantime, though, most of the framework is likely to change little if at all; the implementation clock is ticking, so we all need to continue moving forward. Many of you may be following the Basel II process closely – perhaps more closely than you would really prefer – but let me briefly recap where things currently stand in the U.S., and what the next steps are likely to be. The U.S. rule is now final. The earliest date at which U.S.

banks can begin parallel run is April 1 of this year. However, to start on that date the rule requires banks to notify their primary supervisor 60 days in advance. I'll save you the trouble of doing the calendar alignment in your heads: that would have been the beginning of February. Since we haven't received any notifications, I think it's safe to say that no national bank will be starting on that earliest possible date. Since parallel run can only begin on the first day of a calendar quarter, the next time an institution could begin that process is July 1, but we don't yet know whether any institution will begin as of that date.

It's important to remember that our U.S. rule provides a 36-month window – that is, until April 2011 – for mandatory institutions to start the first of the transition years. Parallel run would have to begin by April 2010 to meet that requirement. Many of the banks have indicated that they will be using the flexibility provided by the 36-month window, which means, I suspect, that the beginning of parallel run is likely to be staggered over time with respect to individual banks. This may allow all of us to ease into the process incrementally, which I think could be a good thing – it is important not only to get this done, but to take the time necessary to get it done right.

There is one other important date coming up for institutions subject to the U.S. rule. By October 1 of this year, each mandatory institution is required to submit to its primary supervisor an acceptable, board-approved implementation plan. That plan should describe how the bank plans to comply with the requirements of the rule, and should incorporate an explicit implementation start date no later than April 2011, by which time the bank would begin the first transition year under the rule. The plan also should do things like ensure appropriate governance and resources for successful

implementation. In addition to committing the bank to a clear path toward compliance, the implementation plan will serve as a touchstone for our qualification activities on the supervisory side at each bank. Thus, 10-1-08 is an important “due date” for a major “assignment” – the implementation plan – and I know banks are working diligently to meet that deadline.

In the meantime, neither the OCC nor the banks we supervise are standing still. Banks are developing and refining systems, collecting necessary data, and putting control processes in place. Because Basel II was designed to build upon a foundation of good risk management practices, much of this ongoing work in the banks reflects the natural refinement of risk management processes and systems. The OCC reviews relevant aspects of these systems and their refinements at the national banks we supervise as part of our ongoing supervision. In a way, qualification for Basel II is incremental – our guiding principle is that Basel II qualification should not be a unique, stand-alone event, but rather should be “normalized” into the supervisory process.

We will continue down this prudent, deliberate path as we implement the Basel standards in the U.S. As we do so, it is clear that international coordination will be a key to success. The rule itself is only one element of a much broader landscape: implementation and enforcement will be the elements that make or break this. In this regard, the OCC continues to work closely with foreign supervisory colleagues and with the Basel Committee’s Accord Implementation Group – as well as with the Basel Committee’s International Liaison Group, which provides an important bridge to non-G10 supervisors – to harmonize and coordinate our approaches to the many facets of Basel II.

Conclusion

That brings me back to the theme I started with: we live in a time when effective supervision and regulation requires that we actively recognize and address the international dimension of banking and finance. I see the international activities of the OCC – including our active role on international supervisory bodies such as the Joint Forum and the Basel Committee – as essential components of our ability to effectively accomplish our mission. Our approach to supervision and regulation reflects the international character of this industry, and of the issues we face. I think it's hard to overstate the importance of the international piece; the global dimensions of recent market turmoil and the implementation of international capital standards are just two of the more obvious examples. That's why I have been pleased to be able to speak to this group in particular, and why I look forward to your questions.

Thank you.