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Let me begin by thanking Larry Uhlick for inviting me to take part in my first IIB conference as Comptroller. This is a distinguished program even by the IIB's high standards. It is also an outstanding opportunity to meet with industry leaders to discuss the important issues affecting the supervision of internationally active banks. I am very pleased to be with you this afternoon.

I'm sure you won't be surprised to hear that my remarks this afternoon will address an issue directly affecting international bank supervision – the Basel II capital accord. In particular, I want to discuss why we are where we are; implementation challenges; and where we hope to go from here.

Why We Are Where We Are

In terms of why we are where we are, let me step back and focus on "first principles," and in particular on three basic principles guiding our work on which there is broad consensus. First, our existing Basel I risk-based capital regime is deficient. The relatively simplistic framework underlying these rules has become increasingly incompatible with the increased complexity of the activities of our largest banks. The ham-handed risk weighting "buckets" overstate some risks, understate others, and in other cases simply fail to capture risks altogether. That combination creates inappropriate and even perverse risk-taking incentives that can and often do run at cross purposes to supervisory objectives.

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

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

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

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

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

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

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

Our latest analysis of QIS-4 results suggests that a multitude of factors contributed to this substantial overall drop and dispersion in capital requirements. Institutions are at widely varying stages of development of the advanced credit and operational risk systems and processes required by Basel II. In addition, the results were materially influenced by the benign economic cycle prevailing at the time QIS-4 data was collected. And QIS-4 was carried out without definitive rules and guidance establishing supervisory expectations, and without ongoing supervisory oversight and disclosure.

While each of these factors will undoubtedly change with the implementation of a final Basel II rule, I want to be clear about our view of the final QIS 4 results: if a final rule were to produce the same capital results, that outcome would plainly be unacceptable to the U.S.

supervisory agencies. In light of that conclusion, the agencies have grappled with the issue of what to do to address the results of QIS 4. Last September, we concluded that more study of the conceptual underpinnings of the Basel II framework would yield little additional practical benefit. Instead, we decided that the questions raised by QIS-4 can only be fully answered by observing live Basel II systems that are based on a definitive set of agency rules and are subject to meaningful supervisory validation and scrutiny. That means continuing to move toward implementation, but in ways that recognize and attempt to address QIS 4 concerns. Let me mention five such ways.

First, some adjustments can and will be made to the Notice of Proposed Rulemaking that we plan to issue in the very near future, although such adjustments will not change the fundamental parameters of the previous Basel II approach.

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

Third – and this is critically important, I believe – the U.S. agencies have insisted on stringent safeguards during the initial implementation or transition period of a final Basel II rule. These implementation safeguards consist of (1) delaying the adoption of Basel II for one year, (2) extending the transition period following adoption to three years, and (3) strictly limiting potential reductions in capital requirements during that transition period through a system of simple and conservative capital floors. Why are these safeguards so important? Because they will allow banks adequate time to build fully compliant risk management and risk-based capital systems, and they will allow the agencies to analyze implementation of these systems in a fully supervised environment where sharp regulatory capital declines are not permitted. That, in turn, will enable supervisors to determine whether fully supervised, up-and-running systems using the new risk-based capital requirements result in capital charges that accurately reflect differences in risk within and among banks, which is, of course, the fundamental objective of Basel II.

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

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

Implementation Issues

Let me turn now to implementation issues facing banks subject to Basel II. Obviously, as we move closer to the effective date for Basel II, implementation becomes the focus of attention for both banks and supervisors. It has certainly been the IIB’s focus in its recent discussions with national supervisors and the Accord Implementation Group, or “AIG.” As Basel II was developed, all supervisors recognized that this new Framework would require more cooperation and coordination than the current regime, especially when it involves complex banking groups. The actions of the Basel Committee, most directly seen through the creation and work of the AIG, reflect that need for greater coordination. At the same time, however, we must recognize that, while the Basel Committee is a coordinating mechanism for national supervisors, it is the individual supervisors who will continue to have the legal responsibility to oversee the activities of institutions operating within their respective jurisdictions. If approached pragmatically, I believe that workable solutions to home/host issues that address the needs of both internationally active banks and national supervisors can be achieved.

Later this afternoon, I understand that Nick LePan, Chairman of the AIG, will discuss many of the specific issues facing banks as they move forward towards implementation. In deference to Nick, I will not try to address those issues in the same detail as he will. I do, however, want to offer my perspective on these challenges and possible ways forward. First, there are numerous mechanisms through which we can and will address home/host issues associated with Basel II, including AIG activities and multilateral discussions, bilateral discussions among supervisors, and national rulemaking efforts. In terms of multilateral discussions, the Accord Implementation Group was conceived as a discussion group with a mandate to promote consistency in the application of Basel II in different countries. The AIG has been the primary impetus in the development of "supervisory working groups" – multilateral groups of supervisors responsible for the supervision of individual banks. Within the past few months, the AIG has published a number of documents designed to ensure a measure of consistency in implementation, including papers on home/host information sharing; validation of low default portfolios; and treatment of expected loss under the Advance Measurement Approach for operational risk. The AIG will continue to be an important part of the solution, but it is not and was never intended to be a multilateral rule-setting group.

Indeed, given the differences in national systems that have always been recognized by the Basel Committee, there are practical limits on the ability of AIG or any other multilateral group to fully address home/host issues. As a result, in my view the most effective means to resolve such issues under Basel II is the method most effectively used today: bilateral discussions between different national supervisors in the context of an individual bank. The U.S. banking agencies have had great success working with banks and foreign supervisors to address home/host issues in the past, and we have every confidence that such success will continue under Basel II. Indeed, we see progress in this area already: U.S. supervisors and our foreign-based counterparts have already begun working to understand and coordinate our respective roles in the oversight of individual companies under a Basel II regime.

My second point on home/host issues is also a pragmatic one. Home/host has become a convenient catchall for a wide variety of concerns. It is critical for supervisors and banks to scrutinize and prioritize these concerns to allow us to focus more closely on that smaller set of issues critical to the success of Basel II. Moreover, many of the home/host concerns under discussion today are not new. Rather, they are questions, information-sharing protocols, and coordination challenges that routinely arise in any cross-border banking context. While many of these questions have been made more complicated in the context of Basel II, supervisors have long experience and considerable success addressing these matters.

Third, the U.S. agencies recognize that certain of the home/host concerns relate to the revised implementation schedule for Basel II, with the creation of the so-called "gap-year" in the U.S. implementation of Basel II relative to other jurisdictions. We are very much aware that differences in implementation details, including the timeline, can create significant challenges for banks operating in multiple jurisdictions. While some of these differences are unavoidable, the OCC and the other U.S. banking agencies will continue to work closely with foreign-based regulators to address these issues as they arise. In fact, the bilateral progress already being made on implementation issues specifically includes progress on gap-year concerns.

Finally, many of the home/host concerns appear to arise from the delay in release of proposed U.S. implementing regulations and the resulting uncertainty that has meant for banks. The publication of the U.S. Notice of Proposed Rulemaking for Basel II will not resolve all of these issues, and indeed, it will surely surface others that will attract comment. But the NPR should alleviate the uncertainty associated with many current concerns, including the basis for floor calculations and the resulting need for "throw-away" systems. During the NPR's notice and comment process the agencies will welcome comment from all interested persons who identify implementation issues and other concerns.

In sum, the OCC and the other U.S. agencies strongly believe that the successful resolution of home/host issues is a critical piece of our Basel II implementation program. Solutions to these problems will enhance the ability of internationally active banks to interact on a meaningful and consistent basis with various supervisory authorities while, at the same time, improving the way that supervisors interact with each other. Practical solutions are critical to achieve this goal.

Next Steps

Let me conclude with a brief discussion of where the U.S. agencies hope to go from here. In the next several weeks, we plan to finalize the draft NPR on Basel II, and I believe we are on track to achieve that result. In addition, related materials, including proposed supervisory guidance on both credit risk and operational risk, will also be released for public comment in the coming months. Taken together, these substantial materials will provide a detailed, up-to-date expression of precisely what the agencies have in mind with respect to Basel II.

And that, of course, will be followed by a significant comment period, during which I hope and expect we will receive constructive comments and suggestions, which of course we will take into account before moving to any final rule. I say that with respect to a number of institutions in this room, because all of you can add value to this process. And I say it also with respect to members of Congress, who have made very clear their very real concerns with the future of this rulemaking. If it is to move forward, Basel II must withstand the scrutiny of all interested parties, with modifications made as appropriate. That is the very purpose of the notice and comment process, and the sooner we expose our draft to the public for comment and improvement, the better.

That leads me to our parallel rulemaking regarding changes to the risk-based capital rules for institutions that will not be subject to Basel II. That is, because regulations must be tailored to the size, structure, complexity, and risk profile of banking institutions, we recognize that application of Basel II should and will be limited to large complex institutions. But we also need meaningful but simpler improvements in our risk-based capital rules for smaller, less complex banks. Our Basel IA initiative is intended to address this need, as well as competitive equity issues raised by adoption of Basel II. As you know, we have already issued an Advanced Notice of Proposed Rulemaking with respect to Basel IA. Based on the comments we have received, the agencies expect to complete and release a Notice of Proposed Rulemaking in the next several months, with a comment period that overlaps with the comment period for Basel II. I continue to believe that it is very important that the public be able to compare, contrast, and comment on definitive proposals for both Basel II and Basel IA in overlapping timeframes.

In conclusion, if I could leave you with one basic thought today about Basel II and Basel IA, it would be this: in terms of safety and soundness, which is the very heart of my job, I believe we are moving in the right direction to address the increasingly large and complex risks of our largest banks, as well as the changing risk profiles at all other banks. We may not have the details right yet, and we will surely make changes as we go forward. But so long as we have adequate safeguards in place as we do so, I believe we should push ahead.

Thank you very much.