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TESTIMONY OF

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COMPTROLLER OF THE CURRENCY

before the

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

of the

UNITED STATES SENATE

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Statement Required by 12 U.S.C. § 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, I appreciate this opportunity to discuss the U.S. agencies' proposals to update and enhance our regulatory capital program. The agencies have developed two distinct proposals to better tailor a bank's capital rules to the complexity of its risks. For our largest banks, the fundamental thrust of our efforts is the U.S. implementation of the Basel II Framework – a more risk-sensitive regulatory capital system better suited to the complex operations and activities of these institutions. For banks not adopting Basel II, the primary goal of our so-called Basel IA initiative is to increase the risk sensitivity of our risk-based capital rules without unduly increasing regulatory burden.

These efforts are intended to ensure that bank risk management practices and regulatory capital requirements are commensurate with the current and emerging risks facing the banking industry. I view this goal as one of my highest supervisory priorities and critical to the maintenance of the long-term safety and soundness of our banking system. While the U.S. banking industry continues to operate profitably, supervisors must ensure that bank risk management systems and regulatory capital rules appropriately address current and emerging safety and soundness challenges.

The agencies have and will continue to foster an open process as we move forward with these proposals to consider comments from all interested persons, heed good suggestions, and address legitimate concerns. In this way, we can ensure that we make prudent, well reasoned, and well understood changes to bank capital requirements and to related supervisory policies.

BASEL II

The 1988 Basel Accord, also referred to as Basel I, established a framework for risk-based capital adequacy standards that has now been adopted by most banking authorities around the world. The U.S. agencies have applied rules based on the 1988 Basel Accord to all U.S. insured depository institutions. Although Basel I was instrumental in raising capital levels across the industry in the United States and worldwide, it became increasingly evident through the 1990s that there were growing weaknesses in Basel I. In particular, the relatively simple framework has become increasingly incompatible with the increased scope and complexity of the banking activities of our largest banking institutions. The crude risk-weighting mechanisms of Basel I bear little resemblance to the complex risk profiles and risk management strategies that larger banks are capable of pursuing. The misspecification of risk under Basel I creates inappropriate incentives and arbitrage opportunities that can undermine supervisory objectives. And dealing with outdated and mismatched regulatory requirements is costly to banks.

In response to these issues, the Basel Committee commenced an effort to move toward a more risk-sensitive capital regime, culminating in the publication of the Basel II Framework. As the OCC has noted in earlier hearings, we firmly support the objectives of the Basel Committee and believe that the advanced approaches of the Basel II Framework – the advanced internal ratings-based approach (IRB) for credit risk and the advanced measurement approaches (AMA) for operational risk – constitute a sound conceptual basis for the development of a new regulatory capital regime for large internationally active banks.

Yesterday, the agencies published in the *Federal Register* a notice of proposed rulemaking (NPR) regarding the implementation of Basel II in the United States. While a draft of the Basel II NPR had already been made publicly available, yesterday's publication marks the start of the official 120-day public comment period, which will run through January 23.

This proposal reflects a consensus by all U.S. agencies that implementation of the Basel II Framework should move forward to the next stage in the process. In that context, the agencies agree on two fundamental points: first, supervisors must ensure that regulatory capital rules appropriately address existing and emerging risks, and second, the current, simplistic Basel I framework no longer does that for our more complex banks.

Indeed, the inadequacies of the current framework are especially pronounced with respect to larger U.S. banks, which we know well, because the OCC is the primary federal supervisor for the five largest. These institutions, some of which hold more than \$1 trillion in assets, have complex balance sheets, take complex risks, and have complex risk management needs that are fundamentally different than those faced by community and mid-sized banks. For that reason, the agencies developed the Basel II NPR, which is itself complex, but which would be required to apply to only a dozen of our largest and most internationally active U.S. banks.

The purpose of Basel II implementation in the United States is not only to align capital requirements much more closely to the complex risks inherent in these largest institutions, which the proposal attempts to do. At least as important – and this is a total departure from the existing capital framework – the proposal would also require our

largest banks to substantially improve their risk management systems, control structures, risk information systems, and related public disclosures. These enhancements would be accomplished using a common framework and a common language across banks that would allow regulators to better quantify aggregate risk exposures, make more informed supervisory decisions, and make peer comparisons in ways that we cannot today. If successful, such improvements would establish a more rigorous relationship among risk, risk management, and capital in our supervisory structure and measurably strengthen our safety and soundness regime for our largest banks. In addition, the enhanced public disclosure required under Basel II would better inform the market about a bank's risk exposures and provide a consistent and understandable disclosure framework that would enhance comparability and facilitate market discipline.

As has been widely reported, we have received several comments on an earlier draft version of this NPR. Certain of those commenters requested that we amend the NPR to permit Basel II banks the option of using simpler approaches in the calculation of capital requirements for credit risk and operational risk. To ensure that all interested parties have the opportunity to comment on this fundamentally important issue, the agencies added a question to the Basel II NPR's preamble addressing this issue. As I mentioned earlier, one of the primary goals of the agencies in developing these proposals is – as much as possible – to tailor a bank's capital rules to the complexity of its risks. Thus, the advanced approaches of the Basel II NPR are targeted to large, complex banks. By the same token, the simpler Basel II approaches, as well as the forthcoming Basel IA proposal, have been developed with an eye towards less complex banks with more traditional risk profiles and activities. In this regard, we are very interested in comments

on the appropriateness of permitting simpler alternatives to the advanced approaches for our largest, most complex banks, especially as it relates to safety and soundness and competitive equity concerns. I believe this is a legitimate question, given that the largest banks in other Basel II countries have the option of simpler alternatives to the advanced approaches. On the other hand, as the agencies note in the preamble to the NPR, virtually all non-US banks comparable in size and complexity to our core banks appear to be adopting the advanced approaches, though not with the changes that we propose in the NPR. I hope commenters will take all these factors into account when responding to the question.

The agencies have also received comments from U.S. banks expressing concerns about what they believe is the excessive conservatism of the NPR. Many of the specific provisions of the NPR cited by the banks relate to safeguards put in place by the agencies after an assessment of the results of our last quantitative impact study, discussed below, including the enhancement of the NPR's transition period to strictly limit potential reductions in capital requirements through capital floors and other devices.

In previous Congressional testimony, in Basel Committee deliberations, and in discussions with the industry and other supervisors, the OCC has repeatedly emphasized that reforms to our regulatory and supervisory structure must be adopted in a prudent, reflective manner, consistent with safety and soundness and the continued competitive strength of the U.S. banking system. In furtherance of those standards, the U.S. agencies conducted Quantitative Impact Study 4 (QIS-4) in late 2004 and early 2005.

It is well known that QIS-4 helped us identify significant issues about Basel II implementation that have not been fully resolved. The QIS-4 submissions evidenced

both a material reduction in the aggregate minimum required capital for the QIS-4 participant population and a significant dispersion of results across institutions and portfolio types. One measure produced by QIS-4 is the estimated change in “effective minimum required capital,” which represents the change in capital components, excluding reserves, required to meet the eight percent minimum total risk-based ratio. This measure is independent of the level of capital actually held by institutions and of their currently measured capital ratios. After application of a scaling factor as proposed in the NPR, the decrease in effective minimum required capital compared to existing standards was 11.7 percent, with a median decrease of 22.6 percent, aggregating over the QIS-4 participants. Additional QIS-4 analyses also confirmed that the dispersion in results – with respect to individual parameter estimates, portfolios, and institutions – was much wider than we anticipated. In particular, the agencies’ additional analysis revealed a wide dispersion of results between institutions with respect to individual credit exposures and selected portfolios, even when controlling for differences in risk.

In short, the QIS-4 results and the inevitable questions they raise have been the source of serious concern for the banking agencies. There is consensus among the agencies that, if these were indeed the results that would be produced by a final Basel II rule, that would be unacceptable. Having said that, there were very significant limitations to QIS-4, and as a result, it would be a mistake to assume that the magnitude of the reduction and dispersion in capital requirements that were estimated would hold true with a fully implemented Basel II rule. In particular, because the regulators had not yet specified all the requirements for a complete Basel II regime, QIS-4 could not be designed to take into account such requirements. Even more important, the integrity of

the final capital requirements produced by a “live” Basel II system will be affected fundamentally by the scrutiny that examiners will apply to the inputs that banks will provide to produce the final capital requirements. With a final rule, final supervisory guidance, and rigorous examiner scrutiny, we believe the magnitude of capital reductions and dispersion revealed by QIS 4 is likely to be mitigated.

Nevertheless, that outcome is not assured, and as a result, the process for implementing Basel II as established in the NPR is designed to provide the OCC and other agencies a complete understanding of the Framework’s implications for the banking system without risking unacceptable capital reductions. Specifically, the Basel II NPR includes several key elements that allow for the progress we believe is necessary, over time, for risk management and supervisory purposes, while strictly limiting reductions in risk-based capital requirements that might otherwise result from systems that have not been proven.

The first element is a one-year delay in initial implementation, relative to the timeline specified by the Basel II Framework. As a result, the “parallel run,” which is the pre-qualification period during which a bank operates IRB and AMA systems but does not derive its regulatory capital requirements from them, will be in 2008. The parallel run period, which will last at least four quarters but could be longer for individual institutions, will provide the basis for the OCC’s initial qualification determination for national banks to use Basel II for regulatory risk-based capital purposes. Following initial qualification, a minimum three-year transition period would apply during which reductions in each bank’s risk-based capital would be limited. These limits would be implemented through floors on risk-based capital that will be simpler in design and more

conservative in effect than those set forth in Basel II. For banks that plan to implement the Basel II Framework at the earliest allowable date in the United States, we are proposing the following timetable and transitional arrangements:

Year	Transitional Arrangements
2008	Parallel Run
2009	95% floor
2010	90% floor
2011	85% floor

The OCC will assess national banks' readiness to operate under Basel II-based capital rules consistent with the schedule above and will make decisions on a bank-by-bank basis about termination of the floors after 2011.

We will also retain the Prompt Corrective Action (PCA) and leverage capital requirements in the proposed domestic implementation of Basel II. For more than a decade those provisions have complemented our basic risk-based capital rules, and U.S institutions have thrived while building and maintaining strong capital levels – both risk-based and leverage. This capital cushion has proved effective, not only in absorbing losses, but also in allowing banks to take prudent risks to innovate and grow.

While we intend to be true to the timelines above, we also expect to make further revisions to U.S. Basel II-based rules if necessary during the transition period (*i.e.*, before the system-wide floors terminate in 2011) on the basis of observing and scrutinizing actual systems in operation during that period. That will allow us to evaluate the

effectiveness of the Basel II-based rules on the basis of real implementation and to make appropriate changes or corrections while the prudential transition safeguards are still in effect. In other words, we will have strict safeguards in place to prevent unacceptable capital declines during the transition period, and if we believe that the rule would produce such declines in the absence of these safeguards, then we will have to fix the rule. Of course, any future revisions will also be subject to the full notice and comment process, and we expect to look to that process where necessary to help resolve difficult issues.

Much has been said recently about the differences between our implementation of Basel II's advanced approaches in the United States and that of other countries. While optimistic about the bank risk management and risk information systems improvements, enhanced controls, additional public disclosures and other benefits resulting from Basel II implementation, we certainly recognize that we are approaching Basel II with greater caution than some jurisdictions, and I would like to reiterate our reasons for doing so. First, despite their promise, Basel II advanced systems are as yet untested. We are not so much concerned about whether these systems will ultimately succeed – we believe they will – as we are with understanding what additional refinements may be necessary to ensure that success.

Second, the U.S. rulemaking process gives us advantages that are not shared by all supervisors. We are fortunate to be able to assess potential effects and identify potential concerns *before* finalizing a rule for implementation. In contrast, QIS-5 was conducted in Europe *after* the European Parliament finalized its implementation of Basel II into law, leaving European supervisors with very little ability, at least in the near term, to make changes. I cannot predict whether, in the near term, that might result in declines

in capital requirements for European banks unavailable to U.S. banks under the Basel II NPR as proposed. If it does, however, I can assure you I would rather be in the position we are in here. And if it occurs, it would be neither unprecedented nor necessarily detrimental to our banks. Almost since its adoption, U.S. Basel I-based rules have been accompanied by additional, complementary safeguards not replicated in other jurisdictions. For example, in addition to our unique PCA framework, we amended our Basel I-based rules to address the risks of certain securitization transactions long before most of the rest of the world (some of which will address securitizations for the first time with Basel II implementation), and yet our banks continue to be world leaders in securitization markets. U.S. banks have long operated with both higher capital *and* higher profitability than most of their peers around the world. Strong capital is by no means antithetical to either innovation or high profitability.

Having said all of this – especially the need for caution during the transition period – there may well be parts of the proposal that are overly conservative. The notice and comment process will undoubtedly result in a complete discussion by commenters of provisions that raise such concerns. I will carefully consider such comments, and to the extent they are valid, I believe we should make changes to the rule before it becomes final.

The OCC has been a frequent critic of many elements of the Basel II Framework, and we have worked hard to make important changes to the proposal that we thought made sense. But it is also true that, at critical points in the process, the OCC has supported moving forward towards implementation. Our reason for doing so is simple – an appropriate Basel II regime assists both banks and supervisors in addressing the

increasingly complex risks faced by our largest institutions. While we may not have all the details of the proposals right yet, and we will surely make changes as a result of the public comment process, I fully support the objectives of the Basel II NPR. I want to see these proposals work because I am convinced that, if they do, they will strengthen the safety and soundness of the banking system.

BASEL IA

The complex Basel II NPR is neither necessary nor appropriate for the vast majority of U.S. banks. Many of these institutions need meaningful but simpler improvements in their risk-based capital rules to more closely align capital with risk. The OCC's primary objective in developing the Basel IA proposals is to create a domestic risk-based capital rule with greater risk sensitivity, but without unduly increasing complexity or burden. That is no small challenge, and we recognize that there will be limits in the level of risk sensitivity that we can achieve in a relatively noncomplex rule designed for broad applicability to a vast array of credit exposures.

Nonetheless, we believe there are areas in which our current rules can be significantly improved without requiring massive investments in new systems and controls. In that respect, it is important to note that, unlike Basel II, the Basel IA proposals are not intended, in and of themselves, to dramatically improve risk management. Rather, they represent an effort to design a simple but better measure of minimum regulatory capital requirements. Likewise, the results of Basel IA are not intended to replicate Basel II results – but by moving risk measurements in the right direction, we do expect to narrow some of the potential gaps between Basel IA and Basel II results.

The agencies remain committed to issuing the Basel IA NPR in the near future. We believe that overlapping comment periods for these two rulemakings is a critical element of our on-going effort to assess the potential competitive effects of both sets of proposals on the U.S. banking industry.

Thank you very much.