For Release Upon Delivery
10:00 a.m., May 11, 2005

TESTIMONY OF

JULIE L.WILLIAMS

ACTING COMPTROLLER OF THE CURRENCY

before the

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

and the

SUBCOMMITTEE ON DOMESTIC AND INTERNATIONAL MONETARY POLICY, TRADE AND TECHNOLOGY

of the

COMMITTEE ON FINANCIAL SERVICES

of the

U.S. HOUSE OF REPRESENTATIVES

May 11, 2005

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

Chairwoman Pryce, Chairman Bachus, Congresswoman Maloney, Congressman Sanders, and members of the Subcommittees, thank you for inviting the Office of the Comptroller of the Currency (OCC) to participate in this hearing on the U.S. implementation of the "International Convergence of Capital Measurement and Capital Standards: A Revised Framework," generally known as the Basel II Framework, and on proposed legislation H.R. 1226, entitled "United States Financial Policy Committee for Fair Capital Standards Act." I welcome the opportunity to participate in these important discussions.

My written statement covers five principal areas. First, I will provide a brief review of events and actions that have occurred to date, in order to provide perspective and context to my discussion of where we currently stand. Second, I will explain the current status of the U.S. Basel II implementation process, with particular emphasis on the preliminary analyses of quantitative information that we obtained from a number of large U.S. institutions in the past few months. Third, I will describe the next steps in the implementation efforts of the U.S. agencies, focusing on efforts to better understand the likely effects of the Basel II Framework as we develop domestic regulatory proposals. Fourth, I will review the current status of Basel proposals and industry preparations for the advanced measurement approaches for operational risk. Finally, I will offer comments on H.R. 1226 and its proposed new structure and process for interagency deliberations and international negotiations within the Basel Committee on Banking Supervision.

At the outset, I want to highlight three commitments that are central to our on-going analysis and implementation of the Basel II Framework: first, an open rule making process in which comments are invited and considered, good suggestions are heeded, and legitimate concerns are addressed; second, a reliable quantitative analysis prior to adoption of a rule, through which we can assess the likely impact of Basel II on the minimum regulatory capital requirements of our banks; and third, a prudent implementation in which we make well reasoned and well understood changes to bank capital requirements and incorporate in those changes appropriate conservatism.

Background

In June 2003, principals of the U.S. banking agencies testified before the Subcommittee on Financial Institutions and Consumer Credit on the work of the Basel Committee on Banking Supervision (Basel Committee) to revise the 1988 Capital Accord – work that was ultimately to become the Basel II Framework. 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 most other banking authorities around the world have adopted it. U.S. banking and thrift agencies have applied the 1988 framework to all U.S. insured depository institutions. By the late 1990s, however, it became evident that there were weaknesses in the Basel I framework. In particular, the relatively simple framework was becoming less appropriate for the increased scope and complexity of the banking activities of our largest banking institutions. In response, the Basel Committee commenced an effort to revise Basel I and move towards a more risk sensitive capital regime. As we said in the June 2003 hearing, the OCC firmly supports the objectives of the Basel Committee and believes that the Basel II Framework constitutes a sound conceptual basis for the development of a new regulatory capital regime. As we also noted in that hearing, however, we must better understand the practical effects of the implementation of such a new regime before we move forward.

In the nearly two years since that hearing, much has transpired in the Basel Committee, among the U.S. agencies, and within the U.S. banking industry. Let me briefly recap some of the critical activities during this period.

In July 2003, the U.S. agencies published an advance notice of proposed rulemaking (ANPR), based largely on the Basel Committee's third consultative paper (CP-3). The ANPR provided a description of proposed revisions to current capital regulations, while seeking comment on outstanding or contentious issues associated with the proposal. The ANPR also requested information on the cost of implementing the proposal, and sought comment on the competitive implications in both domestic and international markets for banks of all sizes, in part to help us assess and comply with certain procedural requirements of Executive Order 12866 (discussed below). In conjunction with the ANPR, the banking agencies also issued 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 Internal Ratings-Based Approach (AIRB) for corporate credits.

On June 26, 2004, the Basel Committee published the Basel II Framework, which incorporated significant changes from its earlier proposals, many of which were identified through comments on CP-3, the ANPR, and analyses of a quantitative impact study conducted by the Basel Committee known as QIS-3. Through the publication of the Framework, the members of the Basel Committee sought to secure some measure of international convergence on the risk-based rules applicable to internationally active banks. To facilitate harmonization in national implementation efforts, the Basel Committee also established common timelines for the adoption of the Basel II Framework. As it relates to the AIRB and AMA elements, the Basel II Framework would be available for implementation on January 1, 2008, with a trial "parallel run" period commencing on January 1, 2007.

It is important to recognize that even when adopted by the Basel Committee, the Basel II Framework will not apply to U.S. institutions unless and until the U.S. banking agencies take action, especially including the adoption of regulations, to implement it. Accordingly, on the same day as the publication of the Basel II Framework, the U.S. banking agencies published a Joint Release describing U.S. efforts to implement the Basel II Framework. Reflecting principles described in and comments received on the ANPR, the June 26, 2004 Joint Release described the agencies' plans to incorporate the AIRB and AMA into regulations and supervisory guidance for U.S. institutions. These plans were designed to ensure that U.S. implementation efforts are consistent with the Framework; reflect the unique statutory, regulatory and supervisory processes in the United States; and appropriately seek and consider comments on individual aspects of the plan from all interested parties.

Among the critical features in the U.S. implementation plan described in the June 26, 2004 Joint Release was an assessment of the implications of the Framework on U.S. regulatory capital requirements through a domestic quantitative impact study (QIS-4) and the solicitation of public comments on necessary revisions to existing capital adequacy regulations through a notice of proposed rulemaking (NPR). The Joint Release established a mid-year 2005 target date for the publication of the NPR, with full implementation of Basel II-based rules expected to begin in January 2008, consistent with the timeline in the Basel II Framework.

In another Joint Release published January 27, 2005, the agencies explained their current thinking on optional steps U.S. institutions could begin to take immediately if they wished to prepare for adoption of Basel II-based rules at the earliest possible implementation date. This Joint Release reaffirmed the mid-year 2005 plan for publication of the NPR.

As noted above, the Basel Committee established a common implementation date for the adoption of the Basel II Framework. While necessary to facilitate harmonization among national supervisors, the establishment of a definitive implementation date prior to the development of proposed implementing regulations put significant and unique pressures on the U.S. rulemaking process and on U.S. institutions seeking to adopt the Basel II Framework. To meet AIRB and AMA requirements, those institutions will need to develop and employ extensive data systems, management structures, and control devices. Obviously, without the ability to reference fully articulated implementing regulations and standards, it is difficult for institutions to undertake this work. The January 27, 2005 Joint Release discussed how best to address this problem, especially for those banks wishing to begin preparations now in order to adopt Basel II-based rules at the earliest possible implementation date. However, the need for supervisors and institutions to take tangible steps before the issuance of final rules and guidance will continue to present challenges to the Basel II implementation process.

While the vast majority of the substantive requirements relating to the Basel II Framework were set forth in June 2004, the Basel Committee is still considering additional substantive additions to Basel II. On April 11, 2005, the Basel Committee published for comment a proposal to modify certain aspects of the Basel II Framework. These modifications relate to the treatment of counterparty credit risk for over-the-counter derivatives and certain short-term financing transactions; the treatment of "double-default" effects for hedged transactions; short-term maturity adjustments under internal ratings-based approaches; the valuation, risk management and capital treatment for less liquid instruments held in the trading book; and the design of a specific capital treatment for unsettled and failed transactions. The Basel Committee and the International Organization of Securities Commissions (IOSCO) jointly developed this proposal, which deals in part with issues especially critical to IOSCO's endorsement of Basel II for securities firms.

The Basel Committee is also considering whether adjustments or clarifications are necessary to the provisions currently in the Basel II Framework regarding how institutions are to take economic downturn conditions into account in developing estimates of loss severities, referred to as loss given default (LGD). Basel II requires banks to consider the extent to which loss severities are likely to exceed long-run average rates during periods when credit default rates are substantially higher than average. When significant cyclical variability in loss severities exists, banks are required to incorporate that variability into their LGD estimates, resulting in so-called "economic downturn" or "stress" LGDs. However, there are currently no established industry standards or common practices relating to how to estimate downturn LGDs, and variances in practice will lead to corresponding differences in capital requirements.

Competitive Effect Concerns

As a critical feature of the Basel II negotiation and implementation process, the OCC and the other agencies have focused considerable effort and attention on the potential competitive effects of the Basel II Framework on the U.S. financial services industry. As the OCC has stated in prior testimony, we are concerned that Basel II may create or exacerbate relative advantages between large domestic banks and mid-size/small domestic banks; between bank and non-banks; and between domestic banks and foreign banks. It is imperative that the U.S. agencies remain sensitive to these concerns and continue to assess any unintended consequences resulting from the implementation of Basel II.

As implemented in the U.S., Basel II would result in a bifurcated regulatory capital regime, with the largest banks subject to Basel II-based requirements and most 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. Rather, the agencies are undertaking a separate but related effort to update and revise existing risk-based capital rules for those institutions not subject to Basel II-based rules. The agencies are developing these two regulatory capital regimes in tandem, to ensure that consideration of competitive effects are factored appropriately into each proposal. A more in-depth discussion of the effort to revise existing risk-based capital rules for those institutions not subject to Basel II-based rules is provided below.

Numerous efforts are in progress to further clarify potential competitive effects of the Basel II Framework on the U.S. financial services industry. Most certainly, the QIS-4 effort is the most direct and in-depth effort to better quantify these effects. The results are germane to both of the rulemaking efforts discussed above. Also, the OCC is preparing a regulatory impact analysis of the Basel II-based regulations pursuant to Executive Order 12866. This assessment of costs, benefits and alternatives will again aid in the assessment of relative competitive effects in our planned regulatory capital proposals. Finally, the agencies have made special efforts to better understand the impact of the Basel II operational risk proposal. Specifically, the agencies have completed on-site reviews of the operational risk practices at the largest U.S. banks and have received and continue to analyze data detailing recent operational risk losses. These efforts will help inform the agencies' work in assessing the extent to which the Basel II Framework might alter competition between certain banks and non-banks, particularly in businesses such as asset management and payments processing.

Each of the above efforts to better understand the potential competitive effects of the Basel II Framework are described in more detail below.

Current Status

Over the past several months, the U.S. agencies have engaged in what may be the most difficult stage of the Basel II implementation process – developing regulations and policies that both foster international harmonization of bank requirements and address the realities and practicalities of bank practices and bank supervision. As the discussions above and prior agency testimony point out, there is one constant in the OCC's work in this endeavor – reforms to our regulatory and supervisory structure must be adopted in a prudent, reflective manner, consistent with the safety and soundness and continued competitive strength of the U.S. banking system. In this regard, we are fully committed to three things in our on-going analysis of the Basel II Framework: first, an open rule making process in which comments are invited and considered, good suggestions are heeded, and legitimate concerns are addressed; second, a reliable quantitative analysis in which we can assess the likely impact of Basel II on individual banks and on the national banking system *prior* to its adoption; and third, a prudent implementation in which we make well reasoned and well understood changes to bank capital requirements and incorporate in those changes appropriate conservatism.

The U.S. agencies' efforts to better understand the possible effect of Basel II through the QIS-4 process is a critical element of the NPR development process. The QIS-4 process was designed to provide the agencies with a better understanding of how the implementation of the Basel II Framework might affect minimum required risk-based capital within the U.S. banking industry overall, at consolidated U.S. institutions, and for specific portfolios. As mentioned earlier, the Basel Committee has conducted earlier quantitative impact studies, but following the Basel Committee's QIS-3 exercise, it became clear to the U.S. agencies that we needed to do more. The QIS-3 results were simply not reliable in numerous respects – important elements of the proposed Framework were still unsettled, institutions had very little idea of what was expected of them and little ability to generate reliable data with existing systems, and supervisors had only limited ability to tailor the QIS-3 survey to reflect expectations about national implementation decisions. These shortcomings, combined with our steadfast belief in the need to understand the ramifications of Basel II *before* implementation, led us to undertake QIS-4 in the U.S.

While based on the provisions of the international Basel II document, QIS-4 reflected certain adjustments and clarifications needed to tailor the exercise for U.S. implementation and to elicit specific policy information considered helpful for the U.S. rulemaking process. The agencies intend to use the results of the QIS-4 process as critical inputs in the formulation of the NPR and in the assessment of competitive implications of the adoption of the Basel II Framework. QIS-4 results will also inform our efforts to update the U.S. regulatory capital regime for the vast majority of U.S. institutions that are unlikely to either be required to or to opt to use the Basel II-based regulation.

Institutions participating in QIS-4 were asked to submit results in the form of spreadsheets and answers to detailed questionnaires by the end of January. Agency staffs spent most of February and March compiling and assessing those results on an institution-by-institution basis, including direct follow up with institutions when necessary that, in some cases, resulted in substantial resubmissions. I commend the willingness of the industry to participate in this difficult and time-consuming effort.

After completing a preliminary analysis of the QIS-4 spreadsheets and questionnaires, certain initial observations became evident. Although apparently to a lesser extent than with QIS-3, institutions are still at various stages of development of the AIRB and AMA systems and processes necessary to implement the Basel II Framework in the U.S., particularly as it relates to data sufficiency. This differentiation among the industry was somewhat anticipated, but the data challenges are proving to be difficult to resolve, and they created limitations for the QIS-4 process. Even with those limitations, however, QIS-4 represents the best information available to the agencies in our assessment of effects and competitive implications of the implementation of Basel II.

The QIS-4 submissions evidence 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. Even acknowledging the differentiation in Basel II readiness among industry participants and the inherent limitations of the QIS-4 process, these results, and the inevitable questions they raise about the underlying causes, are a source of concern for the banking agencies.

Accordingly, on April 29, 2005, the U.S. agencies announced we would not publish an NPR with respect to U.S. implementation of Basel II on the schedule that we had previously announced. In order to ensure that we meet the standards we have set for ourselves in this process – that reforms to our regulatory and supervisory structure be adopted in a prudent, reflective manner, consistent with the safety and soundness and continued competitive strength of the U.S. banking system – the agencies have concluded that we must undertake additional analysis beyond that contemplated in the initial implementation timeline before publication of an NPR. This additional work is necessary to determine whether the preliminary QIS-4 results reflect actual differences in risk, simply reveal limitations of QIS-4, identify variations in the stages of bank implementation efforts, and/or suggest the need for adjustments to the Basel II Framework.

The decision to delay the NPR was not one that any of us reached easily or took lightly. We are particularly cognizant of the investment that institutions are making to prepare for Basel II implementation and the need those institutions have for greater certainty in the details of the U.S. implementing rules. We also understand U.S. institutions' concerns about maintaining competitive equality with large foreign banks moving perhaps more quickly toward Basel II. Based on the preliminary assessment of QIS-4 results, however, we concluded that a delay was the only responsible course of action available to us.

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 8 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. Aggregating over the QIS-4 participants, the decrease in effective minimum required capital was 17 percent, while the median decrease among participants was 26 percent (see Attachment 1).

Moreover, the dispersion in results – both across institutions and across portfolios – was much wider than we anticipated or than we can readily explain. Changes in effective minimum required capital for individual institutions ranged from a decrease of 47 percent to an increase of 56 percent. For individual QIS-4 participants, these changes would have a direct and dramatic effect on total risk based-capital ratios if existing levels of Tier 1 and total capital held were maintained. They are also roughly indicative of the proportions by which existing levels of risk-based capital would need be reduced or increased in order to maintain an institution's current risk-based capital ratio. 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-4 can be fully explained by relative differences in risk among institutions; it appears that comparability of QIS-4 results among different institutions may be severely lacking.

Finally, changes in minimum capital requirements – both increases and decreases – of certain portfolios significantly exceeded our expectations (see Attachment 2). An area likely to be of particular interest to a number of U.S. institutions is "qualified retail exposures," or QREs – essentially credit card receivables. For example, the increased capital requirements for QREs raise questions about whether the Basel II Framework runs the risk of disrupting established business models for QRE lenders and potentially affecting pricing or availability of consumer credit. Certain other product lines indicated larger declines in required capital than may be warranted. Residential mortgage and mortgage-related products, such as home equity lines of credit, for example, are among those that will require further analysis to better understand and assess the QIS-4 results and to determine if these results accurately reflect risk.

To the extent that the issues noted above cannot ultimately be explained by actual differences in risk, they may be attributed to either misspecifications in the institution-supplied inputs to the Basel II formulas, or to misspecifications in the formulas themselves. If estimates of basic inputs in the Basel II formulas (i.e., probabilities of default, loss severities in the event of default, and estimates of total exposures at the time of default expected loss) vary significantly between different institutions for similar exposures, that might indicate the possibility of insufficient reliability of the systems of one or both institutions. On the other hand, if inputs are reliably accurate but the resulting capital requirements do not appropriately relate to differences in risk between different exposure types, that would be a sign that the Basel formulas themselves need to be adjusted. Much of the further work we describe below will be designed to help us distinguish between these two types of potential shortcomings.

Next steps

The obvious question this raises is "what now"? We continue to believe in the potential of Basel II to achieve its crucial objectives – improved risk management, supported by significantly greater risk sensitivity in the regulatory capital framework. Yet, both the supervisory community and the industry have consistently underestimated the time required to convert the conceptual underpinnings of Basel II into a workable regulatory capital regime. We remain committed to pursuing the avenues available to us to find the right balance between flexibility and consistency in implementation of Basel II.

As I have indicated, the issues surfaced during our preliminary work point to a need for additional follow-up. We will continue to work with the other agencies toward a more complete assessment of the QIS-4 results. This assessment will focus on understanding the drivers of the dispersion in capital requirements across institutions as well as the dispersion of capital requirements within particular portfolios. We will also examine the causes of significant increases in capital requirements for credit card receivables and significant decreases for mortgages and mortgage-related products.

The first step in that process will be to continue our review and analysis of quantitative and qualitative information collected as part of the QIS-4 exercise. This information should give us a better sense of whether differences in historical data sets or quantification methodologies used by QIS-4 participants, rather than actual differences in risk, can explain some of the variations in Basel II capital requirements. For example, we are aware from QIS-4 questionnaires and preliminary follow-up discussions that many institutions used relatively short data histories, which, for most retail portfolios, represent a benign economic environment. We will examine whether those institutions using relatively longer data histories that incorporate periods of economic stress generally show higher capital requirements.

We will also conduct additional follow-up with certain QIS-4 participants. This follow-up will include the collection of additional targeted information that will allow us to better assess whether institutions assign significantly different risk parameters to the same or similar loans. For selected credit exposures with similar credit risk characteristics, for example, we expect to be able to compare the inputs that different institutions used in the QIS-4 process. For loans by different institutions to the same borrowers, we will specifically compare probabilities of default, and for some syndicated loans we will also be able to compare loss severities and exposures at default assigned by different institutions. We expect to make similar comparisons for pools of retail credits with similar risk characteristics.

We will also examine the extent to which different portfolio mixes affected QIS-4 results. For example, we will attempt to quantify the extent to which some institutions' drop in capital requirements are larger than others due to a relatively larger share of low-risk exposures, rather than due to differences in estimation of risk parameters. We will also attempt to examine the effect of the current stage of the economic environment by comparing selected data with data from lower points in the economic cycles. These and other sensitivity analyses should give us a better sense of the factors driving the QIS-4 results.

Once we have completed those steps, the agencies expect to be in a position to fully evaluate additional implications of the QIS-4 results, such as reconsideration of whether and the extent to which adjustments to the formulas or design of Basel II itself may to be needed. If we believe that changes in the Basel II framework are necessary, we will seek to have those changes made by the Basel Committee. While some might argue that the Committee is too far down the path of "finalizing" Basel II to accept any changes at this stage, I do not believe that most Basel Committee members would find their interests best served if the U.S. agencies were compelled to deviate significantly from Basel II in order to fulfill our supervisory responsibilities.

Executive Order 12866

Based on an assessment of its potential effects, the OCC has determined that the rules implementing Basel II will be a "significant regulatory action" for purposes of Executive Order 12866 (EO 12866). Consequently, the OCC (and OTS) must assess all costs and benefits of regulatory alternatives, including the alternative of not regulating. This assessment requires the preparation of a regulatory impact analysis (RIA) that will be published with the NPR.

Prior to publication, we will submit both the NPR and the RIA to the Office of Management and Budget (OMB) for review. The RIA will contain (1) a statement of the need for the proposed action, (2) an examination of alternative approaches, and (3) an evaluation of benefits and costs.

This analysis has begun and will continue, drawing in part on what we learn from additional work on the QIS-4 data. As we understand it, a similar pre-publication submission to OMB will be necessary prior to the issuance of any final Basel II-based rulemaking.

The RIA will describe the statutory authority for the regulatory action and identify the conditions that necessitate the regulatory action. It will include a description of the regulated community and a brief review of the history of capital adequacy regulation. We will analyze several alternatives to the regulatory action we propose, including maintaining the *status quo*, and several alternatives regarding the scope of the application of the proposed rule.

Our analysis of the costs and benefits of the proposal will consider the costs of complying with the proposed rule, the costs to the government of administering the rule, and systemic costs. We will consider the benefits of various features of the proposed rule, including the incorporation of advances in risk measurement and risk management practices into supervisory assessments of capital adequacy, the lessening of distortions in credit markets created by the current capital standard, and improvements in bank safety and soundness from a more risk-sensitive approach to establishing minimum capital requirements. Our analysis will also review the growing body of economic research on the potential for rules that implement the Basel II framework to affect competition among providers of financial services.

Revisions to Capital Rules for Non-Basel II Banks

As the agencies have announced previously, we will continue work on the development of a proposal to update and revise existing risk-based capital rules for those institutions not subject to the Basel II-based regulation in tandem with our ongoing work on Basel II implementation. Among the primary objectives in this effort will be to improve risk sensitivity in the domestic capital regime without the level of complexity found in Basel II. While we know we will not achieve identical results as the Basel II framework, we do expect to reduce some of the more significant differences in capital requirements between Basel II and non-Basel II institutions, and thus reduce potential competitive inequities.

We expect to publish an advance notice of proposed rulemaking concurrently with the Basel II NPR that will further explore and seek comment on possible revisions to the regulatory capital rules that will continue to be applicable to those banks not subject to Basel II. Because this proposal is a work in process, I can only speak about it in general terms, but some of the broad types of revisions that we are considering include: increasing the number of risk weight categories; expanding the use of external ratings in determining risk weights; modifying the risk weights associated with residential mortgages; assigning a credit conversion factor to certain types of short-term commitments and to certain securitization transactions; and assigning potentially higher risk weights to past due, nonaccrual and other loans deemed to present higher than normal risk.

Operational Risk

One of the most contentious issues in the development of the Basel II Framework was the introduction of operational risk as a separate and distinct component of minimum regulatory capital. Since the inception of the Basel II proposal, there were two competing views of the regulatory treatment of operational risk. Some have argued that operational risk is sufficiently similar to credit risk and market risk to be included as a Pillar 1 charge directly in capital regulations. Others have maintained that operational risk inheres in the quality of an institution's internal control systems, supporting a Pillar 2 approach in which supervisors focus on the qualitative evaluations of such systems.

It is important here to explain the evolution of the Basel Committee's consideration of operational risk, especially the development of the AMA proposal. While still included within Pillar 1, the AMA evidences a clear movement towards the principles underlying Pillar 2. Under the AMA, institutions will use their own internal assessment of the operational risks they face and the capital needed to support those risks, subject to supervisory approval. As set forth in the Basel II Framework, institutions would have considerable flexibility in developing their AMA estimates, provided their processes are comprehensive and well reasoned, and reflect accurately the risks the institution faces.

While recognizing the evolving nature of operational risk management as a discipline and the difficulties in quantifying operational risk exposures, institutions are making progress in developing and implementing effective operational risk management and measurement techniques. Over the past year, the U.S. agencies have undertaken a number of projects to directly assess the industry's efforts in this regard. During 2004, the agencies conducted an operational risk benchmarking review at each U.S. bank subject to Basel II-based rules on a mandatory basis as proposed under the ANPR. These reviews were intended to identify the current range of practice within the industry for the measurement and management of operational risk, to help assess the appropriateness of the agencies' current AMA guidance, and to assist agency efforts to develop additional supervisory guidance and training materials for institutions and examiners. Additionally, in conjunction with the QIS-4 process described earlier, the U.S. agencies also commenced an operational risk loss data collection exercise (LDCE). The LDCE was a voluntary survey that asked banking organizations to report the amount of individual operational losses as well as certain descriptive information regarding each loss (e.g., date, business line, loss type). The primary purpose of the LDCE was to aid supervisors in better understanding the completeness of the internal loss data on which the QIS-4 results are based and the extent to which those results depend on an institution's internal data, choice of modeling approaches, the incorporation of qualitative risk assessments, or other factors.

Preliminary analysis of the benchmarking and LDCE results highlights the significant efforts banks are making in addressing AMA requirements. The analysis of LDCE results confirms progress in the creation of AMA governance structures, development of quantification models, and construction of data systems to capture operational risk loss events. However, that analysis also confirms the need for additional work. Significant challenges remain in the collection and maintenance of comprehensive loss data and in model validation necessary to the development of acceptable AMA methodologies.

H.R. 1226

Recently introduced legislation entitled "The United States Financial Policy Committee for Fair Capital Standards Act" (H.R. 1226) would create an interagency Financial Policy Committee (FPC), chaired by the Secretary of the Treasury, responsible for unifying U.S. positions and reporting to Congress on the impact that Basel II would have on domestic and global financial systems. The FPC is designed to develop a cohesive U.S. government position prior to negotiating with other regulators on the Basel Committee. In the event of disagreement among the regulators or an inability to reach a consensus, the position of the Secretary of the Treasury would prevail.

We understand and share the desire of the bill's sponsors 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. As principal participants in both the Basel II and the domestic rulemaking processes, however, we do not believe that legislation is needed to compel that result. The rulemaking process itself for Basel II is an interagency endeavor that involves all the banking agencies in joint rulemaking. While we have not all agreed on every issue at every stage of the process, the interagency approach by necessity is highly collaborative and we are confident that we will continue to be able to work out any future differences, just as we commonly do in other joint rulemaking exercises. The fact that we recently agreed to delay the publication of the NPR is indicative of our commitment and ability to work together to ensure a full understanding of the ramifications of Basel II before proceeding with the next step in that formal rulemaking process.

Additional safeguards are already in place to require us to fully understand and publicly report on the implications of Basel II implementation in the U.S. Specifically, as noted above, the OCC has determined that the NPR regarding Basel II implementation will be a "significant regulatory action" for purposes of EO 12866. EO 12866 requires the OCC (and OTS) to provide specific information to the OMB for review prior to publication of the NPR and any final rule, including an assessment of the costs and benefits of the proposed regulatory action. We have begun this assessment, which will incorporate the results of additional QIS-4 analyses and will be published when the NPR is issued.

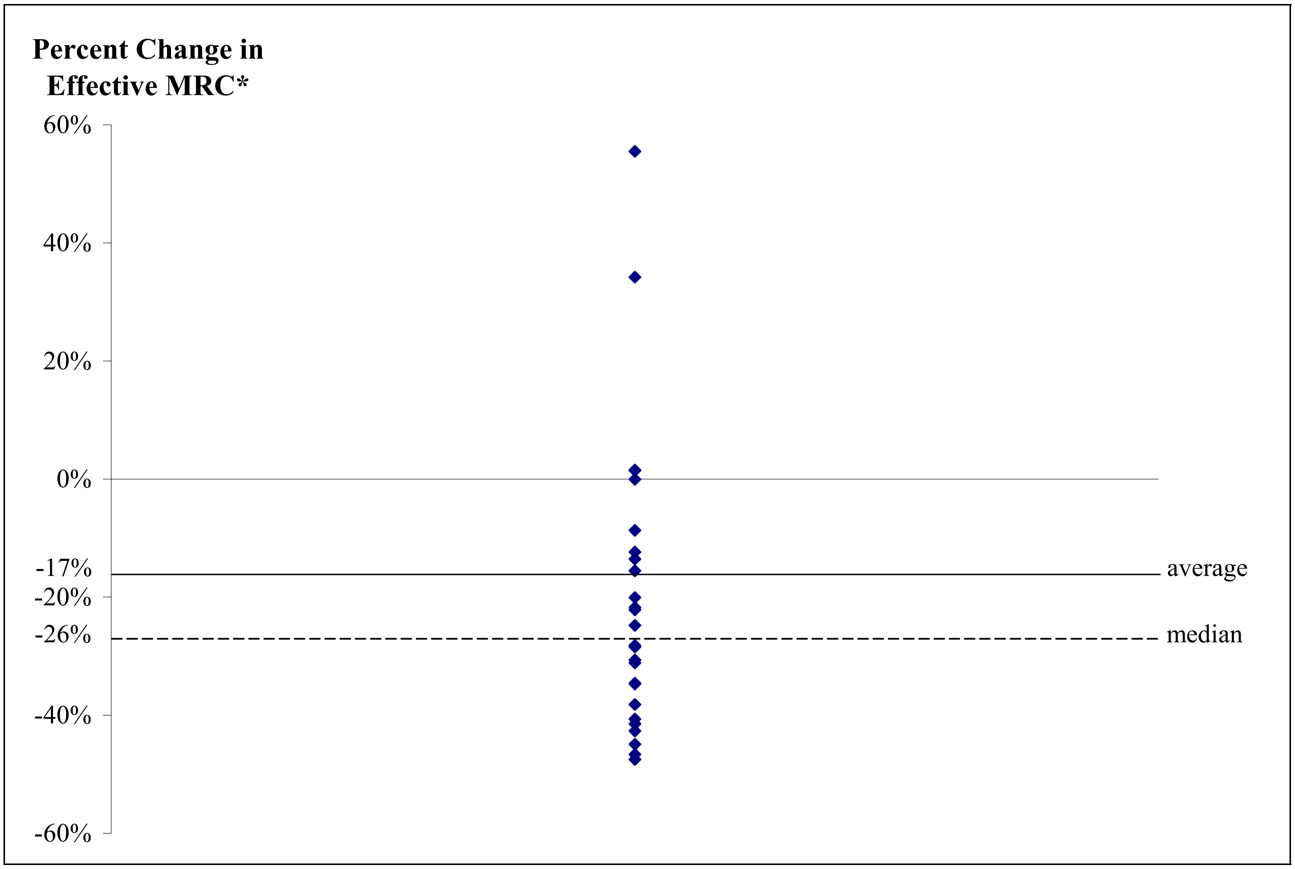
In short, we believe the interagency process is working well as currently structured and we are already obligated to conduct and make publicly available the kinds of analyses envisioned by H.R. 1226.

Conclusion

QIS-4 identified issues that we need to understand before taking the next formal steps toward U.S. implementation of Basel II – i.e., issuing an NPR. We cannot yet answer all the questions raised by those issues, but we remain committed to proceeding in a responsible manner. Despite the significant challenges that remain, we are committed to developing a revised risk-based framework that is fully consistent with safety and soundness, good risk management practices, and the continued competitive strength of all sectors of the U.S. banking system.

Attachment 1

Preliminary Change in Effective Minimum Capital Requirements of Participating Institutions: Basel I to Basel II



*This is the change in the amount of Tier 1 capital and Tier 2 elements other than reserves needed to meet the minimum capital requirement.

Note:
This is preliminary data as of May 5, 2005 for the twenty-six participating QIS-4 institutions; caution should be used in drawing any inferences from the aggregate data at this stage. The U.S. banking agencies plan additional work to determine whether these results reflect differences in risk, reveal limitations of QIS4, identify variations in the stages of bank implementation efforts (particularly related to data availability), and/or suggest the need for adjustments to the Basel II Framework.

Preliminary Change in Minimum Capital Requirements of Participating Institutions: Basel I to Basel II

Portfolio	% Change in Portfolio MRC	Median % Change in Port. MRC	Share of Basel I MRC	Share of Basel II MRC
Wholesale Credit	**(25%)**	**(24%)**	**44.3%**	**38.8%**
Corporate, Bank, Sovereign	(22%)	(30%)	33.9%	30.7%
Small Business	(26%)	(27%)	4.6%	4.0%
High Volatility CRE	(33%)	(23%)	1.8%	1.4%
Incoming Producing RE	(41%)	(52%)	4.0%	2.7%
Retail Credit	**(26%)**	**(50%)**	**30.5%**	**26.3%**
Home Equity (HELOC)	(74%)	(79%)	6.1%	1.8%
Residential Mortgage	(62%)	(73%)	11.1%	4.9%
Credit Card (QRE)	66%	63%	6.1%	11.7%
Other Consumer	(7%)	(35%)	6.0%	6.5%
Retail Business Exposures	(6%)	(29%)	1.2%	1.3%
Equity	11%	(9%)	1.3%	1.6%
Other assets	(12%)	(3%)	10.1%	10.4%
Securitization	(20%)	(40%)	7.9%	7.7%
Operational Risk			**0.0%**	**9.0%**
Trading Book	0%	0%	5.2%	6.0%
Portfolio Total	**(14%)**	**(24%)**	**100.0%**	**100.0%**
Change in Effective MRC*	**(17%)**	**(26%)**		

*This is the change in the amount of Tier 1 capital and Tier 2 elements other than reserves needed to meet the minimum capital requirement.

Note:
This is preliminary data as of May 5, 2005 for the twenty-six participating QIS-4 institutions; caution should be used in drawing any inferences from the aggregate data at this stage. The U.S. banking agencies plan additional work to determine whether these results reflect differences in risk, reveal limitations of QIS4, identify variations in the stages of bank implementation efforts (particularly related to data availability), and/or suggest the need for adjustments to the Basel II Framework.