Remarks by
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Before the
2007 RMA Annual Risk Management Conference
New Orleans, Louisiana
October 23, 2007

I appreciate the opportunity to be here today, for my third visit to New Orleans as Comptroller. Hurricane Katrina devastated this city just three weeks after I took office, and while banks have done an outstanding job here right from the initial days after the storm, there is still much to be done. I commend RMA, and other groups like yours, for making a point of bringing your convention business to the city as it continues its long struggle to get back on its feet — it's by no means a solution to the city's problems, but it certainly helps.

Before I turn to my remarks, let me officially congratulate Kevin Blakely, new president and CEO of your organization. He certainly has the right experience for the job – especially his 17 years with the OCC – and we wish him the best of success.

This morning, I would like to return to a topic that I have addressed several times during my tenure as Comptroller, and one that is most familiar to this audience – the Basel II Capital Accord. This time, however, I am delighted to say that my overall Basel II message can be summarized in two words: "forward progress." Now <u>that's</u> a phrase you don't often hear in the United States in the same sentence as "Basel II."

Specifically, I want to focus on three aspects of this forward progress: Pillar 1, meaning the enormous strides that the banking agencies have made – finally – in the rule-writing efforts regarding minimum capital requirements; Pillar 2, meaning the supervisory review of capital adequacy at individual firms, which has not received quite as much attention as Pillar 1; and finally – I'll bet you thought I was going to say Pillar 3, but I'm not

– what we have in mind for the very first stages of actual implementation of the new Pillar 1 rules for the so-called advanced approaches, that is, the Internal Ratings Based Approach for credit risk, or "IRB," and the Advanced Measurement Approach for operational risk, or "AMA."

Update on Rulemaking Efforts

So let me begin with the Basel II regulations and where we stand. On July 20th, the banking agencies announced our agreement resolving the major outstanding issues regarding a final U.S. regulation on the advanced approaches. This agreement successfully balanced a number of important factors, including safety and soundness, regulatory burden, and competitive equity, both from international and domestic perspectives.

For example, the agencies agreed that the final rule for large, internationally active banks in the U.S. should be fundamentally consistent in most respects with the Basel II Framework that is already being implemented in Europe and other countries. In so doing, the agencies acknowledged that the proposed rule had diverged too far from the text agreed to in Basel. During the notice and comment process, the agencies received many comments on the proposal, especially on such areas of divergence as the 10 percent limitation on aggregate reductions in risk-based capital and the different definition of default for the internal ratings-based approach to credit risk. The agencies found many of those comments compelling. Accordingly, the final rule has been revised to closely track the international framework text in most substantive respects.

At the same time, however, the July 20th agreement reiterated the intent to preserve unique U.S. safeguards that are critical for safety and soundness. Specifically, the final rule will retain the proposal's more stringent transitional floor periods and the Prompt Corrective

Action Regime of existing law, including the leverage ratio. The agencies also agreed to undertake a study during the transition period to assess whether the U.S. Basel framework is working as intended. As I have stated repeatedly, the OCC will closely monitor the effect of Basel II throughout implementation. The stringent transition safeguards will allow the agencies to analyze the implementation of IRB and AMA systems in a fully supervised environment where sharp regulatory capital declines are not permitted. That, in turn, will enable supervisors to determine whether the fully implemented regime results in capital charges that accurately reflect differences in risk within and among banks – which is, of course, the fundamental objective of Basel II. If it does not, then the agencies have committed to make further changes to address material problems.

Since July 20th, the agencies have worked very hard to translate the agreement in concept on the advanced approaches into the actual text of a final rule. I am pleased to report today that that objective has been accomplished. The OCC and OTS submitted a final draft of the advanced approaches rule to the Office of Management and Budget on October 5th, and we are hopeful for an expeditious response. The Federal Reserve and the FDIC are currently planning to vote on the text in early November, at which point it will become publicly available, with publication in the Federal Register likely to occur in late November or early December.

Meanwhile, also pursuant to the July 20th Agreement, the agencies are hard at work drafting a proposed rule that would provide all non-core banks with the option to adopt a standardized approach under the Basel II Framework. This proposal would replace the so-called "Basel IA" proposed rule that was issued last year. We expect this proposed standardized option to be published in the next several months, with the final rule issued before the advanced approaches become operational for the first year of the transition period.

Finally, other remaining materials for Pillar 1 are also nearing completion. Within the next few weeks, the agencies hope to approve and publish in final form the regulatory reporting requirements for the advanced approaches, otherwise known as the "templates." We also hope to conclude shortly the final amendments to the market risk rule governing banks with significant trading activities.

While I am very pleased with all this forward progress, I would also say that it's an awful lot to digest. That is especially true for banks implementing the advanced approaches, and banking agencies responsible for supervising that implementation. While everyone involved in this process wants to move forward as quickly as possible, we need to act prudently to implement this important change in our capital and supervisory regime. Bankers and examiners alike must take the time necessary to adequately review, understand, and prepare for the new regime, including the first stage of implementation of the advanced approaches – the so-called "parallel run" year.

Pillar 2

Let me now shift gears to my second topic. While most of the attention surrounding Basel II has focused on Pillar 1, the Basel Framework is designed to be more than just a new set of capital rules. It also aims to promote a more forward-looking approach to capital supervision, one that encourages banks to identify the risks they face and to work to improve their ability to manage those risks. I am talking now about supervisory review of capital adequacy under Pillar 2.

Pillars 1 and 2 of the Basel Framework were designed to be complementary. One way to think about the basic difference between these two pillars is this: Pillar 1 is about minimum regulatory capital requirements, based on stylized measures of some of the most important risks banks face, while Pillar 2 addresses whether actual capital held by a particular bank is adequate for all of its material risks, regardless of how they are addressed under Pillar 1.

For the most part, the U.S. approach to Pillar 2 is a restatement of longstanding U.S. supervisory practice. Supervisory assessments of capital adequacy for U.S. banks have long considered a variety of information in addition to regulatory capital ratios. For example, the OCC Examination Handbook clearly reflects the broader view of capital adequacy in supervisory practice. The "C" component of the CAMELS rating – for capital – considers factors such as plans for growth and past experience managing growth, earnings quality and dividend policy, access to capital markets, and the ability of the bank to address emerging needs for capital.

The ultimate aim of the Pillar 2 process is the comprehensive supervisory assessment of capital adequacy for an individual bank. This must include assessment of risk management processes, controls, risk profile, and existing capital position. It also must assess compliance with requirements for minimum regulatory capital (for example, as articulated in the advanced approaches); many of those requirements can be met with varying degrees of rigor, which in turn can be a crucial consideration in assessing the bank's overall capital adequacy.

Comprehensive supervisory assessment also incorporates consideration of a bank's Internal Capital Adequacy Assessment Process, the acronym for which is ICAAP. Most banks adopting the Basel II Framework already have some type of process like this. Now, I know that some have interpreted ICAAP to require complex models – specifically those based on the concept of "economic capital." There is no such requirement. ICAAP is a <u>process</u>, not a <u>model</u>. The acronym is I-C-A-A-**<u>P</u>**, with "P" standing for process; there is no "M for model" in the acronym for a reason.

I have nothing against models. But there's a good reason we don't require a single, all-encompassing risk model for Pillar 2. As you all know, models can be very useful. But as you all also recognize, there are important, material risks that can't be credibly or reliably measured. For risks that <u>are</u> deemed measurable, a quantitative approach should form the foundation of the risk assessment. But some material sources of risk, such as reputational and strategic risks, may be quite significant for some institutions. These less tangible risks certainly should be taken into account when assessing capital adequacy, but are not readily addressed by existing models. They require a more qualitative approach based on sound judgment. Of course, banks may use models based on economic capital methods as part of their ICAAP, and I would expect economic capital measures to be useful in the ICAAP. But economic capital models definitely are not required for ICAAP or for Pillar 2.

As a key part of this process we're calling ICAAP, banks are expected to engage in capital planning, which is an internal process for taking a thoughtful approach to ensuring that capital is adequate not just today, but also for the foreseeable future. Capital adequacy may vary over time with economic, financial, or credit cycles; a well-managed bank must plan for this kind of variation. A bank may choose to hold more capital to cover potential variations, or may have contingency plans with credible mechanisms for adjusting capital or risk in response to changes in the cycle. Of course, regardless of the outcome of the ICAAP, the bank's capital must continue to meet or exceed regulatory minimums.

Let me address one other common misperception in this area. The purpose of Pillar 2 is not to create an additional minimum regulatory capital requirement or an "add-on." Pillar 1 sets regulatory minimums, but does not say how much capital a bank should actually hold; Pillar 2 recognizes that a well-run bank needs its own process for determining that its capital is adequate, and also recognizes that supervisory review of such a process must be a key part of how we as supervisors determine a bank's capital strength.

Ultimately, the U.S. approach to Pillar 2 recognizes and reflects the longstanding practice of U.S. bank supervisors to exercise sound judgment in a reasonable, comprehensive way to account for the many factors that affect the adequacy of bank capital. This is the way we do it now, and this is the way we will do it in the future, because this just makes sense.

Implementation of the Advanced Approaches

Finally, let me turn to my third topic: an overview of the initial implementation work that we will expect of core banks adopting the advanced approaches. What I mean by this is the work required to begin parallel run, and thereafter, the work required to qualify for actual operation under the new regime for the first year of the bank's transition period. Much of what I am about to say is not new to many in this room. That's especially true for those of you who have been directly involved in the Basel process in the U.S., whether through commenting on rules or engaging with examiners in discussions concerning supervisory expectations on a whole range of matters. I raise it again, however, because I want to reemphasize that we are about to enter a new stage in the Basel process in the U.S. – a stage that focuses on institution-specific implementation efforts and the supervisory scrutiny of those actions.

In this new stage, the first step belongs to banks. Before starting parallel run, each banking organization adopting Basel II should have in place an effective governance program to support its implementation efforts. A Board-approved implementation plan will be the foundation document used by examiners to assess and monitor a bank's Basel II implementation efforts and progress toward meeting qualification requirements. While no formal supervisory approval is required to begin parallel run, a bank will need to submit a Board-approved implementation plan to its primary supervisor before that process can commence.

This implementation plan should identify necessary resources and actions that the bank must take in order to qualify for the advanced approaches for credit risk and operational risk. With the issuance of the final rule, banks will need to refresh their existing Basel II implementation plans and modify systems to ensure conformity and consistency with the final rule.

In the assessment of a bank's readiness to move towards qualification for the advanced approaches, examiners will also focus on the other major features of a sound Basel II governance program, including the bank's validation process, audit function, and reporting framework. Let me touch on each of these points.

The OCC has long emphasized the critical role of validation as a control mechanism for banks using quantitative methods of any kind. Banks are expected to have robust validation processes for key models used in risk quantification for IRB credit risk and AMA operational risk. In addition, banks need validation processes to ensure they meet qualification requirements initially and on an ongoing basis.

Similarly, I'm sure we all recognize the importance of robust internal audit as an element of the control environment. For Basel II, the audit function should have sufficient staff and expertise to conduct reliable testing of remedial actions in implementation plans. It should also ensure that Basel II validation processes are in place and effective.

Finally, a bank's Board of Directors and senior management together are the cornerstone of good corporate governance, and they must be appropriately engaged in Basel II implementation. To keep them well informed of bank implementation efforts and regulatory capital requirements, there are a minimum set of reports that should be received and reviewed, including the execution status of the Board-approved implementation plan; results from verification and validation processes; minimum regulatory capital calculations and ratios; results from the bank's ICAAP; and disclosures required under Pillar 3.

The information generated from a sound and effective Basel II governance program will assist the Board of Directors, senior management, and bank supervisors in determining a bank's readiness to begin parallel run. And of course, it also makes the entire process much more likely to succeed as we all want it to.

Ultimately, qualification for Basel II will not be a single, "big bang" event. As the OCC has stated previously, we envision the parallel run period as an iterative supervisory process where IRB and AMA data and risk quantification are assessed through numerous discussions, reviews, and examination activities. As our examiners identify risk quantification or other issues that need to be addressed, they will say so to bank management so that improvements in the process can be made throughout the parallel run period.

Conclusion

In closing, we really are about to enter a new stage in the Basel process in the U.S., one that focuses on implementation efforts and the supervisory scrutiny of those actions. While it has been a long time coming, we welcome this forward progress, and look forward to even more of it in the weeks and months to come.

Thank you very much.