Remarks of
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Bank Regulation and Risk Management

It is a pleasure to be here today, and an honor to follow Nout Wellink, the Chairman of the Basel Committee. As a member of that Committee, I can tell you we've been fortunate to have such an able replacement for Jaime Caruana, the former Committee Chair.

But believe it or not, I'm not going to talk about Basel -- well, not the whole time anyway. As risk professionals, I suspect you don't spend all of your time on Basel, any more than I do. My job is to make sure we have a healthy, effective national banking system, and while capital standards are certainly a part of that, they're still only a part.

1. Risk management is important to bank regulators; good risk management is essential for a sound, vibrant banking system.

What I want to talk about this morning is the connection between what you do and what I do, between risk management and bank regulation. To state the obvious, risk managers are an important line of defense against things that might threaten the health of our banks, because good risk managers identify and help control risks. And although I'm a bank regulator – or maybe especially because I'm a bank regulator – I recognize that it's not just banks that need good risk management. The way markets and financial industry practice have developed, weak players anywhere – banks, customers, counterparties, service providers – can generate the kinds of systemic problems that directly affect banks. So, I believe that good risk management at a wide

variety of institutions leads not only to stronger banks, but a healthier, more robust financial system overall.

Those of you who are risk managers are the ones with the most direct responsibility to identify risks and help control them. We regulators have a corresponding responsibility to let you do it. That is, we need to be sure we don't unduly interfere with your pursuit of good risk management. Ideally, we should do whatever we can to support and encourage you; the more successful you are in controlling risk, the easier our job is. That's why our rules and guidance often emphasize the importance of risk management, in all of its various dimensions.

Of course the financial world is constantly changing, and risk management has to change with it. Regulators recognize – I recognize – that *we* are not usually the source of those better approaches to risk management, *you* are. We're all better off if we as regulators make sure that you have room to innovate – to create new and improved methods of identifying, measuring, and managing risk. One thing we can contribute, and something we try to do as much as possible, is to encourage the spread of good practices as we see them emerge.

2. Regulation shouldn't be just an annoyance or a compliance exercise for risk managers; good regulations can support your objectives within your firms.

The fact that we want good risk management and you want to be good risk managers is actually very convenient: it means that our goals are pretty well aligned most of the time. This general alignment of goals and incentives works to your benefit, and works to mine. It means that our rules – either regulations, or guidance that establishes standards and expectations – don't need to be an annoyance, or a mere compliance exercise: they can actually support you in meeting your objectives within your firms.

For example, regulators might be able to help highlight risks that some of your colleagues in certain business areas might prefer to minimize or ignore. I'm not suggesting that they intend

to put the firm at risk; but sometimes competitive pressures can be powerful forces that work against risk management. It can be difficult to take desirable, risk-reducing actions if your competitors aren't choosing to do the same thing. You do that, and they take the business. In cases like that, regulators can help by ensuring that everyone in the market faces the same expectations, that they take similar steps to reduce risk at the same time.

As a concrete example, we recently released guidance on non-traditional mortgage products. Among other things, this guidance establishes expectations for prudent underwriting, taking into account some of the unique features of these newer types of mortgages that are widely recognized to present risks. A single bank applying these underwriting standards on its own would be less risky, but could well be priced out of the market. By applying this guidance widely and consistently, to both bank and nonbank lenders, risk is reduced across the financial system, at all affected firms.

3. Regulations are better if they are well aligned with good risk management practice; they accomplish our objectives with lower compliance burden and provide more scope for healthy innovation in both products and management techniques.

We can maximize these kinds of benefits if regulatory standards are thoughtfully designed to align with sound risk management practice. That means that we regulators have an obligation to approach the development of any new rules with a solid grasp of what you and your colleagues do.

One of the ways we do that is through the comment process. As you probably know, new rules and certain types of guidance go through a rigorous formal comment process before they're issued. The comments we receive through that process are taken very seriously, and they result in improvements to the final regulatory standards. But the process only works if we get constructive, informed comments from knowledgeable professionals like you. I'd like to

encourage you this morning to watch for notices we put out for comment, and give us good, thoughtful feedback on proposals; that will help ensure that the regulatory requirements you end up facing also make sense from a business perspective.

But while that formal comment process is essential, informal communication about risks and risk management is equally valuable, if not more so. That's why we maintain a constant, continuing dialogue with bankers and others regarding market practices and the latest and best risk management thinking. Believe it or not, we don't just walk into the office in the morning, sit down at our desk, stare up at the ceiling, and start making up rules. There's an enormous amount of time and effort at the front end of almost any policy initiative that is simply a time of thinking and discussing and learning before anyone ever starts writing. During that stage, we draw on our knowledge of industry practice, and often talk over ideas with the members of the public as well as industry representatives, so that we can come out with something that both accomplishes our objectives *and* makes sense.

When our regulatory standards show this kind of solid understanding of industry practices, they are at their best: practical and effective. Rules that align with sound industry practice – that build off of what you as good risk managers already do – let us accomplish our policy objectives with a relatively low compliance burden on you, since any changes you are expected to make to what you're already doing should be kept to the minimum necessary. Rules that draw upon clearly developed, sound industry practices also can be more principles-based, rather than becoming a set of detailed, prescriptive requirements that you follow only as a compliance exercise. Finally, rules that reflect sound industry practice are much less likely to lead to attempts to evade misguided regulatory standards. I would much rather have the intellect

and creativity of this audience focused on providing financial services and running good institutions than on evading poorly designed rules.

I'm not going to try to pretend that this alignment of interests between regulators and risk managers is so close that you'll always agree with what we do, or always like the results. In fact, I know there will be times when you won't like all aspects of the regulations you face or the guidance we issue. Our objectives are reasonably aligned with yours, but not perfectly so. Ultimately, we regulators have to step back and take a systemic view, and you don't, so we may end up with conflicting ideas about what is needed. But when that happens – when the occasional but inevitable conflicts arise – I can promise you that we at the OCC work hard to make sure that the reason for the conflict really has to do with our statutory responsibility to the public, and not with some misunderstanding of industry practice on our part. Or, I might add, some misunderstanding on your part of what we're asking for.

4. Basel II is a good example of this interplay between risk management and regulation; it is built on a foundation of modern risk management practice, and it will help encourage continuing improvements in risk management.

I said I wasn't going to talk much about Basel II. But you just heard from the Chair of the Basel Committee this morning, and I know that many of you were also here yesterday for the extensive discussions of the Basel II framework. Basel II happens to provide a good illustration of this interplay between good risk management and good regulation that I've been describing.

I'll bet many of you are a little surprised that I would choose Basel II as a positive example, in view of some of the criticism of the framework and its proposed U.S. implementation. I'm certainly well aware that parts of it are controversial; those of you who are familiar with the proposal could probably easily point to parts of it that you don't like, as could I. But overall, the framework – especially the advanced approaches for credit and operational risk –

provides a sound conceptual basis for a capital standard for large, internationally active banks. It sets capital requirements on a foundation of modern risk management principles and methods. And it does that in large part because of something that I fear is being overlooked at times: this is a framework that was built through a process of extensive exploration by regulators of emerging industry practices in risk measurement.

For example, the internal ratings-based approach to credit risk was developed through a process that began when staff from the regulatory agencies went out and took close looks at the rating systems that major banks were using as part of their credit-risk management. We discussed those systems with the banks and considered whether those systems could be used in some way for capital adequacy. Since then, we've worked closely with other regulators here and abroad to develop the Basel II framework and the proposed U.S. implementation of it. But all along the way, we have had continuing dialogue with the industry and the public, at almost every stage of the process. All of that interaction and consultation has improved the capital framework tremendously, and at the same time has created a better, shared understanding all around.

Does the result perfectly align with risk management practice? Of course not. No doubt many of you could point to parts of the proposed US rule that diverge from the way you do risk management at your firm. How does that happen? Some of those differences are needed to create consistency across banks or across countries. Some are to add an appropriate element of caution around a capital framework that has not yet been fully tested. Some are to meet other supervisory objectives. Of course, where the divergence from practice is *not* necessary, you should let us know through the comment process I mentioned earlier, as I know many of you are. I can assure you, we will be listening carefully. The comment period for the current proposal ends about a month from now, on March 26 – so now is the time to speak.

One of the criticisms I've heard from time to time is one that I suspect most of you in this audience would find laughable; that is, that the capital framework relies on models that are "too complicated and hard to understand." My guess is that most of you would have the opposite reaction: the Basel model may look simplistic or even primitive compared to what you do every day. But that illustrates the kind of trade-off I just mentioned. The Basel framework leverages risk management processes to the extent possible, such as in its reliance on internal risk ratings and credit-risk quantification for individual obligors or loans. But you know and I know that you don't all model things exactly the same way. The differences may be appropriate and even desirable for risk management. But for effective capital regulation we also need a degree of consistency and transparency across banks, so elements of the risk measurement framework had to be simplified for uniform application.

Our implementation of Basel II aims to strike a balance between risk-sensitivity and complexity. Capital requirements would be more risk sensitive than under our existing capital standards – banks that take more risk would have to hold more capital. The way risks are assessed is better suited to the complex operations and activities of the large complex banks that exist today. And because the framework rests on a more coherent conceptual foundation, it should be more robust to the ongoing evolution of financial activity – it shouldn't become quickly obsolete, as people like you and your colleagues invent new and better ways to provide financial services.

But the biggest attraction, in my mind, is that ultimately Basel II will encourage good risk management. Because it ties regulatory capital requirements to the results of internal systems and processes, it creates incentives for improvement – improvements that have a tangible benefit. That's what regulations aligned with risk management can do. And we're already seeing some

of these benefits. Basel II has increased the discussion of new techniques for measuring risk and validating models. It has created a common vocabulary around important risk concepts, such as the difference between default risk and recovery risk. It has led banks to recognize the value of formalizing aspects of risk processes that were being treated a little too casually at some institutions. And it has helped encourage data collection and systems improvements that are already bringing benefits to firms that are working toward implementation, most notably in operational risk but also in other areas. This is *not* just “a big compliance exercise” as some have tried to paint it, or at least it shouldn’t be – not unless those implementing it treat it that way.

I support implementation of the Basel II framework, and believe it’s an appropriate step forward in regulation and supervision, despite its simplifying assumptions. We will surely have to make changes along the way as we get experience with the new framework. But compared to our current capital standards, it will be more risk-sensitive; better suited to the structure, activities, and operation of modern, large financial firms; and more robust to changes in the nature of banking activity. And it will provide better information to regulators and the markets through regulatory reporting and disclosure. But most importantly, it will encourage better risk management.

5. Further improvements in risk management will help us gain comfort that capital levels under Basel II are in fact adequate for the risks.

Now, I predict that risk management is going to play a key role in another Basel-related concern: reductions in bank capital. Declining capital is a very real concern if it isn’t accompanied by reductions in risk. In fact, some of the more controversial elements in the proposed rule, like the transitional floors and the limits on aggregate capital reductions, are there precisely to address this concern. And it's a legitimate concern: some early analysis suggested

there could be large reductions in required capital, reductions that would not be acceptable based on what we know about the current risk profiles of the banks involved.

Still, the thing about a risk-sensitive capital standard is that it is supposed to be sensitive to risk. If risk is higher at a bank, I want that bank holding more capital. But it shouldn't be one-sided. In cases where we can achieve an appropriate level of comfort that risk is truly reduced, then lower capital is warranted. The question is, how can we gain that comfort? How can we be confident enough that risk has *truly* fallen to such an extent that lower capital is appropriate? This is where sound risk management comes in. If we can gain enough comfort that institutions are assessing and managing risk well, that they have a firm grasp on their own capital adequacy, with trustworthy internal processes that give great confidence that risks have been identified, assessed, and managed – that risk is indeed low – then the case for lower capital to match that lower risk is significantly strengthened.

In that regard, there are some things that are almost guaranteed to give us less comfort. For example, an institution with an internal culture that minimizes the importance of risk management. Or has weak internal controls. Or displays a dismissive attitude toward the need for documentation and validation. Or has information systems that don't produce good information, or the right information, or don't capture the relevant data.

6. The OCC is well positioned as a regulator to maximize the benefits of the interaction between regulation and risk management, due to the nature of our approach to supervising large banks.

Now, let me conclude by touching briefly on the OCC's particular approach to bank supervision at our largest banks, which dovetails, I believe, with the approach to regulation I've been describing. We supervise about 1800 national banks. At 22 of the largest of these banks, we have staff on-site full time, every day; at the very largest, this can mean an OCC staff of 60 or

more. And we complement these so-called “resident” teams with a staff of specialists in quantitative modeling, our Risk Analysis Division. Many of you are familiar with this group, as it has become well known throughout the industry for its professionalism, competence, and thoughtful integration of modeling and quantitative analysis with hands-on supervision. This group has grown over time as banking has become more quantitative, and I expect it will continue to do so, at least for the near term.

Our full-time presence and continuous approach to large-bank supervision gives us a deep understanding of each bank’s processes, the risks it faces, and how those risks are managed. We have the opportunity to observe emerging risk management practices at ground level, real time, and to gain a solid understanding of them. We believe this unique supervisory model, combined with the composition of the population of banks we supervise – some of the largest, most complex institutions in the world – gives us the insight and the confidence to judge whether changes in the capital position of a bank truly correspond to changes in risk.

7. Ultimately, recognizing the interaction between regulation and risk management helps both sides do a better job.

More generally, we use this knowledge of large banks, their risks, and their management to make better, more effective, more sensible decisions on regulatory and supervisory issues. As risk management continues to evolve, the OCC is positioned to see that evolution, understand its implications, and ensure that our regulations and our supervisory guidance, and indeed our entire supervisory process, evolve correspondingly.

I've told you why as a bank regulator I see good risk management as essential, and why the best regulatory standards acknowledge the key role of risk management, build off of it, and strengthen it. Ultimately, recognizing the inter-connection between regulation and risk

management helps both sides. Bad risk management makes my job harder; bad regulation makes your job harder.

We all have an interest in both good risk management and good regulation, and it's in our interest to continue to work together, with an ongoing, candid dialogue. And that is precisely why I have been pleased to be able to speak with you here today, and why I welcome your questions. Thank you very much.