Statement by
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Acting Comptroller of the Currency
Regarding Proposed FDIC Exam Activities
For Insurance Purposes
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I have substantial concerns with this proposed delegation. The delegation would authorize the FDIC Chairman to approve participation by FDIC personnel in examinations, visitations, data analysis and similar activities concerning FDIC insured institutions, in situations where institutions compute regulatory capital using "own estimates" of risk, or use customized or assumption driven asset valuation or income recognition methodologies" which "may involve a sufficiently material degree of uncertainty or subjectivity to potentially affect the adequacy of such an institution's capital structure relative to the risks it assumes." Lest anyone think this undertaking would be narrow in scope, information provided to the Board indicates that areas of interest include evaluation of risks in banks' trading books, modeling and measurement of institutions' economic capital adequacy, and the income recognition and reserving practices of large retail lenders.

My concerns relate to both process and substance.

First, with regard to process, I have already spoken separately to the Chairman, Vice Chairman Reich, and Director Curry and also with Director Gilleran about my deep – and personal – distress and dissatisfaction about how this issue has been handled. As I have already said, we should not be having this discussion at this time and in this manner.

Second, I must say that I was amazed to hear, as the premise for this expansion of *special exam* authority, that there exists uncertainty about risk estimates, asset values, and income numbers stemming from model-based or assumption-driven estimates – referred to in the Board materials as "assumption risk" or "model risk." There is uncertainty about those elements even when banks **don't** use models. And while the use of models does introduce a different source of uncertainty about those estimates, model use is not new. The use of models -- in risk measurement, as decision tools, and as inputs to valuations -- is intrinsic to the way that modern banking is conducted. The recognition of model risk is reflected in the modern approach to bank supervision. Banks are expected **not** to use models in a naïve way that takes their outputs as objective facts. Rather, supervisors expect banks to apply prudent qualitative judgments in their use and application of models.

This unease with the use of models in risk measurement is especially surprising given the recent experience of the U.S regulators in preparing for the reform of regulatory capital requirements, Basel II. Acting together, the U.S. regulatory agencies have been leaders in calling for Basel II banks to have control and oversight mechanisms to assure that the risk estimates and risk ratings are produced in a fair and reasonable way. The U.S. agencies have called for such governance mechanisms precisely because of the recognition that estimates are subject to risk. Furthermore, we have been vocal proponents of cautious U.S. implementation strategy for capital reform for the same reasons.

Third, the proposed delegation is described in the materials provided to the Board as narrow in scope. I strongly disagree. Based on OCC's experience with banks that use sophisticated models, the proposed delegation would, in practice, result in a major expansion of FDIC activities.

Our experience in the supervision of banks that use sophisticated models is that understanding the use of these models is not amenable to a quick, purely objective, quantitative exercise. Instead, the evaluation of bank model use is an ongoing, iterative, expert-judgment supervisory process that requires an understanding of the purpose and use of the model, the techniques used to build the model, and the qualifications and expertise of the modelers. If, as the materials prepared for the Board indicate, the FDIC seeks to independently evaluate situations in banks featuring "model risk," then FDIC examiners will need to duplicate existing examination processes.   This is particularly striking since the focus of this effort would be banks, rated 1 or 2, not in any near term danger of being troubled.

And finally, the consequences of attempting to use special examination authority in this manner must also be evaluated in light of the substantial amount of supervisory data currently available to the FDIC, and the current interagency efforts to determine and define the information required for banks to use Basel II methodologies and the process for Basel II qualification. Today, the four banking agencies share a tremendous amount of information, especially as it relates to our largest financial institutions. Based on an information sharing and coordination agreement entered into in 2002, the agencies have established fundamental expectations for enhanced coordination and cooperation of supervisory efforts. This agreement was designed to ensure that the FDIC is able to fulfill its responsibilities as deposit insurer in the most efficient and least burdensome manner possible. The agreement also provided enhanced supervisory data sharing, access by FDIC staff to dedicated supervisory staffs at the other banking agencies, and limited participation by FDIC staff in existing supervisory processes in specified large financial institutions. Based on comments and assessments by management, the FDIC seems satisfied with the nature, scope and operation of the coordination agreement. Moreover, as I noted, there is an interagency process already ongoing to identify the specific data that Basel II banks will be required to maintain and provide to supervisors and the methodologies for Basel II qualification.

It is also important to be aware of the broader dimensions of the issue of the role of a bank's primary supervisor. The International Lending Supervision Act is crystal clear that it is the responsibility of "each appropriate Federal banking agency … to establish such minimum level of capital for a banking institution as the appropriate Federal banking agency, in its discretion, deems to be necessary or appropriate in light of the particular circumstances of the banking institution." The U.S. banking agencies currently are engaged in a process of reviewing and assessing existing information sharing protocols and cross-border supervisory arrangements with foreign supervisors, largely precipitated by the publication of proposed revisions to the Basel Accord. The objective of this effort is for home and host supervisors of internationally active financial institutions to better coordinate communication, examination and supervisory approval of Basel II methodologies.

Ideally, a supervisory protocol will be established that will allow host supervisors to rely in whole or in substantial part on home supervisor assessments, and limit redundant supervisory activities. The FDIC's apparent unease with reliance on the work of its sister U.S. banking agencies – on a matter fundamental to the premises of Basel II – in is an unfortunate position in this context – particularly unfortunate if it has detrimental repercussions on the U.S. negotiating posture in these sensitive discussions, and ultimately, on U.S. financial institutions.

For all of the foregoing reasons, I am unable to support the proposed delegation.