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TESTIMONY OF

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Before the

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

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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 plans of the U.S. banking agencies to update and enhance our regulatory capital program in two fundamental ways: first, through the implementation of the "International Convergence of Capital Measurement and Capital Standards: A Revised Framework," generally known as the Basel II Framework; and second, through revisions to our existing domestic risk-based capital framework for banks not adopting Basel II, generally known as Basel IA.

The primary impetus for the agencies' work to revise existing risk-based capital rules is to enhance the long-term safety and soundness of our banking system. While the U.S. banking industry continues to operate profitably, supervisors must ensure that regulatory capital rules remain relevant and appropriately address existing and emerging safety and soundness challenges. For our largest banks, the fundamental thrust of our efforts has been to develop a more risk sensitive regulatory capital system better suited to the complex operations and activities of these institutions. For banks not adopting Basel II, our primary goal is to increase the risk sensitivity of our risk-based capital rules without unduly increasing regulatory burden. Work in these areas is again moving forward as the result of agreement by the agencies, announced in a joint statement on September 30.

The joint statement included a revised timeline for U.S. implementation of Basel II and a series of prudential safeguards to ensure that capital levels similar to those that exist in our largest banks today will be maintained over an extended transition period. The statement also highlighted our expectation that the rules implementing Basel II in the United States will be modified as necessary based on experience with the new Framework during that transition period, and before the prudential safeguards expire.

The joint statement reflected a consensus by all the U.S. agencies that implementation of the Basel II Framework should move forward. Our agreement to do so was based on several key premises:

- First and foremost, the Basel II Framework offers necessary and appropriate improvements to address recognized flaws in the existing risk-based capital regime for our largest, most complex banks. Basel II will promote significant advances in risk management that will benefit supervisors and banks alike and that will enhance the safety and soundness regime under which the largest institutions operate.
- Second, to achieve its intended purpose, the Framework will have to be thoroughly tested and almost certainly adjusted. The recent quantitative impact study (QIS-4) of estimated Basel II results in large U.S. banks produced significant dispersion of results across institutions and portfolio types and suggested a material reduction in aggregate minimum required capital. Apart from the notice and comment process, however, additional agency study of the Basel II Framework itself will do little to resolve those concerns. Indeed, without seeing live systems in operation – and subjecting them to supervisory scrutiny – we will not be able to gain the level of comfort we ultimately must have in order to rely on Basel II for regulatory capital purposes.
- Third, it is our intention to proceed deliberately, gaining a better understanding of the effects of Basel II on bank risk management practices and capital levels. Upcoming Basel II rulemakings, therefore, will include a meaningful transition period during which we can observe and scrutinize Basel II systems while strictly limiting, through a system of simple and conservative capital floors, potential reductions in capital requirements. Based on the experience we gain through supervisory oversight in the transition period, we will incorporate any necessary revisions to the U.S. Basel II-based rules before the transition period ends.

Because we believe that regulations must be tailored to the size, structure, complexity, and risk profile of banking institutions, we expect mandatory application of Basel II to be limited to large complex institutions. However, we need meaningful but simpler improvements in our domestic risk-based capital rules for banks that will not be subject to Basel II. Our Basel IA initiative is separate from but complementary to the Basel II rulemaking process, and it is important that the public be able to compare, contrast, and comment on definitive proposals for both Basel II and Basel IA in similar timeframes. 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 these proposals on the U.S. financial services industry.

On this basis, the banking agencies agreed that it is both prudent and necessary to develop and issue a notice of proposed rulemaking (NPR) for Basel II implementation and to solicit comments from the public. In order to do this, however, prudential safeguards are an absolute necessity, and we recognize that further changes will take place through future rulemakings.

THE NEED FOR BASEL II IN THE UNITED STATES

The implementation of Basel II in the United States remains controversial, requiring banks and supervisors to balance sometimes conflicting objectives regarding complexity of minimum capital requirements, regulatory burden, competitive equity, alignment of regulatory capital with better measures of risk, and recognition of marked improvements in risk management capabilities. A fair question, and one we have asked ourselves at various stages of this process is, "Given all the difficulties and uncertainties associated with Basel II, why move forward with it at all?" While other sections of my testimony explain *how* we plan to go forward, I also understand the need to address *why*.

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 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. 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. In a system in which some individual institutions hold well over $1 trillion in assets, the flaws of the current, overly simplistic risk-based capital system cannot be seen as merely superficial or inconvenient.

It is important to understand that the supervisory benefits of Basel II are found not only in the increased risk sensitivity in regulatory capital requirements, but also in the significantly improved bank risk management systems required to generate them. As the front-line supervisor for national banks, which hold nearly 70 percent of the nation's banking assets, the OCC stands to gain significantly from implementation of those systems, not only from improved risk sensitivity of regulatory capital ratios, but also from the wealth of internal information and analyses that banks will provide us under Basel II. Banks will be better informed about the risks they face, and supervisors will have information about those risks from both an individual institution and industry perspective. Large banks have already made substantial investments in the development of Basel II systems. Without further guidance and proposed rules, however, progress toward Basel II standards will be severely limited.

While clearly secondary to U.S. safety and soundness concerns, another important consideration is the need for internationally active banks to have similar capital regimes in the jurisdictions in which they operate. The benefits of global comparability in regulatory capital are not limited to level playing field considerations. Moving forward with Basel II also enhances internationally active banks' ability to interact on a meaningful and consistent basis with various supervisory authorities while improving how supervisors interact with one another. Without a common framework, our ability to gain useful information and cooperation from foreign supervisors would be severely constrained. We are very much aware that differences in the implementation

details, including the timeline, can create significant challenges for banks operating in multiple jurisdictions. While some of these differences are unavoidable, the OCC and the other U.S. banking agencies will continue to work closely with foreign-based regulators to address these issues as they arise. The implementation of Basel II will ultimately serve to increase the dialogue and coordination among national supervisors and to enhance the level of cross-border cooperation for our largest banks.

In short, the continued safety and soundness of our banking system demands that we move away from the current simplistic system to one that more closely aligns capital with risk. Put another way, doing nothing to change capital requirements would over time threaten the safety and soundness of the banking system, especially with regard to our largest banks that engage in increasingly complex transactions and operations and hold increasingly complex assets. In these largest banks, more closely aligning regulatory capital and risk management systems with actual risk is a conceptually sound and prudent way to move forward. That is the fundamental purpose of Basel II, and while the Framework may require significant changes over time, it is moving in the direction required by safety and soundness concerns.

That is the essential reason why I believe we should support the Basel II approach.

QIS-4 Results and Analysis

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 an extensive quantitative impact study, 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. Even subsequent to additional agency analysis, 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. Aggregating over the QIS-4 participants, the decrease in effective minimum required capital compared to existing standards was 15 percent, with a median decrease of 26 percent. As noted above, the additional QIS-4 analyses also confirmed that dispersion in results – with respect to individual parameter estimates, portfolios, and institutions – was much wider than we anticipated or than we can readily explain. 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.

The agencies are in the process of preparing a more detailed summary of results of our follow up analyses of QIS-4 for public release and are now conducting meetings with participants to discuss observations about their particular submissions. There are, however, some broad observations I can make today about the apparent underlying causes of the significant reductions and wide dispersions in capital requirements in QIS-4:

- The single most important conclusion from our analysis is that differences in results between banks and within portfolios evidenced in QIS-4 submissions did not correspond directly to identifiable differences in risk. Banks' current estimates of key parameters in the IRB approach – probabilities of default, loss given default, and exposure at default – fall well short of the level of reliability that will be necessary to allow supervisors to accept those estimates for risk-based capital purposes.
- Closely related is the observation that institutions are still at widely varying stages of development of the systems and processes necessary to implement the Basel II Framework. This finding is not intended to be a criticism of bank implementation efforts; banks have dedicated significant staff and budget resources to Basel II. Rather, these development efforts have been hindered by the absence of definitive rules or final guidance in the United States. Consequently, the full impact of Basel II implementation remains to be seen, as do potential ramifications for the U.S. banking system.

- Basel II results appear to be materially influenced by the prevailing economic cycle, which suggests significant fluctuations in capital requirements under the Framework over the course of economic cycles.

In short, the QIS-4 results and the inevitable questions they raise are sources of concern for the banking agencies. The process for implementing Basel II as established in the September 30 joint statement is designed to provide the OCC and other agencies a complete understanding of the Framework's implications for the banking system. We have concluded that some of the weaknesses identified in QIS-4 are attributable to the fact that no "live" Basel II systems have been built – in large part because we have not yet fully specified all the requirements for such a system. We also believe that certain of the concerns identified in QIS-4 will only be fully understood and resolved as the Basel II Framework is implemented through a final rule, final supervisory guidance, and rigorous examiner scrutiny.

THE NEED TO SEE SYSTEMS IN OPERATION

QIS-4 was a voluntary, "best efforts" undertaking by participant banks. The actual implementation of Basel II systems will be preceded by stringent qualification assessments and, assuming qualification, will be subject to regular on-site review by examination staff and other subject matter experts. We expect to see less dispersion in results for similar risks as banks more fully develop IRB and AMA compliant methodologies, supported by enhanced data systems and subject to rigorous ongoing supervisory oversight and disclosure requirements. We remain convinced that supervisors and the industry will both eventually reap significant rewards – in the form of better risk management and better information about risk – when Basel II systems are built and operating.

It became apparent as we analyzed QIS-4 results that we have reached a point where more study of the conceptual underpinnings of Basel II will yield little additional practical benefit. Rather, the questions that we as supervisors still have about Basel II – and there are several that are extremely important – can only be answered by continuing to move toward implementation. Given the obstacles that have not yet been cleared, though, I firmly believe that the only

responsible way to do that is in a carefully controlled manner, with strong safeguards, during a significant transition period to see the systems in actual practice.

We see only one pragmatic solution to resolve this inherent stalemate between our insistence on understanding the effects, and allowing for and encouraging the development of systems that will allow us to gain that understanding. That is to proceed with the next steps of Basel II implementation, but with a series of prudential safeguards in place until we can observe approved Basel II systems in actual operation and subject them to supervisory scrutiny. Only then will it be possible to judge whether Basel II is operating as intended and to make adjustments as necessary to ensure that it does.

TRANSITION PROVISIONS

The revised implementation plan announced by the agencies on September 30 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 expect to propose 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 also intend to retain the Prompt Corrective Action (PCA) and leverage capital requirements in the proposed domestic implementation of Basel II. During the several years in which those provisions have complemented our basic risk-based capital rules, 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.

I have mentioned that the floors we intend to apply during the transition period will be simpler in design and more conservative in effect than those set forth in Basel II. I expect PCA requirements to play a significant role in the floor requirements. For example, in order to be "well-capitalized" for PCA purposes, a Basel II bank in 2009 (subject to a 95 percent floor) would be required to have a total risk-based capital ratio of at least ten percent, calculated under non-Basel II rules but with a five percent reduction in risk-weighted assets. The bank would also have to meet the ten percent total risk-based capital threshold on the basis of its Basel II results, with similar dual calculations applying to the six percent well-capitalized threshold for the Tier 1 risk-based capital ratio. PCA thresholds for the leverage ratio would of course also remain in place as they are today.

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. 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.

The revised timeline detailed in the September 30 joint statement also makes possible greater coordination between the Basel II process and the on-going effort to revamp risk-based capital rules governing banks not adopting Basel II. The agencies expect that proposed rules for the U.S. implementation of Basel II will be available in the first quarter of 2006. As discussed in more detail below, the banking agencies are also jointly seeking comments on a number of possible revisions to our existing risk-based capital rules for banks not adopting Basel II. After consideration of public comments on that proposal, the agencies expect to move forward with a notice of proposed rulemaking on Basel IA in 2006. As I have made clear previously, it is imperative that there be substantial overlapping comment periods on the Basel II and Basel IA proposed rules. This will permit regulators and industry participants to directly compare the two proposals and assess competitive effects and other issues in the development of comments.

BASEL IA

On October 20, the agencies jointly published in the *Federal Register* an advance notice of proposed rulemaking (ANPR) seeking comments on suggested broad revisions to our existing domestic risk-based capital rules, which are based on the 1988 Basel Accord. I believe the ANPR is a good first step in the direction of improving the risk-based capital rules that apply to U.S. banks without the enormous expense and massive complexity of the Basel II Framework.

The modifications we are considering would:

- Increase the number of risk-weight categories to which credit exposures may be assigned;
- Expand the use of external credit ratings as an indicator of credit risk for externally rated exposures;

- Expand the range of collateral and guarantors that may qualify an exposure for a lower risk weight;
- Use loan-to-value ratios, credit assessments, and other broad measures of credit risk for assigning risk weights to residential mortgages;
- Modify the credit conversion factor for various commitments, including those with an original maturity of under one year;
- Require that certain loans 90 days or more past due or in a non-accrual status be assigned to a higher risk weight category;
- Modify the risk-based capital requirements for certain commercial real estate exposures;
- Increase the risk sensitivity of capital requirements for other types of retail, multifamily, small business, and commercial exposures; and
- Assess a risk-based capital charge to reflect the risks in securitizations backed by revolving retail exposures with early amortization provisions.

Our primary goal in this rulemaking effort is to increase the risk sensitivity of our domestic risk-based capital rules without unduly increasing regulatory burden. This is no small challenge, and we cannot easily accomplish that goal without substantial input from the public. In crafting the current proposal, the agencies drew from discussions with the banking industry, Congress, and our experiences in supervising the current risk-based capital regime. It is important to acknowledge that much important work on this proposal lies ahead. While some of the modifications the ANPR presents are well defined, there are some areas that are not specified in great detail at this time. We are looking to commenters to provide additional views and information on current risk management practices to help refine these areas. So I am eager to hear from the industry and other interested parties, and I hope this public comment process will begin a fruitful dialogue that will lead to more definitive proposals for a more risk sensitive regime.

We recognize that a number of banks and industry groups are concerned that banks operating under Basel II might gain a competitive edge over banks not governed by the Basel II Framework. That issue will remain in the forefront as we more fully develop any proposals that

might stem from the Basel IA ANPR as well as proposals for Basel II implementation. It is almost a certainty that the level of risk sensitivity we hope to achieve under Basel II is not possible in a simpler risk-based capital regime. However, we need to be very mindful of competitive equity issues, and we will endeavor to reduce gaps between the two frameworks as much as possible given our overarching priority to ensure that both frameworks move in the direction of greater risk sensitivity. That will require, among other things, an assessment of the quantitative effects of the Basel IA proposals as they become more fully developed. It is also critical for regulators and interested parties to be able to review and compare definitive proposals for Basel II and for other domestic capital revisions within the same general timeframes.

CONCLUSION

The overarching challenge we face is to improve on the simplistic Basel I risk-based capital regime. That regime is a poor arbiter of risks being taken by banks, insufficient to the task of monitoring risk in large, complex financial institutions, and long overtaken by events in the marketplace. It is also a source of inefficiency in the financial system. What we have learned through the development of Basel II is that for institutions that have the scale and financial capacity to do so, we can and should establish high standards of risk management that can be used to improve the alignment of regulatory capital with risk. Our Basel IA efforts embody our belief that we can and should do better in defining capital requirements for the vast majority of national banks without massive complexity or enormous expense.

We are committed to improving risk sensitivity of the risk-based capital rules for all institutions, but doing so in a way that is tailored to the size, structure, complexity, and risk profile of the institution, and that ensures safety and soundness. For the complex operations of our largest globally active national banks, we believe the Basel II Framework holds great promise, and we remain committed to the next steps of implementing it in the United States. For the vast majority of national banks that will not use Basel II, we believe that the Basel IA proposal introduces enhancement in the risk sensitivity of regulatory capital without unduly increasing regulatory burden.

We have undertaken this task with full awareness of the challenges ahead. The OCC would not be pursuing these proposals if we did not believe they would take the industry and us in the direction of not only better risk-based capital calculations, but also better risk management, and even more fundamentally, a stronger and safer banking system.