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**TESTIMONY OF**  
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**before the**  
**SUBCOMMITTEE ON DOMESTIC AND INTERNATIONAL MONETARY**  
**POLICY, TRADE AND TECHNOLOGY**  
**of the**  
**COMMITTEE ON FINANCIAL SERVICES**  
**of the**  
**UNITED STATES HOUSE OF REPRESENTATIVES**  
**February 27, 2003**

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**

Chairman King, Congresswoman Maloney, and members of the Subcommittee, thank you for inviting the Office of the Comptroller of the Currency (OCC) to participate in this hearing on proposed revisions to the 1988 Capital Accord developed by the Basel Committee on Banking Supervision (Basel Committee), and the policy implications and effects these revisions will have on domestic and international banking systems. I welcome the efforts of the Subcommittee to focus attention on these critical issues. Given the importance of the U.S. commercial banking system to our domestic economy, it is essential that any regulatory changes that might affect our banking system's financial condition and competitiveness be fully understood and considered by the banking industry, the U.S. Congress and the American public.

The 1988 Accord, referred to as Basel I, established the framework for the risk-based capital adequacy standards for commercial banks in all of the G-10 countries, and has been adopted by most other banking authorities around the world. U.S. banking and thrift agencies have applied the 1988 framework to all U.S. insured depository institutions.

Over the past several years, the Basel Committee has been developing a more detailed and risk sensitive capital adequacy framework to replace Basel I. The OCC and the other U.S. banking agencies expect to revise U.S. risk-based capital regulations to reflect the primary components of the Basel Committee's new capital adequacy framework (Basel II), but before doing so, the agencies will publish proposed revisions for public comment. Let me be absolutely clear about the integrity of this rulemaking process – the OCC, which has the sole statutory responsibility for promulgating capital regulations for national banks, will not sign-off on a final Basel II framework until we have fully considered all comments received during our notice and comment process – as we would with any domestic rulemaking. If we determine through this process that changes to the proposal are necessary, we will not implement proposed revisions until appropriate changes are made.

The OCC fully supports overhauling the existing capital adequacy framework. The original Capital Accord, groundbreaking when adopted in 1988, has become increasingly obsolete. Moreover, the OCC fully endorses the goals and objectives of Basel II. The Basel Committee's efforts in this regard are to be commended. They have advanced the cause of international cooperation, supervisory competence, effective risk management practices in financial institutions, and the safety and soundness of the global financial system.

Having said that, I should add that significant work remains before the current draft of Basel II can be considered final. Supervisors and bankers, as well as legislators and other interested parties, need to gain a level of comfort that the revised Capital Accord has truly achieved the objectives first enunciated by the Committee in 1999. This minimum level of comfort is conditional on achievement of the revised Capital Accord's objectives from both a theoretical, as well as a practical perspective.

In working towards finalizing Basel II, we must also be mindful of the risks of excessive complexity. Achieving a level playing field among large, international banks has been a principal objective of the Basel Committee since its formation and is a major goal of Basel II. However, the more complex Basel II is, the more difficult it will be to implement it consistently across countries, especially in light of widely varying supervisory structures and approaches. We also need to think carefully about the competitive effects of Basel II on the domestic banking scene. Maintaining an appropriate competitive balance in the U.S. between our large, internationally active banks, on the one hand, and the thousands of smaller banks and thrift institutions, on the other, is a crucial consideration. Finally, we need to avoid issuing a rule that is so prescriptive in its approach that it would discourage innovation in market practices and advances in risk management. I will address each of these challenges below.

## **Background**

The Basel Committee was established in 1974 by the governors of the central banks of the G-10 countries in the aftermath of disturbances in international currency and banking markets, notably the failure of Bankhaus Herstatt in West Germany. Originally, the Basel Committee focused

primarily on cooperation and information sharing among its members. Increasingly, the Committee has come to see its role as promoting international harmonization through the issuance of “best practices” papers and the development of supervisory standards to which its members voluntarily agree to adhere. The Committee does not have any formal authority, and its standards are not legally binding on its members. The Committee’s current members are the senior officials of bank supervisory authorities and central banks of Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom, and the United States.

One of the most significant efforts of the Basel Committee was the development and issuance of the 1988 Capital Accord (Basel I). Basel I established the framework for the risk-based capital adequacy standards for counter-party credit risk used by all G-10 countries and by most other banking authorities around the world. The first Capital Accord represented an important convergence in the measurement of capital adequacy, a strengthening in the stability of the international banking system, and a removal of a source of competitive inequality arising from differences in national capital requirements.

However, by the late 1990s, the Committee realized that Basel I had become outdated. The increased scope and complexity of the banking activities of our largest banking institutions over the last decade, and the unintended consequences of various provisions of the regulations, severely undercut the utility of the Capital Accord. Basel I simply does not provide large, internationally active banks with a meaningful measure of the risks they face or the capital they should hold against those risks.

In commencing the effort to revise its Capital Accord, the Basel Committee adopted five key objectives to guide its efforts:

- The Accord should continue to promote safety and soundness in the financial system, and should at least maintain the current overall level of capital in the system.
- The Accord should continue to enhance competitive equality.
- The Accord should constitute a more comprehensive approach to addressing risks.

- The Accord should contain approaches to capital adequacy that are appropriately sensitive to the degree of risk involved in a bank's position and activities.
- The Accord should focus on internationally active banks, although its underlying principles should be suitable for application to banks of varying levels of complexity and sophistication.

The development of Basel II has been a prolonged and often difficult process. The first public document, Consultative Paper No. 1 (CP-1), was issued in June 1999. That document provided the framework of Basel II, but provided few details. The Committee provided additional detail on the specifics of Basel II in its January 2001 issuance of Consultative Paper No. 2 (CP-2). Although it was more than 500 pages long, CP-2 still left a number of key issues unaddressed and unresolved. Industry reaction was mixed, with concerns expressed regarding the incompleteness of the proposal, regulatory burden, the treatment of operational risk, and a potential spike in regulatory capital requirements.

### **Current Basel Proposal**

Since the issuance of CP-2, the Basel Committee and its numerous task forces and working groups, have been laboring to complete a series of revisions to Basel I. In addition to assessing the comments received on the first two consultative papers, Committee staff and principals have made numerous contacts with third parties to understand the nature of the comments and to assess more completely the likely effect of Basel II on measured levels of required regulatory capital, risk management systems, data requirements, supervisory programs and credit availability.

An important component of the impact assessment has been the Basel Committee's quantitative impact surveys. The Committee concluded its third Quantitative Impact Study, known as QIS-3, on December 20, 2002. The objective of the three impact studies has been to assess the impact of Basel II on required capital levels across all Basel-member countries. The individual bank regulatory capital amounts submitted under the impact studies provide indications of whether the Committee has met the first key objective for the new Basel Accord – ensuring that the new

framework maintains the current overall level of capital in the system. At this point, Basel Committee staff is still analyzing the results of the QIS-3 exercise.

The Basel Committee has outlined an aggressive timeline for the remaining actions leading to the adoption of Basel II. As described by the Committee in a July 2002 press release, and subsequently reaffirmed, the remaining timeline for adoption of Basel II is as follows:

- May 2003: Issuance of Consultative Paper No. 3. A three-month comment period is expected for this document.
- December 2003: Finalization of Basel II by the Basel Committee.
- December 2006: Implementation of Basel II.

### Forthcoming Consultative Paper No. 3

While work on Consultative Paper No. 3 (CP-3) continues, we are in a position to describe much of its expected content. The attachment to this written statement provides a summary of the substantive provisions likely to be contained in CP-3. As before, this iteration of the proposed new Accord will have three mutually reinforcing “pillars” that comprise the framework for assessing bank capital adequacy. The first pillar of the new Accord is the minimum regulatory capital requirement. The Pillar 1 capital requirement includes a credit risk charge, measured by either a standardized approach or one of the new internal ratings-based (IRB) approaches (foundation or advanced), an operational risk charge, and a market risk charge. Again, the attached document provides a more detailed description of the various components of the Pillar 1 charge.

Pillar 2 addresses supervisory review. It is “intended to ensure not only that banks have adequate capital to support all the risks in their business, but also to encourage banks to develop and use better risk management techniques in monitoring and managing these risks.” This pillar encourages supervisors to assess banks’ internal approaches to capital allocation and internal assessments of capital adequacy, and, subject to national discretion, provides an opportunity for the supervisor to indicate where such approaches do not appear sufficient. Pillar 2 should also be

seen as a way to focus supervisors on other means of addressing risks in a bank's portfolio, such as improving overall risk management techniques and internal controls.

The third pillar recognizes that market discipline has the potential to reinforce capital regulation and other supervisory efforts to ensure the safety and soundness of the banking system. Thus, the Committee is proposing a wide range of disclosure initiatives, which are designed to make the risk and capital positions of a bank more transparent. As a bank begins to use the more advanced methodologies, such as the Advanced IRB approach, the new Accord will require a significant increase in the level of disclosure. In essence, the tradeoff for greater reliance on a bank's own assessment of the building blocks of capital adequacy is greater transparency.

### U.S. Implementation Actions

It is important to recognize that the Basel Accord is not self-executing in the U.S. Even when adopted by the Basel Committee, the revised Basel Accord will not apply to U.S. institutions unless and until the U.S. banking agencies adopt regulations to implement it. In accordance with the Administrative Procedure Act, 5 U.S.C. 551, *et seq.*, the U.S. banking agencies must publish notice and seek comment from all interested persons on any such proposal, and must fully consider those comments, before adopting a new capital regulation in final form. Obviously, the OCC and the other federal banking agencies intend to fully comply with these requirements. We believe that the solicitation and assessment of comments is a critical step in determining the workability and effectiveness of Basel II and related domestic capital regulations.

This summer, the U.S. banking agencies expect to issue an Advanced Notice of Proposed Rulemaking (ANPR) soliciting comment on proposed revisions to the existing domestic capital adequacy regulations that would implement Basel II. The ANPR, which would be largely based on CP-3, would provide a description of proposed revisions to current capital regulations, seeking comment on outstanding or contentious issues, a draft of qualifying criteria for those banks seeking to make use of the advanced methodologies set forth in Basel II (*i.e.*, the Advanced IRB approach for credit risk and the Advanced Measurement Approaches (AMA) for operational risk), and supervisory guidance articulating general supervisory expectations.

Recognizing that CP-3 will likely be as lengthy and complex as its predecessors, we understand the importance of U.S. banks being able to review and comment on U.S. implementing documents as soon as practicable. By describing these concepts within the context of our existing regulatory and supervisory regime, this ANPR will provide a meaningful forum for a dialogue on Basel II.

After fully assessing comments generated during the ANPR process, the U.S. banking agencies will develop specific regulatory language for a full Notice of Proposed Rulemaking (NPR). In order to meet the aggressive timeline for the adoption of Basel II, the agencies anticipate issuing the NPR in the fourth quarter of 2003. Again, the banking industry and other interested parties will have a full opportunity to comment on this fully articulated proposal before any revisions to our capital regulations are finalized.

I want to focus on two important, unique features of the U.S. regulatory capital regime that will be highlighted in the ANPR and NPR – the scope of application of Basel II and the content and structure of the proposed revisions to the capital adequacy regulations. First, the U.S. expects to set forth in the ANPR definitive criteria for identifying which banks in the U.S. will be subject to the new Accord. In 1988, despite language in the Capital Accord permitted a more limited application, U.S. banking and thrift agencies applied the Basel framework to all U.S. insured depository institutions. As we will highlight in the forthcoming ANPR, the U.S. agencies have determined to apply Basel II concepts more narrowly. Specifically, proposed regulatory text incorporating Basel II concepts will apply on a mandatory basis only to large, internationally active institutions that compete on a significant global basis with other financial service providers. Other institutions will have the opportunity to voluntarily opt into the Basel framework upon application to, and approval by, their primary federal supervisor.

Preliminary analysis by the U.S. agencies suggests that under the narrow approach we are proposing, there are currently fewer than a dozen U.S. banks that would be mandatorily subject to Basel-based regulatory capital requirements. Of course, the approach of requiring only a small population of banks to comply with Basel II will be subject to notice and comment in the



ANPR and will be definitively resolved only after the U.S. rulemaking process has been completed.

Second, in developing revisions to existing capital adequacy regulations, U.S. banking agencies recognize that the revised regulation, and interagency implementation policy, need not follow the literal structure and language of Basel II. While consistent with the objectives, general principles and core elements of the revised Basel Accord, the language, structure and degree of detail of U.S. implementing documents could be very different from Basel II. These implementation differences are reflective of the particular statutory, regulatory and accounting structures and practices in place in the U.S., including, for example, regular on-site supervision, our prompt corrective action rules, and our minimum leverage ratio for capital adequacy. As is described more fully in the attachment, the U.S. agencies will likely propose for notice and comment a Basel II-based regime incorporating the Advanced IRB approach for credit risk, the AMA for operational risk, and the internal ratings approach for market risk.

As noted above, we believe that the solicitation and careful consideration of comments is a critical step in the overall assessment of Basel II and related domestic capital regulations. U.S. banking agencies will work within the Basel Committee to ensure that comments by U.S. banks or other interested persons are appropriately taken into account prior to the finalization of Basel II.

### **Status of Basel Proposal – Outstanding Issues**

Despite the protracted nature of Basel II deliberations, significant issues remain, and the aggressive timeline for implementation of Basel II noted earlier will almost certainly be under pressure.

In commencing an objective assessment of the status of Basel II, it is important to reiterate and reaffirm the commendable work of the Basel Committee, and in particular, the strong and intelligent leadership of its Chairman, William McDonough, President of the Federal Reserve Bank of New York. The OCC strongly supports the objectives of Basel II. These objectives,

restated above, constitute a sound conceptual basis for the development of a new regulatory capital regime and should continue to serve as a useful benchmark to gauge our progress in this effort.

While theoretically sound, the concepts underlying Basel II present significant implementation challenges. Those concepts have their foundation in modern financial theory. However, some of the concepts, such as the Advanced IRB approach for credit risk and the AMA for operational risk, are untested, with only limited industry practice to substantiate their practicality. Agency staffs have worked diligently, but have not yet achieved a necessary level of comfort with the effectiveness of many of these Basel concepts in application. Moreover, the agencies have not fully assessed the effect of Basel II on bank regulatory capital, risk management systems, data requirements, supervisory programs and credit availability. For example, there is an obvious tension between the objectives of maintaining the current overall level of capital in the banking system, on the one hand, and, on the other, providing an inducement to banks to lower their capital by investing in more refined risk measurement systems. A discussion of some of the specific unresolved implementation issues is provided below.

### Complexity

Perhaps the most important objective for Basel II enumerated by the Basel Committee is that the Accord should promote approaches to capital adequacy that are appropriately sensitive to the degree of risk involved in a bank's balance sheet and activities. This desire for risk sensitivity has led to a proposal that focuses on a bank's own determination of risk. Reliance on internal determinations of risk for capital adequacy, however, is a radical departure from Basel I and mandates changes in the way we structure the capital framework. In order for external stakeholders – shareholders, creditors, and supervisors – to have confidence in the capital numbers produced by the proposed system, bank internal risk determinations will have to be verifiable. Much of the material developed as part of the Basel II process seeks to specify expectations for rating systems, control mechanisms, audit processes, data systems and other internal bank processes in an attempt to gain comfort with the reliability of internal determinations of risk by individual banks. The challenge for supervisors, however, is to create a

verifiably accurate system that does not at the same time stifle innovation in risk management and that takes into account practical cost/benefit considerations.

I have consistently expressed profound concern about the level of detail and specificity of the Basel proposal. In my view, the complexity generated in Basel II goes well beyond what is reasonably needed to implement sensible capital regulation. CP-2 reflected a desire to develop encyclopedic standards for banking systems that minimizes the role of judgment or discretion by those applying or overseeing the new rules. While the intent of such prescriptiveness is to promote consistency and uniformity in the application of Basel II, this approach is highly problematic, especially in the rapidly changing financial landscape that confronts both financial institutions and supervisors. It must be recognized that credit risk management is continuing to evolve in the financial services industry. Banks currently use a variety of different approaches to estimating appropriate capital levels and no “best practice” has yet emerged.

A highly detailed capital rule may make it easier to compare banks’ capital numbers. But it may not be possible, or even desirable, for the Basel Committee to craft a capital rule that prescribes to the same level of detail a uniform set of risk management systems and processes that each individual bank would be expected to put into place. Our large banks are not homogeneous entities – their operations and business strategies vary significantly. A highly detailed and prescriptive rule that would apply to every large bank may have unintended consequences. And while we do not know the magnitude of the *cost* of attempting to implement such a prescriptive rule, we do know that there will be costs. One cost will be the burden on banks of conforming their current systems and processes to what is required under the new rule. A related cost is that we may lock banks into a particular way of measuring risk that may, ultimately, prove to be inferior to, as yet, undiscovered techniques.

We should remember that Pillar 2 and Pillar 3 were introduced precisely because of recognition by the Committee of the limitations of Pillar 1’s formulaic approach to determining capital requirements. Pillars 2 and 3 offer complementary sources of discipline over bank risk taking. In short, with more modest expectations concerning the need for precision under Pillar 1 comes more modest demands for prescriptiveness.

While much is still unclear about the issues that will determine the correct balance between prescriptiveness and flexibility in the proposed capital reform, I offer three guiding principles. First, the capital rule that we implement must respect the evolutionary nature of risk management. As regulators we must acknowledge that we are still in the relative early days of credit risk measurement and we must recognize the inevitability of further innovation. We are about to propose a capital rule that will require banks to devote significant resources to developing and implementing complex measurement systems, data systems, and control structures. While we believe that some amount of additional expenditure for those purposes is justifiable on the basis of a new approach to regulatory capital requirements, we recognize that there will be a limit to that justification. And one factor that contributes to that limit is the possibility that banks will want to change those systems and structures in response to improvements in risk measurement technology.

Second, Basel reform should, in our view, be more principles-based than is suggested by the level of detail in the Basel documents. Attempting to regulate a bank's internal capital assessments, a complex and evolving field, by issuing detailed and prescriptive rules will most likely create an environment in which banks are constantly developing new instruments and practices not anticipated by the rules. The concern about the complexity of Basel II is similar to the current debate on possible improvements to the U.S. financial reporting system, especially as it relates to the U.S. accounting standards process. As you know, in the Sarbanes-Oxley Act, Congress required the Securities and Exchange Commission (SEC) to study the adoption of a system of principles-based accounting standards<sup>1</sup>. In recent testimony<sup>2</sup>, the Chief Accountant of the SEC described the rules-based versus principles-based accounting standards debate in the following way: "Rule-based accounting standards provide extremely detailed rules that attempt to contemplate virtually every application of the standard. This encourages a check-the-box mentality to financial reporting that eliminates judgments from the application of the reporting." A principles-based accounting standard "requires financial reporting to reflect the economic

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<sup>1</sup> See section 108(d), Sarbanes-Oxley Act, Public Law No. 107-204 (January 23, 2002).

<sup>2</sup> See Written Statement, Robert K. Herdman, Chief Accountant, U.S. Securities and Exchange Commission, Before the Subcommittee on Commerce, Trade and Consumer Protection, Committee on Energy and Commerce, U.S. House of Representatives (February 14, 2002).

substance, not the form, of the transaction . . . . Principle-based standards will yield a less complex financial reporting paradigm that is more responsive to emerging issues.”

Third, regardless of the degree of specificity of the proposal, the document must be written in a manner that is understandable to the institutions that are expected to implement it, and to third parties, without regard to the complexity of the subject matter. It is imperative that the industry and other interested parties understand the proposed regulatory requirements and appreciate the supervisory expectations, if they are to provide a meaningful assessment of the consequences of the proposal. It is also imperative that any final capital rule be understandable by banks and supervisors in order to minimize unnecessary regulatory burden due to misunderstandings and confusion. And finally, given the importance of disclosure under Pillar 3 in reinforcing the efficacy of capital regulation and supervision, it is imperative that outside stakeholders in banks understand the operation of capital requirements.

### Competitive Equality

The second stated goal of the Basel Committee in developing Basel II was that “the Accord should continue to enhance competitive equality.” Despite QIS-3 and other similar efforts, however, we are not in a position to definitively assess the full range of consequences from the implementation of Basel II, including its effect on competitive equality in the global financial marketplace. We are particularly concerned that Basel II may create or exacerbate relative advantages between domestic banks and foreign banks; between banks and non-banks; and between large domestic banks and mid-size/small domestic banks. It is imperative that the U.S. banking agencies remain sensitive to these concerns and assess, to the extent possible, any unintended consequences resulting from the implementation of Basel II.

One of the primary objectives of the Basel Committee itself is the reduction of gaps and differences in international supervisory coverage by national supervisory agencies, especially as it relates to large internationally active banks that compete on a significant global basis with other financial service providers. This principle of competitive equality and a level playing field

for international banks is an admirable one, and an appropriate goal of the Committee's efforts. Yet one must question whether the exceedingly complex and highly prescriptive approach to capital reflected in Basel II will truly foster competitive equality.

Global rules, no matter how carefully weighed and measured, are not a satisfactory substitute for judgment, especially in a field like financial risk management, where the state of the art is constantly in flux. In the United States, we have a highly developed – some say intrusive – system of bank supervision. For example, the OCC has full-time teams of resident examiners on site at our largest banks – as many as 20 to 30 examiners at the very largest. In addition, most U.S. institutions are also subject to holding company supervision by the Federal Reserve, and in some cases by the FDIC and state supervisors. In other countries, by contrast, supervision may rely less on bank examiners, as we know them, and more on outside auditors to perform certain oversight functions. Given such disparities in the methods of supervision, I submit that U.S. banks are more likely to be subjected to more vigorous enforcement of a set of complex and prescriptive rules, and less likely to be the beneficiaries of permissive exceptions, than banks in countries whose supervisory practices fall at the other end of the spectrum.

Second, for many banks, the principle source of competition is not other insured depository institutions, but non-banks. This situation is especially pronounced in businesses such as asset management and payments processing. As you are aware, however, regulations implementing Basel II-based concepts in the U.S. will apply only to insured depository institutions and their holding companies. While differences in regulatory requirements for banks and non-banks exist today, many institutions have voiced concern that implementation of Basel II may unduly exacerbate the current differences. These concerns have been focused on the effects on competition from the application of the operational risk proposal and the enhanced disclosures required under Pillar 3.

Third, there is concern about the potential effect of Basel II on the competitive balance between large and small banks. As implemented in the U.S., Basel II would result in a bifurcated regulatory capital regime, with large banks subject to Basel II-based requirements and 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. In fact, the banking agencies sought comment from the banking industry, especially smaller institutions, on the development of a simplified capital framework specifically for non-complex institutions. See Advance Notice of Proposed Rulemaking, Simplified Capital Framework for Non-Complex Institutions, 65 FR 66193 (November 3, 2000). Industry comments were overwhelming negative on the proposal – most institutions felt that the cost of adopting a new regulatory capital regime outweighed any potential benefits. Accordingly, the banking agencies tabled the proposal.

With that said, the banking agencies need to continue to assess the competitive effects of a bifurcated regulatory capital regime. There are two primary concerns in this regard. First, banks using a Basel II-based regime will likely have a lower minimum capital requirement, allowing those banks to grow and compete more aggressively with small banks for both assets and liabilities. That concern is discussed in more detail in the “Calibration” section below. Second, banks using a Basel II-based regime will have a lower marginal regulatory capital charge for some types of loan products. As stated by the FDIC in a recent paper<sup>3</sup>, under the current capital regime, the regime applicable to most small banks after Basel II, a bank making a \$100.00 commercial loan is required to hold \$8.00 in capital. For banks using advanced methodologies in a Basel II-based regime, the required capital for that same loan would range from \$0.37 to \$41.65, depending on the riskiness of the credit exposure<sup>4</sup>. The banking agencies must continue to assess this situation and, if warranted, take steps to mitigate adverse effects on the competitive balance between large and small banks. We would be concerned if, as an unintended consequence of the implementation of Basel II, we significantly alter the structure of banking in the U.S.

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<sup>3</sup> See “Basel and the Evolution of Capital Regulation: Moving Forward, Looking Back,” FDIC Emerging Issues Paper (January 14, 2003).

<sup>4</sup> Calculations reflect representative lower and upper bounds for capital to be held in support of the \$100.00 loan. Lower bound reflects an LGD of 10% (high recovery) with a one-year maturity loan. Upper bound reflects an LGD of 90% and a five-year maturity loan.

## Operational Risk

Perhaps the most contentious aspect of the proposed revisions to the Basel Capital Accord has been the introduction of operational risk as a separate and distinct component of minimum regulatory capital. I should say at the outset that the OCC supports the view that there should be an appropriate charge for operational risk. Indeed, our banks already take account of operational risk in their own internal economical capital allocations. Since the issuance of CP-1 in June 1999, there have two competing views on the regulatory treatment of operational risk. Some have argued that operational risk is sufficiently similar to credit risk and market risk to be included in the Pillar 1 charge, while 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 a qualitative evaluation of such systems. I have consistently advanced the position before the Basel Committee that any charge for operational risk should be committed to the discretion of bank supervisors, under Pillar 2 of the proposal, rather than being calculated through a formulaic approach under Pillar 1. I regret to say that I have not been able to persuade the Committee as a whole to adopt this approach.

Nonetheless, it should be recognized that Basel's operational risk proposal has changed considerably since CP-1, reflecting some convergence from the on-going debate about whether the subject should be addressed under Pillar 1 or Pillar 2. The current operational risk proposal, especially the option of the AMA, which the OCC helped develop, is a significant improvement over earlier proposals. Recognizing the early stage of development of operational risk as a separate discipline, the AMA is a flexible approach that allows an individual institution to develop a risk management process best suited for its business, control environment and risk culture. The AMA tries to balance this need for flexibility with the establishment of broad standards for the identification, measurement, management, control and mitigation of operational risk to ensure a measure of consistency of application.

Despite recent improvements in the operational risk proposal, the OCC remains receptive to comment on this aspect of Basel II. While credit, market and operational risks can all cause



significant financial losses to financial institutions, those risks are not identical in character and the differences need to be reflected in any regulatory capital regime incorporating an operational risk charge. Unlike credit risk and market risk, which a bank consciously assumes in the expectation of financial return, operational risk is an unwanted byproduct of day-to-day business activities. At the same time, banks can take significant steps to mitigate exposure to operational risk ex ante, rather than relying on capital to absorb losses ex post. As was described in a recent paper<sup>5</sup>, the trade-off a bank faces in managing operational risk is not risk versus return, but risk versus the cost of avoidance.

As events in recent times have confirmed, internal control deficiencies, external and internal fraud, system breakdowns and other similar “operational” risks can result in significant financial losses, undesirable earnings volatility and reputation damage for individual institutions. The challenge for banks and bank supervisors is to identify the appropriate response to those risks. Banks have used an assortment of risk management tools in addressing operational risk, including enhanced controls, audit, improved risk measurement, pricing, insurance and capital. As the U.S. banking agencies develop the domestic capital rules, qualifying criteria and supervisory guidance for operational risk, supervisors must ensure that implementing regulations and policies appropriately reflect the full range of management choices in addressing this risk.

### Calibration

As discussed earlier, the first objective of the Basel Committee in embarking on the Basel II effort was to calibrate minimum capital requirements to bring about a level of capital in the industry that, on average, is approximately equal to the global requirements of the present Basel Accord. That calibration was to be designed to provide an incentive to banks to develop and maintain sophisticated and risk-sensitive internal ratings-based systems. The recent QIS-3 exercise was designed, in part, to determine whether this calibration exercise was successful. While, as noted earlier, the Basel Committee has not yet officially received a report on the results

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<sup>5</sup> See “Operational Risk Capital: A Problem of Definition,” Andrew Kuritzkes, *The Journal of Risk Finance* (Fall 2002).

of the QIS-3 exercise, issues concerning the overall calibration of regulatory capital amounts can be identified and discussed.

To ensure that it meets its goal of avoiding significant decreases in the aggregate level of required capital in the banking system, the Committee has proposed the use of a minimum floor capital requirement in the revised Accord. Under this approach, there will be a single overall capital floor for the first two years following implementation of the new Accord. This floor will be based on calculations using the rules of the existing Accord. Beginning in the first year following implementation, minimum regulatory capital at an individual bank cannot fall below 90% of the minimum level required under the capital rules, and in the second year, the minimum will be 80% of this level.

Based on preliminary analysis, the minimum floor capital requirements may prove binding on a number of U.S. institutions. The OCC does not believe that a reduction in minimum regulatory capital requirements for certain institutions is, in and of itself, an adverse feature of Basel II. Such a result is only acceptable, however, if the reduction is based on a regulatory capital regime that appropriately reflects the degree of risk in that bank's positions and activities. The OCC is not yet in a position to make that determination as it relates to Basel II. Given our current understanding of the data provided by banks that participated in QIS-3, and the uncertainty surrounding those submissions, the OCC is not yet comfortable allowing national banks to materially lower their current capital levels simply on the basis of the output of the currently proposed Basel II framework.

## **Conclusion**

As I have indicated, the OCC strongly supports the objectives of Basel II – a more risk-sensitive and accurate capital regime. However, I believe that significant work remains before the current draft of Basel II can be considered final. This summer, the OCC and the other banking agencies expect to seek notice and comment on an ANPR that translates the current version of Basel II into a regulatory proposal and accompanying supervisory guidance for U.S. banks. Once this process is complete, we will be in a position to have a full and complete consideration of the

proposal from all interested parties. As I said in the beginning of my statement, the OCC, the agency to which Congress has committed the authority to define capital requirements for national banks, will not sign off on a final Basel II framework until we have fully considered all comments received during our notice and comment process. If we determine through this process that changes to the Basel proposal are necessary, we will press the Basel Committee to make changes, and we preserve our ability to assure that any final U.S. regulation applicable to national banks reflects those views. Given the importance of this proposal, the significant issues that remain unresolved, and the prospect that whatever emerges from this process is likely to govern the financial landscape for years to come, we need to take whatever time is necessary to develop and implement a revised risk-based capital regime that achieves the stated objectives of the Basel Committee in both theory as well as practice.

I am pleased to have had this opportunity to provide our views on this important initiative, and I would be happy to answer any questions you may have.

## **Summary of Basel II: The Proposed New Accord Office of the Comptroller of the Currency**

The Basel Committee has been developing the new Accord over the past five years. During that time, two full-scale consultative papers (June 1999 and January 2001) and numerous working papers supporting various elements of the new Accord have been released to the industry for comment. This summary is intended to convey a general idea of the structure and substance of the proposed new Accord, and does not attempt to provide a complete analysis. It is based on the most recent publications from the Basel Committee, notably the Technical Guidance of the Quantitative Impact Study and the recent consultative paper of Pillar 3 on transparency and disclosure; the underlying documents can be found on the Basel Committee's website at <http://www.bis.org/bcbs/index.htm>.

The new Accord will include menus of approaches for measuring the capital required for credit risk, market risk, and operational risk. For credit risk and operational risk, each of the proposed approaches is described briefly below; capital charges for market risk are unchanged in the new Accord and are not discussed here. Some of the approaches described are unlikely to be implemented in the U.S. and have been noted as such. Moreover, based on preliminary analysis by the U.S. agencies, currently there are less than a dozen U.S. banks that would be mandatorily subject to Basel-based regulatory capital requirements. While other banks would be permitted to opt in to the Basel rules (subject to meeting prudential qualification requirements), the U.S. capital rules will remain in place for the vast majority of U.S. banks that either are not required to or do not opt to apply the Basel II framework. Of course, any issues regarding U.S. implementation of the new Accord will be definitively resolved only after the U.S. rulemaking process has been completed.

### **General Structure of the Proposed New Accord**

The new Accord has three mutually reinforcing "pillars" that make up the framework for assessing capital adequacy in a bank. The first pillar of the new Accord is the minimum regulatory capital charge. In order to calculate the capital charge under Pillar 1, banks will have to determine the individual charges for credit, market and operational risk. The new Accord offers a series of options for calculating credit and operational risk. Market risk will remain unchanged from a 1996 amendment to the Accord. The new options for credit and operational risk were designed to be available to a wide range of banks, from relatively simple to very complex. For credit risk, the Pillar 1 capital requirement includes both the standardized approach, updated since the 1988 Accord, and the new Internal Ratings-Based (IRB) approaches (foundation and advanced). Pillar 1 has been the focal point of much of the discussion and comment from the industry on the new Accord.

Pillar 2 covers supervisory review and banks' obligation to hold sufficient capital vis-à-vis their risk profile. The pillar is "intended to ensure not only that banks have adequate capital to

support all the risks in their business, but also to encourage banks to develop and use better risk management techniques in monitoring and managing these risks.” This pillar encourages supervisors to assess banks’ internal approaches to capital allocation and internal assessments of capital adequacy. It provides an opportunity for the supervisor to indicate where such approaches do not appear sufficient. Pillar 2 is also a way to focus supervisors on other means of addressing risks in bank’s portfolio, such as improving overall risk management techniques and internal controls.

The third pillar recognizes that market discipline has the potential to reinforce capital regulation and other supervisory efforts to ensure the safety and soundness of the banking system. Thus, the new Accord proposes a wide range of disclosure initiatives, which are designed to make the risk and capital positions of a bank more transparent. As a bank begins to use the more advanced methodologies for market and operational risk, the new Accord will require a significant increase in the level of disclosure. In essence, the tradeoff for greater reliance on a bank’s own assessment of capital adequacy is greater transparency. This pillar was subject to a recent redraft and consultation process (ended 2/14/03); the new draft was in response to significant concerns raised about the January 2001 proposal.

## **Capital for Credit Risk**

Under Basel II, banks must select one of three approaches to determine their capital for credit risk. The three approaches, from simplest to most complex are: the standardized approach, the foundation IRB and the advanced IRB.

### Standardized Approach

The 1988 Accord introduced the standardized risk-bucketing approach for setting the minimum regulatory capital requirement, which is still used in the U.S. today. The approach has been subject to criticism that it lacks sufficient risk sensitivity. The revised standardized approach under Basel II enhances the 1988 Accord by providing greater, though still limited, risk sensitivity.

Key changes to create a more risk-sensitive framework include the refinement and addition of risk buckets, the introduction of external credit ratings, and a wider recognition of credit risk mitigation techniques. Risk weights are still determined by category of the borrower—sovereign, bank or corporate—but within each of these categories changes have been made to make the capital more reflective of the riskiness of the asset category. For example, the risk weight on mortgage loans has decreased from 50% to 40% and the risk weight on certain retail credits has moved from 100% to 75%. Risk weights for externally-rated corporate credits, currently 100%, will range from 20% to 150%. Sovereign risk weights are no longer dependent upon whether a country is a member of the Organization for Economic Cooperation and Development (OECD), but rather on the external rating identified for the country.

The standardized approach is not likely to be implemented in the U.S. U.S. supervisors believe that credit risk measured under the standardized approach of Basel II would generally not be

appreciably different than that measured under current rules for most U.S. bank, and the marginal changes in capital requirements would not justify the cost of implementation.

### Internal Ratings-Based Approach (Foundation and Advanced)

The IRB approach represents a fundamental shift in the Committee's thinking on regulatory capital. It builds on internal credit risk rating practices used by some institutions to estimate the amount of capital they believe necessary to support their economic risks. In recent years, as a result of technological and financial innovations and the growth of the securities markets, leading banking institutions throughout the world have improved their measurement and management of credit risks. These developments have encouraged the supervisory authorities to devote greater attention to developing more risk-sensitive regulatory capital requirements, particularly for large, complex banking organizations.

Banks must meet an extensive set of stringent eligibility standards or "qualifying criteria" in order to use the IRB approach. Because the requirements include both qualitative and quantitative measures, national supervisors will need to evaluate compliance with them to determine which banks may apply the new framework. The requirements vary by both the type of exposure and whether the bank intends to use the simpler foundation IRB framework or the more advanced IRB framework. The requirements are extensive and cover a number of different areas, including rating system design, risk rating system operations, corporate governance, and validation of internal estimates. A brief sample of actual criteria include:

- The board of directors and senior management have a responsibility to oversee all material aspects of the IRB framework, including rating and probability of default (PD) estimation processes, frequency and content of risk rating management reports, documentation of risk rating determinations, and evaluation of control functions.
- A one-year PD estimate for each grade must be provided as a minimum input.
- Banks must collect and store historical data on borrower defaults, rating decisions, rating histories, rating migration, information used to assign ratings, PD estimate histories, key borrower characteristics, and facility information.

As mentioned above, the requirements that a bank must meet are partially dependent upon which of the two IRB approaches a bank will use. The first methodology, called the foundation approach, requires fewer direct inputs by banks and provides several supervisory parameters that, in many cases, carry over from those proposed for the standardized approach. For a variety of reasons, the U.S. does not plan to introduce the foundation approach in its regulations. The second approach, the advanced IRB approach, allows banks much greater use of their internal assessments in calculating the regulatory capital requirements. This flexibility is subject to the constraints of prudential regulation, current banking practices and capabilities, and the need for sufficiently compatible standards among countries to maintain competitive equality among banks worldwide.

There are four key inputs that are needed under IRB, for both the foundation and advanced approaches. The first element is the probability of default (PD) of a borrower; the bank is required to provide the PD in both the foundation and the advanced approaches. The second

piece is the estimate of loss severity, known as the loss given default (LGD). The final two elements are the amount at risk in the event of default or exposure at default (EAD) and the facility's remaining maturity (M). LGD, EAD and M are provided by supervisors in the foundation approach, but must be provided by banks operating under the advanced approach (subject to supervisory review and validation). For each exposure, the risk weight is a function of PD, LGD and EAD.

The IRB approach envisions internal rating systems that are two-dimensional. One dimension focuses on the borrower's financial capacity and PD estimates that quantify the likelihood of default by the borrower, independent of the structure of the facility. The other dimension takes into account transaction-specific factors such as terms, structure and collateral. These characteristics would determine the second dimension, i.e., the LGD. Implicit in this treatment is the assumption that when a borrower defaults on one obligation, it will generally default on all its obligations. (This assumption is relaxed with the IRB treatment of retail portfolios.)

Calculating the capital charge under the IRB approach involves several steps. The first of these steps is the breakdown of the bank's portfolio into five categories: corporate, retail, bank, sovereign, and equity. The IRB rules differ to varying degrees across these portfolios. As a result, the IRB capital charge is calculated by category, with the PD, LGD, and EAD inputs potentially differing across these categories. Supervisory approval is needed before banks can use the IRB approach for any of the five categories. The minimum requirements described above were written to apply across these five types of exposure. The IRB approaches are most developed for portfolios of exposures to corporates, banks and sovereigns.

Another important step is the determination by the bank of the PDs for its loan grading categories. The PD of an exposure is the one-year PD associated with the borrower grade, subject to a floor of 0.03% (excluding sovereigns). The determination of PDs for borrowers supported by guarantees or credit derivatives is more complex. Banks under the advanced approach would use their internal assessments of the degree of risk transfer within supervisory defined parameters, while those under the foundation approach would use the framework set forth in the new credit risk mitigation provisions. Overall, the PD must be "grounded in historical experience and empirical evidence," while being "forward looking" and "conservative." A reference definition of default has been developed for use in PD estimation and internal data collection of realized defaults.

Once the PD has been established, banks must then establish the dimensions of LGD (loss severity) based on collateral and M. Under the foundation approach, M is assumed to be 2.5 years. There are several options that may be selected for the advanced approach, but in general, M is defined as the greater of one year or the remaining effective maturity in years.

After the bank determines the PDs and LGDs for all applicable exposures, these combinations can be mapped into regulatory risk weights. The risk weights, which are calibrated to include coverage for both expected and unexpected losses, are expressed as a continuous function, which provides maximum risk sensitivity and flexibility in accommodating diverse bank risk rating systems. The minimum capital charge is then determined by multiplying the risk weight by the amount expected to be outstanding at the time of default (EAD), and by 8%.

A final step in this process involves the ongoing review by the supervisors of the systems used to develop the IRB capital charge. Periodically, supervisors will need to validate these systems and review the internal controls that provide the foundation for the IRB approach. In addition, supervisors will also have to consider, under Pillar 2, whether the amount of capital generated by the IRB approach is commensurate with the bank's risk profile.

### Implementation of the IRB Approach

In addition to the requirement that a bank meet the qualifying or eligibility criteria, the new Accord requires that banks using the IRB approach run parallel systems for one year before implementation. This means that a bank planning to implement the IRB approach in December 2006, will actually have to begin calculating results as of December 2005, while continuing to run its current systems.

### **Adjustments to the Capital Charge for Credit Risk**

There are additional considerations that banks may have to factor in when determining the capital charge for credit risk. These additional considerations will further adjust required capital, outside of the requirements of the different approaches to credit risk. The two primary adjustments that might be made to the credit risk charge are for credit risk mitigation and asset securitization.

### Credit Risk Mitigation

The new Accord provides a measure of capital relief for certain qualifying risk-mitigating techniques used by banks. However, it is important to note that the credit risk mitigation proposals in the new Accord are generally only directly relevant to the standardized or foundation IRB approaches, which are not likely to be used in the U.S. In the advanced IRB approach, credit risk mitigation must meet certain qualitative requirements, such as legal certainty, but there are no specific proposals for adjusting the capital requirement for transactions that include credit risk mitigation techniques. It is assumed that any credit risk mitigation efforts will be factored into the PDs and LGDs assigned by the bank.

With that caveat in mind, the section on credit risk mitigation in the new Accord attempts to provide rough approximations of the risk reduction attributable to various forms of collateralized credit exposures, guarantees, credit derivatives, and on-balance sheet netting arrangements. The Committee has proposed a conceptual approach to these risk mitigation techniques that, while recognizing their risk reduction benefits, attempts to capture the additional risks posed by such transactions.

The credit risk mitigation proposal provides both a simple and a comprehensive approach to dealing with collateral. The proposal expands the range of eligible collateral from that recognized in Basel I. It also discusses the appropriate treatment for maturity mismatches between the credit risk mitigant and the underlying credit exposure. The proposal introduces haircuts, which the bank may estimate, to cover the market price and foreign exchange volatility



that may be inherent in the mitigant. The proposal allows banks to greatly reduce the capital requirements for exposures with large amounts of high quality collateral. There are strict quantitative and qualitative factors that must be met in order for a bank to be permitted to use its own haircut estimates. The proposal encourages the use of credit risk mitigation by expanding the type of collateral, guarantors and transaction structures that are recognized for capital reduction. Different types of credit risk mitigation techniques pose different levels of additional risk; the proposal incorporates flexibility that recognizes these differences and adjusts the capital treatment accordingly.

### Asset Securitization

Asset securitization is clearly an important issue in the U.S., as the securitization market is significantly greater than the securitization market of any other Basel member country. The Basel Committee believes that it is important to construct a more comprehensive framework to better reflect the risks inherent in the many forms of asset securitizations, including traditional and synthetic forms.

The securitization framework in the new Basel Accord applies generally when there is a transaction that involves the stratification or tranching of credit risk. The Committee has developed securitization approaches for both standardized and IRB banks. The level of complexity is significantly higher for IRB banks. The framework tries to focus on the economic substance of the transaction, rather than its legal form.

Under the proposal for the treatment of securitizations by standardized banks, the capital charge is generally determined by multiplying the amount of the securitization exposure by the risk weight mapped to the long and short term rating categories. Off-balance sheet exposures are subject to a conversion factor before the appropriate risk weight is applied. The proposal does allow for some recognition of credit risk mitigants provided on securitization exposures, but that recognition is permitted only when the bank meets a series of stringent criteria.

Banks that have adopted the IRB approach for credit risk are required to use one of two methods for determining capital requirements for securitization exposures. One method is the Supervisory Formula Approach (SFA), under which capital is calculated through the use of five bank-supplied inputs: the IRB capital charge on the underlying securitized exposures (as if held directly on the bank's balance sheet); the tranche's credit enhancement level and thickness; the pool's effective number of loans; and the pool's exposure-weighted average loss given default (LGD). The second method is known as the Ratings Based Approach (RBA). Under this approach, capital is determined by multiplying the amount of the exposure by the appropriate asset-backed security risk weights, which depend on external rating grades, short- or long-term. Granularity of the pool and the level of seniority of the position are also considered.

The securitization proposal is one of the newest pieces of the Accord and its impact on the industry is not yet fully known. In the latest QIS exercise, banks were asked for the first time to provide data on the relative impact of the proposals. Due to a number of questions about the proposal, the QIS results did not provide entirely reliable results, and it appears that more work is needed to make the proposal more understandable for banks.

## **Operational Risk**

One of the most significant changes in the new Accord is the proposal for an operational risk charge. It is expected to represent, on average, 10-15% of the total minimum regulatory capital charge. The framework is based upon the following operational risk definition: the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.

The Committee has proposed three approaches to calculate the operational risk charge, which represent a continuum of increasing sophistication and risk sensitivity. The Basic Indicator Approach (BIA) is the simplest of the three approaches; the capital charge is determined by taking an alpha factor decided by the Committee and multiplying it by an indicator, gross income. The next approach is known as the Standardized Approach and is similar to the BIA, but breaks out gross income into business lines. Because there is no compelling link between these measures and the level of operational risk, the U.S. does not plan to utilize the BIA or the Standardized Approach to determine the capital charge for operational risk.

The Committee has made the most significant changes to the advanced approach since it was originally introduced in January 2001. At that time, the Committee envisaged a single, very prescriptive advanced approach for operational risk, similar to credit risk. However, after numerous comments from the industry, the Committee made substantive changes in the proposal to reflect the evolutionary nature of the operational risk framework. The Committee recognized that, unlike credit risk, there are very little data and no internal systems specifically designed to target operational risk; instead, banks and supervisors rely primarily on internal controls to deal with a myriad of banking risks that cannot be as readily quantified as credit and market risks.

The Committee considered the comments and analyzed the state of the art of operational risk and developed what is known as the Advanced Measurement Approaches (AMA). Rather than prescribing one methodology, the AMA will allow banks the option of designing the operational risk measurement framework that best suits their institution, subject to some broad criteria. The criteria will be the key to achieving a certain level of consistency and comparability among institutions, as well as providing a margin of comfort to supervisors who must assess these differing systems. The criteria currently identified in the new Accord include the need for internal and external data, scenario analysis, consideration of business environment and internal control factors, and an adjustment for qualitative factors. Banks may also, under the AMA, consider the impact of risk mitigation (such as insurance), again subject to certain criteria set to ensure that the risk mitigants are effective.

## **Temporary Capital Floors**

Two floors that have been established for the Basel II framework. In the first year of implementation, the total capital requirement cannot fall below 90% of the result the bank would have had under the current (1988) Accord; in the second year, that floor drops to 80%.