Remarks by
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Before the
Institute of International Bankers
Washington, D.C.
March 3, 2003

Last week, I testified before a House of Representatives subcommittee on the proposed revisions to the Basel Capital Accord – Basel II, as we call it – and Basel II is what I'll be speaking to you about this morning. Over the past several months, there has been a great surge of interest in the news from the picturesque Swiss city that not too long ago was better known for its museums and medieval cathedral than for the pronouncements of the central bankers and bank supervisors who have been gathering there for decades. The financial press is full of the latest Basel news and rumors; the cottage industry of Basel-watchers could now fill a large office building; and financial institutions are hastening to get their views on the record in the hope that there may still be time to influence the Basel process. Let me assure you that there is still time – but the clock is ticking away.

The growing interest in Basel II comes as the Committee and its various task forces and working groups gear up for a last push to achieve a new capital Accord. Indeed, the year since I last visited with IIB was an unusually eventful and productive one for the Basel Committee, and so I should like to begin with a summary of just what has occurred during this period.

At its July 2002 meeting, members of the Committee reached agreement in principle on a number of important issues relating to Pillar I – the provisions prescribing a minimum regulatory capital charge. As you know, Pillar I offers financial institutions three major options for calculating capital:

- The standardized approach – essentially, a set of refinements to the old risk buckets, which provides for the use of external ratings in certain circumstances, and gives some weight to risk mitigation devices.
- The "foundation internal ratings-based (IRB) approach, which sets forth a methodology for using a bank's own internal risk rating system, including its calculated "probabilities of default" (PD) as a base for calculating capital, using a factor for "loss given default" (LGD) provided by supervisors.
- And the "advanced IRB" approach, which bases capital calculations on the bank's own supervisory-validated models, including bank-calculated PDs and LGDs.
- In each of the three approaches there would be a calculation for determining an assignment of capital to cover operational risk.

These Pillar I options – and the manner in which they would be applied and implemented – had long been among the most problematic elements of the Basel II proposals. That's why the agreements that came out of the Committee's July meeting were so important. We agreed on:

- Creation of a new IRB risk-weight curve that should provide a more risk-sensitive treatment of certain revolving retail exposures, including many credit card exposures.
- The need for banks using the "advanced IRB" approach to take account of a loan's remaining maturity when determining regulatory capital, while allowing national supervisors to exempt smaller domestic borrowers from this requirement
- New elements of the corporate and retail IRB frameworks, and a standardized approach designed to provide reduced capital requirements for loans to small- and medium-sized enterprises – SMEs – under the new Accord.

- The need for flexibility in the capital treatment of operational risk, which I'll return to in a moment.
- A plan to narrow the gap between the amounts of capital required in the foundation and advanced IRB approaches.

Another key milestone achieved during 2002 was the launch of the Committee's third Quantitative Impact Study, known as QIS-3. When the results of QIS-3 are reported to the Committee later this year, we should have some idea of how the latest version of the Basel II proposal may impact bank capital—although I should hasten to say that there are some shortcomings in QIS-3 and I have some serious reservations about the reliability of QIS-3 as a basis for calibrating the new Accord.

The Committee agreed to an aggressive timetable for the remaining actions leading to the adoption of Basel II. The plan calls for issuance of the third consultative paper (CP-3) in May of this year, with a three-month comment period to follow; adoption of Basel II by the Committee in December 2003; and full implementation of the new Accord by December 2006.

All of this represents good progress – far greater than many critics of the process thought possible. The Committee and its various working groups, under the strong and intelligent leadership of Bill McDonough, have achieved impressive results under difficult circumstances. But we're not there yet. Problems – intractable and consequential problems -- remain. Much as we would all like to declare victory and move on to other things, it is imperative that we forthrightly come to terms with these problems rather than trying to minimize their importance in the rush to an Accord – an Accord that will undoubtedly govern the financial landscape for many years to come.

I'd like to spend my remaining time with you this morning discussing a few of what I believe are the major unresolved issues that confront the Basel Committee.

Calibration

As I said a moment ago, one of the key concerns for the Committee in Basel II is to assure that the new framework does not result in a significant decrease in the aggregate level of capital in the banking system. This is, in my view, more a political rather than an economic concern. After all, the very purpose of Basel II is to have capital rules that better reflect actual risk, and a more sophisticated and accurate measurement of risk might well result in a lowering of capital. To be sure, bank supervisors are inclined to believe that more capital is always better, and we would be concerned if Basel II resulted in a lowering of capital that was not clearly related to risk. But we are also aware that there can be adverse consequences for governmental requirements for too much capital – an impairment of the competitiveness of our banks, and a misallocation of resources. From a political point of view, of course, there is a strong likelihood that Basel II might be viewed with a jaundiced eye by legislators if it resulted in an appreciable lowering of capital – particularly since the new process will be based on the banks' own assessments of risk. On the other hand, the Committee wants to induce banks to make the sizeable investments in new risk management systems that will be required to make an internal ratings-based approach feasible and acceptable, and it has held out the prospect of reduced capital as such an inducement. It remains to be seen whether we are up to this kind of prestidigitation --simultaneously allowing large banks to reduce their capital, while keeping the level of capital in the system undiminished. As F. Scott Fitzgerald once observed, "the test of a first rate intelligence is the ability to hold two opposed ideas in the mind at the same time, and still retain the ability to function." There is no question but that the Basel committee is comprised of first-rate intelligences.

To accomplish these apparently inconsistent goals, the Committee has proposed the use of a capital floor 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 the first year following implementation, minimum regulatory capital at individual banks would not be permitted to fall below 90 percent of the current minimum required level, and in the second year, the minimum would be 80 percent of this level. Preliminary analysis suggests that these minimum capital requirements may prove binding on a number of U.S. institutions.

The OCC's position on the proper calibration of the Basel capital rules has been consistent. We do not believe that a reduction in minimum regulatory capital requirements for certain institutions is necessarily an adverse feature of Basel II. Such an outcome is only acceptable, however, if the reduction is based on a regulatory capital regime that has validity and integrity and appropriately reflects the degree of risk in that bank's positions and activities. Until we have better evidence that Basel II meets that standard, the OCC will be reluctant to allow national banks to materially lower their current capital levels.

Operational Risk

No Pillar I issue has generated more controversy than the proposed provision for operational risk as a separate and distinct component of minimum regulatory capital. We define op risk as the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events.

Since the issuance of CP-1 in June 1999, there have been two competing views on the regulatory treatment of operational risk. Some have argued that op risk is sufficiently quantifiable to be treated similarly to credit risk and market risk and to be included in the Pillar 1 charge. Others maintain that an evaluation of op risk is inherently judgmental, inhering as it does in the quality of an institution's internal control systems, thus supporting a Pillar II approach under which supervisors would focus on a qualitative evaluation of such systems. The OCC has consistently advocated a Pillar II approach for op risk, rather than the more formulaic approach of Pillar I. Unfortunately, I have not been successful in persuading my Committee colleagues to adopt that position.

Nonetheless, the Committee's approach to op risk <u>has</u> changed significantly – and for the better, in my judgment -- since CP-1. The current op risk proposal offers three options, reflecting a continuum of increased sophistication and risk sensitivity. The most sophisticated of these options, the so-called Advanced Measurement Approach (AMA), affords considerable flexibility to financial institutions in developing an op risk management process best suited to 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 consistent application.

Whether these improvements are sufficient to bridge what we see as the fundamental differences between credit and market risk, on the one hand, and operational risk on the other, is another question. Banks assume credit and market risk in the expectation of financial return; op risk, by contrast, is an unwanted byproduct of normal business activity.

Banks make provision for operational risk through a variety of risk-management tools. They build internal controls of varying degrees of robustness, develop audit capabilities, purchase insurance – and allocate capital. As the U.S. banking agencies develop the domestic capital rules, qualifying criteria and supervisory guidance for op risk, supervisors must ensure that implementing regulations and policies appropriately reflect the full range of management choices in addressing this risk.

Complexity

The Basel Committee sought to realize an ambitious set of goals in the new Accord. We hoped to integrate all we have learned over the years about capital regulation and risk in a single, logically consistent package. We hoped to recognize the technological and conceptual advances in the science of risk management since the adoption of Basel I, and to provide incentives for bankers to make use of these advances. We wanted to supplement the risk judgments of supervisors with those of the marketplace and of bankers themselves, and ensure that the guidelines supervisors produce are relevant to the changes – structural changes, portfolio changes, and management changes – that have occurred in the international banking environment.

In one respect, the result of such an ambitious undertaking was probably predictable. The process has generated a product of vast complexity – putting to shame the U.S. Internal Revenue Code, long the world's record holder for complexity. Thousands of pages of task force and working group papers, years in the making, have given rise to hundreds of pages of rules, guidelines, and standards saturated with arcane mathematical formulae. They're not written by or for bankers – or for that matter, by or for conventional bank examiners. They're written for mathematicians and economists – "quants."

When I have complained in the Basel Committee about the complexity problem, my colleagues have roundly admonished me. "We live in a complex world," they say. "Don't quibble if we try to fashion capital rules that reflect that complexity." But with great respect for my colleagues, the complexity we have generated goes far beyond what is reasonably needed to deal with the intricacies of sensible capital regulation. It reflects, rather, a compulsion to close every possible loophole, to dictate every detail, and to exclude to the maximum extent possible any opportunity for the exercise of judgment or discretion by those applying and overseeing the application of the new rules. In short, it reflects much more a commitment to prescriptiveness than a mere recognition of the complexity of today's banking business.

This complexity has a price. Most obviously, it will impose a heavy cost burden on bankers, who have to design systems and educate staff to deal with the complex new rules. It may also have a cost in terms of credibility and public acceptance, for if legislators, customers, and market participants cannot penetrate the new rules, can we expect them nonetheless to love and respect them?

Finally, it may have a cost in terms of competitive equality, and this is what concerns me most. Bank supervision varies significantly from one country to another in approach, intrusiveness, and quality. Is it realistic to think that an enormously complex set of rules will be applied in an evenhanded way across a broad spectrum of supervisory regimes? For example, the OCC has as many as 30 or 40 full-time resident examiners in our largest banks. They are intimately involved as supervisors in watching the banks' operations and judging the banks' compliance with a myriad of laws, rules, and guidelines. Some other countries may send examiners in once a year to comparably sized institutions, or may put heavy reliance on the oversight of outside auditors. It's fair to ask, I think, in which regime 800 pages of detailed, prescriptive capital rules are more likely to be robustly enforced? The Basel Committee has not undertaken to set standards of supervision for member countries. Yet the attainment of competitive equity among internationally active banks is a bedrock principle of Basel II. Can we really achieve competitive equality without addressing disparities in supervision – particularly when we are operating on the assumption that the complex new rules we're writing will be applied in an evenhanded way throughout the world?

I cannot resist recalling words that seem peculiarly relevant to this effort. In the 1780s, as Americans engaged in a great debate on the principles that should underlie their new government, one of the most original of our thinkers on that subject (and later president), James Madison, contributed an important insight. Popularly elected governments do not automatically command popular confidence, Madison observed. "It will be of little avail to the people if laws are made by men of their choice, if the laws be so voluminous that they cannot be read, or so incoherent that they cannot be understood."

Certainly what has come out of Basel has been voluminous; whether it is incoherent I shall leave for others to decide – although I frankly confess that much of it boggles my mind. But in light of some of the criticisms I've heard, I think it would be well to consider whether we're not approaching that point of perfect impenetrability – as with our tax code -- that makes honest compliance difficult, if not impossible.

Each of the problems I have outlined deserves serious consideration by the Basel Committee -- and by everyone who will be affected by what comes out of its deliberations. Until the final Accord is inked, the Basel Committee must remain open to new ideas and new solutions, even if that involves some further slippage in the timetable for bringing the Accord to a conclusion. Congress is playing a key role – as it should -- in ensuring that the interests of U.S.-based institutions – and U.S. citizens – with respect to Basel II are properly understood and safeguarded.

Most of all, we're counting on continued input from the banks that will have to live under the new Basel regime -- and pay most of the costs associated with it. I assure you that we will take your comments with the utmost seriousness – now and during the formal notice and comment process. The OCC, which has been invested by Congress with the statutory duty and authority to fix capital requirements for national banks will not give its final agreement to Basel II until we have fully and objectively considered all the comments we receive. And we will not sacrifice good public policy to the dictates of an arbitrary time schedule. If, after reviewing the views of commenters, we determine that changes to the Basel proposal are necessary, we will insist upon such changes. The integrity of the process is crucial if Basel II is to achieve the goals we set out to achieve – for now and for years to come.

Since we began the process of revising Basel I, the OCC's position has been firm and unequivocal. This is a tremendously important endeavor, and we strongly support its objectives. But Basel II must work in practice as well as theory; it must provide supervisors with sufficient flexibility to accommodate differences among financial institutions; and it must work in a way that avoids placing banks at a competitive advantage compared to other financial services providers. In advocating these broad policy goals, the OCC has looked at the issues independently as on operational risk. And while we have not always prevailed where we have had differences, I believe our efforts make it more likely that we'll eventually get a workable new Basel agreement – one that all concerned parties can live with and prosper under.