Statement of
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and the
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Committee on Financial Services
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Chairwoman Pryce, Chairman Bachus, Congresswoman Maloney, Congressman Sanders, and members of the Subcommittees, thank you for inviting the Office of the Comptroller of the Currency (OCC) to participate in this hearing on the U.S. implementation of the Basel II framework, and on proposed legislation, H.R. 1226, the "United States Financial Policy Committee for Fair Capital Standards Act." This hearing is very timely given recent developments in the U.S. banking agencies' Basel II implementation process.

In my remarks this morning, I would like to highlight three areas: First, where we stand on implementation of the Basel II Framework in light of the recent results of the fourth quantitative impact study, "QIS-4;" second, our commitment to modernize the current domestic capital rules for those banks that will not be governed by the Basel II rules; and finally, some thoughts on H.R. 1226.

The two years since we last testified have been eventful years for the Basel Committee, the U.S. banking agencies, and the U.S. banking industry. On June 26, 2004, culminating a six-year effort, the Basel Committee published the Basel II framework. Later in 2004, the U.S. banking agencies undertook QIS-4, with the specific goal of gaining a better understanding – before its adoption – of how Basel II might affect minimum risk-based capital within the U.S. banking industry.

The agencies recently completed a preliminary analysis of the QIS-4 data, and certain initial observations became evident to us.

In brief, the QIS-4 data evidence both a material reduction in the aggregate minimum required capital for QIS-4 participants and a significant dispersion of results across institutions and loan portfolio types. For example, 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 8 percent *minimum* total risk-based ratio. Aggregating over the QIS-4 participants, the *decrease* in effective minimum required capital was 17 percent, while the *median decrease* among participants was 26 percent.

Moreover, the dispersion in results – both across institutions and across portfolios – was much wider than we anticipated or than we can readily explain. Changes in effective minimum required capital for individual institutions ranged from a decrease of 47 percent to an increase of 56 percent. While some dispersion of results in a truly more risk-sensitive framework is to be expected, we are not convinced that the wide ranges indicated by QIS-4 can be fully explained by relative differences in risk among institutions.

I must pause to strongly emphasize here that the change in what we are calling "effective minimum required capital," represents the change in capital required to meet the 8 percent *minimum* total risk-based ratio; it does not reflect that individual institutions in fact hold capital in excess of regulatory minimums, and therefore it does not imply that any particular institution would need to actually increase its capital in order to be capital-compliant.

Finally, changes in minimum capital requirements – both increases and decreases – of certain portfolios significantly exceeded our expectations. For example, the *increased* capital required for "qualified retail exposures," or QREs – essentially credit card receivables, raise questions about the treatment of this type of credit under Basel II. Certain other product lines indicated larger *declines* in required capital than may be warranted. Residential mortgage and mortgage-related products, such as home equity lines of credit, for example, are among those that will require further analysis to better understand and assess the QIS-4 results and to determine if these results accurately reflect risk.

Based on this preliminary assessment of QIS-4 results, the agencies concluded that a delay in the notice of proposed rulemaking was the only responsible course of action available to us. For that reason, on April 29th, we announced that we would not publish an NPR on the schedule that we had previously forecast.

The obvious question all this raises is "what now"?

We continue to believe in the potential of Basel II to achieve its crucial objectives – improved risk management, supported by significantly greater risk sensitivity in the regulatory capital framework. But, the issues surfaced during our preliminary work point to a need for a more complete assessment of the QIS-4 results. This additional work is necessary to determine whether the preliminary QIS-4 results reflect actual differences in risk, simply reveal limitations of QIS-4, are the product of variations in the stages of bank implementation efforts, and/or suggest the need for adjustments to the Basel II Framework.

The results of our additional work will tell us much about the steps that will need to be taken in order to make Basel II a reality for U.S. financial institutions. If we believe that changes in the Basel II framework are necessary, we have consistently said that we will seek to have those changes made by the Basel Committee.

I also want to reassure you that the U.S. banking agencies recognize that domestic institutions not subject to Basel II-based capital requirements – including mid-size and community banks – have a strong interest in the ways in which their products, pricing and business strategies might be affected by implementation of Basel II by their competitors.

That is why we have undertaken a separate but related effort to update and modernize the domestic risk-based capital rules for those institutions not subject to Basel II. The agencies are developing these two capital rulemaking projects in tandem, to ensure that appropriate risk sensitivity and consideration of competitive effects are factored appropriately into each proposal.

Finally, the Committee has asked for our views on H.R. 1226. We share the desire of the bill's sponsors to ensure a strong and consistent position among the banking agencies in our approach to Basel II, and we also agree that the types of factors listed in the bill are very relevant to evaluating the impact of implementing Basel II. However, we do not believe that legislation is needed to achieve these results. Since the beginning of the process that led to the adoption of the Basel II framework, the agencies have worked closely together, and while there have been differences of views along the way, I believe these different perspectives have, on balance, been constructive. I have confidence that this will continue to be the case.

Also very relevant here is the fact that the OCC has designated the Basel II rulemaking proposal as a "significant regulatory action" for purposes of Executive Order 12866. That Executive Order requires us to provide specific information, a "Regulatory Impact Analysis" (RIA), to OMB for review prior to publication of the proposal. The RIA will include an assessment of the costs and benefits of the proposed regulation and thus will address many of the factors identified in H.R. 1226.

In closing, let me emphasize three commitments that have been and that remain central to our work on implementation of the Basel II Framework: First, an open rule making process in which comments are invited and considered, good suggestions are heeded, and legitimate concerns are addressed; second, a reliable quantitative analysis prior to adoption of a rule, through which we can assess the likely impact of Basel II on the minimum regulatory capital requirements of our banks; and finally, a prudent implementation in which we make well reasoned and well understood changes to bank capital requirements and incorporate in those changes appropriate conservatism.

Thank you for holding these important hearings. I look forward to answering your questions.