Remarks by
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Just as bankers eagerly await the annual Washington conference of the Institute of International Bankers each year, so, too, do we at the OCC. We welcome this conference as one of the best opportunities we have to meet with industry leaders and to discuss developments related to the supervision of internationally active banking organizations.

So, with gratitude to Larry Uhlick and the IIB staff for making it possible, I'd like to spend the next several minutes offering some perspectives and providing some updates on one question that I would expect is of keen interest to IIB members: after years of effort, where <u>do</u> we stand in the U.S. regarding implementation of the new Basel capital accord?

At the outset, it's important to stress that the process and procedures for implementing Basel II capital rules here in the U.S. are very unusual. In fact, they are exactly backwards of how we usually do a regulation. Ordinarily, in response to a legislative directive, or external developments, U.S. banking regulators propose a rule, take public comments, and then based on those comments and their own analysis, adopt a final rule. *Then* the banks affected by the rule take steps to implement and conform to the new rule. Sometimes, *after* a rule is promulgated, the agencies may issue further implementation guidance to the industry. Obviously, this sequence is not what's happening here.

Rather, we have a new capital framework recently agreed to by an international body, which requires years of advance planning, systems creation and data collection by banks prior to actual implementation of the new standards. Here in the U.S., those banks that will be required to follow Basel II, and those that may want to "opt-in" to the new Basel II rules won't know exactly what the rules will say until we finish the U.S. rulemaking process. Yet today, they are spending hundreds of millions of dollars to get ready for it. And we have been very clear from the beginning on the need for a rulemaking process with integrity – one that gives all interested parties a fair chance to be heard and to influence the outcome, even if in so doing, new issues – or changes – are introduced into the mix.

Let me be very clear about this last point. We are quite aware that some thoughtful and knowledgeable bankers and policymakers have expressed misgivings about Basel II's models-based approach and its complexity, and about particular components of the Basel II approach. We fully expect some of those concerns will be reiterated as part of the public comment process on the banking agencies' Notice of

Proposed Rulemaking later this year. If we don't have good answers to good issues that are raised in the rulemaking process, appropriate revisions to the proposal must be made.

We also have been saying for some time that it is entirely possible and appropriate that the U.S. Congress would become a more active participant in the debate once the Accord is finalized and the QIS 4 results began to come in. There is still some likelihood that this engagement will occur; indeed, Basel-related legislation was introduced just last week in the House of Representatives.

Nevertheless, because of the need to plan and take steps for implementation well in advance of a final rule, much has been accomplished and Basel II implementation planning continues. We have established an interagency working group structure, developed and conducted training for examiners, published draft guidance for banks and an Advance Notice of Proposed Rulemaking (ANPR), carried out home-host case studies, and communicated qualification timetables, and expectations to banks.

But the greatest challenges lie ahead – after so many years of debating the theoretical side of regulatory capital and dealing with the complex Basel formulations, we are at the point where we must come to grips with how Basel II will work with the realities and practicalities of bank supervision.

The dynamics of the Basel II process, with the January 2008 implementation deadline facing us, requires that we move the process ahead – subject to the caveats I just noted – and thus the focus has now shifted to the Basel Committee's Accord Implementation Group (AIG), under the wise leadership of Nick LePan, which is charged with the task of facilitating the resolution of many of the key practical issues that remain, including those arising from home-host coordination and the exercise of national discretion. The AIG, in others words, has a vital role to play in ensuring some consistency in making the theoretical tapestry of Basel II actually work in bank supervision.

While we have come far in our implementation planning, there <u>are</u> critical issues that remain unresolved – for the Basel Committee itself, for the bank regulatory agencies of each of the participating nations, and for the financial institutions that expect to operate under the Basel II Framework. Each of those entities face major challenges. It will require each of them to work very diligently, both separately and in concert, if the January 2008 implementation deadline is to be achieved.

Let me briefly touch on some of the particular issues still facing the Basel Committee, although these issues will of course also have to be taken up in the U.S. rulemaking process. One of the most vexing issues is the need for banks adopting the Advanced Internal-Ratings Based approach to credit risk to reflect economic downturn conditions in their estimates of Loss Given Default. As has been the case with many elements of the Basel II Framework, the challenge here is to balance the theoretical with the practical – an IRB process designed to capture unexpected credit risk losses should incorporate systematic volatilities in loss severities. Risk data must capture the broad range of historical loss possibilities. But what if a bank has never experienced such losses?

At the same time, however, supervisors must be cognizant of the pragmatic feasibility of the proposals, looking to the burden and practicality of how these risk parameters can be estimated and validated. As many in this room can attest, these "stress LGD" discussions are critically important, affecting not only burden considerations, but also overall calibration issues.

The Basel Committee is also deeply involved in assessing the current Basel capital charge for bank trading book positions. As you know, the Committee has set up a joint group, together with the International Organization of Securities Commissions (IOSCO), to accomplish this goal. The mandate of this group is extremely broad, addressing such topics as the treatment of counterparty credit risk for over-the-counter derivatives, repo-style and securities financing transactions; cross-product netting; the short-term maturity adjustment within the IRB for some trading book-related items; the treatment of "double-default" effects for hedged transactions; and the valuation, risk management and capital treatment for less liquid instruments held in the trading book. The Basel Committee's Capital Task Force will be considering this issue, as well as the Stress LGD issue, this week, with the Basel Committee itself deliberating on these issues later this month.

But let me now focus on the challenges facing us as bank supervisors. Clearly, the Basel II implementation timeline presents enormous stresses. Within the next 15 months, we must finalize international negotiations on remaining outstanding issues in the Basel II Framework; analyze QIS 4 and Loss Data Collection Exercise submissions; draft and publish for public comment a Notice of Proposed Rulemaking; finalize updated supervisory guidance for the IRB and AMA; draft and issue a final rule, reflecting public comments; integrate Basel II supervisory standards and regulatory requirements with our existing supervisory process; continue to develop incentives for institutions to develop and submit Basel II implementation plans to their primary supervisor; increase the level of coordination with relevant home and host supervisors; and begin to conduct supervisory assessments supporting IRB and AMA qualification decisions.

I know of only one way for supervisors to accomplish these aggressive objectives. Given the unusual sequence of the rulemaking and implementation processes, we must undertake these efforts with an unprecedented level of transparency, engaging in an open dialogue with the banking industry and with <u>all</u> interested persons, on all aspects of the proposal, to ensure that interested parties are aware of our current plans for implementation as early as possible.

The industry also needs to be fully engaged in this dialogue. Banks, large and small, foreign- and domestic-based, along with Congress and all other interested parties, need to react and respond to our solicitations for comment. Institutions contemplating adoption of Basel II should discuss their plans with their primary supervisor early in the planning process. As provided in the Interagency Statement issued in January, institution-specific implementation plans, describing the planning process and tangible steps to be taken by that bank, are the most effective communication tool for Basel II discussions between institutions and their supervisors. Supervisors, institutions, and the public share a common goal in the implementation of Basel II – the development of a prudentially sound and risk-sensitive regime of risk management, regulation and supervision that does not introduce unacceptable regulatory vagaries and burdens. We need to work together in this effort.

With this formidable task ahead of us, it is especially useful not to lose sight of how much U.S. bank supervisors have already accomplished since June 2004, when U.S. members of the Basel Committee began to work toward the key implementation milestones. It was a long and ambitious list – particularly ambitious when one considers that there was considerable skepticism at the time that there would even be an agreed upon Framework.

Looking back now, considerably less than a year later, the achievements of the U.S. banking agencies and the banking industry are impressive. In that time, we published for notice and comment a critical piece of supervisory guidance, on Internal Ratings-Based Systems for retail credit, which followed two even earlier pieces of guidance, one covering corporate credit and the other, the AMA for assessing operational risk.

We launched QIS 4 – a critical step in our assessment of the likely impact of Basel II on capital requirements in the industry, for banks and on business lines. In October we issued the spreadsheets, instructions, and questionnaires, and collected all of the responses in January. We are still immersed in the analysis of that data and will soon begin the process of teasing out, in our interagency discussions, what the QIS findings foretell about the Framework's likely affect on U.S. capital levels.

Let me say parenthetically that quite apart from what QIS 4 might eventually have to tell us about the likely impact of Basel II, the QIS process represents a success on another plane. Although industry participation was voluntary, the level of cooperation and involvement has been impressive. So has the dedication of the staff charged with compiling and analyzing the data. I can't let the opportunity pass without commending everyone who has been involved in the effort.

And while all this represents an important start, it is no more than that – a start. There remains an enormous amount of work to be done before the January 2008 implementation deadline for the advanced credit and operational risk approaches in the United States. Regulators and financial institutions, both mandatory and opt-ins, have daunting schedules to meet and complete. The focused dialogue between supervisors and the industry on the practical effects of Basel II evidenced in the QIS 4 process will need to be replicated as we move towards the notice and comment process for the NPR and IRB and AMA supervisory guidance.

The most pressing and immediate regulatory deadline is the Notice of Proposed Rulemaking that we have targeted for issuance by the middle of this year. We have always known that this would be an ambitious deadline, given the complexity of the proposal and the many concerned parties whose views we are absolutely committed to providing with a thorough hearing at every stage of the process. Once all comments have been fully considered, we expect to publish the final Basel II rules and final supervisory guidance by mid-year 2006. But again, let me stress, that we are – indeed we must be – committed to the integrity of the U.S. rulemaking process. There is no "done deal" here; much could change based on information developed in QIS 4 and the public comment process.

Nevertheless, while the deadlines I have described are challenging, they're not impossible, as I believe we've already demonstrated. Obviously they don't leave much time for false starts and second-guessing, and they require efficient use of the calendar and our limited resources. But it can be done.

Recall that the ANPR was released fully 14 months before publication of the midyear text, and that the draft guidance on op risk and corporate credit predated the final accord by a significant period. Taking a similar tack could make it possible for financial institutions to develop, establish, and gain agency approval for the systems and methodologies needed to quality for Basel II's advanced approaches.

That brings me, finally, to the specific challenges facing financial institutions. What will your primary Federal supervisors be looking for when we assess our individual institutions' readiness for the advanced approaches? Let me summarize our expectations on this score. For detailed information, I would encourage you to consult the "Interagency Statement – U.S. Implementation of the Basel II Framework" issued this past January 27th.

As first indicated in the August 2003 ANPR, institutions seeking to adopt Basel II regulations are encouraged to develop comprehensive, written implementation plans that detail the necessary elements of a rollout strategy for the IRB and AMA as early as possible. Such a plan would link existing agency guidance with the institution's specific implementation activities, and would provide an initial basis for the development of supervisory plans related to the qualification process. We would expect that such an implementation plan would reflect extensive discussion with the institution's primary supervisor and then approval by the institution's board of directors. Finally, we also expect IRB and AMA implementation plans to be comprehensive. That is, we assume, that unless specifically exempted by the primary Federal supervisor, the advanced approaches would apply across all material business lines, portfolios, and geographic regions.

Having such a written implementation plan is a necessary but hardly a sufficient condition for institutions to qualify for advanced approaches, for we do not view "qualification" as a single, isolated event. Follow-through is crucial, both for institutions and supervisory agencies. For financial institutions, execution is everything. Assessing the effectiveness of institutions in translating their implementation plans into action will be the responsibility of the primary regulator. Subsequent to our initial qualification decision, we will perform ongoing validation of institutions' implementation efforts, through discussion, reviews, and examination activities, as a regular part of the supervisory process.

What is envisioned as the final test in the qualification process for using the IRB and AMA systems is a one-year parallel run, to be conducted under the watchful eye of each bank's primary supervisor. This would allow those systems to be observed in actual operation and would provide useful quantitative information about the revised regulatory capital requirements during the period prior to their first use for regulatory capital purposes. A positive supervisory judgment about the parallel run process would be required for banks to use the IRB and AMA systems for regulatory risk-based capital purposes.

For those of you who would like to learn more about the qualification process, let me assure you that the forthcoming NPR will add several levels of detail and clarification. In the meantime, I would encourage you to take us up on our offer to meet with any financial institution – mandatory or opt-in – that seeks assistance in understanding or implementing the new framework.

While there are many examples of how cooperation is pointing the way to 2008, I am particularly impressed by the effective way that the AIG is serving as a forum for multilateral discussions and for furthering bilateral efforts to coordinate supervisory evaluations among national supervisors. While cross-border issues have always existed in the supervision of internationally active institutions, Basel II has raised new practical challenges in this regard.

But these challenges – involving data sharing, examination coordination, validation, and other pragmatic supervisory questions – are being resolved in a methodical manner, through hard work and good will. I hope that today's discussion of some of those challenges has contributed to your understanding of where we stand – and the issues we still face – in implementation of Basel II.

Thank you.