Remarks by
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It is an honor and a pleasure to be with CSFI as it celebrates ten years of distinguished service to the financial community. The roster of your officers, sponsors, and trustees – as well as the impressive list of CSFI publications – makes it self-evident why the organization enjoys the reputation it does. I particularly want to express my appreciation to Sir Brian, Minos Sombanakis, and Andrew Hilton, for the invitation to speak as well as for this evening’s fine hospitality.

When I alluded to your “distinguished service to the financial community,” I was obviously not referring to “service” in the same sense one might use the term in a gathering of back-office consultants or software developers. What CSFI provides is quite different – and extraordinarily important in an age when polemics and self-interest masquerade as solemn truth. What CSFI gives us is judgment we can trust, perspective we can apply, and forthright analysis that is indispensable to our understanding of the pressing policy issues of the day.

For internationally active banks, their supervisors, and those who try to make sense of it all, no public policy issues matter more than those currently on the table at Basel. In the U.S., Basel II has recently attracted a great deal of attention from banks and policy makers following a Congressional hearing in mid-February at which I expressed concerns with the proposal.

It has certainly been a difficult journey for the members of the Basel Committee and the various working groups and task forces from the central banks and supervisory agencies that are so heavily involved in the Basel process. We have been at it for nearly four years now, and will be at it for some time longer – at least until the end of 2003.

With respect for the kind of perspective that informs so much of CSFI’s work, I thought that I would step back and look at Basel II in the context of the history of capital regulation. In what ways does Basel II draw on the experiences of the past – and to the extent that it is leaving experience behind and breaking new ground, what kinds of
issues may it be raising?

One needn’t go back too far – the late 1970s would do – to find a time when many bank supervisors believed they could easily get along with no formal rules on capital. Experience had taught them that such simple ratios as capital to assets and capital to total deposits were not very useful, and that supervisory judgment was a far better tool than mathematical ratios. I recall asking the head of supervision at the Federal Reserve years ago how much capital was enough, and he answered, “I can’t tell you, but I know it when I see it” – a response that sounded eerily like that of a late U.S. Supreme Court Justice who was asked to define obscenity.

In any case, bank supervisors of a generation ago were reluctant to place too much faith in fixed capital ratios, partly because they feared giving rise to a false sense of security – or insecurity – about the safety and soundness of the banking system, and partly because the idea that formulaic ratios should carry any decisive weight in an assessment of a bank’s condition offended their sense of professionalism. It had taken many decades to overcome the view of the bank examiner as an accounting clerk with enforcement powers – people who might be depended upon to find shortages in the till or moribund loans still being treated as viable, but not much else. In place of that image, a shiny new one was evolving of bank supervisors, whose expertise in banking and finance was matched only by their intuition, discretion, and ability to look beyond the raw numbers to discern the true condition of the institutions under their responsibility.

Not surprisingly, therefore, in the United States the initiative for a return to capital ratios as a supervisory mainstay came not from bank supervisors themselves, but rather from lawmakers reacting to the rather abrupt deterioration of the U.S. banking system during the late 1970s. Post-mortems on several high-profile failures revealed that the industry’s capital-to-assets ratio had been eroding for some time, although it was never definitively established that more capital would have averted or significantly ameliorated the crisis. Regardless, in response to congressional pressure, the regulatory agencies, including the OCC, adopted blunt regulatory capital requirements.

As the regulators had predicted, problems quickly cropped up. First, by each adopting its own requirements for regulatory capital, the agencies inevitably found themselves in conflict with one another. That generated restrained dispute among the regulators and the advocates for their respective points of view. But more importantly, it led regulated institutions to engage in a new form of regulatory arbitrage, since it was a simple matter to move to the charter that offered the most permissive approach to capital. In the international arena, it also created invidious distinctions among institutions competing across borders, affording a competitive advantage to those whose home country supervisors took a more lenient approach to capital.

Congress took steps to deal with the domestic ramifications of the problem in several legislative enactments. In 1978 it created the Federal Financial Institutions Examination Council, with a mandate to achieve greater uniformity among the supervisory agencies. In the International Lending Supervision Act of 1983, it required the U.S. banking agencies to do what they had already done voluntarily, if reluctantly, in regard to capital policy, and in 1984, the Federal Reserve, the FDIC, and the OCC agreed to revise their new capital-adequacy guidelines to establish common capital standards for all banking organizations.
The goal of creating a more level playing field for financial institutions – and promoting more consistent supervisory treatment of those institutions -- was one of the central objectives of the Basel Committee from the time of its inception in 1974, and it remains one of its overriding objectives today. By the mid-1980s, the Committee had turned its attention to the development of common capital standards for all internationally active banks.

But the Basel process took off in a different direction from where the U.S. had started under congressional mandate – and it produced very different results. France, the United Kingdom, and Germany had adopted risk-based capital standards starting in the late 1970s, reflecting the industry shift toward higher risk assets and off-balance sheet activities. This approach involved less prescription and more discretion on the supervisors’ part than the more rigid, formulaic approach that U.S. supervisors had objected to but adopted nonetheless under pressure. The European approach became the starting point for work on an international capital accord – and, with minor exceptions, its end result.

The Basel Accord set forth capital standards that U.S. supervisors were well satisfied with – capital standards that not only went a long way toward harmonizing international practice, but that also carved out an important role for supervisory judgment and expertise in determining how much capital a particular institution required, given its risk profile.

If the Basel principals thought that the publication of their work marked the final word on the subject, however, they were mistaken. First, at least in the United States, the adoption of the Basel Accord represented no definitive ratification of the philosophy it embodied. Indeed, the Basel approach scarcely survived the U.S. banking crisis that was already underway when the Accord was adopted. In the light of mounting losses and near insolvency of the federal deposit insurance fund, supervisory discretion – the underlying approach of Basel -- was increasingly viewed as a euphemism for forbearance, which even some U.S. bank supervisors, under the spotlights, conceded had helped to create and prolong the crisis. In the FDIC Improvement Act of 1991, Congress acted to strip away some of that discretion. Putting strong new emphasis on “prompt corrective action” – that is, a mandate to supervisors to force remedial steps, including recapitalization, when capital levels fall – Congress hard-wired a set of capital trigger points in an effort to limit discretion and to prevent forbearance by the banking agencies – not recognizing that since the supervisors retained the power to assay what the level of capital actually is, any effort to force action based on specific capital levels was not likely to eliminate discretion from the process.

It’s unclear which strain in the current philosophical duality is responsible for the industry’s impressive current capital strength. However, some bankers have since spoken of their experiences during the crisis of a decade ago as a personal turning point that convinced them never again to split hairs over the risk weight of a given asset and to build capital well beyond regulatory minimums to enable them to weather any foreseeable contingency.

Looking back from today’s perspective, the original Basel Accord – Basel I – may be viewed as charmingly unsophisticated, comprised, as it was, of a handful of prefabricated “risk buckets.” Two things became clear before long: first, that these rather coarsely structured “buckets” had little to do with real risk; and, second, that it was a simple matter to arbitrage from one bucket to another. These realizations helped to give
birth to Basel II.

The authors of Basel II established a noble and ambitious set of goals for themselves: to integrate all that we have learned about capital regulation and risk over the years in a single, logically consistent package; to accommodate, if not resolve, the chronic tension between prescription and supervisory discretion; to recognize the technological and conceptual advances in the science of risk management, and to provide incentives for bankers to make use of those advances; to fine-tune our current risk ratings in a way that makes them more sensitive, more discriminating, and more forward-looking; to supplement the risk judgments of supervisors with those of the marketplace and of bankers themselves; and to ensure that the regulations we produce are relevant to the massive changes that have occurred in international banking – structural changes, portfolio changes, and management changes – since Basel I.

I assume that this audience is reasonably familiar with the key features of Basel II, but at the risk of being tedious, let me briefly outline the structure. The new approach would be built on three “pillars” — the first, a set of formulas for determining regulatory capital; the second, a set of principles for the exercise of supervisory oversight; and the third, a set of disclosure requirements intended to enhance market discipline.

Pillar I basically sets out three means 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.

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 separate calculation for determining an assignment of capital to cover operational risk. In measuring their operational risk, banks can choose between a basic approach, a standardized approach that looks at individual business lines, and an advanced measurement approach.

I suppose in one respect the result of such an ambitious undertaking might have been predictable. The process has generated a lengthy and complex product, as the Committee has sought to develop a risk-based rule that could be applied to banks around the world with varying degrees of sophistication. Part of the complexity of the most recent consultative paper (CP-2), which will be reflected in the soon to be released CP-3, is simply the consequence of there being so many different components of the rule, and thus a variety of possible permutations.

When I have complained in the Basel Committee about the complexity of the paper, I am roundly admonished by my colleagues. “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 desire 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. To be sure, much of the complexity also reflects the myriad compromises negotiated in the drafting process. And therein lies the greatest obstacle to simplification, for almost any effort to simplify runs the danger of being viewed as having the potential to upset compromises that have been hammered out.

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 to 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 a comparably sized institution, or may examine such an institution thoroughly only every five or six years, or may put heavy reliance on the oversight of outside auditors.

It’s fair to ask, I think, in which regime hundreds of 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 bedstone 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?

As a practical matter, particularly given the rigorous schedule set by the Committee, I think it is unrealistic to think that we will see significant simplification in the next iteration of the proposal. I would count it a major achievement, nonetheless if we were able to do no more than simplify the articulation of the proposal.

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 you to decide – as you try to make your way through it.

So where do we go from here? The Committee has reaffirmed its intention to release a third consultative paper for comment in early May, with a view toward issuing a final document by year-end. While some have argued that we should scrap the whole Basel II process and go back to the drawing board, or even adopt an entirely new approach, that is not going to happen. There is enormous momentum being generated by Basel Committee members, and by the central bank governors who comprise the Bank for International Settlements, to move ahead with the current approach on the current timetable.

In the U.S., the three bank regulatory agencies (Fed, FDIC, and OCC) have jointly agreed to three steps to simplify our implementation of Basel II.

First, we will make available to U.S. banks only the advanced IRB and the advanced measurement approach to operational risk. 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. The underlying strategy is that banks would realize lower capital charges as they moved up the scale of sophistication, and would thus have an incentive to make the investment in systems required to make such a movement.

Second, we will apply Basel II only to our large internationally active banks. We do not intend to apply it to the thousands of smaller community banks we have in the U.S. While other banks in the U.S. can apply to come under Basel II, we anticipate that at the outset only a very few will do so – although we also anticipate that market forces will drive some of them in this direction. We expect these two actions will make it easier for us to develop a draft U.S. regulation, which will in effect be a subset of Basel II, and by limiting the number of banks coming under Basel, it will help focus these key banks on the proposal during the comment period, which we expect to undertake this summer.

Third, in drafting the proposed U.S. capital framework, we will use a combination of regulatory language and supervisory guidance to “translate” the objectives and principles of Basel II into terminology and a framework consistent with the U.S. approach to capital regulation. We expect the U.S. rule will require at least as much capital as a literal interpretation of Basel II; at the same time, we will seek to write regulations and guidance that can be understood by both our large banks and by the line bank supervisors enforcing the new capital rule -- mindful that we are required to articulate all our regulations in “plain English.”

In the U.S., our Congress is just beginning to focus on this subject, and is considering what its role should be in the process. While to date the heavy lobbying has been related to the handling of operational risk, there is still a possibility, in my view, that Congress could be energized by some of the large internationally active banks, if they are discontented with the terms of Basel II in its final iteration, or with its impact on their required capital, or by smaller banks claiming that they will suffer a competitive inequity because they don’t have access to the potential capital reductions offered the large banks. Members have been particularly insistent that when U.S. regulators translate Basel II into specific regulatory language, which will then be published for public comment, that process must have real integrity – that is, the banking agencies must give serious consideration to the comments they receive, and, if they find some problems, must resolve those issues or bring them back to Basel for further consideration. Let me reaffirm that the OCC and the other U.S. banking agencies cannot
sign off on a final Basel II framework until we have weighed the final product in the light of all the comments we receive and have determined that we can implement the new rules in a way that does not compromise safety and soundness or the competitive strength of our banking system. We expect that other countries will go through a similar process with their banks and may also identify substantive issues. One “safety valve” in the process is the Accord Implementation Group the Committee has formed. The AIG will be a continuing subset of the Committee that will address problems encountered during the implementation phase, with the potential for mitigating unforeseen difficulties.

The Office of the Comptroller of the Currency has from the outset argued strongly and consistently that Basel II must work in practice as well as in theory; that it must provide supervisors with sufficient flexibility to accommodate differences among financial institutions; and that it must work in a way that avoids placing banks at a competitive disadvantage compared to other financial services providers. In advocating these broad policy goals, the OCC has staked out its own independent positions, as on operational risk. And while we have not always prevailed, I believe that our efforts make it more likely that we’ll eventually get a workable new Basel agreement – an agreement that all concerned parties can live with and prosper under.

One final word on timing. The Basel Committee, under the strong and intelligent leadership of Bill McDonough, has wisely set time frames as a means of disciplining itself, and we will work earnestly within the Committee in an effort to achieve that schedule. We need to be sure, however, that we get it right. We have taken on a huge task for ourselves as supervisors, and we are confronting our banks with imposing new challenges and cost burdens. The new rules will govern banking for many years to come, and we need to keep the long view in mind, even as we press ahead.

In that endeavor, we have counted on the support and assistance of CSFI, and look forward to continued collaboration with you on Basel II – and beyond.

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The OCC charters, regulates and examines approximately 2,100 national banks and 52 federal branches of foreign banks in the U.S., accounting for more than 55 percent of the nation’s banking assets. Its mission is to ensure a safe and sound and competitive national banking system that supports the citizens, communities and economy of the United States.