Statement of
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Chairman Shelby, Senator Sarbanes, and members of the Committee, I appreciate this opportunity to discuss the U.S. banking agencies’ proposals to enhance our regulatory capital program under Basel II.

The U.S. implementation of Basel II is, at its core, the effort to move away from the simplistic Basel I capital regime for our largest internationally active banks. The inadequacies of the current framework are pronounced with respect to these banks, which is a matter of great concern to the OCC because we are the primary federal supervisor for the five largest. These institutions, some of which hold more than $1 trillion in assets, have complex balance sheets, take complex risks, and have complex risk management needs that are fundamentally different from those faced by community and mid-sized banks.

Because of these attributes, Basel II is necessarily complex, but it would be mandatory for only a dozen large U.S. institutions. The new regime is intended not only to align capital requirements more closely to the complex risks inherent in these largest institutions, but just as important – and this is a total departure from the existing capital framework – it would also require them to substantially improve their risk management systems and controls. This would be accomplished using a common framework and a common language across banks that would allow regulators to better quantify aggregate risk exposures, make more informed supervisory decisions, disclose more meaningful
risk information to markets, and make peer comparisons in ways we simply cannot do today.

Earlier this month, the agencies took a critical step forward in this process by approving a notice of proposed rulemaking. In addition to establishing the basic Basel II framework in the United States, the NPR addresses two key issues about implementation.

The first concerns the reliability of the framework itself. As you know, last year’s quantitative impact study of the potential impact of an earlier version of Basel II predicted substantial drops and dispersions in minimum required capital. These QIS 4 results would be unacceptable to all the agencies if they were the actual results produced by a final, fully supervised and implemented Basel II rule. But they were not. Some changes already made in the proposed rule – and others that will be considered after the comment period – should mitigate the QIS 4 results. More important, we believe that a fully supervised implementation of a final Basel II rule, with examiners rigorously scrutinizing the inputs provided by banks, is likely to prevent unacceptable capital reductions and dispersions.

We cannot be sure, however. That is why the proposed rule will have strict capital floors in place to prevent such unacceptable results during a three-year transition period. This will give us time to finalize, implement, supervise, and observe “live” Basel II systems. If during this period we find that the final rule would produce unacceptable declines in the absence of these floors, then we will have to fix the rule before going forward – and all the agencies have committed to do just that.

The second issue concerns optionality. The NPR asks whether Basel II banks should have the option of using a simpler approach. This is a legitimate competitive
question, given that the largest banks in other Basel II countries have such an option, although, as a practical matter, all such foreign competitors appear to be adopting the advanced approaches. We are very interested in comments about the potential competitive effects of providing such an option to U.S. banks.

The OCC has been a frequent critic of many elements of the Basel II framework, and we have worked hard to make important changes to the proposal that we thought made sense. But at critical points in the process, the OCC has supported moving forward towards implementation. Our reason for doing so is simple – an appropriate Basel II regime will help both banks and supervisors address the increasingly complex risks faced by our very largest institutions. While we may not yet have all the details right, and we will surely make changes as a result of the public comment process, I fully support the objectives of the Basel II NPR for the supervision of our largest banks. Likewise, for non-Basel II banks, I fully support our interagency effort to issue the so-called “Basel 1A” proposal in the near future as a way to more closely align capital with risk without unduly increasing regulatory burden.

In closing, let me emphasize that, as we move forward with these proposals, the agencies will continue to foster an open process, consider all comments, heed good suggestions, and address legitimate concerns.