Good afternoon. I would like to thank you for the opportunity to join you at this impressive conference.

You asked me to provide some thoughts about Basel II, particularly its application in the United States. Before doing that, I would like to inform you of our progress in developing the new accord. As most of you know, we are in a very important stage of the process. Over the past six weeks there have been some crucial developments as a result of the discussions among member regulators, a demonstration once again of the Basel Committee's determination to listen to comments and make those modifications necessary to deliver the best accord possible. The proposal for a capital standard based on unexpected losses submitted by the committee for public comment is a good example of this earnestness in seeking an improved final product. Other issues are still being discussed, including securitization, retail credit, and credit risk mitigation.

One should not forget that, on a parallel track, member countries still have to complete their own domestic efforts to translate the accord into national regulation. As you probably know, the comment period for the initial U.S. proposal for Basel II--known as the advance notice of proposed rulemaking (ANPR)--just ended earlier this month. U.S. supervisors are reviewing the comments carefully. If supportable arguments are given for further accord alterations, we will develop proposed changes to present to our colleagues on the committee.

In the United States, after this next round of discussions there will still be additional procedural steps before a final rule is in place, with opportunity for comment at each stage. To be clear, the need for more procedural steps in the United States should not be taken as an indication of our lack of commitment to the Basel process. Rather, it is a sign of our attempt to develop these proposals on as transparent a basis as possible and to hear a wide range of comments. The Congress of the United States has also held hearings on the development of the new accord. The interest and oversight by our Congress in these discussions is appropriate and welcome, particularly for an undertaking as extensive as Basel II. The U.S. regulators appreciate the fact that we are able to operate as independent agencies but also realize that we have an obligation to keep the elected representatives informed of our progress in this major effort. Of course, it is expected that other countries and the European Union will be following their own procedures as well.

Overall, I have been impressed by the efficacy of the comment process and believe it offers an open forum for all parties to voice their opinions. Debate and discussion on such an important undertaking are essential, and--if solid and convincing arguments are put forth--provide a real opportunity for enhancements to the final product. The current proposal is
better because the comments have elicited good ideas that have been taken seriously. Future comments based on sound thought and evidence will create further modifications. But I must say that simple assertions will not carry very much weight.

At the same time, we do need to ensure that momentum is maintained. In October, the committee members committed to work promptly to resolve outstanding issues by mid-2004. In January, the Basel Committee will meet to address further analysis of outstanding issues and review the timetable for completing and implementing the committee’s work on the accord. Using the agreement reached in the committee as a template, U.S. supervisors then plan to conduct another Quantitative Impact Study (QIS) to gauge more clearly the impact of the Basel proposals. We believe it is critical that we carefully test the new proposal to determine its effects on individual institutions and to ascertain the need to fine-tune the proposal further, a process that could include recalibrating some of the risk-weight functions. It is our sense that other countries will be doing the same. Because timing is a function of the degree of changes required by the QIS, the U.S. agencies will then conduct a full notice of proposed rulemaking once again to seek and then evaluate public comments before adopting a final rule.

U.S. proposals for Basel II

Against that background, let me turn to a number of topics that some have raised about Basel II.

The U.S. banking agencies have, as you know, proposed to implement Basel II somewhat differently than other nations have. These differences are perfectly consistent with the spirit and letter of the proposal, and reflect the particular characteristics of the U.S. banking system and the rules and regulations under which it operates. While our approach is best for the United States, it is not necessarily best for other nations.

The U.S. banking agencies propose that only the most advanced approaches under Basel II be offered for banking organizations in the United States: the advanced internal ratings-based approach for credit risk, known as A-IRB, and the advanced measurement approach for operational risk, known as AMA. As indicated in the ANPR, the standardized approach and the foundation IRB approach to Basel II would not be permitted for credit risk. Nor would the basic indicator approach or standardized approach be available for operational risk. The banking agencies took considerable time to develop the advanced proposals, which we believed would clearly be the best option for the U.S. banking system. The complex operations of the largest banks have outgrown the existing capital regime, and for them Basel I has become less and less effective. Indeed, in the view of U.S. supervisors, an overhaul of the regulatory capital system for our largest banks would be worthwhile only if the most advanced approaches were used.

Because of the heterogeneous nature of the U.S. banking system, some balance in the application of Basel II would be necessary. On the one hand, the size, scale and complexity of the internationally active U.S. banks requires, in the opinion of the U.S. supervisors, that these entities operate with the best feasible risk measurement and management procedures, and these procedures are most consistent with the advanced versions of Basel II. On the other hand, the U.S. agencies do not want to impose the higher costs of the advanced version of Basel II on institutions for which it is clearly not suited. In the end, the U.S. banking agencies tried to allow as much choice as possible, while ensuring that banks are still meeting domestic regulatory obligations, avoiding private-sector costs that do not produce some clear and convincing level of benefits, abiding by the evolving Basel II agreement, and,
most important, maintaining a safe and sound U.S. banking system.

The U.S. banks that would be required to adopt Basel II, as well as those that we expect to choose or opt in to the new regulatory capital rules, are those that, because of size and complexity, should operate with the most sophisticated risk-management practices. The ANPR lays out objective criteria, including asset size and foreign exposure, to identify the large, internationally active banks that would be considered mandatory banks. Naturally, there are also thousands of banks in the United States that do not qualify as large and internationally active and for which the advanced approach of Basel II may not necessarily be appropriate. The overwhelming majority of these banks are significantly less complex and have a scale of operations and market that generally does not extend beyond the United States. As I will discuss, these entities need not be covered by the revised accord to meet international obligations or our own regulatory responsibilities. Thus, the U.S. banking agencies have proposed that those banks not operating under Basel II advanced approaches would remain under the current U.S. regulatory capital rules.

An important factor in our decision to retain the current capital regime for those entities that are neither large nor significant global competitors is the scale and nature of the existing capital regime in the United States. The U.S. supervisory regime already contains the substantial elements of Pillar Two under Basel II, including evaluations of internal capital adequacy processes. U.S. supervisors have for many years conducted extensive and thorough on-site supervisory reviews, a process which we believe has contributed to a sound banking and financial system. In addition, the culture of disclosure within the United States already comes close to, and in some areas exceeds, the Pillar Three requirements of the accord revisions. For those U.S. institutions with public debt or equity, requirements by the Securities and Exchange Commission, as well as demands by the market, translate into fairly extensive public disclosure.

Moreover, these small and medium-sized banks for the most part already hold capital well in excess of the supervisory minima under both the current and proposed capital regimes. Indeed, the overwhelming majority of U.S. banks maintain capital above the well-capitalized criteria of 10 percent of risk-weighted assets under the U.S. prompt corrective action rules, and generally the smaller the bank, the larger the proportionate capital cushion. Nearly 95 percent of all small and medium-sized banks have regulatory capital ratios of at least 10 percent, and thus it is likely that their current ratios would essentially meet or surpass proposed requirements under Basel II. Therefore, we believe that the current approach to determining regulatory minimum capital in the United States is at least as prudent as Basel II.

While U.S. supervisors see no need to require Basel II for banks not considered large or internationally active, the proposal would allow any bank to adopt the accord revisions if it so desired. Of course, any bank wishing to adopt Basel II would have to meet the same high standards applied to mandatory institutions, particularly the internal measurement and management of risk for its exposures. For some large nonmandatory regional institutions, moving to Basel II may be a good choice, and we anticipate that at least ten, and perhaps more, may do so. In effect, the approach proposed in the United States requires that those institutions that would not be required by scale or global activities to adopt the A-IRB version of Basel II would have to conduct their own cost-benefit analysis to determine if they should opt in or wait, perhaps for the costs of implementation to come down through vendor and other developments, or, alternatively, if they should remain under the current capital regime. Initially, some of our colleagues on the Basel Supervisors' Committee criticized the U.S. agencies' approach to scope of application, claiming that the application
was too limited or inconsistent with the proposed accord. But this criticism has faded with better understanding of the structure of the U.S. banking system: More than two-thirds of the assets of U.S. banking organizations are likely to be covered by Basel II, as well as more than 99 percent of the foreign claims held by U.S. banking organizations.

**Potential Competitive Effects**

The U.S. agencies have increasingly focused on the potential competitive effects of Basel II on U.S. banks. As the ANPR outlines, policymakers will be attentive to the competitive concerns of both the institutions expected to adopt Basel II in the United States, and those that might not. We are of course interested in the evidence developed from the ANPR. In addition, Fed staff members are now conducting empirical research to try to determine if the bifurcated approach has any implications for possible acquisition strategies to be used by advanced Basel II banks in acquiring non-Basel II banks. Moreover, we are also trying to determine empirically the evidence for the competitive implications of the U.S. implementation proposals on credit for small and medium-sized business, residential mortgage, and credit card markets. If that empirical evidence indicates a high probability of general competitive imbalances, we will then review our options for addressing the problem. But we first need to see the evidence that a problem exists and then determine how large it may be. That these issues surfaced, I might add, illustrates the benefits of a transparent comment period.

**Standards for Basel II**

One would hope that, by now, no one misunderstands the extensive requirements for any institution adopting Basel II, particularly for the advanced approaches that will be the only option in the United States. Because capital requirements under the advanced approaches will be based on bank inputs, the bar will clearly have to be raised, particularly for risk management and control systems. For most banks--in fact, I would say for all banks moving to the advanced versions of Basel II--meeting these standards and requirements will be very challenging and will require substantial resources. Managers at some institutions may believe that their institution is already very close to meeting all the prerequisites for Basel II. Although our rules and standards are not yet final, on the basis of pilot reviews and discussions with line supervisors here in the United States, I would advise any institution thinking it has little work remaining to make a careful and frank reassessment of where it stands.

In the United States we are developing a set of supervisory guidance to accompany our rulemaking. This supervisory guidance, which will be developed for all A-IRB credit portfolios of Basel II as well as for the AMA, is intended to provide additional clarity and interpretation of the rule, and to more clearly define supervisory expectations. And the guidance, by describing in more detail what it will take to satisfy U.S. supervisors, should assist nonmandatory banks in deciding whether to opt in. Initial drafts of supervisory guidance for corporate A-IRB and for AMA were published for comment in concert with the ANPR. U.S. regulators are already reviewing feedback on this draft supervisory guidance and, as with the ANPR, remain open to suggestions for altering that guidance if we are presented with valid arguments for doing so. Draft guidance for other A-IRB portfolios, such as retail, is being developed and will be published for comment as well.

This is also a good opportunity for me to add a few initial thoughts about the possible nature of qualifying examinations for Basel II in the United States. As I noted, we still need to reach an agreement in Basel and complete the process for formulating a final rule in the United States before we can start assessing institutions vis-à-vis new standards related to Basel II.
However, the U.S. agencies are starting to identify, on a joint basis, what a qualification process for Basel II would encompass, both for mandatory and opt-in banking organizations. This will not be an easy task, in part because our particular regulatory structure has different supervisors overseeing different banks and legal entity types. And it will be complicated by the need to coordinate qualification internationally with host jurisdictions to minimize the burden on banking organizations supervised by agencies from multiple countries.

Cooperation among the U.S. agencies on this and other matters relating to Basel II implementation has been excellent. There is, of course, no expectation that under Basel II the U.S. regulatory structure will change in terms of the legal mandates assigned to each agency. As the ANPR states, an institution's primary federal supervisor would have responsibility for determining an institution's readiness for an advanced approach and ultimately would be responsible, after consultation with other relevant supervisors, for determining whether the institution satisfies the supervisory expectations for the advanced approaches. And this procedure will obviously apply at both the bank and bank holding company level in the United States. Given the significance of Basel II, enhanced communication and cooperation among U.S. supervisory agencies—and between U.S. supervisors and affected host country supervisors—will be necessary. We are already in agreement that the U.S. qualification process will be intensive, rigorous, and lengthy, because of the nature of what we are about to embark upon. But in the end we believe that a rigorous qualification process will create a more risk-sensitive regulatory capital regime and improve risk management.

**Cross-border issues**

The accord revisions wisely contain a certain amount of flexibility to account for differences in the banking systems of member countries. These so-called national discretion elements, combined with different approaches that member countries might choose for their banking system, mean that maintaining a level playing field across countries is a challenge. Achieving an acceptable level of consistency in implementation is something that the Basel Committee takes seriously and is the reason it formed the Accord Implementation Group (AIG) two years ago. The AIG comprises line supervisors from member countries and is charged with identifying potential implementation issues and creating as much consistency as possible across countries. These issues, which are referred to as "cross border" or "home/host" issues, cover both credit and operational risk. Cross-border issues are particularly complicated because the new accord will apply to both consolidated banking organizations in home countries as well as subsidiary bank and bank holding companies in host countries.

This August the AIG issued a set of high-level principles for cross-border implementation of the accord. These principles lay the groundwork for further cooperation and coordination for implementation among member countries. They clearly identify the need to respect both home and host country rules and regulations, the need for enhanced and pragmatic cooperation between both types of supervisors, and the desire for supervisors to minimize the burden on banking groups as much as possible. The U.S. agencies believe that their choice for scope of application is consistent with these principles. For example, the proposal to allow only the advanced approaches in the United States also extends to any U.S. banking subsidiaries of foreign banking organizations and reflects our legitimate role as host country supervisors and the principles of national treatment. At the same time, we understand that other countries may offer approaches that are different from those offered in the United States. So a consolidated banking organization not based in the United States may choose to operate under an approach not offered in our country—such as foundation IRB for credit risk or basic indicator for operational risk—even though the advanced approaches would be the
only ones available to its U.S. bank and bank holding company subsidiaries. And if those U.S. subsidiaries are not considered mandatory Basel II institutions, they also have the option of remaining on the current U.S. regulatory capital regime.

By the same logic, foreign banking subsidiaries of U.S.-based organizations would have to abide by the local rules and regulations of host country supervisors, even if their consolidated entity is operating under different rules. These differences between approaches offered in host versus home countries present challenges for global banking organizations, both foreign-based and U.S.-based. As a result, U.S. supervisors need to work very closely with supervisors from other member countries to assist banking organizations in meeting the various requirements. The AIG has already begun to foster this type of collaboration. For this issue the bottom line is that legal mandates across countries are not going to change, and supervisors realize that they have an added responsibility to keep complexity to a minimum.

One of the most challenging home/host issues that has arisen of late is the allocation of operational risk capital within a consolidated banking organization. This issue, similar to other cross-border issues, goes right to the heart of home/host supervision. The conflict arises because host supervisors may require subsidiary banks at the local level to hold a certain amount of capital which, when aggregated across both geography and entity type, may be greater than what the consolidated organization deems necessary, because of diversification effects. This is clearly a difficult issue. As Chairman Caruana commented last month, it may well take some time for our efforts to converge to an acceptable solution in this matter, and that solution may not be completely satisfactory for all parties. Right now the AIG is working with the Committee's Risk Management Group (RMG) to develop a set of possible solutions to the problem. My expectation is that reaching a solution will require a slow and steady effort, but in the end, we will reach an acceptable compromise. In that sense, this issue reflects much of what the Basel II process is all about--identifying challenging issues, listening carefully to comments, conducting analysis to find a range of possible options, and then reaching an acceptable compromise solution that is consistent with safety and soundness.

Finally, I would like to turn to the AIG's work on consistency of standards. Because member countries have different supervisory regimes, there is the possibility for Basel II rules to be applied in a variety of ways. While some variety in standards across countries may be unavoidable, we believe that maintaining as much consistency as possible is a worthwhile objective. It benefits no one if there is an appearance that countries vary considerably in their application of standards. The entire accord is undermined if a set of banks from one country appears to be subject to softer standards. We are already happy with the progress we have seen within the AIG on this issue and believe that pursuing the goal of consistent standards will truly bring about a better and safer global banking system.

**Concluding Thoughts**

I thank you for the opportunity to share some of my thoughts on Basel II. As I stated, I consider the recent decisions reached by the Basel Committee to be a very good example of how supportable and valid arguments for alterations in the accord proposals are taken seriously. In the United States, additional opportunities still remain for comments to be heard and for possible modifications as the United States continues its rulemaking processes. That said, we do not expect to slacken the high standards expected of banks operating under the advanced approaches for Basel II.

The U.S. agencies have tailored the application of Basel II to the particular characteristics of
the U.S. banking system, while maintaining both the letter and spirit of the accord. We expect other countries to act similarly with regard to their own banking systems. We understand that a number of cross-border issues relating to Basel II implementation pose challenges, and that it may take some time to resolve them. This will of course mean that supervisors across countries must work even more closely together. But I hope it is evident that the fervent efforts among member countries to heed comments and to find solutions underscore our commitment to craft the best accord revisions possible, while maintaining a safe and sound global banking system.