

“Safeguarding Trust in Banking”

Remarks by Acting Comptroller of the Currency Michael Hsu

Exchequer Club

September 15, 2021

Good afternoon and thank you for having me at the Exchequer Club. It is an honor and a privilege to be here.

I was appointed as Acting Comptroller of the Currency this past May, and it has been an honor to lead the nearly 3,500-strong employees of the OCC during these challenging times.

Today, I want to discuss the importance of safeguarding trust in the banking system and of guarding against complacency. These two imperatives anchor my priorities and inform all that I do. They derive from my experiences around the financial crisis of 2008. The trauma of that event continues to cast a long shadow, especially on the people who depend every day on the banking system to work safely and fairly for them. Trust and vigilance can help us deal with the past, while also guiding us going forward.

Let me start by giving some context and background on myself. I am a career public servant and have been supervising financial firms in one form or another since 2002. I started as an attorney at the Federal Reserve and became a supervisor when I moved to the Securities and Exchange Commission (SEC). From 2004 to 2008, while overseeing the major U.S. investment banks, I had a front row seat to the rise of securitization, the black magic of financial engineering, and the collapse of the shadow banking system. At the Treasury Department, while helping to firefight the crisis, I acutely felt and sympathized with the public’s anger at having to

bail out too-big-to-fail firms. My time at the International Monetary Fund gave me perspective on financial stability, which proved helpful when I returned to the Federal Reserve in 2010 to assist with post-crisis initiatives.

After the global financial crisis, the bank supervisory and regulatory agenda was very clear: repair, rebuild, and reform the banking system. The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) reset many of the terms of engagement between the banking industry, regulators, consumers, and the taxpayer. Operationalizing these reforms for the largest banks – through stress tests, living wills, the Volcker rule, and enhanced prudential standards – has taken years and significant effort. I know, because I had a hand in many of them.

Increasingly, however, the question arises: What now?

Having a compass is important. To me, the ultimate objective for us and the banking system is to foster and safeguard *trust*: Trust between financial providers and their consumers, trust between regulators and supervised institutions, trust that banks will not exploit working Americans and the vulnerable, and trust amongst financial regulators that we can work together to solve problems that we can't solve alone.

Strong rules and regulations can help, of course, but they are not adaptive to emerging risks. Rules cannot perceive and respond to trends and developments that may erode or threaten trust. Rules are inert, while the behaviors that give rise to distrust, i.e., deception, exploitation, arbitrage, hubris, and incompetence, are organic. We need to be careful to not put too much faith in existing rules and regulations to safeguard trust in banking – as that would be evidence of *us*, regulators, becoming complacent.

In May, I laid out four key priorities for the OCC: (1) reducing inequality, (2) adapting to digitalization, (3) acting on climate change, and (4) guarding against complacency. Each priority

addresses what I see as a significant threat to trust in banking. Each will require time and substantial interagency coordination to address fully. I will now take each in turn.

### Reducing Inequality

I want to start with inequality.

Americans know intuitively that inequality is getting worse, that the rich are getting richer and the poor are stuck. And they are right. In 1983, the median wealth of lower income households was \$12,300; for upper income households it was \$344,100.<sup>1</sup> Twenty-three years later, in 2016, upper income wealth had jumped to \$848,400, while lower income wealth had *fallen* to \$11,300. This bears repeating. Lower income households had *less wealth* in 2016 than they did in 1983.<sup>2</sup>

As we all know, it is expensive to be poor. This can create a vicious cycle. The *perpetuation* of inequality is a key problem, not just for our society but for trust in the banking system because of the role banks play in this. To date, banks have both helped and hurt. My focus is to tilt the balance more clearly in favor of helping poor and working Americans obtain and build wealth – specifically, by strengthening the Community Reinvestment Act (CRA), by bringing so-called “credit invisibles” into the financial mainstream, by supporting and revitalizing minority depository institutions (MDIs), by reforming bank overdraft programs so that they empower rather than exploit consumers, and by vigorously enforcing fair lending laws, among other efforts.

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<sup>1</sup> Pew Research Center, January 2020, “[Trends in U.S. income and wealth inequality](#)”.

<sup>2</sup> In absolute terms, middle income household wealth was essentially flat between 1983 and 2016. In relative terms, those households saw their share of the aggregate wealth pie decrease from 32 percent to 17 percent, with all of the gains going to upper income households.

The pandemic has had a disproportionate impact on minority and low- and moderate-income (LMI) communities and continues to make inequality worse. But it is also providing banks with opportunities to bolster and rebuild trust with hardworking Americans who may have been let down by the system or never trusted it in the first place. A great recent example of this is the outperformance and determination demonstrated by community banks in facilitating PPP loans. With forbearance and other pandemic relief programs ending, banks of all sizes have another opportunity to demonstrate that they have their customers' backs and can be trusted, through foreclosure avoidance where possible and by working with borrowers in their time of need.

On the regulatory front, I believe *strengthening*, not just modernizing, the CRA will be necessary to reduce inequality and foster trust. This means substantially increasing the level of lending, investments, and services to LMI communities. Just as importantly, banks need to increase their engagement with community groups so that the specific needs of each community, which vary widely, are understood and are met. Today we are one step closer to this. Last week, the OCC formally proposed rescinding the agency's 2020 final rule and committed to working with the other federal banking regulators to develop a joint CRA proposal.

Strengthening and modernizing the CRA is just one part of the solution. Addressing the problem of credit invisibles – the 45 million Americans without a credit score – improving access to affordable housing, increasing credit availability to minority and small businesses, and supporting and revitalizing minority depository institutions are also required. Specific workstreams addressing each of these topics are the focus of Project REACH, an innovative OCC initiative that brings together leaders from banks, community and civil rights groups, and technology firms to reduce barriers to financial inclusion.

The potential trust earned from the efforts noted above will be lost if banks engage in predatory and exploitive behavior, especially of vulnerable populations, such as those living paycheck to paycheck. High cost debt traps, which can result from predatory loans or overdraft practices, are particularly pernicious in perpetuating inequality and should be eliminated. Any product or program that relies on recurring penalties to be profitable is a trust-eroding one. For instance, I am concerned with programs, such as buy-now-pay-later (BNPL), in which the value proposition to those who administer them rest on such penalties. By contrast, banking products and programs that provide financial flexibility and enhance the financial capacity of consumers are trust-building. Several large banks have instituted reforms to their deposit programs by empowering customers with options, such as the no-overdraft BankOn accounts, or by providing customers with low-cost flexibility to control their payments and limit overdraft fees through cure periods and other measures. Such reforms can both help reduce inequality and build trust with consumers.

### Adapting to Digitalization

The issue of adaptation, innovation, and the bank regulatory perimeter is something I care deeply about because I have seen firsthand the loss of trust that can result when the perimeter is porous and regulatory agencies fail to work together.

After the passage of the Gramm-Leach-Bliley Act in 1999, most assumed that the large investment banks would seek to become financial holding companies, which would have subjected them to Federal Reserve supervision. In 2004, however, the SEC established an alternative, the Consolidated Supervised Entities (CSE) program, which the investment banks opted for. I helped stand up and lead that program. It was short-lived. In March 2008, Bear

Stearns collapsed and was bought by JPMorgan Chase. In September, Lehman Brothers filed for bankruptcy, Merrill Lynch was acquired by Bank of America, and Goldman Sachs and Morgan Stanley became bank holding companies supervised by the Federal Reserve. The CSE program was quietly shuttered shortly thereafter. The SEC's experiment in consolidated supervision had spanned just four years. I learned a great deal from that experiment about the risks of going it alone.

That fall I moved to the Treasury Department to help contain the growing financial crisis. There, I covered the Treasury Department's investment in AIG, another non-bank regulated giant. I had a good understanding of derivatives from my time at the SEC, and the primary risk to the taxpayer emanated from the firm's derivatives portfolio. It was small in size on a gross notional basis, but highly directional, highly leveraged, and highly toxic. Such a portfolio would have had a hard time escaping supervisory scrutiny had it been subject to thorough federal bank regulatory oversight.

I have reflected long and hard on these experiences. Staring into the abyss of a financial meltdown was sobering. Feeling the public's justified anger and growing distrust with the government's actions bailing out too-big-to-fail firms was humbling. *How was all of that allowed to happen?* is a question that I have grappled with for many years.

There are many answers, of course. But a key contributor, from my perspective, is that the financial regulatory agencies were siloed. Regulators did not act in a coordinated fashion. This created an unlevel playing field and opportunities for regulatory arbitrage, which firms exploited, creating vulnerabilities across the financial system.

The risk of something similar happening today is rising. Changes in banking are being driven by the mass adoption of digital technology, innovation in payments, and an explosion in

cryptocurrency activities and decentralized finance (defi) where banks are bypassed. Banking is again being disintermediated but in a different way. Instead of securities firms and capital markets, it is fintechs, technology platforms, crypto, and defi. Instead of lending, it is payments. Instead of financial engineering, it is application programming interfaces, machine learning, and distributed ledgers.

How are we, as regulators, going to adapt? If we take the same approach that was taken pre-crisis – putting our individual agency interests first – I fear we will arrive at a similar outcome in several years' time. The public is counting on the financial regulatory community to work together to ensure the stability of the system and fairness to its participants.

There are hopeful signs. With regards to crypto, for instance, the President's Working Group – spanning Treasury, the Federal Reserve, SEC, CFTC, FDIC, and OCC – is expected to issue a paper on stablecoins later this fall. In addition, the federal banking agencies have been collaborating via a “crypto policy sprint” to agree on definitions, use cases, risks, and gaps, and to discuss policy options related to digital assets. While controlling the growth of crypto and defi is challenging given their nature and in light of market demand, it is imperative that financial regulators work together to ensure that crypto/defi activities that take place within the banking system or are facilitated by banks are trustworthy. Innovation is important, but safeguarding trust is paramount.

Coordination among all financial regulators will also be needed in the future to ensure a level playing field and limit regulatory arbitrage and to keep shadow banking at a safe distance from the regulated financial system. These goals cannot be achieved if the financial regulatory agencies, including state banking supervisors, do not work together. Public trust in bank regulators will rise or fall depending on our ability to do so.

## Acting on Climate Change

Climate change poses an existential risk to society and the associated financial risks pose safety and soundness risk to banks. To safeguard trust, banks and regulators must begin to take action now.

Banks are exposed to both physical and transition risks presented by climate change. Physical risks include the increased frequency, severity, and volatility of extreme weather and long-term shifts in global weather patterns and their associated impact on the value of financial assets and borrowers' creditworthiness. Transition risks relate to adjustments to a low-carbon economy and include associated changes from government policy, technology, and consumer and investor sentiment. This risk is particularly important if the transition is disorderly and abrupt – the likelihood of which increases each time we kick the can down the road.

The physical and transition risks posed by climate change present novel challenges for risk management. How should such risks be identified, measured, and managed? What data is needed? What time frames and risk mitigants should be considered? It is going to take time and effort to answer these questions, develop clear supervisory expectations, and push banks to adopt prudent practices. And time is not on our side.

To tackle these challenges, the OCC has adopted a two-pronged approach. We are engaging with and learning from others. The OCC participates in the Basel Committee on Banking Supervision's Task Force on Climate-Related Financial Risks, recently joined the Network for Greening the Financial System, a group of central banks and supervisors from across the globe who share best practices, and is working collaboratively with the FSOC

agencies on the upcoming climate risk report. The more perspectives and experiences we can leverage, the better.

We are also focused on developing effective climate risk management guidance for large banks, working with our interagency peers. I recently announced the appointment of Darrin Benhart as the OCC's first Climate Change Risk Officer. The creation of this position will significantly expand the agency's capacity to collaborate with stakeholders and to promote improvements in our supervision of climate change risk management.

### Guarding Against Complacency

My fourth priority is guarding against complacency. This priority permeates my first three and pertains to both regulators and banks.

As regulators, we are at risk of getting lulled into a sense of over-confidence by banks' compliance with the enhanced standards established by post-crisis reforms. Compliance with those standards is critically important, but does not ensure that trust in the banking system will be safeguarded. In short, it is necessary, but not sufficient. The perpetuation of inequality is a deepening problem. The pace of technological change is increasing. Climate change's impacts, which can already be felt today, are going to get much worse. We need to address these proactively to maintain trust and be effective.

For banks, the following excerpt defines complacency well:

*...a lackadaisical attitude towards risk and risk discipline; a lack of accountability for risk failures; risk systems that identified acute risks, which were systematically ignored by business and risk personnel; and a cultural unwillingness to engage in challenging discussions or to escalate matters posing grave economic and reputational risk.*

This quote is from the Credit Suisse report on the failure of Archegos Capital Management.<sup>3</sup>

Some will be quick to dismiss this as something that could never happen at *their* institution.

After all, *they* didn't lose money on Archegos. *Their* risk culture and systems are too good to let something like this happen. If you are one of those people or if your firm is one of those firms, be careful.

Pre-crisis, I recall once asking the head of market risk at one of the best managed dealers about whether his firm engaged in total return swaps on hedge funds that were collateralized by those hedge fund's shares. It was something we had come across at several competitors and the clear wrong-way risk profile concerned us. "We don't do that," he replied reflexively. The next time we met him, he confessed, "When I said we don't do that, what I actually meant was: we do a lot of that." Complacency can set in, even at the most disciplined firms.

Overconfidence leading to complacency is a risk especially during periods of growth and innovation. Many large banks have ambitious growth plans, a robust M&A outlook, and a "risk on" posture evident from recent investor calls. Many community banks face strategic planning challenges and are compelled to grow, organically or through mergers, to achieve economies of scale. When done prudently, growth can provide significant benefits to consumers, communities, investors, and the U.S. economy. When done in an unsafe, unsound, and unfair manner, however, excessive growth can cause significant damage and raise questions about management competence. To protect the gains in trust made since the financial crisis, banks must remain vigilant and be on the lookout for a "lackadaisical attitude towards risk and risk discipline."

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<sup>3</sup> Credit Suisse Group Special Committee of the Board of Directors, *Report on Archegos Capital Management* (July 29, 2021), at p2.

## Conclusion

Since May, I have had the pleasure of meeting with many of you, banks of all sizes, community groups, and other stakeholders, and I have been encouraged by our conversations. The priorities I have outlined above are shared by many, and stakeholders have described various actions they have already taken to address some of them. I would like to close with one final example of a shared priority that we all must work on: increasing diversity, especially at the leadership level.

Supervisors and the banking industry should reflect the diversity of the communities we serve. Diversity at the executive and board of director level is especially important for fostering trust. While we all need and can do more in this area, including at the OCC, I have been encouraged by some industry efforts, which demonstrate that with sufficient focus, sustained effort, and investment of time and resources, meaningful progress can be made.

In conclusion, I believe that truly effective bank supervision and regulation requires a proactive identification of threats to trust in banking and the mapping out of strategies to address them. Each of my four key priorities for the OCC speaks to a significant trust vulnerability that we must all work together to address: guarding against complacency to protect gains in trust since the financial crisis, reducing inequality to rebuild trust with working Americans and vulnerable communities, adapting to technological change to ensure trust in government, and acting on climate change to earn the trust of current and future generations. Each of these vulnerabilities also represents an opportunity to improve the lives of the American people and to promote a safe, sound, fair, and secure banking system.

I again want to thank the Exchequer Club for having me here today. I truly appreciate your hospitality and the opportunity to share my priorities and perspective as Acting Comptroller of the Currency. I would be happy to answer questions as time permits.