It is a pleasure today to return to the Exchequer Club for my last speech as Comptroller of the Currency. Not only have I given two previous speeches to you as Comptroller, but I have many fond memories of my time spent before that as Chancellor for the club – this has always been an excellent forum for speeches on important financial issues.

It is tempting to try and summarize in this final speech all the key issues that have been on my plate at the OCC during these last five years. But that would really be a fool’s errand, I think, given all that has happened. Let me focus instead on a few experiences and issues that I have found especially significant, particularly in the context of the financial crisis and the financial reform legislation just signed into law.

As my term comes to a close, I find myself looking back not just on my service as Comptroller, but on how that service was informed by my previous 20 years in the financial services arena as a legislative staffer, Treasury official, and bank regulatory lawyer. In particular, there appears at first blush to be a number of striking similarities
between the financial crisis of the late 1980s and early 1990s and the financial crisis of
the last several years.

Both began with mortgage problems that caused severe stress in the thrift
industry, which in turn helped spawn sharp losses in commercial real estate loans. Both
involved spikes in the number of bank and thrift failures, with huge deposit insurance
losses. Both involved systemic problems at large financial firms. And both prompted
sweeping legislative and regulatory changes intended to avoid similar problems in the
future. These included systemic risk measures (one of which I had a hand in drafting in
1991); wholesale restructuring of thrift industry regulation; and renewed emphasis on
regulatory capital requirements.

So if we had these problems before, why didn’t the measures we took then
adequately anticipate and stave off the problems we’ve experienced these last few years?
Did we fail to learn from our past mistakes, or did we take the wrong measures to address
those mistakes? And what makes us think that the measures we’re taking now will have
any better success in the future?

These are all good questions. Unfortunately, I think the answers are not so
straightforward. But let me give them a shot.

First, the differences in the two crises are at least as significant as their
similarities. The mortgage problems of the 1980s resulted from severe interest rate
mismatches caused by inflation and a sharp rise in short-term interest rates. In contrast,
our more recent crisis resulted from terribly underwritten mortgages and a housing
bubble that popped. The commercial real estate loan losses of the 1980s were more
heavily concentrated in non-residential real estate (though certainly not exclusively), and
had far more significant implications for the largest banks than today’s CRE problems, which have been residentially focused and more concentrated in community banks. An oil patch recession and tax law changes were much bigger factors then; securitization and structured products much bigger factors today. Likewise, the systemic problems have been far more severe and far more global this time around, and unregulated or less regulated financial firms have played a much more significant role than they did 20 years ago.

Still, we should have learned some lessons better from the past. For example, in the wake of the savings and loan crisis, I think we should have done more to harmonize the regulation of banks, thrifts, and their holding companies. The Dodd-Frank Act that just passed takes more significant steps in this direction, and I think that’s appropriate.

Problems with commercial real estate lending are another example. As a result of the 1980s, we did see the risk building from increasing concentrations by community banks in commercial real estate loans, and we knew they were vulnerable. The regulatory community spent a great deal of time issuing significant guidance – over strong industry objections – to address these issues. I know that we at the OCC worked long and hard with our examiners and with community national banks to anticipate the issues that we thought could arise with the next real estate downturn. And I think these measures helped in a number of cases, either fending off failure or reducing the deposit insurance losses associated with failure.

But honestly, it was just not enough. Too many banks, even those that were well run, simply could not withstand the types of losses generated by significant concentrations in residential construction and development lending, especially when
funded by brokered deposits or other forms of higher cost borrowing. The resulting failures have caused and continue to cause massive losses to the deposit insurance fund. I put this in the category of a lesson that regulators learned, but should have learned better. Unfortunately, we have not yet taken additional policy steps to address this issue, but I think we should.

Then, of course, there are measures that were adopted after the 1980s crisis in the Federal Deposit Insurance Corporation Improvement Act of 1991 – “FDICIA” – to establish higher capital requirements and the capital-related regulatory regime of “prompt corrective action” or “PCA.” There were high hopes that the new PCA regime would lead to earlier intervention, which in turn would allow troubled banks to avoid failure and significant losses to the deposit insurance fund. But it hasn’t quite worked out that way.

I think PCA proved valuable during benign economic times, when banks with problems that took longer to play out really could be addressed earlier than they had been previously, avoiding costly failures. Indeed, I would argue that the PCA regulatory regime was a contributing factor to the longest period without a failure in the FDIC’s history – almost three years – which unfortunately ended midway through my tenure as Comptroller.

PCA’s record in the last three years, however, during which over 260 banks have failed, has been far less positive. During this period, declining capital levels of banks – on which the PCA regime is fundamentally premised – lagged far behind the relatively sudden and large problems caused by troubled construction and development loans that precipitated failure. For example, of the 45 national banks that have failed since the beginning of 2008, nearly all had amounts of capital that significantly exceeded the PCA-
required “well capitalized” level just one year before failure. But the CRE and other loan charge-offs that sunk these firms did not spike until this last year before the institutions were closed. By that time, the regulatory intervention authorized under PCA was too late to avoid failures and losses to the deposit insurance fund.

Of course, critics will surely argue that examiners were simply not causing banks to make provisions and take losses soon enough and in large enough quantities, which is why, they will say, that capital levels were still so high so soon before failure. I disagree. While there may have been some instances in which more reserving could have been done earlier, in general, that was not the case. Given current loan loss reserving rules – which sorely need revision – it simply was not possible to require massive loan loss provisioning and write-downs at a time when real estate and other loans were fully performing and appraised values were stable. As soon as we could require large reserves, examiners generally did so – but by that time it was often too late to save the institution.

Again, this is not to say that PCA isn’t valuable, because it is. Even in this crisis it has allowed OCC examiners to act earlier than they did in the 1980s. Indeed, I think that is one reason why the deposit insurance loss rate on assets in failed national banks has been relatively low – just 16 percent – and why the total estimated deposit insurance loss from failed national banks is just 12 percent of the total estimated loss – even though national banks comprise 17 percent of all banks and thrifts and hold over 60 percent of all bank and thrift assets.

Now, for the most part, what I have been talking about thus far have been problems in community banks and thrifts. While these institutions have caused the lion’s share of recent losses to the deposit insurance fund, that is a fundamentally misleading
measure for the causes or severity of the recent financial crisis. The biggest problems, of course, were centered in the largest financial institutions. And while the crisis began in large unregulated or less regulated financial firms, it quickly spread to some of our largest banks. Extraordinary and temporary government assistance has thus far allowed these large banks to avoid losses to either the deposit insurance fund or the taxpayer. In fact, I believe the government will in the end make a significant profit from the assistance provided to the national banks supervised by the OCC, which is all to the good. But that should not obscure in anyone’s mind the damage caused to the economy by the severe problems of these and other large financial firms, both here and abroad.

By and large, these were not the same types of problems that large banks experienced in the 1980s and ‘90s, which were precipitated by huge losses on commercial real estate loans, energy loans, and loans to developing countries. Instead, the recent financial crisis was caused by a number of factors that had little or nothing to do with previous crises, including, among others: poorly understood securitizations and complex structured credit products, such as collateralized debt obligations; over-reliance on flawed credit ratings; inadequate aggregation of risk across different business lines; low reservoirs of liquidity and common equity; concentrated levels of unhedged credit default swaps provided by insurance companies; fragmented and grossly uneven levels of regulation; and of course, at the heart of it all, the worst mortgage underwriting in our nation’s history.

This is not to say, however, that some of these factors could not have been anticipated, and in fact some were, at least partially. For example, with respect to poor mortgage underwriting, I am especially proud of the OCC’s early recognition of the
problems of negatively amortizing “payment option” loans; our subsequent nontraditional mortgage guidance; and our implementation of that guidance to keep these high loss loans out of national banks.

Similarly, truly predatory forms of subprime loans never took root among national banks in part because of the OCC’s early and strong guidance addressing these types of loans. And even non-predatory forms of subprime lending – and yes, it is not an oxymoron to put those terms together in the same phrase – were never dominated by national banks as a whole because of the much more stringent credit and reserving standards that bank examiners applied to these loans. The numbers bear out this statement, as I have repeatedly testified, which is the strongest proof that the federal preemption that applies to national banks did not create a haven for subprime mortgages. I won’t repeat my many remarks on this subject here, except to say again, categorically, that federal preemption did not cause the mortgage crisis.

I am not trying to suggest, however, that we couldn’t have done more to address the problems earlier with respect to mortgage underwriting. For example, while the OCC became very vocal about the problems with low- and no-documentation loans in 2007, I wish I and all the bank regulators had taken action on this deeply pernicious practice earlier, because none of us was ever comfortable with it. Of course, even such concerted action would not have stopped the many low documentation mortgages originated outside the banking system. I am very pleased that the Dodd-Frank Act has essentially prohibited this practice.

Part of the reason we were slow to act, however, was that most of these “stated income” loans, like most subprime loans, were sold to the secondary market through
securitization, and were therefore not kept as ongoing risks on bank balance sheets that pose the most direct ongoing credit risk to the banks we supervise. Moreover, the vast growth in securitization products meant that many, many more unregulated individuals and firms could dominate the underwriting and holding of mortgage loans in the system. Bank regulators couldn’t reach these market participants directly, even though they had an enormous indirect influence through competition on the underwriting practices of the institutions we supervise.

And that leads me to a much larger point about regulatory fragmentation and gaps. Differential regulation was a substantial contributor not only to the decline in mortgage underwriting, but also to other key causes of the crisis, as well as to our impaired ability to deal with that crisis once it arrived. The fact is that our financial regulatory system was designed to be extremely bank centric. Extensive rules and tremendous supervisory resources were focused on banks, with far less of both devoted to other types of financial firms. As these other types of firms became much more significant in the delivery of financial services through the growth of securitization, structured products, and derivatives, our bank-centric regulatory apparatus was not adjusted to keep pace.

I am referring now, for example, to the substantial differences in regulation of banks and investment banks, even though firms like Bear Stearns, Lehman Brothers, and Merrill Lynch were increasingly in the same businesses as JP Morgan and Citigroup. Another example is the difference in derivatives regulation as it applied to major bank participants, where it was substantial, as opposed to AIG and the monoline insurance companies, where it was not. And I’m also referring to differences within the regulatory
umbrella between bank holding company regulation, which was more rigorous, and thrift holding company regulation, which was less so. Likewise, banks themselves have always been subject to considerably more extensive regulation and supervision than their nonbanking affiliates in the same holding company.

Leading up to the crisis, these differences in regulatory regimes made it increasingly difficult for regulators to apply the same capital and prudential standards across the board to the same activities and practices engaged in by different firms, whether those activities involved mortgages, derivatives, structured credit products, proprietary trading, leveraged lending, off-balance sheet funding, or any of the other types of instruments that became household names in the crisis. These differences and regulatory gaps were a big part of the problem, compounded by the fact that regulators had very limited access to information from unregulated firms about the risks building in their part of the system. In addition, once the crisis hit, we simply did not have the same stabilizing tools available to deal with nonbanks as we had for banks, such as the discount window, deposit insurance, or the systemic risk authority of the FDIC – and the limited scope of these tools made crisis management far more difficult.

While all of us recognized that these differences in our regulatory regimes were not ideal, and raised potentially significant issues, I don’t think anyone realized just how much they were contributing to a systemic problem. The crisis changed all that, exposing the glaring regulatory gaps and differences that caused so much damage.

As a result, perhaps the single most important part of the Dodd-Frank Act is its ambitious set of provisions intended to address these gaps and differences. There will be no more separately regulated industries for investment banks and commercial banks. A
company that becomes systemically important in the future like AIG will be subject to
bank-like regulation. There will be greater harmonization of the regulation of banks and
thrifts, of their holding companies, and of depository institutions and their affiliates
within holding companies. The government will have much greater ability to obtain
information on risks of financial products and markets as those risks develop, regardless
of the types of institutions involved, and much greater ability to recommend and put in
place across-the-board rules and regulations. And regulators will have much stronger
tools to address systemic financial crises, including a new resolution mechanism for
addressing the failures of systemically significant firms.

In short, the regulatory paradigm has clearly shifted away from limiting the scope
of intense financial regulation to institutions that enjoy explicit access to the federal
safety net of deposit insurance and the discount window, namely banks. Instead, such
regulation will now apply to all systemically important financial institutions, whether or
not they are banks. That is a true sea change.

Just as an aside, I can’t resist commenting on the systemic risk authority that
Congress provided to the FDIC 19 years ago in FDICIA, which allowed the agency to
guarantee obligations other than insured deposits in extraordinary circumstances. As I
mentioned earlier, I was involved in the drafting of this provision while serving at
Treasury in 1991. It was expressly designed to be used in a crisis to maintain financial
stability in the event of a potential failure of a systemically significant firm. Of course,
this was the provision that we did use when the crisis hit, not only in individual cases
involving several large institutions, but also more broadly to temporarily guarantee the
obligations of a wide range of financial institutions, just as other governments were doing
around the world. As a result, this is the provision that has been widely criticized as the wellspring for the government’s “too-big-to-fail” actions, unfairly allowing bailouts of large firms about to fail, while smaller distressed banks have been forced to close their doors without government help.

This characterization is most certainly true, as the systemic risk provision in practice, at least as applied individually to distressed large banks, proved to be unfair. But here’s the thing of it: in the middle of the crisis, it worked. That is, in the absence of an orderly resolution mechanism for large financial firms, the provision worked phenomenally well to avoid runs and restore confidence, just as it was intended to do – and it will even end up making money for the taxpayer. Despite its unfairness, the moral hazard it created, and the severe political problems it generated, the FDIC’s systemic risk authority made both the financial crisis and the Great Recession, as bad as they have been, far less catastrophic than would otherwise have been the case. The Dodd-Frank bill is right to try to avoid the clear unfairness of this provision by adopting a new orderly resolution mechanism that can achieve the same effects without bailing out uninsured stakeholders. I only hope it works as well to maintain stability and restore confidence if, heaven forbid, we face a similar crisis in the future.

Finally, let me close with a few thoughts about regulatory capital. Since the crisis of the 1980s and FDICIA, there has been a clear focus on strengthening minimum required capital as a means to build confidence in the banking system and avoid costly failures. We have devoted a substantial amount of regulatory time and resources, both in the United States and abroad, to improving our risk-based regulatory capital requirements. In particular, we have expended maximum effort on trying to assess the
relative riskiness of assets that banks hold or guarantee – the denominator in the ratio of
capital to risk-weighted assets – which was the core of the Basel II reforms.

Regulators learned several hard lessons from the crisis that have significantly
changed the focus of regulatory capital reform. Most of the severe losses that began the
crisis occurred in banking organizations’ trading books, or in credit activities related to
trading, rather than arising from the more traditional activities on which Basel II had been
most focused. As a result, better capturing such trading-related risks in the denominator
of the risk-based ratio has rightfully become a key focus of the so-called “Basel III”
reforms.

Even more important, however, have been the crisis-learned lessons about the
quality of capital – the numerator of the risk-based ratio; the overall level of minimum
required capital; and the need for a backstop leverage ratio on a global basis that is
similar to what we already have in the United States.

In terms of the quality of capital, the crisis made plain that so-called Tier 1 capital
had become too far removed from the most loss-absorbing form of capital, namely
common equity. Large initial losses in the crisis depleted banks’ common equity,
shaking investor confidence in banks to the core, while other forms of Tier 1 capital did
little to restore that confidence – indeed, even non-equity TARP investments structured
as Tier 1 did not have the full confidence-restoring impact that was intended. The Basel
III process has therefore focused heavily on developing a tight, strong, and transparent
definition of common equity that would govern the core of required capital going
forward, for banks around the globe. I am pleased to say that the Basel Committee is
making excellent progress in doing just that. And the same is true with respect to the
development of a credible backstop leverage ratio.

I think the most significant challenge for the Basel Committee and international
policymakers, however, will be determining the amount by which the level of required
capital, especially common equity, should increase. Too much leverage in the system
was a root cause of the crisis. That is, losses reduced banks’ already thin capital margins
to levels that fundamentally impaired both confidence in the banking system and banks’
ability to perform their core intermediation functions that are critical to the economy. As
a result, there is a regulatory consensus that capital levels need to increase so that the
banking system is not nearly as vulnerable to such devastating systemic problems in the
future when the next round of significant unexpected losses occurs, as will surely happen
sooner or later.

But how much should required capital ratios increase? At some point higher
required capital levels can become counterproductive by causing banks to shrink their
balance sheets – that is, make fewer loans – as the principal means to increase their ratios.
We need to require banks to be safe enough to provide credit even when unexpected
losses occur – but not so safe that they choke off credit. Striking that balance will be the
critical challenge facing policymakers in the next several months – made more difficult,
perhaps, by today’s economic environment of fragile recovery. And the answer could
have a profound effect on the future shape of the banking system, especially for large,
internationally active banks.

In closing, it is hard to imagine a more challenging period for banking than these
last few years. At the same time, we know that new crises will emerge, and all the
changes put in motion by the last crisis will be extremely important for regulators to implement wisely. The next few years will present different challenges than the ones I faced – which is a good thing, by the way – and I wish my successor and his or her colleagues the very best of success in meeting them.

Thank you very much.