

The 2016 Robert Glauber Lecture

By

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Good evening. Thank you for that kind introduction and thank you for having me deliver the 2016 Robert Glauber Annual Lecture here at the Harvard Kennedy School. I am humbled by the distinguished list of leaders who have preceded me, and I am grateful to Bob for extending his personal invitation. Bob, thank you for letting me be a part of this.

I've been looking forward to this event for some time, because it provides the perfect occasion to discuss how we have progressed since the Great Recession, why we are better off today than we were in 2008, and why now is not the time to change course.

Applying the Lessons of 2008 and the Great Recession

It has been eight years since the crisis that spurred the Great Recession. For some, those events are already ancient history. For others, like me, it's as though it all happened yesterday because even today we are working to apply the basic lessons the crisis taught us—the value of strong capital and its corollary the danger of excessive leverage, the need for ample liquidity, and the importance of effective supervision.

With regard to capital, our banking system is now as well capitalized as any in the world. We achieved this level of capital through the concerted effort of regulators and bankers who recognize that stronger capital means stronger banks and that banks should grow their capital during healthier economic periods so that it is available during a downturn. The crisis

demonstrated that a strong capital base is an absolute necessity, and that when the market begins questioning a bank's capital strength it might already be too late, as liquidity challenges and existential questions of solvency can quickly follow.

You can see evidence of six years of steady progress in building capital among U.S. banking companies in the Federal Reserve's stress tests. This year's results show common equity at levels more than double that of the first quarter of 2009.¹ In raw numbers, that's a \$700 billion increase in common equity capital. This level of capital suggests that even under the *most severe* scenario considered, the 33 largest bank holding companies would continue to be well capitalized.² That level of capital would allow these companies to lend into a recession, and reduce the severity and length of the downturn.

At this point though, we are hearing some people question whether capital requirements have gone too far. Critics suggest the capital requirements restrict lending and place a drag on the economy. While a legitimate policy concern, the crisis provided an unfortunate reminder of the devastating consequences that can be inflicted on the public when banks fail to hold capital levels commensurate with their risks. The benefits of a strong banking system built on a strong capital base should not be forgotten in debates about striking the right balance in capital standards. Our capital requirements are providing resiliency to our banking system, allowing it to be a source of strength.

While we have strengthened capital standards, we have done this by placing more of the burden on larger institutions that were closer to the epicenter of the crisis. Because we scaled our enhanced capital requirements to apply primarily to the largest most complex banks, the quality

¹ See *Comprehensive Capital Analysis and Review 2016: Assessment Framework and Results*. The Board of Governors of the Federal Reserve System. June 29, 2016 (<http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20160629a1.pdf>).

² Average calculated from on table 4, page 16 of *Comprehensive Capital Analysis and Review 2016: Assessment Framework and Results*.

and volume of capital is increasing in those institutions with the greatest complexity and systemic impact. At the same time, we are seeing lending grow and profitability return.

Another lesson of the crisis that is closely tied to insufficient capital levels was the danger of excessive leverage. Leverage among financial services companies leading up to the crisis increased dramatically, particularly among the former “investment banks.” *And*, we know what happened to these companies. In response, regulators subjected large banks to stricter leverage ratios limiting the amount of leverage they could employ. While it makes perfect sense for banks to hold capital levels commensurate with their risks through the application of aptly named risk-based capital standards, we also have long recognized that such measures are not perfect. For this reason, we have employed leverage ratios to serve as an additional line of defense, or backstop, to the risk-based capital measures. As noted previously, we have taken a proportionate approach to constraining bank leverage by employing a slightly more sophisticated leverage ratio measure for the largest banks.³ One of the key features of these leverage ratio metrics for larger banks is that they capture elements that contribute to leverage that are not captured by simpler measures that focus exclusively on a bank’s balance sheet. And as we have done with capital standards more generally, we have required our largest banks to meet more stringent leverage ratio requirements than smaller institutions given their systemic importance.

But here too, some want to water down the ratios by manipulating what is included or excluded from consideration. I’ve been very consistent about the need for clear definitions that accurately and transparently capture the leverage of the institutions we regulate. Weakening the ratio through special exclusions only undermines our original intent and weakens the protection against excessive leverage. For example, some wish to exclude certain assets from measures of

³ NR 2014-118, “Agencies Adopt Supplementary Leverage Ratio Final Rule.” September 3, 2014 (<http://www.occ.gov/news-issuances/news-releases/2014/nr-ia-2014-118.html>).

leverage on the grounds that it could affect certain business lines' profitability. Yet the essence of assessing a bank's leverage is about comparing its equity to its assets, and carving out various assets would cut against the very meaning of leverage. In addition, if a relatively simple and straightforward metric is riddled with exceptions, it will become much more complicated and difficult to understand, which will make market participants less trusting at the most critical points of a downturn, and when investors most need a clear understanding of a bank's leverage and capital.

The third lesson of the crisis is the need for ample liquidity. Good memories will recall that the lack of liquidity was a significant factor in the solvency issues faced by finance and banking companies in 2008. Since then we have taken steps in the right direction by implementing the Liquidity Coverage Ratio and proposing the Net Stable Funding Ratio. These two ratios complement each other and push covered banks to hold sufficient ready resources to meet short-term cash outflows and encourage banks to shift to more stable, longer-term funding by relying less on short-term wholesale funding. U.S. banks must comply with the Liquidity Coverage Ratio by 2017, and the proposed U.S. Net Stable Funding Ratio would become effective in January 2018.

These safeguards bolster the strength of our banking system, and allow it to weather financial storms, while still meeting the financial needs of its customers. The safeguards also make the riskiest behavior more expensive, while minimizing the impact on smaller, less complex institutions that do not pose broader risks to the system.

While improving capital, limiting leverage, and enhancing liquidity have helped restore our financial system; the importance of effective supervision is perhaps the crisis' greatest lesson. As a regulator with more than three decades of experience overseeing financial

institutions of all shapes and sizes, I know supervision is the regulators' primary means of affecting behavior and promoting a healthy risk culture. In some ways, weak capital and excessive risk taking were symptoms of unhealthy risk cultures that led to lapses in compliance and controls affecting the safety and soundness of an institution. Addressing the risk culture within the banking system was an early priority of mine as Comptroller and is a continuing theme in conversations I have with bankers, examiners, and other regulators.⁴

To address risk culture and improve risk management in the industry, particularly the largest banks we supervise, we set heightened standards for management and boards of directors that established clear expectations for governance and risk management. These standards grew from on-site supervisory observations. Essentially, examiners had an up-close view of what worked and what didn't during the crisis—across the industry. We took those observations and distilled them into enforceable standards for our largest banks and we supervise against those standards today. We are making progress but more work remains. We must be especially vigilant when it comes to practices that can undermine the trust and confidence in our financial institutions.

While the crisis pointed to the need for change across the industry, it was also an opportunity for the OCC to work on its risk culture and effectiveness, too. We used it to take a closer look at ourselves—how we supervised large banks, how we strategized, and how we assessed risk. In 2013, we asked respected international peers to help by reviewing our approach to supervising large banks.⁵ This International Peer Review provided 23 pages of recommendations in six broad areas that included mission, vision, and strategic goals; risk

⁴ See “Unwritten Rules: The Importance of a Strong Risk Culture,” *Banking Perspective*, The Clearing House. Q3 2014 (<https://www.theclearinghouse.org/publications/2014/banking-perspective-q32014/unwritten-rules-the-importance-of-a-strong-risk-culture>).

⁵ See NR 2013-184, “OCC Releases International Peer Review of OCC Supervision of Large and Midsize Institutions.” December 5, 2013 (<http://www.occ.gov/news-issuances/news-releases/2013/nr-occ-2013-184.html>).

identification; ratings systems; staffing; the scope and consistency of supervisory strategies; and enterprise governance. We went about this process in a transparent way, publishing the team's findings *and* what we did to address the issues.⁶ I am proud of our OCC employees, who worked to transform the agency because they recognized that world-class organizations stay that way by seeking feedback, measuring results, and continuously improving.

The many changes at the OCC over the past few years go beyond the recommendations of the international supervisors to make us a more effective and efficient regulator. We increased our lead expert program and our use of horizontal reviews to provide more industry-wide perspective. We reduced the percentage of examiners residing in large banks to reduce the perception of regulatory capture. We expanded term limits and rotational assignments to ensure examiners bring fresh perspectives to their work. We enhanced how we identify and assess risk to the banking system earlier and more effectively. We raised the profile of compliance by establishing an executive-level function dedicated to that part of our mission. We created an Office of Enterprise Risk Management, and published an enterprise risk appetite statement so employees and external stakeholders know our tolerance in key areas.

We enhanced our use of metrics to assess the quality of our work and to be more forward-looking. We increased the ties between our strategy and budgeting process so that every dollar in assessments paid by national banks and federal savings associations yields greater value in the form of more effective supervision. We established a strategic workforce plan to better manage succession and recruitment so that we can be assured of having the right talent and skill in the right place at the right time. And, we are working to ensure that we make continuous improvements—learning and growing from our successes as well as our lapses.

⁶ See NR 2014-75, "OCC Announces Actions to Respond to International Peer Review Recommendations." May 28, 2014 (<http://www.occ.gov/news-issuances/news-releases/2014/nr-occ-2014-75.html>).

We also recognize that we need to look forward at what a banking system 20 years from now should be, and what kind of regulator does that system need. We recognized that across the industry technology and innovation were remaking how people interacted with banks and accessed financial services. To that end, I announced the OCC's initiative to ensure that institutions with federal charters have a regulatory framework that is receptive to responsible innovation and supervision that supports it. The intent of that effort is to provide more timely guidance and decisions on innovations, increase our openness to responsible innovation that can help banks and thrifts operate more effectively and better meet the needs of their customers, and, in furtherance of our mission, encourage innovation that promotes fair access by increasing the financial inclusion of underserved consumers and communities. A significant milestone in that effort occurred, right here in March, when we unveiled our white paper outlining the principles guiding our efforts.⁷

All of these changes help ensure the agency is capable of delivering effective supervision for decades to come.

The Strength of U.S. Banks Today

In the end, the measure of this work is whether the financial system is now stronger, more resilient, and more capable of satisfying the financial needs of the United States, and can adapt to changing consumer demands, market opportunities, and new technology. I think that answer is “yes.”

We can see it on the balance sheets. Tier 1 common equity is nearly 13 percent of risk-weighted assets, up from 9 percent in the fall of 2008. The leverage ratio is now at 9.3 percent,

⁷ See *Supporting Responsible Innovation in the Federal Banking System: An OCC Perspective, March 2016* (<http://www.occ.gov/publications/publications-by-type/other-publications-reports/pub-responsible-innovation-banking-system-occ-perspective.pdf>).

almost one-third higher than in 2008. And, liquid assets have achieved a 30-year high of 16 percent of total assets.

The high standards here in the United States have made our banks stronger in absolute terms and in comparative terms. Liquid assets for U.S. G-SIBs is up \$400 billion on average, versus \$130 billion for non-U.S. G-SIBs. Capital is up more than \$70 billion compared with just \$16 billion on average for G-SIBs in other countries. The list of positive numbers is long.

Some suggest that such a conservative posture hurts U.S. competitiveness, but that's not the case. The strength of U.S. banks has improved their competitiveness not weakened it. In 2015, revenue for the top five U.S. banks was more than double that of their European counterparts, and U.S. banks' pre-tax profits of \$33.5 billion dwarfed their European counterparts' \$4.2 billion.⁸ U.S. banks are better today because of the rigor of the new standards, and how quickly we implemented them. It's also a result of earlier recognition of losses and troubled assets and the discipline to work through those issues aggressively.

The progress we've made is not limited to large banks. America's community banks have gotten stronger too. Return on equity among community banks has nearly recovered to pre-crisis levels, and loan growth has been steady. To help community banks further, we have worked aggressively to remove unnecessary burden by simplifying the call report, lengthening the exam cycle for well-managed banks, and encouraging collaboration.

The Need for Continued Vigilance

The hard work that U.S. regulators and bankers did in response to the crisis now has U.S. banks in a position of strength. But my job is to ask how well we—regulators and bankers—are preparing for the next stress event or downturn. And, now is not the time to change course.

⁸ See "US investment banks open gap over Europeans with quick moves." *Financial Times*. March 8, 2016 (<http://www.ft.com/cms/s/0/65eb0710-e3bd-11e5-a09b-1f8b0d268c39.html#axzz4GMICiyIw>).

We must remain vigilant about the levels of capital in good times so it will be there to serve as a bulwark during the next recession. We need to manage the risks of eventually increasing interest rates after this extended period of historic lows. We have to be careful to limit concentrations in assets such as commercial real estate that historically have been sources of problems when the tide turns. And, we have to constantly improve our defense against cyber attacks and enhance the resiliency of our systems and institutions.

Our banks *are* stronger today, but now is not the time to let our guard down. Those who have been in this business for more than one cycle know a downturn will come. Effective regulation and supervision will help ensure that the trough will not be so deep or so wide.

Conclusion

I want to conclude by noting that lessons from 2008 were not *really* new lessons. Rather, the crisis reminded us of basic principles that have been around since the very first Comptroller of the Currency, Hugh McCulloch, provided sage advice to bankers in 1863.⁹ His advice included:

- Let no loans be made that are not secured beyond a reasonable contingency.
- Distribute your loans rather than concentrate them in a few hands.
- Treat your customers liberally, bearing in mind a bank prospers as its customers prosper.
- The capital of a bank should be a reality, not a fiction.

I could not say it better myself, and I look forward to your questions.

⁹ See “Advice to Bankers of 1863” (<http://www.occ.gov/about/what-we-do/history/mcculloch-advice.pdf>).