Acting Comptroller of the Currency Michael J. Hsu
Remarks at the Bloomberg Risk & Regulation Week 2022
"When the Tide Goes Out"
May 17, 2022

Good afternoon. It is a pleasure to join you for this year's Bloomberg Risk & Regulation Week event. My remarks today are going to focus today on the first "r": risk.

As a bank regulator, the current market environment makes me think of the famous Warren Buffet quote, "Only when the tide goes out do you discover who's been swimming naked." While the long-term outlook for the U.S. economy generally remains positive, financial assets and other market indicators have been sending decidedly mixed signals.[1] With significant monetary tightening projected in the short- to medium-term, banks should be asking themselves, "What would happen to us if the tide were to go out?"

The banking system as a whole appears well-positioned to handle a range of scenarios and many banks have already adjusted their risk profiles. Capital and liquidity levels remain high,[2] despite a war in Europe, commodities and supply chain disruptions, uncertainty in China, and the recent correction in the tech market. Nonetheless, some banks unknowingly may be swimming naked, or at least with a lot less on than they think, carrying exposures that could turn into unexpected losses when the tide eventually goes out.

Now is the time for banks to take a fresh look at their exposures and take actions to adjust their risk positions – to "trim their sails," so to speak – ahead of potential uncertainty and

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[1] The May 2022 Blue Chip Consensus Forecast expects real GDP growth of 2.6 percent in 2022 and 2.1 percent in 2023 on healthy consumer spending and historically above average business investment; total Consumer Price Index inflation for the full-year 2022 is estimated to be 7.1 percent, dropping back to 3.2 percent in 2023.

[2] Federal Reserve Supervision and Regulation Report (May 2022); Semiannual Risk Perspective (Fall 2021) | Office of the Comptroller of the Currency (occ.gov)

volatility. Empowering risk managers and enforcing discipline in risk-taking will enable banks to better navigate the rate environment and will lower the chances of nasty surprises as quantitative tightening occurs. Actions today to defease high-impact tail risks can temper the need to go full "risk-off" tomorrow, ensuring that the banking industry can remain a source of strength to the economy, as it has throughout the pandemic and recent market turbulence.

The Tide

From a long-term perspective, financial market conditions have been relatively benign since the 2008 financial crisis. Of course, there has been choppiness at times – the spikes in market volatility due to the pandemic and the debt crisis in Europe in 2011-2012 come to mind. But those proved temporary, at least to investors and most market participants.

Take interest rates, for example. In the U.S., until very recently, banks and financial markets had been operating at the zero lower bound for over a decade. The so-called "low for long" phenomenon was not limited to the U.S. Low interest rates have been a global feature. Historically, long periods of low interest rates have encouraged borrowing and risk-taking behaviors. Reaching for yield, the growth of alternative and riskier assets, and asset-price bubbles have been associated with long periods of low interest rates.[3]

Similarly, trends in credit have been benign for an extended period. Delinquencies, past-dues, and charge-offs have been low for a prolonged period by historical standards. Notably,

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[3] Refer to https://www.bostonfed.org/-/media/Images/research-conference-2018/papers/how-does-low-for-long-impact-credit-risk-premiums.pdf; Barclays CEO warns of 'asset bubbles' due to low interest rates (cnbc.com). Others have found the connection between low rates and asset-price bubbles more tenuous. For example, refer to https://rba.gov.au/publications/confs/2003/pdf/posen.pdf.

before the pandemic, many economists and large bank analysts were forecasting a recession in the U.S., based in part on an overdue turn in the business cycle.[4] Today, despite the pandemic and largely due to the response of governments, bank loan performance is near an all-time best for most loan types, and there have been record low defaults for the past two years. In addition, traded credit spreads, which widened during the onset of the pandemic, have returned to pre-pandemic levels.[5]

These trends may unwind or reverse at some point as rates rise and business cycle dynamics reassert themselves. While the timing and speed of the tide going out is unclear, a quick glance at history suggests that caution is warranted.

High inflation in the mid- and late-1970s led to monetary tightening and recessions in the early 1980s. Between 1980 and 1991, approximately 1,500 commercial and savings banks and 1,200 savings and loan associations failed and had to be resolved.[6] These resolutions represented about 10 percent of all banks at the beginning of the period and 25 percent of all S&Ls.

This is not to say that a similar result is foreordained today. The banking system has substantial capital and liquidity buffers. That stated, to the extent that there are banks taking outsized risks, the chances of broader instability increase with the tightening of monetary policy. The largest unexpected losses of the past decade – like those of Archegos and the London Whale – took place during benign periods. Such losses during a period of broad uncertainty could trigger a "risk off" sentiment and make it harder for the banking system to serve as a source of

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[4] A Majority of Economists Think the Next Recession Will Come by the 2020 Election (fortune.com); How likely is a recession by the 2020 elections? Here's what top economists say (bankrate.com); Three Reasons Recession Fears Have Suddenly Increased (forbes.com)

[5] ICE BofA US High Yield Index Option-Adjusted Spread (BAMLH0A0HYM2) | FRED | St. Louis Fed (stlouisfed.org)

[6] The Banking Crises of the 1980s and Early 1990s | Federal Deposit Insurance Corporation (fdic.gov)

strength to the economy. In this way, micro-prudential actions (or inactions) today can have macro-prudential consequences tomorrow.

Trim Your Sails

What can banks do to mitigate this risk? Targeted and sustained adjustments early on can limit the need for large over-reactions in the future. I would like to highlight a few areas for consideration.

Counterparty Concentrations

The default of a single counterparty can lead to large, unexpected losses and, in some cases, to broader contagion. This lesson seems to get re-learned the hard way every few years.[7] Today, risk aggregation and accommodations for priority clients warrant special attention.

Let me start with risk aggregation. Counterparty credit risk demands proactive risk management that considers a wide range of states of the world and is able to aggregate exposures enterprise-wide. Especially at large banks, which engage in a range of activities, identifying and summing up exposures to single counterparties may be difficult since such risks may exist across a range of businesses and operating entities and take a variety of forms. Siloed risk systems tend

[7] For example, in the aftermath of the near collapse of Long-Term Capital Management and resulting market turmoil, a group consisting of twelve major commercial and investment banks formed the Counterparty Risk Management Policy Group in January 1999 to promote enhanced practices in counterparty credit and market risk management. Following the near collapse of insurance company AIG during the 2007-2009 financial crisis, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 established a framework in which the Financial Stability Oversight Council (FSOC) may designate as systemically important a non-bank financial company, thereby subjecting the company to an enhanced prudential regulatory regime. In 2021, FSOC reestablished its Hedge Fund Working Group (HFWG) to update the FSOC's assessment of potential risks to U.S. financial stability from hedge funds and their interconnections with other market participants. The HFWG found that the failure of Archegos Capital Management—a family office employing leveraged strategies also used by hedge funds—transmitted material stress to large, interconnected financial institutions.

to under-estimate enterprise-wide counterparty exposures and to overlook concentration risks. This – in addition to "a lackadaisical attitude towards risk discipline"[8] – contributed to several banks' outsized exposures and losses to Archegos Capital Management.[9]

The challenge of risk aggregation is more apparent when considering the variety of ways in which counterparty exposures may manifest. Loans outstanding, undrawn commitments, letters of credit, securities financing transactions, derivatives trades, clearing and settlement lines, investment portfolio positions – these are just a few of the ways in which large banks may have exposure to a single counterparty. In challenging market conditions, the risk from large single counterparties can grow rapidly as exposures increase, collateral values fall, margin calls become more frequent, and liquidity dries up.

OCC Bulletin 2011-30 provides banks with interagency supervisory guidance on counterparty credit risk management expectations and sound practices.[10] Now is a good time for banks to re-review their risk identification capabilities and the comprehensiveness of their counterparty credit risk management practices. That work will help to ensure complete and accurate risk capture, which is foundational to risk aggregation and managing the aggregated risk.

In addition to this, banks should pay special attention to where risk limits, margin practices, escalation procedures, and client onboarding criteria have been relaxed. This focus is most important in relation to high-priority, high-growth clients, especially where increasing

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[8] Credit Suisse Group Special Committee of the Board of Directors, Report on Archegos Capital Management (July 29, 2021), page 2

[9] Report on Archegos Capital Management, page 3; https://www.nytimes.com/2022/04/27/business/archegos-bill-hwang-patrick-halligan.html

[10] OCC Bulletin 2011-30 | Office of the Comptroller of the Currency (occ.gov)

wallet share has been a goal. The risk/reward calculus for such accommodations when markets are rising may look quite different when the tide is about to go out.

Particular attention may be warranted for wealthy individuals and family offices, whose trading strategies and financials are starting to approximate those of sophisticated hedge funds, but who can be onboarded through wealth management and private banking channels. Several of the largest, unexpected counterparty losses over the past several years have been to such clients, like Steinhoff and Archegos.[11]

Sector Concentrations

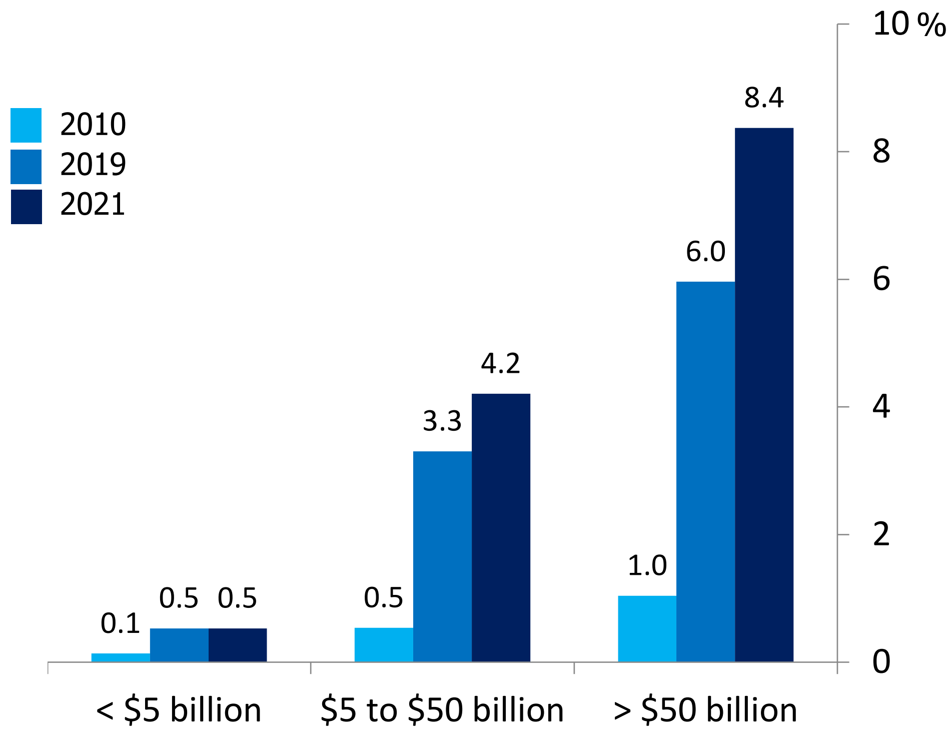
Banks with large sector concentrations can suffer considerable losses when markets turn. Two sectors in particular are worth highlighting: NDFIs and CRE.

Loans to non-depository financial institutions (NDFIs) have grown significantly over the past decade. NDFIs include a range of entities, from broker-dealers to asset managers to investment funds. Figure 1 shows that for banks with assets greater than $50 billion, loans to NDFIs have grown from just 1 percent of total loans in 2010 to 8.4 percent of total loans at the end of 2021. Midsized banks with assets between $5 billion and $50 billion have experienced similar growth.[12]

[11] Family offices are diving into new markets | Financial Times (ft.com); Archegos avalanche shows cracks are hidden under the surface | Financial Times (ft.com); Will Steinhoff margin loan fall-out mark end of easy money? | Euromoney

[12] Data compiled from Bank Call and Thrift Financial Reports and is merger adjusted for institutions in continuous operation from the first quarter of 2010 through the fourth quarter of 2021. Midsized banks with assets between $5 billion and $50 billion had loans to NDFIs grow from 0.5 percent to 4.2 percent of total loans at the end of 2021. For small banks with assets below $5 billion, loans to NDFIs grew from 0.1 percent to 0.5 percent by the end of 2021. Data for small banks excludes certain specialty lenders.

Figure 1: Loans to Non-Depository Financial Institutions as Percentage of Total Loans



Given this growth, banks should review their exposures to NDFIs individually and in aggregate. While NDFIs are diverse in their business models and form, they may fare similarly in a downturn and, as such, warrant risk analysis as a sector.

For many OCC-supervised midsize and community banks, commercial real estate (CRE) remains the most significant sector concentration. It was also the loan category with most significant volume growth in 2021.[13] While CRE loan performance has stabilized, certain CRE subsectors warrant continued attention including hospitality, retail, and office properties. Properties located in urban business districts are particularly challenged due to reduced business travel and changing consumer and business preferences. Vacancy rates for the largest metro

[13] Bank Call and Thrift Financial Reports

markets are near record highs and increased availability continues due to rising sublet and construction volumes. Non-office real estate used by retail and other small businesses relying on consumer traffic faces reduced cash flows and increasing vacancy as return-to-work plans evolve. Major corporations continue to contemplate new operating postures (in-person, hybrid, or remote), making it challenging to forecast the long-term outlook. In the current environment, borrower risk is even more idiosyncratic depending on customer base, geography, employee capabilities, business resilience, and divergence from patterns observed in prior downturns.

OCC Bulletin 2006-46 conveys interagency guidance on CRE concentration risk management.[14] The guidance reminds institutions that strong risk management practices and appropriate levels of capital are important elements of a sound CRE lending program, particularly when a bank has a concentration in CRE loans. It emphasizes the importance of performing sensitivity analysis to quantify the impact of changing economic conditions on asset quality, earnings, and capital; and the need for an effective, accurate, and timely risk-rating system as a foundation for the institution's credit risk review function to assess credit quality and, ultimately, to identify problem loans.

<u>Some Observations on Underwriting</u>

To round things out, I will highlight some OCC observations on underwriting trends and developments, starting with commercial credit.

- Credit markets remain open and liquid (U.S. better than Europe) with some exceptions for more vulnerable sectors, such as cyclical companies and those with highly leveraged capital structures. The volume of near-term maturities appears manageable for now, but is

[14] OCC Bulletin 2006-46 | Office of the Comptroller of the Currency (occ.gov)

something we are monitoring. Amend and Extend transactions are active in particular for companies still challenged by supply chain disruptions.

- With regards to leveraged lending, Shared National Credit (SNC) reviews continue to identify elevated levels of marginal or weak transaction structures including covenant-lite deals. In addition, leveraged credits originated or renewed during the pandemic have exhibited higher levels of leverage and weaker seven-year repayment capacity.
- In CRE we are seeing increased use of interest only non-recourse loans to institutional investors such as funds, real estate investment trusts (REIT), and real estate operating companies (REOC). Many of these loans are unsecured, although supported by pools of unencumbered properties. Support is based on an ability to repay over the life of the underlying asset, which is reinforced by low loan-to-value ratios (LTV) due to high asset valuations. In community banks, underwriting remains consistent with pre-pandemic trends. Nevertheless, we have observed increasing interest-only loans on properties that have reached stabilization with structural support from similarly lower LTV and shorter terms (around three years). Potential asset devaluation in certain submarkets could pressure such deals if the property was overvalued relative to income generated.
- We are observing increased activity from private lenders, particularly in the middle market, which has pressured terms and conditions. We also see private lenders originating larger and riskier loans with repayment often based on expectations for future growth, including loans to fund start-up companies with limited financial performance.
- Sponsor-backed leveraged buyout (LBO) issuance volumes were strong in 2021. Banks have noted more aggressive underwriting given demand by institutional investors and competition among private equity sponsors. These deals may be particularly sensitive to

rising rates given their leverage levels. Some banks have begun adjusting their risk management practices, such as by increasing losses given default (LGD), which effectively increases the capital held against such exposures.

In retail credit:

- Although most banks have returned to pre-pandemic origination practices, we have observed some banks increasing risk appetite and loosening some underwriting practices to obtain new customers and volume growth.
- Underlying collateral valuations securing retail products are elevated, driven by supply constraints in homes, automobiles, and recreational vehicles. Elevated asset valuations increase the indebtedness of new borrowers and can contribute to unsustainable competitive trends. As consumer indebtedness increases, pressure to maintain market share may facilitate loosened underwriting standards.
- Inflation in common consumer expenditures has largely outpaced wage growth. As such, consumers' ability to qualify for credit products or maintain their capacity to pay existing debt may diminish.
- Lower-income, fixed-income, and highly leveraged households are currently shouldering the greatest impacts from inflation as they spend a greater proportion of their income on necessities. Banks could see elevated revolving balances as consumers and small businesses draw on revolving credit lines to meet their obligations.
- As in previous economic downturns, consumers may adjust their payment priorities. Consumers who have relied for extended periods on debt repayment moratoriums may struggle to resume normal payments.

Resisting the Pressure to Capitulate

Taking disciplined risk management actions is important in preparing for the tide going out. Maintaining those actions can be much harder.

In 2006, I was working at the Securities and Exchange Commission supervising the largest securities firms and meeting monthly with senior risk managers. Over the course of that year, nearly every chief credit risk officer told me that credit markets were frothy and overbid. The "fundamentals" were being overridden by "technical," and their advice was to flatten risk positions (or even go short) in preparation for the correction.

Over the course of the year, no correction materialized. Trading desks that were flat or slightly short lost money. Those that threw caution to the wind were wildly profitable (until later, of course). Eventually, I heard the same phrase repeated over and over again: "We're capitulating." Despite some cracks in the subprime mortgage market in early 2007, the capitulation continued in full swing through the summer, famously summed up by Citigroup CEO Chuck Prince in July of that year: "[A]s long as the music is playing, you've got to get up and dance."

In retrospect, what is interesting about that quote is the sentence that preceded it: "When the music stops, in terms of liquidity, things will be complicated." It is a bit less visual than Buffett's "swimming naked" quote, but the idea is the same.

Banks can avoid these risks by interrogating their exposures, reviewing limits, reducing concentrations, and staying disciplined, especially when others are still dancing.

Conclusion

Just as the banking system stepped up and provided invaluable support to the economy as part of the pandemic response, the banking system can be a source of strength to communities, individuals, and businesses, if banks are disciplined in their risk management and fully prepared for the tide going out.

I would like to close with advice that the first Comptroller of the Currency, Hugh McCulloch, gave to bankers in 1863,[15] when the OCC was established:

> *Let no loans be made that are not secured beyond a reasonable contingency. Do nothing to foster and encourage speculation. Give facilities only to legitimate and prudent transactions. Make your discounts on as short time as the business of your customers will permit, and insist upon the payment of all paper at maturity, no matter whether you need the money or not. Never renew a note or bill merely because you may not know where to place the money with equal advantage if the paper is paid. In no other way can you properly control your discount line, or make it at all times reliable…. Pursue a straightforward, upright, legitimate banking business. Never be tempted by the prospect of large returns to do anything but what may be properly done under the National Currency Act. 'Splendid financiering' is not legitimate banking, and 'splendid financiers' in banking are generally either humbugs or rascals.*

[15] Comptroller McCulloch's "Advice to Bankers" of 1863 | Office of the Comptroller of the Currency (occ.gov)

During times of great uncertainty, the banking industry's deep roots and timeless principles of prudence and restraint – as so simply expressed by Comptroller McCollough almost 160 years ago – can serve as a bedrock of stability and hope.

Thank you for the opportunity to speak today.