Remarks by

Thomas J. Curry

Comptroller of the Currency

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Thank you, Paul, and thanks to The Clearing House for offering me this opportunity to join you today. I had the pleasure of being with you two years ago, barely half a year into my term as Comptroller of the Currency, and at that time, there was no shortage of regulatory or supervisory issues to talk about. We – the OCC and the other financial regulatory agencies – have made a lot of progress in addressing those issues, including implementation of most of the major provisions of the Dodd-Frank Act. But new laws and new regulations only take us so far. Supervision plays an equally critical role in assuring safety and soundness, and so does the health of an organization's culture.

In the current issue of *Banking Perspective*, The Clearing House quarterly journal, I had the opportunity to talk about the importance of sound organizational risk management and a strong risk culture to banking organizations. This is a subject that has received considerable attention of late, in regulatory circles and elsewhere. In particular, I appreciate the work The Clearing House has done to advance this discussion through its publications and programs.

My article touched on what is by now a nearly inarguable point: that a strong risk culture that promotes responsible business practices is important not just for its own sake, but is essential to safety and soundness. As regulators, we are as concerned with the health of an organization's risk culture, which includes ethical standards, as we are with its underwriting standards, and, in a moment, I'll describe what we have done at the OCC, and what we will be doing going forward, to support those goals.

In the process, however, we've had to confront important questions about the proper role of regulators in the effort. In fact, we do have a crucial role to play, assuring that banks have appropriate internal controls, a strong risk management framework, and compensation programs that incent employees to abide by the bank's rules and culture. Law enforcement also occupies an important place in this framework, by serving as a third line of defense in the event that the bank goes really wrong. But for all this, we cannot lose sight of the fact that the full responsibility for building and maintaining a strong risk culture belongs, first and foremost, with the bank and its management and board of directors. They clearly need to set the tone at the top.

Business ethics is always a sensitive subject, and no business arouses stronger feelings in the United States than banking. This was true when Jefferson and Hamilton debated the subject in the 1790s, and it is still true today. Some distrust banks for being such powerful players in a market economy; others welcome them for precisely that same reason.

During the recent financial crisis, banks fell badly in public esteem as a result of the abuses we saw. But now, for the first time in a very long while, some polls are suggesting small improvements in public attitudes toward banks in general, undoubtedly affected by an appreciation of the fact that banks are essential to investment and job growth, which is everyone's priority.

However, it would be a mistake to make too much of this. It is far from certain that this shift in public opinion is real, and if so, whether it can be sustained. But what is true is that long-term improvements in public confidence depend greatly upon the industry's willingness and commitment to correct the behaviors that helped to erode its reputation in the first place.

There are encouraging signs that some bankers have committed themselves to raising standards, and are taking actions to show that they mean it. One large bank, for example, decided to stop offering interest-only Home Equity Lines of Credit, sacrificing short-term profits and market share to protect its customers from the payment shock such products inevitably present. Risk officers, once relegated to the margins of bank leadership structures, have gained both in prestige and influence, and are being compensated accordingly. Some banks that faced legal or financial penalties as the result of employee misconduct are terminating bad actors and withholding bonuses. I believe that many banks have accepted, and some have even embraced, the reality that shareholders and the public will no longer bear all the downside of a bank's risk-taking while the bankers themselves land on their feet.

The other reason public opinion may be changing is the growing recognition that regulators are expecting more from banks and are taking decisive action when those expectations go unmet. The magnitude of the legal settlements and regulatory penalties assessed against large financial institutions in the years following the financial crisis demonstrate our commitment to deterring and punishing abuses. Similarly, regulatory reforms made by the OCC and other financial regulators guard against excessive risk-taking. These actions include stronger capital and liquidity requirements and implementation of key provisions of the Dodd-Frank Act.

These structural reforms, while critically important, did not fully address what the OCC believes is one of the key lessons from the financial crisis: that supervisory expectations for front-line units, risk management, internal audit, and corporate governance in our largest and most complex banks need to be substantially higher, especially for the most systemically important institutions. To achieve that goal, the OCC developed a program of "heightened expectations." Starting in 2010, we introduced the plan to our large banks, assessed compliance with its provisions, and incorporated our findings into our risk assessments of those institutions.

Frankly, progress was too slow. It's clear that a more robust approach, providing for the possibility of an enforceable response, was needed. In January 2014, the OCC released proposed guidelines and, in September, adopted final standards as a new appendix to Part 30 of our regulations.

Part 30 codifies an enforcement process set out in the Federal Deposit Insurance Act that authorizes the OCC to prescribe operational and managerial standards. If a bank fails to satisfy a standard, the OCC may require it to submit a compliance plan detailing how it will correct the deficiencies and how long it will take. The OCC can issue an enforceable order if the bank fails to submit an acceptable compliance plan or fails in any material way to implement an OCC-approved plan.

By now, many of you are probably familiar with the provisions of the new guidelines. But I think they are important enough to bear repeating.

First, it should be understood that the standards generally apply to OCC-supervised institutions with $50 billion or more in average total consolidated assets. They do not apply to community banks.

The guidelines have two major components. The first sets forth the minimum standards for the design and implementation of a covered bank's risk governance framework, stipulating that it should be based on what the industry commonly refers to as the three lines of defense:

front line units, independent risk management, and internal audit. The risk governance framework and the three lines of defense are intended to ensure that the bank has an effective system to identify, measure, monitor, and control risk-taking and standards of behavior. Those units must ensure that boards of directors have enough information on their bank's risk profiles and risk management practices, so that the bank operates within the board-approved risk appetite. If variances arise, the boards of directors would then have more meaningful data with which to credibly challenge management.

Under the OCC's heightened standards guidelines, large banks are required to develop risk appetite statements that define both quantitative and qualitative parameters for safe and sound operating environments. The guidelines require that these statements address the question of how the bank will assess and accept risks, articulating behavioral expectations that shape the risk culture. In addition, they make clear that quantitative limits on risk-taking should be based on sound stress testing processes and other methods, taking into account banks' earnings, capital, and liquidity positions.

The second component of our heightened standards guidelines pertains to the responsibilities of boards of directors. It sets criteria to ensure that bank boards have a minimum number of independent directors and that all board members have the information they need to ensure effective oversight, including the ability to pose a credible challenge to management. The guidelines also require each bank to establish and maintain an ongoing training program for all board members and conduct an annual self-assessment of the board's effectiveness in overseeing the guidelines. The OCC will pursue progressively tougher remedies, up to and including an enforcement action, to ensure compliance.

But cultural and behavioral changes take time to truly take hold. They require a long-term commitment to responsible standards and accountability. They require that normative behaviors be clearly articulated and consistently reinforced. That means setting the right tone at the top and rewarding good behavior and punishing bad behavior. Time alone will tell whether our heightened standards achieve the goal of reducing the number or severity of problems in our banks.

One important aspect of our guidelines is the requirement that a bank's compensation and performance management policies and programs complement and support its overall risk governance framework. Among our expectations, we want these bank policies and programs to prohibit incentive-based payment arrangements that encourage improper risk-taking.

It was of interest to me that a number of commenters on our guidelines prior to their adoption not only expressed their support for the compensation provisions, but also asked that those provisions be made stronger and more specific. We chose not to because we and the other banking agencies are at work on an incentive-based compensation regulation required by the Dodd-Frank Act that will cover many of the same issues. Let me be clear, though; that does not mean that we are not currently assessing compensation structures as part of our ongoing supervision under our heightened standards risk management provisions.

Dodd-Frank requires the agencies to issue incentive-based compensation regulations or guidelines covering institutions with at least $1 billion in assets. These measures must require the reporting of incentive-based compensation arrangements by covered financial institutions and prohibit arrangements that provide excessive compensation or that could lead to a material financial loss.

I regard this as an extremely important rule. Improperly structured compensation plans were a major factor in the financial crisis. They encouraged inappropriate risk-taking and gave employee incentives to place their own financial well-being above the interests of their firm. I'm disappointed that it has taken so long to finish this rulemaking, even if I understand the reasons, but I am hopeful that we are nearing the end of the process.

The proposed rule, which we published in April of 2011, is based on three principles: first, that incentive-based compensation systems should balance risk and financial rewards—for example, by deferring payments, adjusting awards for risk, or reducing their sensitivity to short-term performance. Second, they should be compatible with effective controls and risk management. Finally, the proposal stipulated that incentive-based compensation systems should be supported by strong corporate governance.

These principles sound simple and straightforward, but in practice they are more difficult to implement. Compensation touches upon people in a very material and emotional way, so it is probably not surprising that we received over 16,000 comment letters on the rule. Moreover, Congress assigned responsibility not just to the banking regulators, but to the Securities and Exchange Commission, the Federal Housing Finance Agency and the National Credit Union Administration as well, agencies with different missions and different responsibilities from the banking agencies.

In addition, there have been significant international developments since the agencies issued their proposal. In 2013, for example, the European Union, as part of a package of rules implementing Basel III in the EU, adopted strict limits on bonuses for executive officers and material risk takers at covered firms. The agencies in the NPR did not take a similar approach under Section 956, but international regulations may influence incentive-based compensation practices at some of our regulated entities.

Fortunately, the industry hasn't been idle, and, as our heightened standards program shows, neither have we. As I mentioned at the outset, some banks have taken the initiative to implement compensation systems that achieve a better balance of risk and reward. They are considering how best to structure these systems, how to calibrate the right mix of current and deferred compensation, and whether and to what extent salaries and bonuses should be paid in the form of company debt or equity or both, so that all employees have a material stake in the institution's success as well as their own.

What I have just described may seem to upend the time honored sequence in which regulators regulate and banks comply. But banks should never wait for regulators when it comes to protecting their own safety and soundness or reputations. This lesson seems to be resonating with banks that are working to change their corporate ethics and strengthen themselves financially. I note that many banks adopted the new capital and liquidity standards, and even exceeded them, before regulators formally promulgated those standards. This is all good. Nonetheless, as supervisors, we will continue to bring a healthy dose of skepticism to our work.

As I said, these are all encouraging signs. The more we see, the more confident we can be that banks are rebuilding a culture of integrity. There is no more important challenge for the industry on the road back to providing safe and sound banking services to the American people, our communities, and the real economy in the years ahead.

Thank you very much.