

**Remarks by  
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**Before**

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***Introduction***

I always enjoy visiting London, and this time is no exception. Before becoming Chief of Staff at the Office of the Comptroller of the Currency six years ago, my job as director of the Group of Thirty often brought me to London and provided an opportunity to work with many of the leading lights in British finance: Lord Richardson, for many years G30 chairman and honorary chair; Sir Andrew Large, who is here with us this evening; Sir David Walker and Mervyn King among others. It also provided my introduction to Andrew Hilton, a man most generous with accolades.

And like anyone involved in banking and finance, there is a sense of pilgrimage in visiting the birthplace of economics and the preeminent center of global finance in the modern era. The ubiquity of English as the language of commerce and of British concepts of global finance has ensured that, while the age of empire may have passed, the sun has never yet set on the British Empire. But with the dramatic regulatory changes now being pursued in response to the financial crisis, it will be interesting to see where new centers of global finance will emerge.

To affirm all of the above, the OCC's only office outside the United States is located here, reflecting the importance of the U.K. and Europe to the nationally chartered banks supervised and regulated by the OCC. Although to be frank, I've spent so much time in Basel recently that I feel like we have an office there—which unfortunately is also a sign of the times.

In my remarks this evening, I want to discuss some of the far-reaching changes to the regulatory and supervisory standards taking place in Basel and in the United States in response to the recent financial crisis, changes that are in various stages of implementation. But I plan to take a slightly different approach to this topic than others have. Specifically, I want to urge due caution regarding the cumulative effects of all the contemplated changes. I might have titled these remarks: Beware the Pendulum.

I should start by making it very clear that I support strong capital and strong liquidity for banks, and enhanced supervision of systemically important institutions. I also recognize the importance of considering carefully whether structural changes in the organization of firms are necessary to reduce the potential for crises. However, implementation of these wide-ranging changes—in regulation, in prudential supervision, in the range of activities banks conduct, and in how they organize their conduct of those permitted activities—should be carried out in an atmosphere that recognizes the critical role of banks in promoting strong and sustainable economic growth. We should remain attentive to the ultimate objective of bank regulation, which I submit is not simply preventing the failure of individual organizations. Enterprises fail in a market economy. Alan Greenspan famously observed that “the optimal number of bank failures is not zero.” Rather, our primary objective is maintaining a vibrant, innovative, and competitive banking system, through an oversight regime that protects that system from problems at individual firms.

We have all just lived through a sobering financial crisis, one from which we have not yet fully recovered. At a time like this, it is entirely appropriate to consider lessons learned, and respond with appropriate reforms. Everyone in this room could provide similar lists of key lessons. Among them: Liquidity, or lack of it, can kill an apparently healthy institution faster

than anyone can respond. Equity is the most solid form of capital, particularly in a crisis, as markets are not confident that other forms of capital will truly absorb losses. Risks associated with complex, structured financial products are far greater than many supposed. We are already taking steps to address these and other lessons from the crisis.

Nonetheless, it is also an undeniable quality of human nature that, in the frenzy of the moment, we can overreact in response to crisis. Describing this as a swinging pendulum may be a tired cliché, but it's worth asking ourselves: where is that pendulum right now? One of our OCC supervisors created the wonderful malapropism of "trying to keep the pendulum in the middle of the road," but that is surely not where we are today. To put it plainly, my view is that we are in danger of trying to squeeze too much risk and complexity out of banking as we institute reforms to address problems and abuses stemming from the last crisis.

### ***Recent Initiatives in Regulation and Supervision***

Perhaps the most prominent international response to the crisis has been the set of reforms developed by the Basel Committee now known as "Basel III." The Basel III enhancements to the Basel II framework seek to promote a more resilient banking sector by strengthening standards for internationally active banks.

Built on top of the risk-sensitive regime established by the Basel II capital framework, Basel III aims to ensure that capital requirements appropriately reflect the material risks financial companies face. Basel III also increases the emphasis on systemic risk in bank supervision and in capital rules, and establishes for the first time an international leverage ratio requirement and global minimum liquidity standards. And, as has long been true of the Basel Committee, a secondary objective of its rules, after enhancing the safety and soundness of the global banking

system, is to facilitate a level international playing field by ensuring application of a consistent set of standards for internationally active banks.

I'm sure the outlines of Basel III are familiar to this audience. But let me briefly review the proposed enhancements to capital and liquidity requirements, as well as a few recent proposals to limit the scope of banks' activities and the organizational structure under which they operate, so that I can offer some thoughts on overall direction and where we go from here.

*First, Basel III addresses the quality of capital.* As I mentioned, one key lesson of the financial crisis was the superiority of common equity relative to other capital instruments, at least during a stress period. Basel III defines regulatory capital more narrowly and places greater reliance on common, through explicit standards for Tier 1 common equity capital.

*Basel III also increases minimum risk-based capital ratios.* By the end of the decade, minimum Tier 1 common requirements will move from roughly 2 percent under current rules to 7 percent, including a capital conservation buffer to ensure that banks are well-positioned to withstand economic downturns.

*Basel III limits leverage* by introducing an international leverage ratio requirement designed to backstop the risk-based measures.

In addition, *Basel III improves how risk is assessed for certain types of bank exposures.* Certain securitization positions will be subject to greatly increased capital requirements under the Basel III revisions, and capital for trading activities will increase substantially. Basel III takes a new and more conservative approach to measures of counterparty credit exposures from derivative transactions. Capital requirements also will increase more generally for bank exposures to other large financial firms, addressing concerns with interconnection and possible contagion effects. Taken together, these changes will almost certainly result in significant

increases in capital requirements for many of the types of exposures that were evident sources of risk and loss during the crisis.

*Basel III introduces explicit liquidity standards.* During the early stages of the financial crisis, many banks with adequate capital levels still experienced difficulties as a result of inadequate liquidity. The Basel III liquidity standards seek to promote short-term resilience by ensuring that a bank has liquid resources to offset cash outflows under acute short-term stresses, and longer-term resilience by creating additional incentives for a bank to fund its ongoing activities with stable sources of funding.

*And finally, Basel III includes a proposed capital surcharge for systemically important banks.* The Basel Committee continues to consider the appropriate approach to identifying institutions that should be deemed systemically important, and the potential application of a capital surcharge to those institutions. In fact, this will be one of the main areas of focus of meetings I will attend in Basel later this week.

### ***Constraints on the activities and organization of banks***

These Basel initiatives aimed at capital and liquidity reflect one strand of reform. Another, almost entirely separate strand, aims to revise limits on what banks can do or how they are organized. In the United States, there is a long history of constraints on the activities banks can undertake, and on the firms with which they can be affiliated. For nearly seven decades, until U.S. law was changed in the 1990s, the Glass-Steagall Act limited the range of financial services banks could provide. We also have relied on constraints on organizational form, and on firewalls that insulate banks from the risk of non-traditional activities in affiliates. Recently, some observers of the U.S. banking system have argued in favor of moving back in the direction of a more narrowly defined banking organization.

In this spirit, the Dodd-Frank Act contains a provision that imposes new constraints on bank activities and the relationships between banks and other firms, the so-called “Volcker Rule.” This provision generally prohibits any banking entity from engaging in proprietary trading or from investing in, sponsoring, or having certain relationships with a hedge fund or private equity fund, subject to certain exceptions. The OCC and other U.S. regulators currently are preparing rules to implement the Volcker provisions of Dodd-Frank, and in doing so to define appropriate exceptions.

Perhaps closer to home for many of you, and reflecting a related concern with the scope of the activities of financial firms, the Independent Commission on Banking is considering, among other things, the question of whether there should be greater separation between UK retail banking and wholesale and investment banking. The Commission earlier this year issued an Interim Report to focus the next stage of the debate that addressed the possibility that retail banking activities should be “ring-fenced” from wholesale and investment banking. Such a step would apparently be motivated by the desire to make it easier and less costly to allow different parts of a bank be treated differently during a time of stress. It also seems intended to shield U.K. retail activities from risks arising elsewhere, within the bank or more broadly, while preserving the possibility that retail activities could draw strength from the rest of the firm if necessary.

### ***The role of banks and the purpose of regulation***

This was a quick recitation of a relatively long list of proposals for fairly fundamental change. Although long, the list is far from comprehensive. This multitude of reforms—in Basel, Dodd-Frank, and elsewhere—reflects many good ideas advanced by many knowledgeable

people. But, although regulators are pursuing a number of impact studies, too many of these new approaches to regulation remain untested. In considering whether we're getting all this right, I am reminded of the saying: "In theory, there is no difference between theory and practice. In practice, there is." We don't know how all of these new approaches will work in practice, how they may interact with one another, and what their cumulative impact will be. In an ideal world, we would take the time to find out and be sure we have it right, but clearly we are not living in that world right now.

In my view, it is absolutely vital that we not lose sight of why we regulate banking in the first place as we consider the merits of these and other reforms. At times, the regulatory policy debate has suggested that the primary purpose of regulation is to protect the economy from banks. But that's not why we regulate: it's not because financial firms represent a threat to the economic system, but because banking underpins the economic system. A healthy, well functioning banking system is one of the characteristics that distinguishes developed from less-developed economies, and is crucial to our economic well-being. We regulate banks to make sure they can continue to perform the role we need them to perform.

And what exactly is that role? Banks are central to payments systems and to the flow of funds throughout the economy. More fundamentally, banks intermediate risk. They lend to borrowers—such as relatively small businesses—who cannot easily access capital markets. They fund these loans using short-term liabilities like transaction accounts that can be withdrawn on demand at par, which in turn provide bank customers with a unique way to store wealth and make payments. Banks remain unique within the financial system by offering this package of services, and the types of borrowers who rely on bank-funding generate meaningful amounts of real economic activity and wealth.

The distinctive features of bank assets and liabilities also imply that banks as institutions will by nature be at least somewhat illiquid. Even with the rise in securitization and traded credit, loans to the vast majority of bank borrowers remain illiquid and difficult for outsiders to value properly because those loans are based on information that must necessarily be kept private. With liquid liabilities providing the funding, banks are vulnerable to runs, due to actual or perceived financial problems. Those runs have real economic costs, because they disrupt credit to borrowers who have few if any alternatives to bank credit, and disrupt routine payments on which economic activity depends.

The important economic role of banks, combined with their inherent illiquidity, is the main reason that the governments in virtually all countries provide some form of “safety net” for their institutions. This safety net takes many forms, including explicit deposit insurance and emergency liquidity facilities. A safety net makes bank runs less likely, but introduces a form of moral hazard, as it takes away some of the natural incentives banks have to limit leverage and risk-taking. At the risk of sounding self-promoting, this is where bank regulators come in: Our role is to blunt the distortion of incentives. For example, regulations that specify minimum capital ratios prevent banks from increasing their leverage to dangerous levels in response to the existence of the safety net. Ongoing supervision addresses aspects of bank risk-taking that do not lend themselves to regulation through mechanical rules like capital standards.

### *The impact of reforms*

As we work through the details of financial reform, I believe it is essential to keep a clear sense of the ultimate objectives of regulation as I’ve described them, bearing in mind that bank regulation is a means to an end: a sound and vital banking system that supports economic

growth by serving the needs of businesses and individuals. How are the broad changes in regulation and supervision now in process going to affect banks and their ability to fulfill their crucial role in the economy as financial intermediaries?

Take capital requirements. Capital requirements are important because they prevent instability, and we saw during the financial crisis that unstable banks can be extremely costly to the economy. But capital requirements also tend to raise the cost of providing banking services, and higher costs lead to higher prices (higher interest rates on loans, lower interest rates on deposits, and so on), or a lesser quantity of banking services provided, or both. The strength of the linkage between capital requirements and lending has been the subject of significant debate in financial economics, but to cite one recent study, “there is widespread agreement in the theoretical academic literature that the immediate effects of constraining capital standards are likely to be a reduction in total lending and accompanying increases in market loan rates and substitution away from lending to holding alternative assets.”<sup>1</sup>

It is critical that policymakers remain mindful of that tradeoff. Higher capital fosters a safer banking system, but if carried too far, the economy suffers when banking activity is not sufficient to support desired levels of real economic activity. These economic costs can offset the stabilizing benefits of higher bank capital.

I think this is a particularly important caveat as we implement capital surcharges for systemically important firms. We should recognize, for example, that the systemic surcharge is adding to base capital charges that, under Basel III, were designed specifically to address risks presented by large, internationally active—and therefore generally systemically important—banks. Capital levels are now extraordinarily high by historical standards. Some modest

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<sup>1</sup> VanHoose, David, “Theories of bank behavior under capital regulation,” *Journal of Banking and Finance*, December 2007.

addition to minimum capital may be appropriate to reflect systemic concerns at the very largest firms, but we should not lose sight of the fact that the other components of Basel III already have been calibrated with one eye on the systemic lessons of the recent financial crisis.

Similarly, we should approach the development of explicit liquidity standards thoughtfully, and I might add, with some humility. The move toward common minimum liquidity standards is laudable – sound liquidity management is fundamental to the safety and soundness of all banks. But it is important to remember that the new standards and resulting ratios are untested. In fact, we don't yet know what the standards should be. Last month, the Basel Committee's Chairman noted that the Committee does not have extensive experience with global liquidity standards, and also does not have high-quality data on bank liquidity profiles. The Committee is taking a cautious approach to implementing the new requirements, and will use an extended observation period to review the implications for individual banks, the banking sector, and financial markets. Even so, I suspect this is an aspect of Basel III that may need a more fundamental re-think, rather than marginal technical corrections. I have remarked in the past that I think this is an area in which requirements may interact in unintended ways, with undesirable consequences.

I am even more skeptical about what the efforts to limit banks' activities and organizational form will contribute to our ultimate objective of a safe and sound system that also contributes to a vibrant economy. The final shape of such initiatives will not be known for many months, and it will take even longer until the implications of those decisions are known. But I see several challenges.

One is that precisely defining "core" banking activities is difficult in practice. The tools for conducting "traditional" bank intermediation have broadened over the last two or three

decades. Some of the activities that might be ruled out-of-bounds by an expansive reading of the kinds of restrictions contained in the Volcker Rule and similar initiatives may actually be important complements to the core business of banking. Here I'm thinking of certain activities that lie on the boundary of trading and market-making, or certain basic types of derivatives that are used to tailor financial transactions to meet the needs of bank customers.

If we draw the circle too narrowly around what we call "banking," we will unnecessarily restrict legitimate banking activity and raise its cost. Reliable estimates of the net effects are hard to come by, but that does not make the costs any less real, and we need to tread carefully. I am also skeptical that the focus on limiting risk by restricting supposedly exotic activities will wring risk out of the system. Time and again, including during the most recent crisis, banks have managed to take on plenty of risk through very traditional banking activities. Most U.S. bank failures resulted from bad real estate loans. And while the trigger to the crisis may have come in the exotic form of structured financial products, the raw material was poorly underwritten mortgages—nothing less exotic than that.

Moreover, I would observe that the risk insulation afforded by restricting bank activities and defining corporate structure may prove illusory. As we saw during the financial crisis, when the threat to the financial system is sufficiently serious, central authorities are likely to extend the safety net beyond banks to the holding companies or banking groups of which they are part, and further to financial entities outside the banking system. Pushing certain "risky" activities outside of banks doesn't make that risk disappear.

More generally, I am concerned, in light of recent experience in the United States, that the application of overly stringent regulatory requirements of all types may again cause lending to move from the regulated banking sector into other less regulated sectors, which could serve to

reduce the effectiveness of the enhanced bank regulation and supervision we are working so hard to implement. Again, moving certain risks out of deposit-taking institutions may be desirable, but to the extent that less regulated sectors do not face the same level of regulatory scrutiny, there is clear danger that risks could be more easily hidden in these other pockets of the financial system. Among the key lessons we should learn from the financial crisis is that we cannot tolerate the resurgence of a risky parallel or “shadow” banking system.

### *Conclusion*

To summarize, I believe that we must use the recent financial crisis as an opportunity to learn, and to improve both the business of banking and the practice of bank regulation. Regulators around the world are doing yeoman duty to learn from the crisis and make improvements in supervision and regulation. Surveying the broad sweep of the many, many reform initiatives underway, most of them appear to me to be headed in the right direction. But being directionally correct is not enough. There is also the question how far we should be going in that direction. We have to be able to figure out how far is too far, and when to stop—if we are to keep our pendulum in the middle of the road.

I worry that the high capital requirements, liquidity requirements, and activity restrictions we are pursuing are attempting to banish all risk from the banking system. But the unique role that banks play in the economy requires them to take risk. As I have argued this evening, that role also justifies the maintenance of a public safety net, and because that safety net provides a public benefit, it is unlikely ever to be provided at zero public cost. Steps that we take to make the system safe must be weighed against the costs of reduced financial intermediation and potentially lower economic growth. Finding the right balance in that tradeoff involves as much

judgment as precise measurement. And exercising sound judgment requires us to avoid being swept up in the short-term passions of the times.

Thank you.