**Acting Comptroller of the Currency Michael J. Hsu**

**Remarks at Brookings**

**"Detecting, Preventing, and Addressing Too Big To Manage"**

**January 17, 2023**

Thank you, Aaron, for that kind introduction. It is always an honor and pleasure to speak here at the Brookings Institution.

Last May here at Brookings I highlighted key policy issues related to bank mergers, with a particular focus on large banks.[1] Today, I want to build on that and focus on a challenge that is often talked about but rarely defined: the limits of large bank manageability, or what some call the too-big-to-manage (TBTM) problem.

Large banks provide invaluable support to our economy through lending and other banking services to U.S. households and businesses. Today, they are also bigger and more complex than ever. Twenty years ago, the five largest U.S. banks had roughly $3 trillion in combined total assets (TA). Today, the five largest have over $12 trillion.

There are limits to an organization's manageability. Based on my experience as a bank supervisor and as Acting Comptroller of the Currency, I believe there is a growing body of evidence to support this premise. Enterprises can become so big and complex that control failures, risk management breakdowns, and negative surprises occur too frequently – not because of weak management, but because of the sheer size and complexity of the organization. In short,

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[1] Acting Comptroller of the Currency Michael J. Hsu Remarks at Brookings, "Bank Mergers and Industry Resiliency" (May 9, 2022).

effective management is not infinitely scalable. This axiom underpins the TBTM problem, as well as its solution.

As large banks continue to grow and expand, I believe developing a robust approach to detecting, preventing, and addressing TBTM risks will increasingly become an imperative for both banks and bank regulators.

Why? Because misdiagnosing the problem at a large bank can lead to ineffective solutions. Ineffective solutions can prolong the risk of harm to consumers, counterparties, and the financial system. They can also hurt the credibility of supervisors, as large banks take inordinate amounts of time trying repeatedly to remedy deficiencies, which can and should be addressed more quickly.

The most effective and efficient way to successfully fix issues at a TBTM bank is to simplify it – by divesting businesses, curtailing operations, and reducing complexity. Other, more typical, actions, such as changing senior management, increasing remediation budgets, developing better plans, and hiring more risk and control function personnel will have limited impact at a bank that is TBTM. It is the size and complexity of the bank that is the core problem that needs to be solved, not the weaknesses of its systems and processes or the unwillingness or incompetence of its senior leaders.

This puts a premium on being able to detect when the risks of becoming TBTM may be rising. Prevention is key. It also highlights the need for bank regulators to develop credible, transparent mechanisms to compel divestitures and simplification at large banks when necessary.

Let me start by first discussing detection and prevention. After that, I will lay out how we, at the OCC, are approaching addressing TBTM risks at large banks.

Detecting and Preventing TBTM

What are the signs that a banking organization may be at risk of becoming TBTM? I will discuss five here today. (There are, of course, many more, which I invite others to identify and share.)

*(1) The (im)materiality illusion*. Matters that command the attention of a bank's senior leaders get prioritized and addressed. Those that don't are at risk of falling through the cracks. The challenge at large banks is that the time and attention of senior leaders is fixed – there are only so many hours in the day and so many meetings executives and board members can attend. This dynamic places heavy reliance on materiality determinations, which drive the issues senior leaders consider and make decisions about.

A constant challenge for large banks is that materiality often is defined in percentage terms, and percentages can deceive. Say, for example, that a problem at a bank is impacting X number of customers, which makes it highly material today. If that bank were to double in size tomorrow, would the problem be half as material? Of course not, but senior leaders at banks sometimes fall into this trap when they rely on percentages to identify and describe the materiality of weaknesses and problems. As a result, red flags get missed and important remediation initiatives reside at too low a level within organizations.

This point gets driven home to me every time I toggle between discussions with large bank CEOs and community bank CEOs. In addition to supervising the four largest U.S. banks, the OCC supervises nearly 800 community banks with less than $1 billion in assets. I speak frequently with community bankers. When talking about problems, no detail seems too small for their attention.[2] The same cannot be said at large banks.

Large banks can avoid falling for the immateriality illusion by remembering that absolute numbers matter. While "less than 1 percent," for instance, may sound immaterial, the raw number of affected customers or transactions is important to consider and may warrant senior-level attention.

Large banks should also be careful when assessing financial risks in terms of their capital. Allocated capital provides a more meaningful risk signal than aggregate capital, which can make almost any risk seem immaterial, especially at the largest banks.

(2) *The isolated incident/bad apple illusion*. When a significant problem surfaces at a bank, I have observed one of two reactions. Either the bank assumes there might be similar problems lurking elsewhere in the organization and embarks on a mission to find them and address the root cause. Or the bank assumes that the problem is isolated and reflective of a bad apple and maintains business as usual.

The larger and more expansive a bank's operations become, the more likely it is to assume the latter. This is not unreasonable. Large banks have tens or even hundreds of thousands of employees doing a wide range of tasks spread out nationally or even internationally across multiple jurisdictions.

[2] Community banks can and do experience their own manageability issues, but they tend to be associated with rapid growth or changes in the economic environment – risks that are common to and a longstanding part of the business of banking.

Rogue actors do exist. However, in my experience, more often than not negative surprises are multi-causal and reflect deeper, unseen weaknesses, which if unaddressed can manifest as further incidents in the future.

When a negative surprise occurs, large banks should *presume* that similar risks lay hidden beneath the surface elsewhere and that unseen root causes need to be uncovered and addressed. A "look across" to other units should be standard operating procedure and the burden should be on those units to demonstrate they are not similarly vulnerable. The larger the banking organization, the more important it is to shift the default presumption before concluding that an issue is contained and being addressed.

(3) *External versus internal risk identification*. The business of banking is operationally intensive. Even at banks with strong teams and robust risk management systems and controls, mistakes and problems can arise. Well-managed banks identify such problems early and often, address them quickly, and take steps to prevent their recurrence.

A sign that a bank may be becoming TBTM is when supervisors consistently uncover more risks and problems than the bank's internal risk and control functions do. If the bank is responsive and effective in addressing those problems, examiners take that into account in assessing the supervisory ratings for that bank. At some point, however, the bank may become dependent on examiners to function as a so-called "fourth line of defense."[3] This should be a flag and a sign that the bank is potentially becoming less manageable.

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[3] A common risk management system used in many banks, formally or informally, involves three lines of defense. The first line of defense is the frontline units, business units, or functions that create risk. The second line of defense is commonly referred to as independent risk management, which oversees risk taking and assesses risks independent of the frontline units, business units, or functions that create risk. The third line of defense is internal audit, which provides independent assurance to the board on the effectiveness of governance, risk management, and internal controls. See the "Corporate and Risk Governance" booklet of the *Comptroller's Handbook.*

Banks that are well-managed meet the OCC's heightened standards expectations[4] and tend to have strong "self-identify/self-correct" cultures. They embrace the uncovering of problems and weaknesses, and have strong processes and track records for addressing them. They avoid falling into a checklist or project management mindset, which can feed a cost-of-doing-business mentality, as well as the (im)materiality illusion. Rather, well-managed banks are guided by pride in doing things right and have faith that doing so makes long-term business sense.

Maintaining this ethos and set of practices gets harder the larger and more complex a bank becomes. Tracking the ratio of supervisor-identified issues to self-identified and self-corrected issues is one way to gauge this risk and track it over time.

(4) *Hubris, contempt, and indifference*. Senior leaders who are agitated about an issue will marshal the resources and focus their organizations to address it. It can be extremely effective. I have seen this firsthand many times.

Unfortunately, the inverse is also true: a lack of agitation at senior levels enables inertia and gives space for problems to fester, remediation timelines to extend, and partial efforts to be seen as good enough. At firms where the materiality threshold is too high (flag #1 above), incidents are seen as isolated (#2), and self-identification is weak (#3), insouciance by senior leaders to issues raised by risk managers, auditors, and regulators can set in. Findings are dismissed as nit-picky, blown out of proportion, and not a big deal. Such indifference can lead to blind spots and should be a flag.

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[4] 12 CFR 30, appendix D, "OCC Guidelines Establishing Heightened Standards for Certain Large Insured National Banks, Insured Federal Savings Associations, and Insured Federal Branches."

Supervisory findings by OCC examiners are called “matters requiring attention” (MRAs) for a reason. Without the attention of senior leaders, the weakness is likely to persist. A lack of timely remediation of MRAs indicates an unwillingness or an inability of senior management to address them. The accumulation and aging of MRAs is a signal that something is amiss.

Contempt of examiner findings by senior leaders of large banks can be part of the problem. I have experienced it myself. The eye roll speaks volumes: *How could you possibly know more than us about our bank and our business*? They forget that examiners’ findings often reflect the collective experience of the agency – a perspective that spans many banks and cycles, a perspective that no bank, no matter how big, can gain by itself.

Large banks’ boards of directors have a role to play here, especially the chairs of the risk and audit committees and the lead independent director. They have unique powers and opportunities to question the CEO and senior management, call out any hubris, and hold them accountable for managing the bank well.

(5) *Rushed integration and diseconomies of scale*. The logic for many bank mergers is to “achieve synergies,” i.e., take advantage of economies of scale. While the theory and math supporting this logic are simple and compelling, bank mergers in practice are complicated and messy. Integrating systems, processes, and people is easier said than done.

When integration is done well, the management and manageability of the combined bank is strengthened. Legacy systems get modernized or replaced, workarounds and manual processes get eliminated, and stronger risk management practices and controls get adopted, while weaker practices and controls are stopped.

By contrast, rushed integrations can lead to diseconomies of scale. For instance, merged banks that simply stitch their systems together often must add workarounds and manual processes contributing significantly to the combined bank's technical debt. Changes in oversight intensity can weaken alignment across units and increase the fragmentation and multiplicity of business processes, even for similar activities. The utilization of consultants can morph into reliance, creating governance complexities, muddying accountability, and adding to long-term costs. The stature of risk managers and control functions may be diluted or become more varied, leading to inconsistencies and creating gaps where weak practices and excessive risk taking can flourish. Unless addressed early and often, these problems can worsen and compound as the combined bank grows and expands.

Attentiveness to these dynamics, especially by large bank boards of directors in the first year or two after a merger, is critical to detecting and mitigating such manageability risks. The risks are especially heightened where a bank has executed or is planning multiple mergers.

## Addressing TBTM

Let me now turn to addressing TBTM risks.

As I noted in my opening, the most effective and efficient way to fix problems at a TBTM bank is to simplify it, e.g., through divestitures. Taking such an action would be highly consequential and raises two critical questions: How do we *know* when a bank is TBTM, as opposed to just poorly managed? And how do we *ensure* due process and fairness in making that determination? Given the stakes involved, getting both right is vitally important.

The answer to both questions lies in having a clear escalation framework. An escalation framework ensures that deficiencies are clearly identified, that banks are given opportunities to address them, and that failures to do so result in proportionate, fair, and effective consequences.

A well-calibrated escalation framework gives banks sufficient opportunities to address deficiencies. A bank's repeated failures to do so then become, by themselves, presumptive evidence that it is at the limits of its manageability. Under such a framework, the need for simplification and divestitures at a bank is clear from management's actions and outcomes, or lack thereof.

In other words, the design logic of an escalation framework is to use the credible threat of restrictions and divestitures, guided by and consistent with due process, to force banks to prove that they are manageable and to then let the effectiveness or ineffectiveness of their actions speak for themselves. The goal is to ensure discipline and consistency in promoting management improvements at banks and, when warranted, in imposing growth restrictions or requiring divestiture of certain activities or legal entities.

There are four levels to the escalation framework we are using here at the OCC to address supervisory concerns and deficiencies at large banks.

At the first level, a bank under normal circumstances is put on notice and the nature of the weakness requiring remediation is made clear. Situations vary, but generally this starts with an MRA, which is a non-public supervisory finding typically stemming from an examination. To address MRAs, banks develop plans and take actions, which are eventually validated by internal auditors and assessed by examiners for their effectiveness. More often than not, banks are successful in closing out MRAs in the time frames initially envisioned. MRAs are not uncommon, even for well-managed large banks, which can have multiple open MRAs at any given time, reflecting the breadth of their activities.

Significant deficiencies and/or weaknesses that go unaddressed can escalate into public enforcement actions, such as a consent order, where material safety and soundness risks or violations of laws and regulations are at play. The public nature of consent orders, the legal standard for imposing them, and their enforceability in the courts mark a clear escalation from the issuance of MRAs. Depending on the infraction, a consent order may be paired with a civil money penalty (CMP). At the OCC, CMP amounts are informed by statutory requirements, as well as aggravating and mitigating factors. We recently published an update to our approach to sizing CMP amounts.[5]

In most cases, the imposition of a public enforcement action and civil money penalty is sufficient to motivate a bank to take the necessary actions to fully remediate its deficiencies. Usually no further supervisory actions are needed.

In some cases, however, weaknesses at a bank persist and negative surprises continue to occur, despite the application of an enforcement action. When this happens at large banks, the public perception can be that the bank either does not care enough to fix the problem and sees the CMP as a "cost of doing business," or that the bank is not capable of fixing the problem, or both. In such situations, a restriction on growth, business activities, capital actions, or some combination may be warranted in order to incent corrective action and serve as a compensating control pending effective remediation. I will refer to these as growth restrictions.

[5] OCC News Release 2022-143, "OCC Revises Civil Money Penalty Manual," (November 29, 2022).

Imposing a growth restriction is a significant escalation and must be approached with due process and proportionality in mind. It is a step that we do not take lightly. In general, the OCC will consider a growth restriction when a bank has failed to fully remediate a deficiency within the agreed-upon time frame. With most enforcement actions, banks are required to submit remediation plans with clear milestones for regulatory approval. Failure to meet those milestones may reflect an inability or an unwillingness on the part of the bank to fix the problem in a timely manner. The rationale for imposing a growth restriction must be clear and the remedy should be proportionate to the nature and scope of the problem. Rationales could include repeat offenses, repeated delays in meeting established remediation milestones, or new violations of similar laws or regulations – i.e., what some might call "recidivist" outcomes.

In sum, when a bank is on notice that certain deficiencies need to be fixed and they don't get remediated on time or new things break, the OCC will actively consider imposing growth restrictions.

What if a growth restriction is ineffective and the deficiency is still not remedied? What if a bank, after being publicly reprimanded and constrained in some way, continues to violate the law or drags out remediation timelines? The bank would have had multiple opportunities to address the problem and been publicly motivated to do so, yet fallen short, again. It is at this stage that evidence of the bank's inability to manage itself would become overwhelming and supervisors would consider the fourth level of escalation – simplification via divestiture – what some refer to as "breaking up the bank."

Is this a viable option? Today, the answer is yes. For resolution planning purposes, the U.S. global systemically important banks (GSIBs) are required to be "separable."[6] They must identify lines of business and portfolios that can be sold quickly and ready them to do so as part of the living will process. This means that there are actionable divestiture options at those banks should a situation demand it, be it resolution or an enforcement action to make a TBTM bank manageable.[7] Of course, the same principles that guide our consideration of growth restrictions – having a clear rationale and making the remedy proportionate to the nature and scope of the problem – also guide our consideration of simplification actions.

Stepping back, I believe that following this four-step escalation framework has a number of benefits. First, it strikes a balance and is proportional. Second, it helps to ensure that we avoid doing too little (e.g., simply imposing CMPs) or doing too much (e.g., jumping to breaking up a bank). And, third, it adheres to due process, giving banks time and opportunities to fix their problems, while providing clear steps for escalation to growth restrictions and, if necessary, divestiture, should a bank be unable or unwilling to implement the needed fixes in a timely manner.

Given the stakes involved with restrictions and divestitures, we need to approach such situations and actions with great care. Close coordination with our interagency stakeholders is required to ensure fair, orderly, and effective outcomes. Greater clarity about the process and standards of review would support due process and fairness and bolster the credibility of supervisory actions taken.

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[6] See *Federal Register*, "Final Guidance for the 2019," and subsequent resolution plan submissions by the eight largest, most complex U.S. banking organizations.

[7] See id. This is one example of supervision and resolution complementing each other.

At the OCC, we are considering steps to provide greater transparency and predictability into the escalation framework just discussed. I see significant value in working collaboratively with the other federal banking agencies as we refine our thinking.

## Conclusion

Well-managed large banks support creditworthy households and businesses and the broader economy in invaluable ways. Our country's capacity to grow and generate wealth at scale depends on large banks succeeding. We should all be supportive of large banks, as the strength and resilience of our economy is linked to their strength and resilience.

At the same time, we need to hold them and ourselves accountable. I have seen up close what happens when large banks become unmanageable and need government support to avoid disorderly failure. The negative impacts of TBTM and too-big-to-fail on households and communities, on the banking system and economy, and on trust are immeasurable and can take years to mend.

Most of my career has been dedicated to reconciling the benefits that large banks provide with the risks that they pose. I believe it is possible and imperative to do so. Indeed, effectively mitigating the risks – of being TBTM and TBTF – provides a clear path for large banks to do *more* for Main Street and the economy, not less.

There is a saying, "The better a car's brakes, the faster it can drive safely." I believe this is useful to bear in mind as we consider the devilish details and focus large banks on the risks that can cause them to become TBTM.

Thank you.