Acting Comptroller of the Currency Michael J. Hsu

Remarks at the RMA Risk Management Virtual Conference

"Promoting Prudent Credit Risk Management and Diversity and Inclusion"

December 5, 2022

It is a pleasure to join you for the 2022 RMA Annual Risk Management and Internal Audit Virtual Conference. This year's theme, "Risk in an Ever-Changing Landscape," is apt. Everywhere one looks, it seems, there is uncertainty: from the rate environment and credit outlook to geopolitics and (de)globalization to financial technology and fintech partnerships to crypto, cyber threats, and third-party vulnerabilities. The list goes on (as you all are well aware).

Today, I would like to focus on two topics that may be at risk of being crowded out, given all that is going on, but are important to safety and soundness, especially in an ever-changing landscape: the current expected credit losses standard (CECL) and diversity and inclusion (D&I). My remarks today complement others I've given that have focused on risk management, namely on tail risks,[1] climate-related financial risks,[2] fair lending risks,[3] and risks that may arise when the proverbial tide goes out.[4]

[1] Acting Comptroller of the Currency Michael J. Hsu, "Tail Risks, March 2022," March 31, 2022 (occ.gov).

[2] Acting Comptroller of the Currency Michael J. Hsu, "Five Climate Questions Every Bank Board Should Ask," November 8, 2021 (occ.gov).

[3] Grovetta N. Gardineer, Senior Deputy Comptroller for Bank Supervision Policy, "Keynote Remarks to the 2022 CRA and Fair Lending Colloquium on Behalf of Acting Comptroller of the Currency Michael J. Hsu," November 14, 2022 (occ.gov).

[4] Acting Comptroller of the Currency Michael J. Hsu, "When the Tide Goes Out," May 17, 2022 (occ.gov).

Current Expected Credit Losses Standard

As economic uncertainty persists in the current environment, continued prudent credit risk management remains critically important. While loan portfolios have generally been resilient and widespread deterioration isn't *currently* evident in credit quality metrics, the effects of high inflation, rising interest rates, lagging wage growth, supply chain disruptions, and stress from geopolitical events threaten the unexpectedly strong credit performance observed over the past few years.

The effects of the current economic environment are easy to identify. For consumers, rising prices are inducing sticker shock due to persistent inflation, while rising interest rates and lagging wage growth create even further stress. Longer-term effects of the pandemic such as the shift in preferences toward online shopping, food delivery, and remote work are causing stress on the real estate market for shopping malls, restaurant spaces, and office buildings. All of these factors can have a cascading effect that erodes business profit margins, debt service capacity, and collateral valuations, which may adversely affect credit risk levels at institutions.

Maintaining safe and sound credit risk management practices through this period of economic uncertainty is critical; now is not the time to be complacent. Management should continue to closely monitor borrower financial position and behavior as the effects of inflation and rising interest rates continue to evolve. Accurate and timely risk identification and ratings, increased focus on concentrated portfolios and vulnerable borrowers, and stress testing and sensitivity analysis are particularly critical risk management activities at this time.

The current economic environment makes credit loss estimates challenging, particularly for institutions that will apply the new current expected credit losses standard, or CECL, for the first time in 2023. Similar to institutions that adopted CECL in 2020 at the height of the COVID-

19 pandemic, these institutions will adopt CECL during a period of significant uncertainty. Like the 2020 adopters, I am confident that those adopting CECL next year will successfully implement the standard.

As we shared with the 2020 adopters, we are looking for a good faith effort to implement CECL, and our expectations for CECL are scaled to the size and complexity of the institution; small institutions don't need big models or overly complex methodologies. We understand that the estimate will continue to evolve and become more refined over time, and don't expect perfection on Day 1.

I believe institutions adopting CECL will find many benefits with the new standard. We've heard fairly consistently from institutions that have implemented CECL that it better aligns with their credit risk management practices and has brought together multiple disciplines in the organization such as credit risk, accounting, modelling, and treasury that may previously have operated more independently.

We've also observed that the quality and transparency of the discussion around credit loss estimates has improved under CECL. I think all stakeholders—management, boards, investors, regulators and others—are benefiting from the discussion shifting from "what's happened," to "what do you expect to happen and why, what's driving your assumptions, and how could they change." This is more decision-useful information for all stakeholders, including regulators.

Lastly, I'd argue that the great benefit of CECL is that it provides institutions with flexibility to bring context, a broader perspective, and judgment to bear. CECL allows management to use all the information that is available to them, including forward-looking information, to appropriately reserve for all expected credit losses—not just those that are

probable of having been incurred. CECL allows management to use judgment to reserve for expected losses earlier in the life cycle of assets, even when credit metrics may not currently be showing signs of deterioration. This type of flexibility is critical in this environment when there's so much uncertainty and the past two years of credit performance have been supported—some might say masked—by government actions in response to the pandemic.

That said, the flexibility that CECL provides must be exercised in a disciplined manner to ensure safety and soundness. There needs to be appropriate support and documentation of management's judgments. We expect thoughtful documentation of the methodology selected, as well as management's assumptions, decisions, expectations, and qualitative adjustments. This is an area that our examiners will be monitoring closely, especially as it relates to any changes in an institution's credit loss methodology and assumptions. We understand and expect that credit loss estimates will change with the economic outlook and as new information surfaces; however, any changes to credit loss estimates need to be appropriately supported and documented.

Diversity and Inclusion

I would now like to turn to the second topic and discuss the importance of diversity and inclusion in the banking industry and broader financial services sector. As risk management professionals, you know that effective risk management depends on many factors. But even the best risk management framework can't be effective without the right team to carry it out. That is why I'd like to encourage you to think about how a bank's commitment to meaningful diversity, equity, and inclusion at every organizational level can strengthen its risk management.

As bank supervisors, we often talk about how vital a bank's board of directors can be to ensuring that the bank is adequately prepared for the risks it faces. I've spoken before about how

the diversity of a bank's board can contribute to the bank's safety and soundness.[5] Without diverse leadership, banks and their regulators may develop blind spots or suffer from groupthink. These blind spots can lead to the kinds of nasty surprises that threaten safety and soundness—and possibly the financial sector as a whole. There is a growing body of empirical evidence that companies that address these blind spots by having diverse boards of directors have stronger earnings, more effective corporate governance, better reputations, and less litigation risk.[6] The OCC has repeatedly emphasized that the ideal board is well diversified and composed of individuals with a mix of knowledge and expertise in line with the bank's size, strategy, risk profile, and complexity.[7]

As a first step toward improving diversity, equity, and inclusion, we should expect more transparency from the financial services industry—particularly large banks—about the diversity of their boards and executive leadership. For our part, we are exploring and considering other steps. For example, we have seen other standard setters encouraging banks to make it a practice to nominate or consider a diverse range of board candidates or to require companies to either diversify their boards or explain why they have not.

However, the board is not the only place where diversity, equity, and inclusion matter. As the leader of an organization with about 3,500 employees, I have thought deeply about what we need to do to be effective and meet our mission in the face of a rapidly changing industry and complex regulatory environment. I firmly believe that if we are serious about preparing our

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[5] "Remarks by Acting Comptroller of the Currency Michael J. Hsu, Institute of International Bankers, Annual Washington Conference," March 7, 2022 (occ.gov).

[6] See, for example, McKinsey & Company, "Diversity Wins: How Inclusion Matters" (May 2020); Ann L. Owen and Judit Temesvary, "Gender Diversity on Bank Board of Directors and Performance," FEDS Notes (February 12, 2019); Margaret Heffernan, *Willful Blindness: Why We Ignore the Obvious at Our Peril* (New York: Bloomsbury, 2011).

[7] *Comptroller's Handbook*, "Corporate and Risk Governance," p. 7.

organizations to effectively manage risks, our workforces need to be up to the task of adapting to change and calling out institutional blind spots. This means creating cultures that foster a true sense of belonging for everyone. Unless people with diverse experiences and points of view feel empowered to speak up about the risks they see and to share their ideas for managing those risks, we will be stuck in an old school mindset, always fighting last year's war and overconfident in our risk management capabilities.

One way to promote diversity, equity, and inclusion, and one that is included in our strategic plan for fiscal years 2023–2027, is to develop diversity plans and monitor outcomes. As risk management professionals, you know how to do this kind of work: You evaluate the current state and set measurable targets for improvement. And I will be frank, our current state is not what we want it to be. We can and need to do better in reflecting the communities we serve, and we are taking concrete action to increase the number of people from underrepresented groups and diverse backgrounds into our workforce. We suspect that we are not alone in needing to improve. We have some indication that banks also struggle to recruit and retain women and people of color, particularly for their boards of directors.[8]

But numbers don't tell the whole story of diversity, equity, and inclusion, and numbers alone are not sufficient to strengthen our risk management efforts. It is also important to consider how we can promote an organizational culture that is truly inclusive of thought, experience, and knowledge, and brings multiple perspectives to bear on issues, particularly the identification and management of risk. It does not matter if we hire or promote more people with diverse experiences if we're not also actively fostering a culture where they are confident that their

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[8] A recent study of 72 North American banks by Moody's Investor Services found that women make up between just 24 and 31 percent of those banks' boards of directors. See Laura Alix, "Do Women on Boards Make Banks Less Risky? It's too Soon to Say," *American Banker*, September 24, 2021.

voices and ideas will be heard, valued, and respectfully considered. Without true inclusion, or perhaps more accurately, without a sense of belonging, diversity over time becomes a box to be checked or a number on a spreadsheet rather than a value to be upheld.

I know what it's like to be the only person in the room who looks like me. I know what it's like to feel like there's a secret language that only those in the in-group speak. And I know that, no matter how much experience and expertise you possess, it is hard to bring your best self, to contribute fully, and to take risks if you feel alone, like you don't belong. This is why it is not sufficient simply to bring people with diverse experiences to the table. It is also my job as the head of my organization to make sure that I actively invite their input and listen and react. This culture of mutual respect helps ensure that I hear a range of views, including those I don't initially or always agree with, when making decisions and setting policies, practices, and procedures. I hope to model for my colleagues a spirit of intellectual curiosity, humility, and continuous learning, as we work together to address rapidly evolving risks. Especially in times of uncertainty and change, it is critically important that we hear and consider views from people who can bring a wide range of perspectives to bear on the challenges, emerging risks, and new opportunities we encounter.

In short, improving diversity and inclusion is a "need to have" for us to achieve our mission of assuring safety and soundness, fair access to financial services, and fair treatment of customers. It will help us ensure that we can adapt and respond to increasingly complex financial, compliance, operations, technology, cybersecurity, and resiliency risks. A diverse, equitable, and inclusive workplace will allow us to attract top talent, widen our perspective, and expand our networks to meet these new challenges.

Conclusion

Thank you for the opportunity to contribute to the conversations on prudent credit risk management and on promoting diversity and inclusion. I look forward to the opportunity to continue discussions of these topics.