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Observations on the National Bank and Thrift Examiners' Conference

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Mr. Chairman and Members of the Committee:

We are pleased to be here to provide you with our observations on the National Bank and Thrift Examiners' Conference held in Baltimore, Maryland on December 16 and 17, 1991. This conference was hosted by the four federal financial institution regulators who jointly issued the November 7, 1991 "Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans." The stated purpose of the conference was to review with senior examination personnel the policy statement and other issues related to credit availability.

Unfortunately, the conference did not allay our concerns about the policy statement. We continue to be concerned that the policy statement is not consistent with the objectives of the recently passed bank reform legislation.

We first discussed these concerns during your December 11, 1991, hearing on the Comprehensive Deposit Insurance Reform and Taxpayer Protection Act of 1991. Our view then, as now, was that the joint policy statement was at odds with the objectives of the bank reform legislation and, more specifically, its accounting principles for financial institutions. We expressed concerns that the guidance places a great deal of emphasis on valuations of real estate loans under conditions that reflect a return to normal market circumstances, and deemphasizes current market conditions. We were also concerned about the increased burden placed on examiners who disagree with judgments of bank managers about the classification of real estate loans and the dollar amount required for reserves for potential loan losses.

During the hearing, we stated that we were attempting to attend the then-upcoming National Bank and Thrift Examiners' Conference in Baltimore to see whether and how the regulators would resolve the inconsistencies between the policy statement and the bank reform legislation. The following account of the conference reflects the observations of the one representative we sent to it.

The conference opened with introductory comments from administration officials about the impact of regulatory actions on credit availability, particularly those relating to real estate lending. Panel speakers included top policymaking officials of the regulatory agencies--including the agency heads, who participated actively throughout the conference.

The overriding message of the conference was articulated repeatedly and, perhaps most memorably, with a golf analogy: examiners should strive to "play it right down the middle of the fairway and stay out of the roughs and hazards." Administration officials urged examiners to recognize that their actions affected not only the loans, projects, and institutions they supervised, but also credit availability, real estate markets,

and the overall economy. Administration and agency officials said that as examiners evaluate the quality of loans, they should avoid the most pessimistic scenarios based on appraisals and cash flow analyses of real estate projects suffering through depressed local market or economic conditions. To accomplish this, examiners were told to add to their analyses a broader view of the prospects for repayment of commercial real estate loans.

The conference offered only limited clarification of the meaning of the phrase "broader view." Generally, examiners were encouraged to use their professional experience and judgment to consider prospects of repayment in the future, when market conditions may be improved. The broader view was also described as including in its focus more than the specifics of the project's current value and the loan's repayment prospects. That is, the broader view should include the borrower's other ventures and activities and the capability those other projects provide the borrower to repay the troubled loans. The broader view is to include, as part of its loan classification strategy, assessments of the viability of the institution as indicated by its internal and managerial controls, including its underwriting practices.

Consistent application of the "broader view" message is unlikely because its meaning was not clearly spelled out at the conference. Panel members acknowledged the difficulty of agreeing on specific criteria on a national, industry, or agency level. Attempts were made through case study examples to get consensus on how to apply the policy guidance, but the results of those attempts were mixed and confusing. While some case studies seemed to clarify the guidance, that clarity was offset by discussions of other case studies.

While it is unrealistic to expect that criteria can be developed that would eliminate all inconsistencies, we strongly believe that accounting needs to report the facts. Where judgments are needed, they should be based on the best current market data available. If the available data show that the borrower is not going to be able to fully repay a debt and the prospects for full recovery from the underlying collateral are dim, the institution's management needs to recognize the loss. If there is information that justifies a deviation from current market data, that information needs to be explicitly set forth as a basis for not recognizing the loss. The guidance offered at the conference will not accomplish this result because of its emphasis on middle-of-the-road scenarios which deemphasize current market conditions in evaluations of loan repayment prospects.

Panel members also discussed the attributes of an enhanced examination appeals process to address substantive problems raised by institution officials about examination findings. The principal difference between the enhanced process and the current

process lies in the new ability of the affected institution to appeal directly to senior regulatory officials on a confidential basis. Under the current process, appeals are made through the regulators' supervision hierarchy to senior supervisory officials. Panel members emphasized that the enhanced appeals process is intended to address major problems that institution officials raise about examiners' findings. It is not to be used to delay the examination or enforcement processes. Each agency plans to issue specific enhanced appeals procedures to articulate how the attributes discussed apply.

While we believe bank and thrift management should have the opportunity to raise reasonable concerns about examination findings, the process needs to ensure that the examiners' "auditor instincts" are not stymied by the threat of an appeal. The regulators (indeed the Congress and the taxpayers) need an examination force that is rigorous and fair. If the administration's policies result in an examination workforce that is unduly restrained, or perceives itself as being unduly restrained, in making the tough decisions, then the nation is not going to be well served. We need the best information available on the health of our financial institutions.

Panel members also discussed means of ensuring conformance of the basis for examination findings with the policy statement, including certifications of conformance in examination workpapers and reports, and in peer reviews of completed examinations. However, the discussions did not clarify procedures for performing such certifications and peer reviews. Such procedures will presumably be developed by the individual agencies in the near future.

It was also emphasized that the basis for the examiner's findings must be justified, documented, and communicated to institution's managers and directors in exit conferences. Panel members discussed the importance of communicating the basis of examiners' findings to both institution management and boards to ensure that the industry understands the policy statement and its implementation. The panelists suggested that this communication was critical in the next examination cycle to dispel the perceptions of those institution managers and directors who believe that examiners are valuing and classifying loans on an extremely pessimistic basis. We agree that bank and thrift management should be fully informed of the basis for examiners' findings and that loan classifications should reflect the facts.

The questions participants raised at the meeting suggested that additional and more specific guidance is needed before examiners would be able to consistently apply the policy statement when valuing and classifying real estate loans. Although panelists continually encouraged questions or comments from the

participants, they did not have sufficient time to address many of them.

Panelists recognized and acknowledged the need for more specific guidance on issues of concern to examiners--such as the accrual versus nonaccrual bases for loan valuations and classifying and reserving for troubled loans. Panelists assured participants that efforts to provide more specific guidance will continue on an interagency basis, at the individual agencies, and cooperatively with the AICPA, FASB, and SEC. Panelists also indicated that the questions which could not be addressed and answers to them will be compiled by the conference organizers and provided to all participants to supplement the policy statement.

The panelists concluded by saying that the primary message to "play down the middle of the fairway" was clear and that the conference represented the first step by conveying that message to senior examination personnel. The participants were asked to take the message and the conference's guidance to the rank-and-file examiners and, equally importantly, to financial institution managers and directors.

We heard two other messages delivered at the conference. First, because of the impact of examiners' actions on credit availability, real estate markets, and local economies, examiners were advised that they should add to their evaluation of loans and institutional performance a broader view that allows for future improvements in local markets and the economy. Second, examiners were told that they need to better justify, document, and communicate their findings to bank and thrift management and boards to dispel perceptions and misconceptions about their analysis of loans and institutions' performance. However, the conference did little to enhance the examiners' ability to consistently implement the policy statement. Conference organizers acknowledged that more specific direction is needed and said such direction would be forthcoming.

As I indicated at the outset, we remain concerned about the inconsistency which exists between the policy statement and the objectives of the recently passed bank reform legislation. The "broader view" approach to loan evaluation and classification and the seeming shift in the burden of proof that the examination workforce must carry is troublesome to us and potentially dangerous to the maintenance of a safe and sound banking system.

That concludes my prepared statement. My colleagues and I would be pleased to answer questions.

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