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TESTIMONY OF

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Before the

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

COMMITTEE ON FINANCIAL SERVICES

U. S. HOUSE OF REPRESENTATIVES

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Statement Required by 12 U.S.C. § 250:
The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Introduction

Chairman Capito, Ranking Member Maloney, and members of the Subcommittee, I appreciate the opportunity to appear before the Subcommittee on Financial Institutions and Consumer Credit to discuss the Office of the Comptroller of the Currency's (OCC) perspectives on H.R. 3461, "The Financial Institutions Examination Fairness and Reform Act."

As the Senior Deputy Comptroller for Midsize and Community Bank Supervision for the OCC, I serve as the senior OCC official responsible for community bank supervision. The OCC supervises approximately 1,700 national banks and federal savings associations with assets under $1 billion. These community-focused institutions (collectively referred to as "banks" in my testimony) play a crucial role in providing consumers and small businesses in communities across the nation with essential financial services as well as the credit that is critical to economic growth and job creation.

H.R. 3461 contains measures directed at three basic concerns: 1) assuring that banks have access to a fair and independent appeals process if there are disagreements about a bank regulator's supervisory determinations; 2) clarifying or revising standards for classification of loans and placing loans in nonaccrual status; and 3) achieving timely examinations and communication of examination results.

My managers and I hold numerous outreach sessions and meetings with bankers to listen and respond to their concerns and questions, and we have heard many of the same concerns that you have about the challenges bankers are facing. We seek to ensure that the OCC's examinations are fair, balanced, and timely, and that the OCC is fulfilling

its mission of ensuring the safety and soundness of national banks and federal thrifts by identifying problems at the earliest possible stage and holding institutions accountable for taking timely and effective corrective actions. While we understand and support the broader objectives of H.R. 3461, we believe provisions of the bill in its current form could impede our ability to deal with troubled institutions on a timely basis and would undermine Congress's clear direction that regulators[1] identify and promptly address unsafe and unsound practices at depository institutions.

First, let me emphasize that the OCC fully supports providing bankers with a fair and independent process for appealing supervisory determinations. We think our current appeals process, run by our Ombudsman, does just that. H.R. 3461's approach to accomplishing that objective would involve creating a new federal bureaucracy at the Federal Financial Institutions Examination Council (FFIEC) and risks disrupting appropriate and necessary supervisory activities by bank regulators. We believe there are better alternatives – without those downsides – that would accomplish the objectives of H.R. 3461, and we would be happy to work with the Subcommittee to frame out an alternative approach.

Second, we have significant concerns that the standards for nonaccrual loans in H.R. 3461 could result in revenue recognition that is inconsistent with generally accepted accounting principles (GAAP). The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) established that banks must follow GAAP, or standards that are no

[1] Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, §§ 121, 131-32, amending the Federal Deposit Insurance Act, 12 U.S.C. §§ 1831n, 1831o, 1831.

less stringent than GAAP, in reporting their financial condition. Congress put this requirement in place in response to the savings and loan crisis, where non-GAAP regulatory accounting masked the deteriorating financial condition of institutions until it became so serious that a massive bailout was needed.[2] H.R. 3461 would slacken this important standard.

The integrity of financial reporting and regulatory capital is vital to identifying and correcting weaknesses before they threaten a bank's ability to continue to meet the needs of its customers and the communities it serves. Those standards must not be compromised. As we have learned in the most recent crisis, it is also essential that supervisors have the ability to direct banks to hold capital commensurate with their risk profile. H.R. 3461 would, in certain instances, tie the hands of regulators when they have determined that an institution's risk profile warrants a larger capital buffer.

Finally, we agree that completing and communicating our examination findings on a timely basis are essential if we expect bankers to initiate appropriate corrective action to address problems or deficiencies identified by examiners. While clarifying expectations regarding examination timing and communication can be a positive step; as H.R. 3461 recognizes, however, there needs to be flexibility to accommodate situations where an exam may not be finished, or results not yet communicated, for good reasons, such as when an issue raises significant policy issues that need further deliberation before a conclusion is reached.

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[2] A June 1991 Congressional Budget Office Staff Memorandum concluded that a policy of regulatory forbearance increased the eventual bill for resolving failed thrift institutions by about $66 billion. *See:* CBO Staff Memorandum, "*The Cost of Forbearance During the Thrift Crisis,*" June 1991.

Before elaborating further on each of these areas, I want to briefly report on the overall condition of national community banks and federal savings associations. While we have been through an extremely difficult economic cycle, I am pleased to report that conditions are beginning to stabilize for most community banks and thrifts. Through the third quarter of last year, noncurrent loan levels for most loan types have begun to stabilize or trend downward, and returns on assets and equity for many of these financial institutions have improved. However, their operating environment remains challenging. Lending activity, which is the primary revenue source for these institutions, continues to be hampered by the overall economic downturn and net interest margins continue to be strained. Given these challenges, some of these institutions will continue to face significant problems. In these cases, the goal of our supervisory actions is to restore the bank or thrift to health and, if that is not possible, to seek an orderly and least cost resolution.

Despite the financial crisis and the deep recession, three quarters of the community banks and thrifts we supervise have satisfactory supervisory ratings, reflecting their sound management and strong financial condition. These institutions have successfully weathered the recent economic turmoil by focusing on strong underwriting practices, having timely and accurate recognition of problem loans, and maintaining strong capital buffers. These are basic tenets of sound banking practice.

With this as background, let me discuss in greater detail my perspectives and concerns with the three major provisions of H.R. 3461.

Fair and Independent Appeals Process

My management team and I encourage community bankers who have concerns about a particular examination finding to raise those concerns with his or her examination team and with the district management team that oversees the bank. Nonetheless, we also recognize the need for bankers to have an independent channel to raise and discuss their concerns outside of the direct supervisory process. Because of this, the OCC established an Ombudsman's office before it was required by statute. This office provides a venue for bankers to discuss their concerns informally or to formally request an appeal of examination findings.

H.R. 3461 would augment the agencies' existing Ombudsman offices with a separate and independent Office of Examination Ombudsman that would operate as a component of the FFIEC.[3] This office would be authorized to investigate complaints and receive appeals directly from bankers. It would also be charged with holding periodic meetings to obtain feedback from bankers on examination policies and practices and to conduct a regular program on examination quality assurance for all examination types conducted by the federal regulatory agencies.[4]

These provisions of H.R. 3461 would create a new federal bureaucracy – a program office in the FFIEC that will need to be funded and staffed. It also could have

[3] The FFIEC is an interagency body with six voting members: a Governor of the Board of Governors of the Federal Reserve System, the Chairman of the Federal Deposit Insurance Corporation, the Chairman of the Board of the National Credit Union Administration, the Comptroller of the Currency, the Director of the Consumer Financial Protection Bureau, and the Chairman of the State Liaison Committee. The Council's activities are supported by interagency task forces and by an advisory State Liaison Committee, comprised of five representatives of state agencies that supervise financial institutions.

[4] Certain provisions, such as quality assurance reviews of examination practices, would not apply to the Consumer Financial Protection Bureau or state financial regulators.

the unintended consequence of substantially prolonging and adding complexity and costs to the examination process. We believe there are better ways to achieve an effective and independent appeals process that would not involve these downsides. The alternatives we envision would provide an independent and empowered appeals process within each agency. This maintains appropriate agency accountability for the actions it ultimately takes, and would avoid creating a process that could forestall needed corrective actions for up to six months or longer.

In its 2011 policy position paper[5] and in previous correspondence[6] with the OCC, the American Bankers Association (ABA) noted that an effective ombudsman-run agency appeals process has several important characteristics: 1) independence, functioning outside of the supervision area with a direct reporting line to the head of the agency; 2) the authority to suspend or overrule an exam finding, subject only to the final determination by the agency head, and authority to conduct an independent review of post-exam surveys; 3) expertise and sufficient staff that is seasoned and well-respected within the agency; and 4) established processes and time frames following the resolution of an appeal and again after the next examination to see if the bank perceives any examiner retribution, with reports of such reviews provided to the head of the agency and the head of supervision. The ABA also noted the value of having more informal means for a banker to appeal examination findings and to identify issues or practices where there

[5] A copy is available at: http://www.aba.com/Issues/Issues_ExaminationReview.htm.

[6] Letter from Wayne A. Abernathy, Executive Vice President, Financial Institutions Policy and Regulatory Affairs, American Bankers Association, to John C. Dugan, Comptroller of the Currency (January 31, 2008).

appears to be a disconnect between the agency's stated supervisory policies and how those policies are being implemented in the field.

We support the principles for an open and fair appeals process as outlined by the ABA. Indeed, these characteristics are consistent with the OCC's current approach, which works well.

National banks and federal savings associations currently can file appeals with the deputy comptroller that oversees their local supervisory office or directly with OCC's Ombudsman's office. If a banker disagrees with the decision of an appeal filed through the supervisory channel, the banker may subsequently appeal the matter to the Ombudsman.

The OCC's Ombudsman is fully independent of the supervisory process, and reports directly to the Comptroller, not to a supervisory committee or other group that must ratify his decision. In this regard, the OCC's Ombudsman has direct decision-making authority and is empowered to obtain directly whatever information he believes is needed to make a decision. The scope of the Ombudsman's authority includes examination ratings and findings, including items identified in an examination report as a matter requiring attention, the adequacy of loan loss reserves, and appropriateness of loan classifications. With the consent of the Comptroller, the Ombudsman may stay any appealable agency decision or action during the resolution of an appealable matter. The Ombudsman also reports weaknesses in OCC policy to the Comptroller, and makes recommendations regarding changes in OCC supervisory policy. The OCC's Ombudsman is a seasoned national bank examiner with over 20 years of experience and is supported by a dedicated staff of other seasoned bank supervision professionals.

To provide transparency to the appellate process, the Ombudsman's office provides a summary on the OCC's public Web site of every formal appeal it receives and its disposition.

We encourage national banks and federal thrifts to contact the Ombudsman to discuss any agency policy, decision, or action that might develop into an appealable matter. The Ombudsman's objective in these cases is to seek a resolution to the dispute before it develops into a formal appeal. This avenue provides an opportunity for a financial institution to resolve issues in the most efficient and expeditious manner possible.

OCC examiners respect the role the Ombudsman's office plays in the OCC's supervisory process and are familiar with the process for filing and reviewing an appeal of examination findings. They are trained to share that information with bankers when circumstances warrant. The Comptroller and I have made it clear that we will not tolerate actions or statements by an examiner that may suggest that a banker would be subject to any type of retaliation or retribution should he or she raise concerns about their institution's examination. As an additional safeguard, the OCC's Ombudsman's office contacts each appellant bank approximately six months after a decision is rendered to ask whether the bank believes OCC examiners have taken retaliatory action against the bank. In general, this process is completed within 30 days. If the Ombudsman finds evidence that retaliation has occurred, he will refer the complaint for appropriate follow-up.

In addition to administering the OCC's formal appeals process, the Ombudsman's office also assists the agency by administering an optional, confidential questionnaire that bankers can fill out at the end of each of our examinations. This questionnaire helps us to

collect candid feedback on the strengths and weaknesses of our examination processes. Bankers send their responses to the Ombudsman's office to ensure their confidentiality. Depending on the response, the Ombudsman's office may contact the banker to discuss his or her concern or to gather more information. The Ombudsman's office analyzes and shares aggregate responses internally on a semi-annual basis. This feedback is valuable in identifying areas where we may need to make improvements or determine whether there may be "mixed messages" between headquarters and the field.

We welcome the opportunity to share these experiences with the Subcommittee in exploring alternatives to H.R. 3461's approach to an independent appeals process.

Standards for Nonaccrual, Loan Classifications, and Capital Determinations

Assessments of a bank's credit quality as reflected in its nonaccrual and loan classification policies and decisions, and the bank's ability to weather unexpected losses through its capital planning and capital buffers are core elements in ensuring the safety and soundness of financial institutions. H.R. 3461 attempts to provide more clarity and consistency in the regulators' application of nonaccrual, appraisal, classification, and capital standards by, among other provisions, setting forth limitations on when a loan could be placed on nonaccrual status and when a restructured loan would have to be removed from that status. In these cases, it also would prohibit the agencies from directing a bank that meets the Prompt Corrective Action (PCA) definition of "well capitalized" to raise additional capital – regardless of the institution's risk profile.

As I have previously testified, [7] the OCC is committed to providing clear and consistent standards for loan classification and nonaccrual status, and I appreciate the constructive dialogue that I and others at the OCC have had with members of the Subcommittee and their staff on these important issues. Nonetheless, we are concerned that the standards set forth in H.R. 3461 could have several harmful consequences.

First, I would like to provide some clarity regarding the agencies' loan classification and nonaccrual policies. As stated in the agencies' October 2009 policy statement on prudent commercial real estate (CRE) loan workouts, loans that are adequately protected by the current sound worth of the borrower or underlying collateral generally are not adversely classified,[8] i.e., not graded "substandard," "doubtful," or "loss."[9] The policy statement also acknowledges that examiners should not adversely classify performing commercial loans solely because of a decline in value of the underlying collateral as long as there is not a well-defined weakness that jeopardizes repayment. If a loan is classified, bankers and examiners need to consider whether the bank should continue to accrue income on the loan. The determination as to whether a loan should be placed in nonaccrual status is primarily based on an assessment of the collectibility of both principal and interest. Collectibility is the primary basis for these

[7] *See:* Testimony of Jennifer Kelly before the Subcommittee on Financial Institutions and Consumer Credit, Committee on Financial Services, July 8, 2011.

[8] *See: Policy Statement on Prudent Commercial Loan Workouts,* available at: http://www.occ.gov/news-issuances/bulletins/2009/bulletin-2009-128a.pdf, page 7.

[9] The criteria for these classifications can be found in Appendix 4 of the 2009 CRE policy statement, page 33.

nonaccrual policies, because GAAP prohibits the recognition of income if collectibility is not reasonably assured.[10]

Determining whether a loan payment, either principal or interest, is collectible requires judgment on the part of the banker. We are concerned that attempts to impose bright line statutory standards fail to recognize this.

We agree that both collateral value and delinquency status, among other factors, should be considered when assessing whether a loan and interest income are collectible. However, neither of these considerations in and of themselves are sufficient to appropriately assess collectibility. These decisions require an understanding of the loan's term and structure and the borrower's historical and future ability to repay both principal and interest – factors that require considerable judgment based on each loan and borrower's specific facts and circumstances. Removing this judgment from the examination process, the OCC believes, could constrain an examiner's ability to ensure that bankers are preparing financial statements that accurately reflect the condition of their loan portfolio and conform to GAAP. Tying the hands of examiners on these core supervisory judgments, in our view, undermines an essential element of the supervisory process.

As the agencies noted in the 2009 CRE guidance, as the primary sources of loan repayment decline, the importance of the collateral's value as a secondary repayment source increases. We are concerned that H.R. 3461 oversimplifies this important

[10] In accordance with GAAP, the recognition of income involves consideration of two factors: (1) being realized or realizable, and (2) being earned. The first consideration is generally more difficult for financial institutions because it requires an assessment of collectibility. If collection is not reasonably assured, recognition of income, including interest income, is not appropriate.

distinction. H.R. 3461's treatment of commercial loans where there has been a decline in collateral values highlights this problem. For example, the bill adds to the FFIEC Act of 1978 (the FFIEC Act) a new section 1013(a)(1) which directs that a commercial loan shall not be placed in nonaccrual status solely because the collateral for such a loan has deteriorated in value. This is problematic because for many CRE loans the collectibility of the loan is inextricably linked to the value of the collateral, as the sale of the collateral is the primary or sole source of the loan's repayment. In these cases, understanding the current value of the collateral is critical to assessing the collectibility of both principal and interest. Continuing to recognize interest income on such loans despite evidence that the income will never be collected in cash is inconsistent with GAAP.

H.R. 3461's treatment of when a loan could be removed from nonaccrual status presents similar concerns and potential inconsistencies with GAAP as it focuses solely on a borrower's current performance. As previously noted, while a borrower's current performance is certainly a key variable in making an assessment of collectibility, a banker must also consider the borrower's continued capacity to meet the loan's terms in the future. For example, it is common for many construction loans to be structured with an "interest reserve" for the construction phase of the project, with the lender recognizing interest income from the reserve. Proceeds from the sale of lots, homes, buildings or permanent financing based on stabilized occupancy are used for the repayment of principal, which includes any draws from the interest reserve that have been capitalized into the loan balance. However, if the development of the project stalls and bank management fails to evaluate the collectibility of the loan, interest income will continue to be recognized from the initial interest reserve and capitalized into the loan balance

even though the project is not generating sufficient cash flows to repay the principal. In such cases, the loan will be contractually current but collection of principal and interest may not be reasonably assured.

In both instances, the bill would require a divergence from GAAP that could result in the overstatement of income and therefore, regulatory capital. As noted before, similar consequences of regulatory accounting practices were prevalent in the savings and loan crisis that led Congress to pass FDICIA.

Section 1013(b) of the FFIEC Act added by H.R. 3461 would prohibit the regulatory agencies from requiring a financial institution that is "well capitalized" to raise additional capital in lieu of an action prohibited under Section 1013(a). A lesson learned from the recent crisis is that the PCA definition of "well capitalized" does not provide a sufficient capital buffer to maintain a bank's viability in the face of higher levels of risk. This is especially true for community banks that may have a concentration of exposures to certain types of borrowers or industries and geographic areas. We also know that raising capital becomes more difficult as a bank's condition deteriorates and that declining capital ratios often are a lagging indicator of increasing risk in the bank's assets. That is why we direct banks with significant concentrations, or deteriorating asset quality that may pose a risk to their capital, to increase capital before their capital levels breach regulatory minimums – at a stage when they are able to take action to ensure that they can continue to lend to sound borrowers. Such determinations, however, are not made arbitrarily or unilaterally by an individual examiner. Directives to increase capital require multiple layers of management review and concurrence at the OCC.

Restricting the ability of bank regulators to direct institutions with higher risk profiles to hold higher levels of capital undermines a key provision of PCA and is contrary to the recommendation of the Government Accountability Office that the agencies consider additional measures – including higher capital thresholds – to require early and forceful regulatory action to address unsafe banking practices.[11]

Section 1013(c) of the FFIEC Act added by H.R. 3461 would also require the agencies to develop and apply identical definitions and reporting requirements for nonaccrual loans. In this regard, I would simply note that the agencies already have uniform loan classification standards. Likewise, the agencies' Call Report Instructions set forth common definitions and standards for determining when a loan should be reported as nonaccrual for financial reporting purposes.

Timely Examination Communications

H.R. 3461 would establish statutorily mandated time frames for conducting exit interviews and issuing reports of examinations. Exit interviews – and thus completion of the examination – would generally be required within nine months after the start of the examination, and a final examination report issued no later than 60 days after the later of the exit interview or the provision of additional information by the bank. While the OCC shares the goal of ensuring timely and efficient examinations, we are concerned that hardwired statutory deadlines could have unintended consequences. We are particularly concerned that such mandates could undermine our objectives of ensuring that all

[11] *See:* GAO, *Bank Regulation: Modified Prompt Corrective Action Framework Would Improve Effectiveness,* GAO 11-612 (Washington D.C.: June 2011).

relevant information about a bank's condition is considered before we reach and issue final conclusions. Similarly, when an examination raises complex policy or legal issues, it is critical that our policy and legal staff have sufficient opportunity to review and provide direction. Such deliberations may often involve consultations with our regulatory colleagues to help ensure consistency in our supervision.

H.R. 3461 would allow an exception to these provisions by providing written notice to the bank and the proposed FFIEC's Office of Examination Ombudsman. The involvement of the proposed external Ombudsman in this facet of bank supervision simply accentuates the concerns we have expressed about the creation of a new bureaucracy and unduly complicating and delaying necessary examination activities. Indeed, engaging an Ombudsman's office at this stage could taint an Ombudsman's independence should a bank want to file a formal appeal once a final report is issued.

It may be helpful to briefly describe the OCC's processes to ensure open and frequent communication with the banks we supervise, before, during, and after our on-site examinations. Our goal in maintaining ongoing communication is to avoid surprises or misunderstandings about the OCC's assessment of, or expectations for, a bank and to keep bank management fully informed of our supervisory activities. Our examiners meet with bank management at the start of each examination to discuss the purpose and scope of the examination and to answer any questions that bank management may have. Throughout the examination, examiners hold periodic meetings with bank management to discuss and seek clarification about potential issues. Such communication helps to prevent misunderstandings and allows bank management to provide additional information on substantive issues.

Examiners review their preliminary examination conclusions and potential matters that require attention with bank management before leaving the bank. If there are open issues, examiners will generally provide bank management with an opportunity to provide additional information before the formal examination report is completed and issued. While examiners will typically establish a deadline for providing the additional information to allow timely finalization of conclusions, we do not have arbitrary time frames for management responses, and we will generally work with bank management teams that have shown a commitment to being responsive. We will not however, allow bank management to unnecessarily delay finalization of our conclusions in order to forestall necessary corrective actions.

Once an examination is completed, and any additional information from bank management has been received and considered, we strive to complete and issue our formal Report of Examination as quickly as possible. Examination conclusions for problem banks receive additional levels of review. While this additional level of review may lengthen the time required to issue the report, we believe it is an important safeguard to ensure consistency and balance in our examination decisions. In these cases, our local offices keep bank management informed of the status of the review process. If material changes are made as a result of this review, we will meet with bank management to discuss those changes before the final report is issued and to give bank management an additional opportunity to present their perspective on the findings and to address any factual errors we may have made. When the Report of Examination has been finalized and issued to the bank, the Examiner-in-Charge and an OCC manager with direct responsibility for the supervision of the institution will meet with the board to review the

findings, answer questions, and discuss any required corrective actions, including the OCC's plans for supervisory follow-up on those issues prior to the next examination.

Conclusion

In conclusion, let me reiterate the OCC's strong commitment to fair, timely, and balanced supervision, and our willingness to work with the Subcommittee to explore alternative approaches that would achieve goals we share, without raising the types of concerns we have identified.