

Remarks by
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Thank you. It's a pleasure to be here today with a group that includes so many community banks and thrifts, and to have an opportunity to talk about the challenges you face and some of the issues that are drawing attention in Washington. As you know, the vast majority of the banks and thrifts we supervise at the OCC are community institutions. Their supervision is the principal occupation of the OCC, and we devote the preponderant share of our resources to it. More than that, however, they're important to the economic vitality of our nation. They are the financial backbone of towns and cities across America, and they play an outsized role in the funding of small businesses, which in turn are responsible for an important share of new job creation.

So there is a widely shared interest in ensuring the success of community banks and thrifts. But times remain challenging. While we are seeing hopeful signs of an improving economy, many of you are still dealing with problem loans, and nearly everyone is having trouble finding creditworthy borrowers. The industry as a whole is still in the process of coming to terms with the new regulatory requirements of the Dodd-Frank Act, and those of you who manage thrifts are learning to deal with a new regulator.

We've done our best to make that process as seamless as possible, but it's still a significant transition for everyone.

With so many challenges, it's not surprising that industry groups and lawmakers are looking for ways to ease some of the burden that community institutions face, including regulatory burden. One such effort is the Financial Institutions Examination Fairness and Reform Act, which was introduced in both the House of Representatives and the Senate with strong backing from the ABA, and I'd like to spend the rest of my time today discussing this piece of legislation and the issues it raises.

The bill does three things. It seeks to ensure that banks have access to a fair and independent process to appeal examiner findings. It calls for timely examinations and prompt communication of exam results. And it would revise the standards that are now used to classify loans and place them on nonaccrual status and restrict supervisory discretion in a number of ways, including when we can require additional capital and reserves.

The OCC has now testified on several occasions about the serious concerns we have with this bill and similar legislation, so you may be surprised to hear that we agree with key goals that the legislation seeks to accomplish. Exam results should be communicated promptly, and every banker should have an avenue available to appeal those findings without fear of retaliation. But I don't believe that this bill, as it is currently drafted, is the best way to accomplish either objective, and other parts of the bill are very troubling.

For example, the bill would mandate time frames for conducting exit interviews and issuing Reports of Examination. 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 would be required no later than 60 days after the exit interview, unless additional information was submitted by the bank or thrift.

But there are sometimes good reasons why more time is needed to develop conclusions and issue a final report. For example, some examinations raise complex policy or legal issues, and 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. In the meantime, there is ongoing contact with the bank to keep you informed of the issues under review and progress in resolving them.

Communication is key to the success of the supervisory process, and we at the OCC place tremendous emphasis on open, honest and frequent communication. Our examiners meet with bank management at the start of each examination to discuss the purpose and scope of the exam and to answer any questions that bank management may have. During 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 disagreements, 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, 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.

We have been dealing with a higher than normal level of problem institutions for several years and the complexity of the issues in those banks, coupled with the need for additional levels of review to ensure consistency and balance, has resulted in delays in report issuance. The recent integration of over 600 new institutions from OTS has presented further challenges to completing our exam process as efficiently as we would like to. I assure you we are monitoring our performance carefully and seeking to improve it, but speed has to be balanced with the need for careful review to ensure our written products are accurate and well-supported.

We do think that a bank or thrift's management should have every opportunity to appeal exam findings they disagree with, and I am extremely proud of the process we put in place to address that need. Within the supervisory process itself, I encourage you to take up exam issues that you are unable to resolve to your satisfaction with the Examiner-in-Charge, to any level of the district management chain—the ADC, the Associate Deputy Comptroller, or the District Deputy Comptroller. The alternative route is to work with our Ombudsman, Larry Hattix. Larry is a seasoned national bank examiner with over 20 years of experience, and he's supported by a dedicated staff of experienced bank supervision professionals. Our Ombudsman is empowered to render an independent judgment, and I can tell you that he "calls 'em as he sees 'em." You'll find a summary

on our public Web site of every formal appeal that we receive, and the results show that he calls some for the examiners and some for the bank, including some split decisions.

Larry reports directly to me in his appellate capacity, so he's fully independent of the supervisory process. He has direct decision-making authority and is empowered to obtain whatever information he believes is necessary to make a decision. His office is also responsible for identifying and reporting to me on weaknesses in OCC policy, and he makes recommendations for changes in OCC supervisory policy. In short, he is a strong advocate for fairness in the supervisory process, and an advocate for continuous improvement in our approach to supervision. We have procedures in place to guard against the possibility of retaliation, and I can tell you that we stress to our examiners how important it is to the senior management of our agency that the integrity of this process be respected. Federally chartered institutions should not hesitate to avail themselves of the services of the Ombudsman if there is an issue you feel needs review. You won't know if the process works unless you try it.

Now, while we believe firmly in the importance of an independent appeals process, I don't agree with the approach taken in the proposed legislation. The bill would add another appeals process on top of all that I have just described. This would require creation of a new federal bureaucracy— a program office in the FFIEC that will have to be newly funded and staffed, since the Council has no such capacity. It also could have the effect of substantially prolonging the examination process, which another part of the bill attempts to speed up. We believe the better and more efficient course is to ensure an independent and empowered appeals process within each agency. This avoids additional

bureaucracy, maintains appropriate agency accountability for the actions it ultimately takes, and would avoid delaying needed corrective actions for six months or longer.

Principles for such a process were set forth by the ABA in a 2011 policy paper: the appeals process should be independent; function outside the supervision area; report directly to the agency head; and have authority to suspend or overrule an exam finding, subject only to final approval of the agency head. The OCC's process fits those principles and the others outlined in the paper, and the ABA has acknowledged the strengths of our process. We are happy to work with industry to strengthen it further.

Beyond the red tape and bureaucracy involved in the proposed solution, what is most troubling is that the legislation would impede our ability to deal with troubled institutions on a timely basis. You may recall that Congress provided that direction to the federal bank and thrift regulatory agencies more than twenty years ago, when we were struggling with another industry-wide crisis. The Prompt Corrective Action regime created at that time has been an important contributor to timely regulatory action when institutions get into financial trouble.

In response to that earlier crisis, Congress also concluded, correctly in my view, that the savings and loan crisis was made worse by the use of non-GAAP accounting. The non-standard accounting allowed troubled institutions to mask their true condition until so many of them were in such deep trouble that a massive bailout was needed.

We at the OCC believe firmly in the importance of clear and consistent standards for accounting for troubled loans. The problem with this legislation is that it would remove supervisory judgment from this critical area and tie the hands of the banking agencies. It would set standards governing when a loan could be placed on nonaccrual

status and when it 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, or PCA, definition of “well capitalized” to raise additional capital— regardless of the institution’s risk profile.

Let me start with the issue of when a loan should be placed on nonaccrual status. The primary determinant here is collectability, since GAAP standards prohibit the booking of income if it is not reasonably assured that the loan is collectible.

This is where judgment is needed. These are decisions that require an understanding of the loan’s term and structure, and the borrower’s ability to repay both principal and interest, and those calls involve judgments by seasoned bankers. We recognize that, and we expect our examiners to exercise judgment as well in assessing those decisions. Tying the hands of examiners on these core supervisory judgments would hamper their ability to ensure that an institution’s financial statements accurately reflect the condition of its loan portfolio.

There’s also a danger in trying to define supervisory practices in legislation. On the issue of collateral, for example, the bill includes language that is similar to what can be found in our 2009 policy statement on prudent CRE loan workouts: a loan should not be classified simply because the value of the collateral has deteriorated. However, for many CRE loans, the value of collateral is inextricably linked to collectability. This is often the case for construction and development loans where the primary source of repayment is the proceeds from the sale of the developed property. The loan is repaid when the property is sold, and the developer’s business plan assumes that properties can

be sold at a certain value. If the value of the property falls too far, it may be impossible for the borrower to repay the loan in full.

Likewise, a project might stall completely, but interest payments could continue to be funded through an interest reserve. In such cases, the loan will be contractually current, but collection of principal and interest is far from being reasonably assured. In both cases, the legislation requires a divergence from GAAP that could result in the overstatement of income and therefore, regulatory capital.

The bill would also prohibit the regulatory agencies from requiring a financial institution that meets the Prompt Corrective Action definition of “well capitalized” to raise additional capital. One of the most painful lessons of the financial crisis was that the PCA definition of “well capitalized” does not provide a sufficient capital buffer to maintain the viability of a bank or thrift in the face of higher levels of risk. This is especially true for community banks and thrifts 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 financial institution’s condition deteriorates and that declining capital ratios often are a lagging indicator of increasing risk in the institution’s assets. That’s why we direct banks and thrifts with significant concentrations or deteriorating asset quality, to increase capital when they are best able to do so— that is, before their capital levels breach regulatory minimums. These 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, and so there are already very strong safeguards in place that apply to these important decisions.

Tampering with these key areas of judgment and distorting regulatory outcomes risks a repeat of past errors. I come to this conclusion having spent most of my adult life working on banking issues, as a member of the Senate Banking Committee staff in the late 1980s, as director of the Group of 30 and, for the past seven years, at the OCC. I've watched the industry go through the ups and downs of the business cycle, and I've watched it weather two major disruptions—the banking and thrift crisis of the late 1980s and early 1990s, and the financial crisis that began in 2008 and continues to be felt today.

After that earlier crisis, Congress put safeguards in place that we hoped would be sufficient to guard against another crisis. The Financial Institutions Recovery, Reform and Enforcement Act, or FIRREA, and the Federal Deposit Insurance Corporation Improvement Act, or FDICIA, eliminated an accumulation of legislated interventions in valuation and resolutions, instituted important reforms like PCA, and required transparent and accurate accounting. Ultimately those steps were not sufficient to prevent the recent market crisis, but they provided important tools to keep some problems at bay. I would be deeply concerned about taking a step back from those reforms. For some community banks and thrifts, the provisions dealing with capital and nonaccrual loans could mask problems until it is too late to deal with them. We've been down that road before, and I, for one, do not want to make a return visit.

Despite these very serious concerns with the proposed legislation, we are more than willing to look for ways to strengthen and streamline the process in ways that do not sacrifice safety and soundness. We at the OCC stand ready to engage with the industry, with legislators, and with our colleagues at the other financial regulatory agencies, to do just that.

Thank you for your attention. I'd be happy to take your questions.