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TESTIMONY OF  
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Before the

FINANCIAL INSTITUTIONS SUBCOMMITTEE  
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS  
UNITED STATES SENATE

April 6, 2011

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.

## **I. Introduction**

Chairman Brown, Ranking Member Corker, and members of the Subcommittee, my name is Jennifer Kelly. I have been a commissioned national bank examiner for 27 years, and I am currently the Senior Deputy Comptroller for Midsize and Community Bank Supervision for the Office of the Comptroller of the Currency (OCC), reporting directly to the Comptroller. In this capacity, I serve as the senior OCC official responsible for community bank supervision. I appreciate this opportunity to discuss the current state of the community banks the OCC supervises and the impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) on those institutions.

My testimony first presents an overview of the OCC's approach to the supervision of national community banks, then addresses the present state of community banks, and concludes by sharing our perspective on the likely effects of the Dodd-Frank Act on community banks.

Let me say first that community banks 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. While we have been through an extremely difficult economic cycle that has been challenging for institutions of all sizes, I am pleased to report that conditions are beginning to stabilize for community banks, and we are seeing these institutions return to profitability. As a result, the vast majority of these banks will continue to play a vital role in supporting their communities and the nation's financial system.

## **II. OCC's Approach to Community Bank Supervision**

The OCC supervises over 1,200 community banks with assets under \$1 billion; more than 800 of those banks have less than \$250 million in assets. On July 21, in accordance with the Dodd-Frank Act, the OCC will assume responsibility for the supervision of approximately 664 federal savings associations – including 220 mutuals – with total assets of just over \$912 billion. Since the overwhelming majority of those thrifts are community institutions, the number of community institutions we supervise will increase by more than half later this year. These institutions are integral to local economies throughout the country, and we remain deeply committed to their safe and sound operation.

The OCC's community bank supervision program is built around our local field offices. Approximately 75 percent of our examination staff is dedicated to the supervision of community institutions. These examiners are based in over 60 cities throughout the United States in close proximity to the banks they supervise. Every national community bank is assigned to an examiner who monitors the bank's condition on an on-going basis and who serves as the focal point for communications with the bank. The primary responsibility for the supervision of individual community banks is delegated to the local Assistant Deputy Comptroller (ADC), who is under the oversight of a district Deputy Comptroller who reports to me. When we assume responsibility for federal savings associations later this year, we will increase the number of ADCs by more than 20 and open additional field offices.

Our structure ensures that community banks receive the benefits of highly trained bank examiners with local knowledge and experience, along with the resources and specialized expertise that a nationwide organization can provide. While our bank supervision policies and procedures establish a common framework and set of expectations, our examiners are taught to tailor their supervision of each community bank to its individual risk profile, business model, and management strategies. As a result, our ADCs are given considerable decision-making authority, reflecting their experience, expertise and their “on-the-ground” knowledge of the institutions they supervise.

We have mechanisms in place to ensure that our supervisory policies, procedures, and expectations are applied to community banks in a consistent and balanced manner. Every report of examination is reviewed and signed off by the responsible ADC or Deputy Comptroller before it is finalized. In those cases where significant issues are identified and an enforcement action is already in place, or is being contemplated, additional levels of review occur prior to finalizing the examination conclusions. We also have formal quality assurance processes that assess the effectiveness of our supervision and compliance with OCC policies through periodic, randomly selected reviews of the supervisory record. This is done with oversight by the Enterprise Governance Unit that reports directly to the Comptroller.

A key element of the OCC’s supervisory philosophy is open and frequent communication with the banks we supervise. In this regard, my management team and I encourage any banker that has 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. Our ADCs and Deputy Comptrollers expect and encourage such

inquiries. Should a banker not want to pursue those chains of communication, our Ombudsman's office provides a venue for bankers to discuss their concerns informally or to formally request an appeal of examination findings. The OCC's Ombudsman is fully independent of the supervisory process, and he reports directly to the Comptroller. In addition to hearing formal appeals, the Ombudsman's office provides bankers with an impartial ear to hear complaints and a mechanism to facilitate the resolution of disputes with our supervisory staff.

The OCC recognizes the importance of communicating regularly with the industry outside of the supervision process to clarify our expectations, discuss emerging issues of interest to the industry, and respond to bankers' concerns. We participate in numerous industry-sponsored events, as well as conduct a variety of outreach activities, including Meet the Comptroller events, chief executive officer roundtables, and teleconferences on topical issues. We also offer workshops for bank directors to help them understand and effectively execute their fiduciary responsibilities. In preparation for the transfer of federal savings associations to OCC supervision next July, we recently presented 17 day-long programs for thrift executives in locations around the country to provide information and perspective on the agency's approach to supervision and regulation.

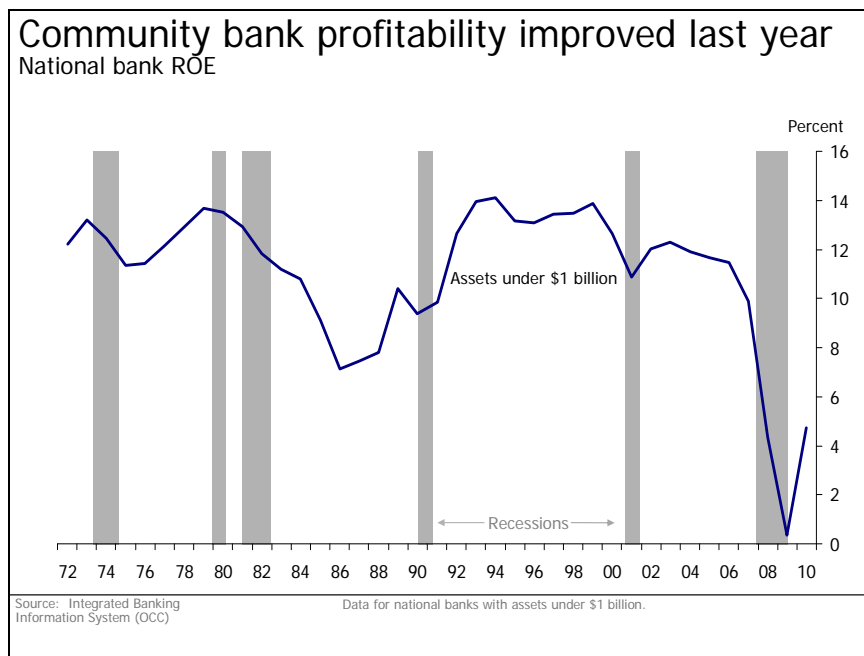
### **III. Current Condition of National Community Banks**

The operating environment for community banks over the last three years has been particularly challenging. Lending activity – the primary revenue source for community banks – has been hampered by the overall economic climate. Although it is

true that many bankers have adjusted and tightened some of their credit underwriting standards, most of the community bankers I talk to reiterate that lending is the backbone of their business and that they are seeking to make loans to creditworthy borrowers. We continue to encourage bankers to lend to such borrowers.

As shown in Chart 1, community bank profitability, as measured by return on equity, improved last year after a precipitous decline in the previous two years but remains sharply below historical experience.

Chart 1

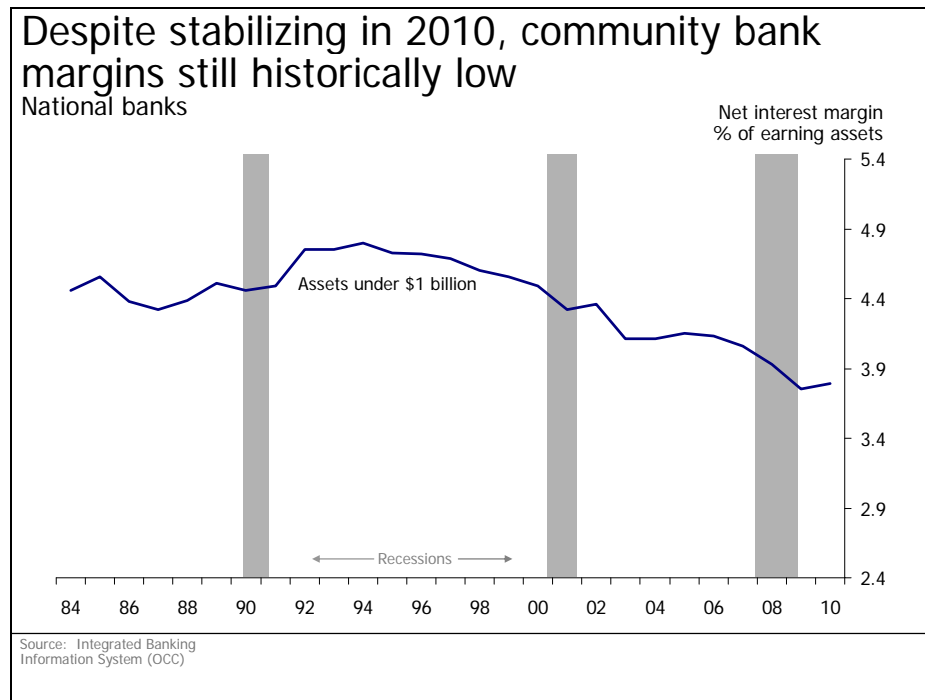


A major factor contributing to the decline in profitability is the continued pressure on community banks' net interest margins. Tepid loan demand and the low interest rate environment are contributing to the decline in these margins: as loans and investments mature, banks are forced to replace them with lower yielding assets. While the rates

banks pay for certificates of deposit and other funding sources have also declined, many core deposits are already at extremely low rates, leaving little room for further declines.

As a result, community banks' margins are at historical lows (see Chart 2).

Chart 2



Elevated levels of problem loans are also hampering community banks' financial performance as banks have had to increase their loan loss reserve provisions to cover loan losses. As shown in Chart 3 on the next page, the net effect of these factors has been a strain on community banks' net income.

Although similar trends are evident for the entire industry, they pose more difficult challenges for small institutions because large banks have more diverse revenue streams and greater economies of scale. When margins are under pressure, other sources

of revenue take on greater prominence. But those other sources of income are also under pressure right now.

Chart 3

Community bank profitability up in 2010 but provisions remain high				
National banks				
Assets under \$1 B				
\$ billions				
Major income components	2007	2008	2009	2010
<b>Revenues</b>				
Net interest income	8.4	8.7	8.8	9.0
Noninterest income	3.3	3.3	3.4	3.3
Realized Sec. G/L	-0.0	-0.3	0.0	0.1
<b>Expenses</b>				
Provisioning	0.5	1.4	2.3	1.6
Noninterest expense	8.0	8.5	9.2	9.1
Income Taxes	0.7	0.3	0.2	0.4
Net income	2.4	1.5	0.6	1.4

Source: Integrated Banking Information System (OCC) Data are merger-adjusted and held constant for banks in operation from 1Q:06 to 4Q:10.

Notwithstanding these pressures, the vast majority of national community banks remain strong: three-quarters of the community banks we supervise have supervisory – or CAMELS – ratings of 1 or 2, reflecting their sound management and strong financial condition.<sup>1</sup> These banks have successfully weathered the recent economic turmoil by focusing on sound banking fundamentals: strong underwriting practices, prudent limits on loan concentrations, and stable funding bases.

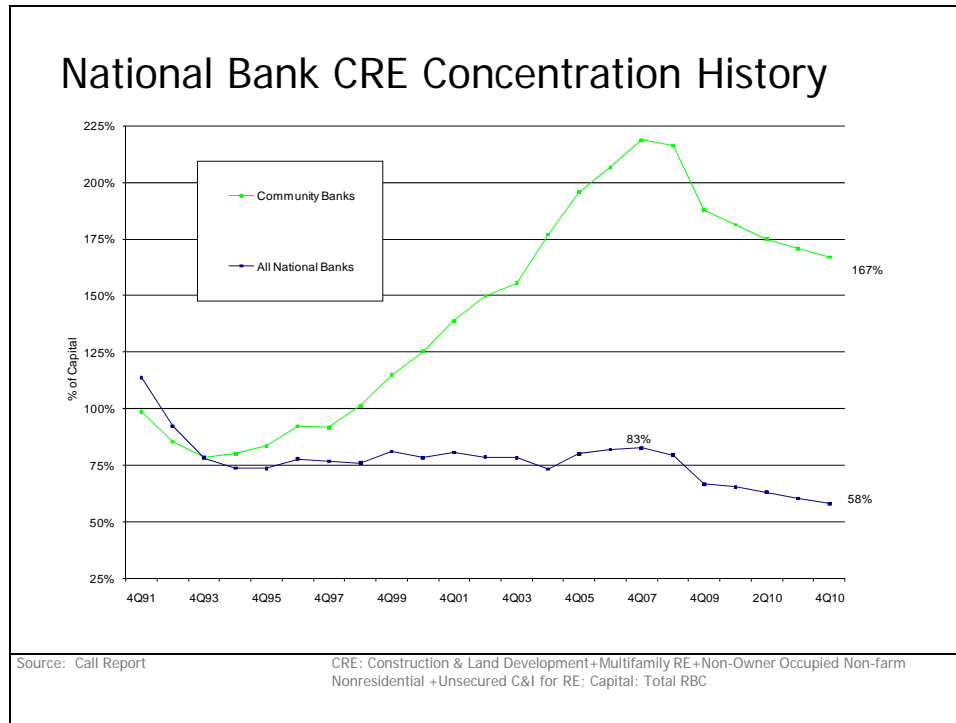
There remains, however, a sizeable segment of community banks that are experiencing more severe financial strains, primarily due to their exposures to the

<sup>1</sup> The Uniform Financial Institutions Rating System is commonly referred to as CAMELS. CAMELS is an acronym that is drawn from the first letters of the individual components of the rating system: Capital adequacy, Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk.



commercial real estate (CRE) markets. As shown in Chart 4, although CRE concentrations as a percentage of capital have trended downward for all national banks, they are still significant for many community banks.

Chart 4



CRE lending is an important product for both small banks and the communities they serve, but CRE concentrations have played a prominent role in most of the problem community banks that we supervise. The timing and effect of the distressed CRE market on individual banks' overall financial condition has varied by the size, location, and type of CRE exposure of the bank. For example, rapid deterioration of construction and development loans led the performance problems in the CRE sector and thus banks with heavier concentrations in this segment tended to experience losses at an earlier stage. Performance in this segment is expected to improve more rapidly as the pool of potentially distressed construction loans has diminished. Conversely, banks whose

lending is more focused on income-producing commercial mortgages, including many smaller community banks, are continuing to experience an increase in problem loans and charge-off rates.

Although commercial property markets across the nation have begun to show signs of stabilization, net operating income (NOI), which is one of the key drivers for CRE property values and the primary source for loan repayment, continues to decline across most CRE sectors. This translates to potential for additional losses in income-producing CRE loans which is a significant issue for community banks since that loan category is twice as large as the construction and development portfolios in aggregate.

The OCC has been raising and addressing concerns about the CRE market and, in particular, the concentrated exposures that many community banks have to this market, since early 2004 when we initiated the first of a series of targeted examinations at banks that we believed were at significant risk due to the nature and scope of their CRE activities. These supervisory efforts have continued with various targeted examinations and reviews at national banks with significant CRE concentrations. Key objectives of our CRE examinations are to ensure that bank management recognizes and addresses potential problems at the earliest stage possible—when workout efforts are likely to be most successful—and that previously identified deficiencies and shortcomings in risk management practices have been addressed. In this regard, I want to stress that the OCC has and continues to encourage bankers to work constructively with borrowers who are facing difficulties. We firmly believe that prudent CRE loan workouts are often in the best interest of the financial institution and the borrower, and it has been our longstanding policy that examiners will not criticize prudent loan workout arrangements. This does

not mean, however, that examiners will allow bankers to ignore loans with structural weaknesses or insufficient cash flows to support repayment. While we encourage bankers to work with troubled borrowers, we also insist that banks maintain the integrity of their financial reporting by maintaining appropriate loan loss reserves and capital and, when warranted, taking appropriate charge-offs.

#### **IV. Challenges Presented for Community Banks by the Post-Crisis Regulatory Environment**

As is commonly observed, the Dodd-Frank Act resulted in the most comprehensive reform of the United States financial system in decades. Some of the best-known changes will primarily affect the largest banking institutions – for example, the new requirements to be imposed on “systemically significant” institutions; the so-called “Volcker Rule” constraints on proprietary trading and investments in hedge funds and private equity funds; new restrictions on derivatives activities; and shifting more of the cost of deposit insurance to large banks. But other requirements within the Act broadly amend banking and financial laws in ways that affect the entire banking sector, including community banks.

The challenges banks face have several dimensions: new regulation – both new restrictions and new compliance costs – on businesses they conduct, limits on revenues for certain products, and additional regulators administering both new and existing regulatory requirements. In the context of community banks, a particular concern will be whether these combine to create a tipping point causing banks to exit lines of business

that provide important diversification of their business, and increase their concentration in other activities that raise their overall risk profile.

For example, the Dodd-Frank Act imposes a range of new requirements on the retail businesses that are “bread-and-butter” for many community banks. The costs associated with small business lending will increase when new HMDA-style reporting requirements become effective. Longstanding advisory and service relationships with municipalities may cause the bank to be deemed a “municipal advisor” subject to registration with the Securities and Exchange Commission (SEC) and rules issued by the SEC and the Municipal Securities Rulemaking Board. And checking account relationships with customers are likely to be re-shaped to recover the costs associated with providing debit cards if debit interchange fees are restricted.

The new Consumer Financial Protection Bureau (CFPB) is charged with implementing new requirements that will affect banks of all sizes. These include new standards for mortgage loan originators; minimum standards for mortgages themselves; limits on charges for mortgage prepayments; new disclosure requirements required at mortgage origination and in monthly statements; a new regime of standards and oversight for appraisers; and a significant expansion of the current HMDA requirements for mortgage lenders to report and publicly disclose detailed information about mortgage loans they originate (13 new data elements).

The CFPB is also authorized to issue new regulations on a broad range of topics, including, but not limited to:

- additional disclosure requirements to “ensure that the features of any consumer financial product or service, both initially and over the life of

the product, are fully, accurately, and effectively disclosed to consumers in a manner that permits consumers to understand the costs, benefits, and risks associated with the product or service, in light of the facts and circumstances”;

- new regulations regarding unfair, deceptive or “abusive” practices; and
- standards for providing consumers with electronic access to information (retrievable in the ordinary course of the institution’s business) about their accounts and transactions with the institution.

While we strongly support clearer, more meaningful, and accessible consumer disclosures, it is important to recognize that the fixed costs associated with changing marketing and other product-related materials will have a proportionately larger impact on community banks due to their smaller revenue base. The ultimate cost to community banks will depend on how the CFPB implements its new mandate and the extent to which it exercises its exemptive authority for community banks.

Community banks also may be particularly impacted by the Dodd-Frank Act’s directive that Federal agencies modify their regulations to remove references to credit ratings as standards for determining creditworthiness. This requirement impacts standards in the capital regulations that are applicable to all banks. National banks are also affected because ratings are used in other places in the OCC’s regulations, such as standards for permissible investment securities. As a result, institutions will be required to do more independent analysis in categorizing assets for the purpose of determining applicable capital requirements and whether debt securities are permissible investments –

a requirement that will tax especially the more limited resources of community institutions.

The Dodd-Frank Act restrictions on corporate governance apply to community banks as well as larger institutions. Banks that are public companies will be subject to several new requirements on compensation, including shareholder “say on pay” votes, disclosures on performance-based compensation arrangements, and compensation clawbacks for accounting restatements.

Regardless of how well community banks adapt to Dodd-Frank Act reforms in the long-term, in the near- to medium-term these new requirements will raise costs and possibly reduce revenue for community institutions. The immediate effects will be different for different banks, depending on their current mix of activities, so it is not possible to quantify those impacts with accuracy. In the longer term, we expect to see banks adjust their business models in a variety of ways. Some will exit businesses where they find that associated regulatory costs are simply too high to sustain profitability, or they will decide how much of the added costs can, or should, be passed along to customers. Others will focus on providing products and services to the least risky customers as a way to manage their regulatory costs. Some will elect to concentrate more heavily in niche businesses that increase revenues but also heighten their risk profile. While we know there will be a process of adaptation, we cannot predict how these choices will affect either individual institutions or the future profile of community banking at this stage.

## **V. Conclusion**

Community banks play a critical role in providing financial services to our nation's communities and businesses. The OCC is committed to providing balanced and fair supervision of nationally-chartered community banks and the federal savings associations that we assume responsibility for in July.

We are mindful of the economic challenges, and the regulatory and compliance burdens facing community banks, and that implementation of the Dodd-Frank Act may accentuate these challenges. It is our goal to implement the Dodd-Frank Act in a manner that accomplishes the legislative intent without unduly harming the ability of community banks to fulfill their role of supporting local economies and providing the services that their customers rely on. It will be extremely important that we hear from community banks during the notice and comment process of our rulemaking efforts to help determine whether we achieved this goal and whether additional changes or alternatives could be considered to lessen the burden on community banks.