

For Release Upon Delivery

9:30 a.m., July 8, 2011

TESTIMONY OF
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Before the

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT
COMMITTEE ON FINANCIAL SERVICES
U. S. HOUSE OF REPRESENTATIVES

July 8, 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.

Introduction

Chairman Capito, Ranking Member Maloney, and members of the Subcommittee, my name is Jennifer Kelly. I appreciate the opportunity to appear before the Subcommittee on Financial Institutions and Consumer Credit to discuss the supervision of insured depository institutions. 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.

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 660 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 banks we supervise will increase by more than half later this month. 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.

A primary goal of our supervision is to ensure that community banks have the strength and capacity to meet the credit needs of their customers and communities. Some bankers have stated that their ability to meet these needs is being constrained by what they regard as overly aggressive regulatory loan classifications and the substitution of

examiner judgment for that of bank management. I appreciate this opportunity to address these concerns and to explain the OCC's approach in assessing the condition of banks' loan portfolios and determining whether a loan should be classified or placed on non-accrual. These assessments are a core component of our examinations and, as my testimony will describe, we strive to make sure that they are fair, balanced, and consistent over time and across institutions. I believe OCC examiners are striking the right balance in encouraging bankers to make loans to creditworthy borrowers, but to also identify and address problem credits. But I recognize that these assessments require considerable judgment and are very fact specific. As a result, my management team and I encourage any banker who believes that examiners failed to fully consider all pertinent information to let us know, either directly through our examiners and supervisory offices, or indirectly through our Ombudsman's office.

My testimony discusses the OCC's supervisory approach to assessing loan quality and performance, and the steps we take to ensure those assessments are fair, balanced, and consistent. Following this discussion, and pursuant to the Subcommittee's request, I will offer the OCC's perspective on H.R. 1723, the proposed Common Sense Economic Recovery Act of 2011, and H.R. 2056, to instruct the Inspector General of the FDIC to study the impact of bank failures.

OCC's Approach to Assessing Loan Quality and Performance

OCC examiners review and assess a bank's loan portfolio during each examination cycle. The primary objectives of these reviews are threefold. First, examiners assess whether the bank has adequate systems to identify, measure, monitor, and control the amount of credit risk in their loan portfolios. A key component of such

systems is the process that the bank uses to monitor and rate the relative risk of their loans. Second, examiners assess whether the bank's financial statements accurately reflect the condition of its loan portfolios and conform to generally accepted accounting principles (GAAP) with regard to loan loss reserves, the accrual of interest income, and the reporting of troubled debt restructurings. Third, examiners assess whether the bank has adequate capital cushions to support the bank's lending activities and credit risk exposures.

When making these assessments, examiners first consider the adequacy of the bank's policies, procedures, and practices to ascertain the degree of reliance that we can place on the bank's own evaluations and assessments. Our goal is to review and confirm bank management's assessments, not to "second guess" or supplant their judgments with ours. Examiners confirm management's assessment through transaction testing of specific loans or loan portfolios. Where weaknesses or deviations from sound practices are found, examiners will direct bank management to take corrective action to ensure that the bank's lending practices are conducted in a safe and sound manner.

With this as background, I will describe the standards that guide examiners' assessments for each of these three areas, and then discuss and clarify some of the common issues we are hearing about how examiners apply those standards and the steps we are taking to ensure our assessments are fair, balanced, and consistent.

A. Credit Risk-Rating and Loan Classifications

The OCC expects national banks to have credit risk management systems that produce accurate and timely risk ratings. How a bank selects and manages its credit risk is critically important to its performance over time; indeed, capital depletion through loan

losses continues to be the proximate cause of most bank failures. Identifying and rating credit risk is the essential first step in managing it effectively.

Well-managed credit risk rating systems promote bank safety and soundness by facilitating informed decision making on matters such as loan selection and underwriting standards, loan pricing, and maintaining adequate loan loss reserves and capital levels. Such systems also serve as important “early warning” indicators for bank management of when a borrower’s or loan facility’s performance may be deteriorating and warrant additional action to improve the likelihood of continued performance. Such action may include a variety of measures, including modification of loan terms and obtaining additional collateral or other forms of support.

Bankers use a variety of systems to “grade” and risk-rate their loan portfolios. To provide consistency in the examination process, the OCC and other banking agencies use a common, uniform risk rating scale to identify problem credits. This regulatory classification system, which has been in use in some form since it was first established in 1938, consists of four levels of designations that identify different degrees of credit weakness, ranging from a potential problem to a more serious actual one.

- Special mention loans have potential weaknesses that deserve management’s close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution’s credit position at some future date. Special mention assets are not adversely classified.
- Substandard loans have well-defined weaknesses that jeopardize the borrower’s ability to continue to make payments or orderly liquidation of the debt. They are

characterized by the distinct possibility that the bank will sustain some loss if the weaknesses are not corrected.

- Doubtful loans have weaknesses that make collection or liquidation in full highly questionable and improbable, but because of specific pending events, its classification as loss is deferred. Doubtful borrowers are usually in default, lack adequate liquidity or capital, and lack the resources necessary to pay principal and interest. Because of their high probability of loss, these loans are placed on nonaccrual status to prevent interest income from being overstated.
- Loans classified as loss are considered uncollectable and of such little value that their continuance as bankable assets is not warranted. Consistent with GAAP, losses are to be recorded in the period that the loan becomes uncollectable.

A loan is considered “classified” when it is rated as either substandard, doubtful, or loss.¹

B. Loan Accrual, Troubled Debt Restructuring, and Loan Loss Reserves

Credit risk rating and loan classification are focused on ensuring that the credit risk of a bank’s loan portfolios is properly identified. Ensuring that those risks are properly reflected in the bank’s financial statements and asset valuations is the function of the bank’s loan accounting policies and procedures. When a loan or borrower shows signs of trouble, there are generally three key accounting concepts that bankers and examiners must consider: whether the loan, for financial reporting statements, should continue to accrue interest or, conversely, be put on nonaccrual status; whether, if the loan is subsequently modified, it should be reported as a “troubled debt restructuring” (TDR); and whether the bank has properly and adequately set aside loan loss reserves for

¹ See the “[Rating Credit Risk](#)” booklet of *The Comptroller’s Handbook* series for a more complete description of the uniform classification system and the OCC’s expectations for bank credit risk rating systems.

any loan impairment.² The OCC and other banking agencies' standards for applying these concepts are governed by GAAP and are contained in the instructions that banks must follow when filing their quarterly Consolidated Reports of Income and Condition (Call Reports).

Examiners review a bank's policies and procedures and its application of those policies as part of each examination. Accurate and transparent financial statements are essential to allow investors, creditors, and regulators to evaluate a bank's overall financial condition. Congress recognized and underscored the importance of ensuring that banks' regulatory reports are accurate when it passed the Federal Deposit Insurance Corporation Improvement Act (FDICIA) in 1991. Section 121 of FDICIA requires that the accounting principles used for regulatory reporting should be no less stringent than GAAP in order to facilitate prompt corrective action to resolve institutions at the least cost to the deposit insurance fund.

- *Nonaccrual Status* – Consistent with GAAP, Call Report Instructions require that a loan be put on nonaccrual status when: 1) payment in full of principal or interest is not expected, or 2) principal or interest has been in default for a period of 90 days or more unless the asset is both well secured and in the process of collection. As noted above, loans that are classified as “doubtful” are placed on nonaccrual status as full payment of principal or interest is not expected. Loans classified as “substandard” may or may not be placed on nonaccrual status, depending on the particular facts and circumstances of the credit and borrower. In many cases, while a substandard loan may have well-defined weaknesses in the primary source of repayment, the bank has

² This discussion assumes that a bank's loan portfolio is accounted for on amortized or historical cost basis. There are some loans or portfolios that are reported at fair value, but the vast majority of loans, especially for community banks, are held at amortized cost.

sufficient collateral or other sources of repayment that reasonably support the ultimate collection of principal and interest. In such cases, maintaining the loan on accrual status would be appropriate. As a general rule, a nonaccrual loan may be restored to accrual status when 1) none of its principal and interest is due and unpaid, and the bank can reasonably expect repayment of the remaining contractual principal and interest, or 2) when it otherwise becomes well secured and in the process of collection.

- *Troubled Debt Restructuring* – Under GAAP, a modification of a loan’s terms constitutes a TDR if the bank, for economic or legal reasons related to the borrower’s financial difficulties, grants a concession to the borrower that the bank would not otherwise consider.³ Not all modifications of loan terms automatically result in a TDR. For example, if the modified loan terms are consistent with market conditions and representative of terms the borrower could obtain in the open market, the restructured loan is not categorized as a TDR. Likewise, designating a loan as a TDR does not, by itself, mean that the loan must be placed on nonaccrual. The accrual status decision of a TDR is a separate and distinct process from the TDR analysis and determination. If the borrower has demonstrated performance under the previous terms and shows the capacity to continue to perform under the restructured terms, the loan will likely remain on accrual. If the borrower was materially delinquent on payments prior to the restructure, but shows potential capacity to meet the restructured terms, the loan would likely remain on nonaccrual until the borrower has demonstrated a reasonable period of performance – generally at least six months.

³ See: Accounting Standards Codification (ASC) 310-40, Receivables – Troubled Debt Restructurings by Creditors.

- *Loan Loss Reserves* – Consistent with GAAP, the OCC expects national banks to maintain an appropriate allowance for loan and lease losses (ALLL). An appropriate ALLL covers estimated credit losses on individually evaluated loans that are determined to be impaired as well as estimated credit losses inherent in the remainder of the loan and lease portfolio. Estimated credit losses mean an estimate of the current amount of loans that it is probable the bank will be unable to collect given facts and circumstances as of the evaluation date. When available information confirms that specific loans, or portions thereof, are uncollectable, those amounts should be promptly charged off against the ALLL.

C. Capital Adequacy

The recent financial crisis has underscored the importance of strong capital buffers in protecting a bank from unforeseen losses and stress events. It is the OCC's long-standing policy that regulatory capital requirements represent minimum capital levels, and that most banks will need to maintain capital levels above these minimums to support their banking activities. When assessing a bank's capital adequacy, examiners consider the bank's internal capital planning and allocation process and risk factors that are not explicitly captured by the agencies' risk-based capital regime. One critical factor is the degree and nature of concentrations that may exist in the bank's loan portfolio. Concentrations of credit exposures that have a high degree of correlation with cyclical changes or economic events can accentuate a bank's risk exposure and therefore generally will require additional capital buffers.

D. Banker Concerns About Examiner Classification and Accrual Decisions

As we work through the current problems in the industry, our messages to examiners continue to be these: Take a balanced approach; communicate concerns and expectations clearly and consistently; and encourage bankers to work with troubled borrowers in a prudent manner and to extend new credit to creditworthy borrowers. This does not mean that bankers can ignore or delay recognition of their credit problems. If a banker is unwilling or unable to take appropriate action to identify and manage the risks in the bank's credit portfolio, examiners will direct bank management to take corrective action. At institutions where bank management has not sufficiently identified or addressed their loan problems, our reviews may result in a bank needing to make additional loan loss provisions; to charge off loans that are deemed loss; or to place loans on nonaccrual where full collection of principal and interest is in doubt. Depending on the specific circumstances, the bank may also be directed to strengthen its credit underwriting or risk identification and management practices.

With this background, let me address some of the specific concerns we are hearing about examiners' actions.

- *Examiners are barring loans to certain borrowers or industries, or are criticizing loans simply because they are located in a state with a high mortgage foreclosure rate or to an industry experiencing problems.*

We expect banks to have robust credit underwriting and risk management processes which, among other things, monitor and control the bank's overall exposure to a particular borrower and industry segment. We also expect bankers to assess how borrowers, and their industries, may perform in stressed economic environments to

ensure that they will continue to have the capacity to perform under the terms of their loan obligations. However, examiners do not criticize loans simply because a borrower is located in a certain geographic region or operates in a certain industry. Each loan must be evaluated based on its own structure, terms, and the borrower's willingness and ability to repay the loan under reasonable terms. Market conditions, however, can influence a borrower's repayment prospects and the cash flow potential of the business operations or underlying collateral, and these are factors that we expect bank management to consider when evaluating a loan.

- *The bank can no longer work with a borrower because the examiner has classified the borrower's loan.*

As previously noted, when a borrower's ability to repay its loan deteriorates or becomes impaired, we expect the bank to "classify" the loan to recognize the increased risk. This means that they move the borrower from a "pass" designation into one of the three categories previously discussed. Although some bankers may infer that they are no longer allowed to extend credit to borrowers whose loans have been classified, this is simply not the OCC's position. We expect and, in fact, encourage bankers to continue working with "classified" borrowers who are viable. An increase in classified loans does not automatically trigger supervisory action – we expect banks to have higher classified loan ratios during economic downturns – provided that bank management is being realistic in its assessments, has reasonable workout plans, and is maintaining adequate loan loss reserves and capital ratios.

- *Examiners are classifying loans to borrowers that are current and can meet their debt obligation – what has sometimes been referred to as “performing non-performing” loans.*

The OCC does not direct banks to classify borrowers that have the demonstrated ability to service both interest and principal under reasonable payment schedules. There are instances, however, where liberal underwriting structures can mask credit weaknesses that jeopardize repayment of the loan. A common example is bank-funded interest reserves on commercial real estate (CRE) projects where expected leases or sales have not occurred as projected and property values have declined. In these cases, examiners will not just accept that the loan is good quality because it is current; instead, they will also evaluate the borrower’s ability to repay the debt within a reasonable timeframe. The agencies’ October 2009 policy statement on CRE loan workouts addresses these situations and provides examples of when classification would and would not be appropriate.⁴ While interest reserves on CRE loans are one common issue, there may be other examples, such as terms that require interest-only payments for extended periods, or the use of proceeds from other credit facilities to keep troubled loans current. Again, in these cases, examiners will consider the totality of the borrower’s credit exposure and debt service obligations.

- *Examiners are criticizing loans or borrowers simply because the current market value of their collateral has declined and are forcing bankers to write down loans to current distressed market values.*

⁴ See: OCC Bulletin 2009-32, “Guidance on Prudent CRE Loan Workouts,” available at: <http://www.occ.gov/news-issuances/bulletins/2009/bulletin-2009-32.html>.

Examiners will not classify or write down loans solely because the value of the underlying collateral has declined to an amount that is less than the loan balance – a point that we reiterated in the October 2009 CRE policy statement and the 2010 interagency statement on small business lending.⁵ For many CRE projects, however, the value of the collateral and the repayment of the loan are both dependent on the cash flows that the underlying project is expected to generate. Because of this linkage, current collateral values can be an important indicator of the project’s viability and can signal changes that will adversely affect the cash flow available to service or repay the loan.

In making loan classification or write-down decisions, examiners first focus on the adequacy of cash flow available to service the debt, including cash flow from the operation of the collateral, support from financially responsible guarantors, or other bona fide repayment sources. However, if these sources do not exist, and the only likely repayment source is sale of the collateral, then examiners will direct the bank to write down the loan balances to the value of the collateral, less estimated costs to sell.

- *Examiners are unduly overreaching and are second guessing bankers and professional independent appraisers.*

One of the areas of greatest controversy during the last significant real estate downturn was the practice of examiners making adjustments to real estate appraisals. We have taken steps to minimize the need for such adjustments during the current cycle. In 2008, in a nationwide teleconference and supervisory memo, we reiterated to examiners that it is management’s responsibility to have updated borrower information and current real estate appraisals. We also noted that a new appraisal may not be necessary in

⁵ See: OCC Bulletin 2010-6, “*Small Business Lending: Meeting the Credit Needs of Creditworthy Small Business Borrowers*,” available at: <http://www.occ.gov/news-issuances/bulletins/2010/bulletin-2010-6.html>.

instances where an internal evaluation by the bank appropriately updates the original appraisal assumptions to reflect current market conditions and provides an estimate of the collateral's fair value for impairment analysis. As noted in the October 2009 CRE policy statement, appropriately supported assumptions are to be given a reasonable degree of deference by examiners. Provided that the appraisal is reasonable, our examiners will not make adjustments or apply an additional haircut to the collateral.

- *Examiners are penalizing loan modifications by aggressively placing loans on nonaccrual status following a modification, even though the borrower has demonstrated a pattern of making contractual principal and interest payments under the loan's modified terms.*

As previously noted, determinations about a loan's accrual status are based on interest income recognition criteria in GAAP. For a loan that has been modified, if the borrower has demonstrated performance under the previous terms and shows the capacity to continue to perform under the restructured terms, the loan will likely remain on accrual. If the borrower was materially delinquent on payments prior to the restructure, but shows potential capacity to meet the restructured terms, the loan would likely remain on nonaccrual until the borrower has demonstrated a reasonable period of performance.

- *Examiners are arbitrarily applying de facto higher regulatory capital requirements, constraining banks' ability to lend.*

In anticipation of rising credit losses, over the last two years the OCC has urged banks to build loan loss reserves and strengthen capital. Indeed, if a bank simply maintained its capital at the minimum level defined by regulation and then incurred unexpected losses, the resulting decline in its capital ratios would immediately trigger the

provisions of Prompt Corrective Action that would constrain the bank's activities. Thus, there are instances where we have directed, and will direct, bank management to maintain higher capital buffers if they choose to have significant risk concentrations. Such decisions, however, are not made unilaterally by a field examiner. Any such directive is reviewed and approved by our district supervision management teams.

E. Ensuring Consistency and Balance in Examiners' Assessments

Given the central role that asset quality plays in a bank's overall safety and soundness, we expend considerable time and resources in providing training and guidance to our examiners on evaluating credit. Loan review and analysis, and the application of appropriate accounting principles, are focal points of every new examiner's classroom and on-the-job training. Topical booklets in *The Comptroller's Handbook* provide detailed examination procedures on various aspects of credit review and lending practices and are available on the OCC's Web site. We offer a variety of continuing educational opportunities for more experienced examiners to ensure that their skills remain current and to keep them abreast of current supervisory policies and expectations and accounting standards. These include various interagency classroom and on-line training opportunities offered through the Federal Financial Institutions Examination Council and topical seminars and conferences.

While our examination force maintains a local presence in the communities national banks serve, our examination policies and emphasis are established and coordinated on a national level. Our examiners are alerted to new policy issuances via weekly updates. When warranted, we supplement these issuances with targeted supervisory memos that provide additional direction on how examiners should implement

those policies or guidelines on a consistent basis across the country. These messages are reinforced and clarified through periodic national teleconferences with our field staff.

We have mechanisms in place to help ensure that our supervisory policies are applied to community banks in a consistent and balanced manner. Every report of examination is reviewed and signed off by an appropriate OCC manager 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. The Enterprise Governance unit that reports directly to the Comptroller oversees this process.

As previously noted, decisions about the proper classification, accrual, and TDR treatment of a loan is fact specific. The examples provided in the 2009 CRE policy statement were designed to provide greater transparency to bankers in how changes in underlying facts or assumptions may affect examiners' assessments. The OCC's Bank Accounting Advisory Series, available on our Web site, provides similar guidance to bankers and examiners by illustrating how various fact patterns will affect accrual, TDR, and ALLL determinations. These examples and fact patterns draw upon frequent issues that examiners encounter and are updated on a regular basis to reflect current situations and accounting standards.

The OCC's supervisory philosophy is to have 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 managers 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.

OCC's Perspectives on H.R. 1723 and H.R. 2056

H.R. 1723 would permit certain loans that would otherwise be treated as nonaccrual loans to be treated as accrual loans for purposes of determining capital requirements or measuring capital of an insured depository institution under the Prompt Corrective Action provisions of the Federal Deposit Insurance Act and other statutory and regulatory requirements. The bill sets forth particular requirements that a loan must meet to be afforded this treatment: the loan must be current and not have been more than 30-days past due during the previous six months; the loan also must be amortizing; and payments made on the loan must not be funded through an interest reserve account.

While we agree with the intent of the bill as described in its title – to support economic recovery – we are concerned that legislation prescribing specific regulatory accounting mechanisms that deviate from GAAP could serve to mask troubled assets. Since the conditions contained in H.R. 1723 address some of the common weaknesses in loan structures that may warrant placing a loan on nonaccrual status, we believe the net effect of this bill on nonaccrual determinations for most community banks could be fairly

limited as most nonaccrual loans would not meet the conditions set forth in the bill. Nonetheless we are concerned that this bill could allow other credit structures, which have similar effects as interest reserves, to support and potentially mask inherent weaknesses in a bank's loan portfolio. More fundamentally, we are concerned that this bill is a step in the direction of regulatory forbearance and, contrary to FDICIA requirements, would create regulatory accounting standards that are less stringent than GAAP for regulatory capital purposes. Such actions, we believe, would undermine a primary objective of FDICIA – prompt corrective action to resolve problem institutions – at a time when independent observers, such as the General Accountability Office, are calling upon bank regulators to consider additional triggers that would require early and forceful regulatory action to address unsafe banking practices.⁶ Such actions could also undermine investor confidence in banks if investors were to conclude that banks were no longer required to recognize troubled assets in an accurate and timely manner.

Additionally, H.R. 1723 requires the Financial Stability Oversight Council (FSOC) to study how to prevent contradictory guidance from being issued by the federal banking agencies to insured depository institutions with respect to loan classifications and capital requirements. This study is to include legislative recommendations that the FSOC believes will prevent such contradictory guidance from being issued. As a member of the FSOC, we would anticipate actively participating in such a study.

The OCC shares Congress's interest in assuring that assessments are fair, balanced, and consistent over time and across institutions. For this reason, we generally coordinate the issuance of regulations, such as those governing capital requirements, and

⁶ See: GAO, *Bank Regulation: Modified Prompt Corrective Action Framework Would Improve Effectiveness*, GAO 11-612 (Washington D.C.: June 2011).

other supervisory guidance such as those related to loan classifications, with the other federal banking agencies. Indeed, as previously noted, the criteria for loan classifications and loan accruals are set forth in interagency guidance and Call Report instructions.

We note that a second, related bill, H.R. 2056, would require the FDIC Inspector General's office to study the effects of certain policies and procedures on the regulation and supervision of institutions facing losses due to deteriorating asset quality, and the ability of those institutions to raise capital through private equity investments. This bill does not require the OCC to take any particular action. However, where the study that the bill requires addresses topics pertaining to institutions directly supervised by the OCC, we believe it would be appropriate for the OCC to be given an opportunity to provide comment before the study is finalized. We stand ready to participate in that process.

Conclusion

The OCC recognizes and shares the Subcommittee's concern that access to credit plays a vital role in restoring economic growth and jobs to our communities, and that banks not be unduly constrained from meeting these credit needs. We are committed to supporting these goals with supervision that is balanced and fair and that does not cause bankers to become too conservative in their lending decisions. At the same time, however, we must avoid forbearance strategies that defer recognition of loss. History has demonstrated that forbearance is not a viable solution during times of economic stress because it leads to larger future losses and more severely troubled banks.