January 26, 2012

Memorandum

To: Members, Committee on Financial Services

From: Committee Staff

Subject: Financial Institutions and Consumer Credit Subcommittee Hearing on "H.R. 3461, the Financial Institutions Examination Fairness and Reform Act."

The Subcommittee on Financial Institutions and Consumer Credit will hold a legislative hearing on H.R. 3461, the Financial Institutions Examination Fairness and Reform Act, at 2:00 p.m. on Wednesday, February 1, 2012, in Room 2128 of the Rayburn House Office Building.

The hearing will examine H.R. 3461, bipartisan legislation introduced by Reps. Shelley Moore Capito and Carolyn Maloney. The bill seeks to achieve the following four goals: (1) to ensure that financial institutions timely receive examination reports and that they are fully informed about the process by which regulators decide contested examination issues; (2) to ensure consistency in examinations; (3) to create an independent ombudsman within the Federal Financial Institutions Examination Council; and (4) to establish a prompt, independent, and fair process through which financial institutions can appeal examination decisions.

This will be a two-panel hearing with the following witnesses:

Panel One

- Mr. Kevin M. Bertsch, Associate Director of the Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System
- Ms. Sandra L. Thompson, Director of the Division of Risk Management Supervision, Federal Deposit Insurance Corporation
- Mr. David M. Marquis, Executive Director, National Credit Union Administration
- Ms. Jennifer Kelly, Senior Deputy Comptroller for Mid-Size/Community Bank Supervision, Office of the Comptroller of the Currency

Panel Two

- Mr. Albert C. Kelly, Jr., President and CEO, SpiritBank on behalf of the American Bankers Association
- Mr. Kenneth Watts, President and CEO, West Virginia Credit Union League on behalf of the Credit Union National Association

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- Mr. Noah Wilcox, President and CEO, Grand Rapids State Bank on behalf of the Independent Community Bankers of America
- Ms. Jeanne Kucey, President and CEO, JetStream Federal Credit Union on behalf of the National Association of Federal Credit Unions
- Witness to be announced

Background

To ensure that financial institutions remain safe and sound while meeting the credit needs of their communities, the federal regulators of financial institutions have broad authority to examine financial institutions. As part of the examination process, federal financial regulators rate financial institutions on several criteria, including safety and soundness[1] and their compliance with legal and regulatory requirements, which includes evaluating their compliance with the Community Reinvestment Act (CRA). Regulators also calculate capital ratios and classify financial institutions according to the adequacy of their capitalization. If an examination reveals that an institution is not complying with the law or that it is undercapitalized, the regulator will assign the institution unsatisfactory ratings or classifications in the institution's examination report. The institution is then subject to penalties that are authorized or required by law, including restrictions on asset growth, expansion, and other activities.

Regulators seek to implement their examination policies to rein in excessive risk taking without causing financial institutions to unduly restrict credit. But reaching the right supervisory balance between reining in risk and encouraging the prudent extension of credit can be difficult, and the financial crisis has made striking that balance even more difficult.[2] Indeed, some participants in the financial services industry believe that examiners are supervising too strictly, aggressively demanding that institutions write down viable commercial loans and other assets. As a result, many financial institutions claim that they must reject worthwhile loan opportunities for fear that examiners may force them to write down these loans, which will result in the loss of income and capital. On the other hand, the regulators point out that waiting too long to re-classify doubtful loans, or supervising too lightly, may permit some institutions to use federally-insured deposits to make unsafe loans that could cause them to fail.

In addition to writing down the value of assets, regulators often impose penalties on financial institutions, such as downgrading their CRA ratings, based on an examiner's determination that the institution has failed to comply with a statute or regulation. These penalties can subject institutions to public criticism and adversely affect their ability to serve their customers. Some regulators, for example, will not allow an institution to open new branches or otherwise expand while a regulatory enforcement action is pending.

In 1994, to promote fairness and transparency in examinations, Congress directed the federal regulators of financial institutions to establish an "independent intra-agency appellate process" by which an institution could seek review of certain regulatory determinations, including (1) examination ratings, (2) adequacy of loan loss reserves, and (3) classifications of loans significant to the institution. Collectively, these determinations are known as "material supervisory determinations." Each federal regulator has instituted

[1] These safety and soundness ratings are known as CAMELS ratings, which stands for capital adequacy, asset quality, management quality, earnings, liquidity, and sensitivity to market risk.
[2] *See* Mary Thompson, "Why Aren't Banks Lending More? What Both Sides Say," CNBC.Com (Jan. 12, 2012), *available at* http://www.cnbc.com/id/45974140/Why_Aren_t_Banks_Lending_More_What_Both_Sides_Say.

its own unique process for appealing material supervisory determinations. For example, the Office of the Comptroller of the Currency (OCC) allows national banks to appeal to its Office of the Ombudsman. The OCC Ombudsman is independent of the bank supervision function and reports directly to the Comptroller of the Currency. When the OCC Ombudsman receives the appeal, the Ombudsman will issue a written recommendation regarding the dispute to the Comptroller within 45 days of accepting the appeal.

Financial institutions have pointed out that the intra-agency review for appealing material supervisory determinations provides them with limited opportunities to challenge these determinations. For instance, an institution does not get an opportunity for a formal hearing before an administrative law judge; an institution cannot compel the regulator to produce information and documents relied upon in making the material supervisory determination; and an institution does not have the right to make an oral presentation. Despite efforts by regulators to offer an impartial appeals process, many financial institutions argue that the intra-agency review process cannot be independent because the regulator's determinations are reviewed by employees of the very same regulator whose determinations are being appealed. In addition, the findings of the regulator's internal review are only recommendations, which the regulator is free to reject.

Summary of H.R. 3461

To address these concerns about the examination process, Chairman Capito and Ranking Member Maloney have introduced H.R. 3461, which creates a more transparent process to appeal examination findings. The bill seeks to improve and clarify how regulators make decisions that can significantly affect the institutions they examine and the communities and customers served by these institutions. H.R. 3461 contains provisions that require the following:

1. **Timely Examination Reports.** Section 2 requires regulators to provide financial institutions with more timely examination reports and more information about the facts upon which the regulator based its examination decisions. Currently, financial institutions can wait as long as 10 months after the examination is completed to receive the examination report. Section 2 would require regulators to provide a final examination report within 60 days of the examination-exit interview or the date upon which a financial institution provides supplemental material following its exit interview, whichever is later.

   Upon the request of the financial institution, the regulator would be required to include in its final report an appendix of all examination or other factual information it relied upon in support of the material supervisory determination.

2. **Clear Exam Standards.** Section 3 provides more clarity and consistency regarding how regulators and their examiners evaluate commercial loans. In particular, Section 2 provides that:

   - Commercial loans cannot be placed in nonaccrual status solely because the collateral has deteriorated in value.
   - Modified or restructured commercial loans must be removed from nonaccrual status if the borrower has demonstrated its ability to perform on such loan over a six-month period. (For loans on a quarterly or longer repayment schedule, the rehabilitation period is three consecutive repayment periods.)

- New appraisals will not be required on commercial loans unless new funds are advanced.
- Commercial loans whose collateral has deteriorated in value must be classified in proportion to the deficiency relating to the decline in collateral.
- Well-capitalized institutions may not be required to raise additional capital in excess of that required by regulation in lieu of actions prohibited or required by the provisions of this statute.
- The appropriate federal regulators must develop and apply identical definitions and reporting requirements for non-accrual loans.
- The definition of "material supervisory determination" would be modified to include any issue listed in the exam report as a "matter requiring attention" by a financial institution's management or board of directors. This modified definition will ensure that a narrow interpretation of "material supervisory determination" will not preclude a financial institution from appealing a regulatory decision that would significantly affect the institution.

3. **The Establishment of the Office of Examination Ombudsman.** Section 4 creates an independent inter-agency Office of Examination Ombudsman ("Examination Ombudsman") within the Federal Financial Institutions Examination Council to ensure the consistency and quality of all examinations. The Examination Ombudsman would investigate complaints from financial institutions about examinations; review examination procedures to ensure that regulators follow their examination policies; and establish a quality assurance program for financial examinations.

4. **Expedited Appeals to Office of Examination Ombudsman.** Section 5 provides a financial institution with the right to appeal a material supervisory determination within 60 days of receiving a final examination report. The appeal would be made to the Examination Ombudsman, who will decide the appeal, after an opportunity for a hearing before an independent administrative law judge (ALJ).

   If requested, the hearing must take place no later than 60 days after the Examination Ombudsman receives the notice of the appeal. After the hearing, the ALJ must make a recommendation to the Examination Ombudsman regarding the merits of the appeal. The Examination Ombudsman must decide the appeal no later than 60 days after the hearing record has been closed. The Examination Ombudsman's decision binds the agency and the institution. Regulators are specifically prohibited from retaliating against an institution that has appealed, including its service providers or affiliates.