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STATEMENT OF

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FEDERAL DEPOSIT INSURANCE CORPORATION

on

LEGISLATIVE PROPOSALS REGARDING BANK EXAMINATION PRACTICES

before the

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

July 8, 2011
2128 Rayburn House Office Building

Chairman Capito, Ranking Member Maloney, and members of the Subcommittee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation on H.R. 1723, the "Common Sense Economic Recovery Act of 2011." My testimony will briefly describe the condition of the industry and the steps that the FDIC and other federal banking agencies have taken to encourage financial institutions to originate and, when necessary, modify or restructure loans to creditworthy borrowers. I will also describe the FDIC's supervisory approach to troubled loans, our concerns about H.R. 1723 and the impact that this proposed legislation may have on banks' financial reporting and capital adequacy.

Condition of FDIC-Insured Institutions

The economic environment for banks and their borrowers is slowly recovering but remains challenging. As a result of continued high unemployment rates and the cumulative effect of substantial multi-year declines in real estate prices, insured banks face weak loan demand and elevated levels of nonperforming assets. As of March 31, 2011, about 12 percent of insured institutions were on the FDIC's "problem bank list." Notwithstanding these trends, the FDIC is cautiously optimistic regarding the current condition and trends in the banking industry. Experience suggests that the sooner banks are able to address the lingering credit quality issues on their books, the faster will be the pace of recovery.

During the first quarter of 2011, FDIC-insured institutions recorded annual net income of $29 billion, the highest level since before the recession, but still well below the all-time highs of the mid-2000s. The main driver of earnings improvement has been steadily reduced provisions for loan losses. This reflects general improvement in asset quality indicators, including declining levels of noncurrent loans and net charge-offs for all major loan types. However, the ratio of noncurrent loans[1] to total loans, at 4.7 percent, is still high and remains above the levels seen in the late 1980s and early 1990s. While the reduced provisions for loan losses are encouraging, it is important to note that net operating revenue[2] fell by $5.5 billion in the first quarter of 2011 compared to one year ago. Lower revenues, in part, reflect reduced loan balances, which have declined in ten of the past eleven quarters.

Given the lingering effects of the recent recession, loan demand is generally weak. Recent surveys, such as the Federal Reserve Senior Loan Officers' Opinion Survey and the National Federation of Independent Businesses' Survey on Small Business Economic Trends, indicate that borrower demand remains sluggish. FDIC examiners also report numerous comments from bankers about current weak loan demand and difficulties bankers are having finding qualified borrowers.

Despite the economic challenges, community banks, which comprise the vast majority of banks that we supervise, continue to play a vital role in credit creation across the country, especially for small businesses.[3] As of March 31, 2011, community banks, which hold only 10.7 percent of industry assets, extended some 38.1 percent of the entire industry's small business loans.

Recent weakness in both residential and commercial property price trends highlight continued concerns. The S&P/Case-Shiller National Housing Index is down 5.1 percent year-over-year through first quarter 2011 and the Moody's/REAL Commercial Property Price Index has decreased by 13.4 percent for the year ending in

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[1] Noncurrent loans are those that are 90 or more days past due or are on nonaccrual.
[2] Net operating revenue equals net interest income, plus noninterest income.
[3] Small business lending defined here as under $1 million for commercial and industrial loans and nonfarm nonresidential real estate financing; and under $500,000 for agricultural production and agricultural real estate financing

April 2011. These indexes are down 29.7 percent and 48.9 percent, respectively from their peaks in 2006 and 2007.

These legacy issues have adversely affected the ability of many institutions to grow their lending activity. The primary reasons banks are not lending more is a combination of tightened underwriting standards based on lessons learned from the recent financial crisis and reduced borrower demand. Industry-wide, banks have plenty of capacity to lend; bank balance sheets are more liquid than before the crisis began in 2008 and capital levels continue to increase.

Credit Availability

The FDIC recognizes and supports the vital role of community banks in serving the credit needs of their borrowers and helping restore economic growth in cities, towns, and farming communities across the country. Throughout the real estate and economic downturn, the FDIC has advocated for policies to help community banks and their customers navigate this challenging economy. The FDIC's examiners operate out of our 85 field offices nationwide. They are well-versed in the business of community banks and their local markets, and have a keen awareness of the challenges many of these banks and their customers are facing. There are creditworthy borrowers that need flexibility in the current environment and bank regulators have provided financial institutions with that flexibility to help customers through the downturn.

The FDIC has joined several interagency efforts that encourage banks to originate and restructure loans to creditworthy borrowers. For example, the federal bank regulatory agencies issued the *Interagency Statement on Meeting the Needs of Creditworthy Borrowers* on November 12, 2008, which encourages banks to prudently make loans available in their markets. In October 30, 2009, the FDIC joined in issuing the *Interagency Policy Statement on Prudent Commercial Real Estate Workouts*, which encourages banks to restructure loans for commercial real estate mortgage customers experiencing difficulties in making payments. This guidance reinforces long-standing supervisory principles in a manner that recognizes pragmatic actions by lenders and small business borrowers are necessary to weather this difficult economic period. The agencies also issued the *Interagency Statement on Meeting the Credit Needs of Creditworthy Small Business Borrowers* on February 12, 2010, which encourages prudent small business lending and emphasizes that examiners apply a balanced approach in evaluating loans.

The policy statement on loan workouts addressed two common misconceptions about supervisory policy towards troubled loans. One of those is that regulators require write-downs of loans to creditworthy borrowers because the value of the collateral has deteriorated. This is incorrect. First and foremost, the agencies look to the ability of the borrower to repay the loan. If the borrower is expected to repay the loan in full according to its terms, there is no required write-down or placement in nonaccrual status, regardless of any deterioration in collateral.

Another misconception is that restructured or modified loans remain in nonaccrual status regardless of the borrower's demonstrated performance and prospects for repayment under the modified terms. In fact, the agencies' instructions for the quarterly Reports of Condition and Income (Call Reports) state that after the borrower demonstrates the ability to perform over a period of six months, the loan can be removed from nonaccrual status.

The FDIC believes that the clarification of policy provided by these interagency statements has helped community banks become more comfortable extending and restructuring soundly underwritten loans. In turn, we expect that borrowers will benefit from more flexible credit structures that banks may offer.

Supervisory Approach for Troubled Loans

The FDIC strives for a balanced approach to supervision that relies significantly on the validation of banks' own credit risk management processes and their adherence to generally accepted accounting principles (GAAP). The FDIC does not micro-manage banks in how they deal with individual customer relationships or how they manage their loan portfolios. The FDIC does not instruct banks to curtail prudently managed lending activities, restrict lines of credit to strong borrowers, or require appraisals on performing loans unless an advance of new funds is being contemplated.

During economic expansions, problem credit relationships are relatively rare at most institutions and are handled in the normal course of business without jeopardizing earnings performance or the capital base. On the other hand, recessions and real estate downturns often result in an increase in problem loans. This necessitates an increased level of bank management resources devoted to monitoring credit performance, loan workouts, loan grading and review processes, and accurate accounting entries for problem loans. In carrying out their statutory responsibilities to ensure a safe-and-sound banking system, banking supervisors also need accurate information about problem assets. Supervisors and investors expect the financial statements prepared by banks to be accurate and to adhere to the standards prescribed by the accounting profession for problem loan accounting, troubled debt restructuring, and loss recognition. Adherence to generally accepted accounting principles should render an accurate, transparent depiction of banks' asset quality, earnings, and capital -- which are central aspects of the bank supervision process.

Accurate problem loan reporting which portrays the actual performance and condition of individual loans and groups of credits within a given portfolio is essential. We rely on these loan reporting conventions to determine the condition of financial institutions both during examinations and in interim periods through off-site monitoring. Aggregate past-due and non-accrual data provided by banks in their quarterly Call Reports are critical components of our supervisory evaluation of banks' financial condition and our assessment of necessary corrective actions.

During each on-site examination, examiners exercise a fact-based, informed judgment to evaluate the quality of individual assets and groups of assets held by an insured institution. Loans that present heightened risk of not being repaid, usually already noted by the bank itself, are subject to adverse classification (Substandard, Doubtful, or Loss) and warrant increased management attention to limit loss exposure. During the credit review process, examiners also review the accuracy and reliability of internal grading systems used by management and in the vast majority of cases, the examiners' results validate bank management findings.

The findings of each on-site examination are discussed with bank management and, as warranted, the bank's board of directors. Such communication provides management with an opportunity to discuss the examiner's conclusions and for examiners to consider management's views, as appropriate. The findings of each examination are also subject to a secondary internal review to ensure that our examination policies and procedures were followed, before the Report of Examination is issued to the bank – this internal review process ensures consistency in our supervisory approach to evaluating loans and other aspects of institution risk. On March 1, 2011, the FDIC issued Financial Institution Letter-13-2011, *Reminder on FDIC Examination Findings*, which encourages an open dialogue between examiners and bank management regarding our examination findings and process.

FDIC Concerns about H.R. 1723

The purpose of the risk management examination is to ascertain the financial condition of an institution. In order to do so, transparent and accurate disclosure and reporting are key requirements. Under the proposed legislation, as long as an amortizing loan is current and has performed as agreed in the recent past, institutions could disregard currently available borrower financial information indicating that the borrower lacks the ability to fully repay the principal and interest on the loan going forward. This, in turn, would enable institutions to include accrued but uncollected interest income in regulatory capital when its collection in full is not expected. Prospective information about the borrower's ability to repay the loan would be disregarded for purposes of placing loans in nonaccrual status and measuring capital, including for purposes of Prompt Corrective Action determinations.

This proposed legislation would result in an understatement of problem loans on banks' balance sheets and an overstatement of regulatory capital. This would be contrary to GAAP and the exercise of our supervisory responsibilities. Compromising the quality of information about nonaccrual or troubled loans, or preventing supervisors from acting on such information, would detract from supervisors' and investors' ability to properly evaluate the safety and soundness of banks or require corrective action as needed.

Changing the agencies' regulatory capital standards to allow institutions to avoid treating certain loans as nonaccrual loans would result in institutions reporting higher regulatory capital than GAAP capital. Such regulatory capital forbearance would detract from investors' confidence in the reliability of all banks' financial statements. Moreover, historical experience has been that policies to systematically delay the recognition of bank losses can ultimately increase losses to the FDIC Deposit Insurance Fund, and thus the cost that healthy banks pay for their deposit insurance premiums.

In our judgment, a safe-and-sound banking system that serves as a foundation for economic growth needs a strong base of high quality capital. We have been strong supporters of recent efforts to strengthen banking industry capital and we believe that under-reporting of nonaccrual loans for purposes of capital measurement would be inconsistent with the direction regulators should be taking with respect to bank capital.

Conclusion

By and large, the banking industry today has ample lending capacity, but the challenge facing many banks is weak loan demand. For some banks, the primary challenge continues to be cleaning up balance sheets from the lingering effects of the crisis, recognizing existing losses, and in some cases raising new capital. This is a painful process, but it is a necessary process.

The FDIC recognizes the challenges in this difficult environment and encourages banks to prudently originate new credits and work with distressed borrowers. At the same time, we believe that accurate, transparent financial reporting is the cornerstone of sound banking practice and we will continue to advocate for standards that promote confidence in the nation's financial institutions.

Thank you and I would be glad to answer any questions from the members of the committee.

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