Testimony of

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On behalf of the
**Independent Community Bankers of America**

Before the

Congress of the United States
House of Representatives
Committee on Financial Services
Financial Institutions and Consumer Credit Subcommittee

Hearing on

**"Legislative Proposals Regarding Bank Examination Practices"**

July 8, 2011
Washington, D.C.

## Introduction

Chairman Capito, Ranking Member Maloney, and Members of the Subcommittee, I am James McKillop, President and CEO of the Independent Banker's Bank of Florida. I am pleased to represent community bankers and ICBA's nearly 5,000 members at this important hearing on "Legislative Proposals Regarding Bank Examination Practices." ICBA supports the two bills that are the topic of this hearing: The Common Sense Economic Recovery Act of 2011 (H.R. 1723) and the bill to instruct the FDIC Inspector General to study the impact of insured depository institution failures (H.R. 2056). These bills will go a long way toward improving the oppressive examination environment, a top concern of community banks.

As a banker's banker, I provide lending, investment and payment services to over 300 community banks members in Florida, Georgia, Alabama, and South Carolina, allowing them to achieve economies of scale to compete with large banks. I have a broad perspective on the challenges faced by community banks in the Southeast, and I'm pleased to have the opportunity to share that perspective with you

Community banks will play a significant role in any broad based economic recovery because we serve rural, small town, and suburban customers and markets that are not comprehensively served by large banks. Our business is based on longstanding relationships in the communities in which we live. We make loans often passed over by the large banks because a community banker's personal knowledge of the community and the borrower provides firsthand insight into the true credit quality of a loan, in stark contrast to the statistical models used by a large bank in another state or region of the country. These localized credit decisions, made one-by-one by thousands of community bankers, support small businesses, economic growth, and job creation.

## Oppressive Examination Environment

The current oppressive exam environment is hampering lending at the very time that bank credit is needed to sustain the economic recovery. While all banks accept the need for balanced regulatory oversight, the pendulum has swung too far in the direction of over-regulation. There is an unmistakable trend toward arbitrary, micromanaged, and unreasonably harsh examinations. Specifically, examiners are:

- Requiring write-downs or reclassification of performing loans based on the value of collateral, disregarding the income or cash flow of the borrowers;
- Placing loans on non-accrual even though the borrower is current on payments;
- Substituting their judgment for that of the appraiser;
- Criticizing the use of certain types of non-core funding such as Federal Home Loan Bank advances and brokered deposits including certificate of deposit account registry service (CDARS) reciprocal deposits, which are used to distribute a large deposit across a network of banks so that it does not exceed the deposit insurance limit at any one bank; and
- Moving the capital level goalposts back beyond stated regulatory requirements.

Community bankers nationwide have reported that bank regulators are often demanding significant capital increases above the minimum regulatory levels established for well-capitalized banks. For example, some examiners are requiring banks to maintain minimum leverage ratios as high as 8 to 9 percent (versus the 5 percent required by regulation) and minimum Tier 1 risk-based ratios as high as 10 percent (versus the 6 percent required by regulation). To bankers, the process appears arbitrary and punitive. A moving and unpredictable capital goalpost makes it nearly impossible to satisfy capital demands in a difficult economy and capital marketplace. As a result, bankers are forced to pass up sound loan opportunities in order to preserve capital. This is not helpful for their communities and for overall economic growth. All bank lending requires judgment and calculated risk. If regulators work to squeeze every ounce of risk out of the system, they will only succeed in stemming the flow of credit to local economies and threatening bank viability. There has to be a reasonable regulatory balance.

What is particularly frustrating to us is that field examination practices are often not consistent with the directives from Washington. A disconnect exists. For example, the November 2008 Interagency Statement on Meeting the Needs of Creditworthy Borrowers states: "The agencies expect all banking organizations to fulfill their fundamental role in the economy as intermediaries of credit to businesses, consumers, and other creditworthy borrowers." Unfortunately, this policy is often overlooked, especially in the regions most severely affected by the recession. We understand that examiners have a difficult job, and the stakes were raised sharply after the financial crisis. But I believe many examiners have overreacted, with adverse consequences for banks and the economy.

Before the crisis, examiners frequently worked in partnership with the banks they examined. They were a resource in interpreting often ambiguous guidance. Where corrections were needed, opportunity was given to make them, and compliance was a mutual goal. This is the best means of achieving safety and soundness without interfering with the business of lending. Today, these relationships are too often adversarial. Understandably, an examiner does not want to be blamed for the next crisis. Examiners are not evaluated on banks' contributions to the economy. At all costs, they want to avoid a bank failure that would put a black mark on their record. As a result, the examiner's incentive is to err on the side of writing down too many loans and demanding additional capital. The current crisis was not caused by a failure to adequately examine community banks.

Additionally, bankers used to receive prompt feedback following their exams which they could act on immediately as part of the exam process. Today, detailed examination reports often arrive months after the examiner's visit, with little opportunity for the banker to sit down with the examiner, go over the results, and respond to the examiner's concerns on the spot.

The misplaced zeal and arbitrary demands of examiners are having a chilling effect on credit. Good loan opportunities are passed over for fear of examiner write-downs and the resulting loss of income and capital. The contraction in credit is having a direct, adverse impact on the economic recovery. Exams could be greatly improved by being made more consistent and rational. This would encourage prudent lending without loosening standards.

**H.R. 1723 Will Reaffirm Existing Guidance on Loan Classifications**

ICBA supports H.R. 1723, introduced by Rep. Bill Posey, because it will reaffirm existing agency guidance on loan classifications and bring more consistency to the examination process. The bill provides that, for the purpose of determining regulatory capital requirements, a bank may treat a loan as an accrual loan if the following conditions are met:

- The loan is current;
- No monthly payment has been more than 30 days delinquent in the past six months;
- The loan is an amortizing loan; and
- The loan is not being funded through an interest reserve account.

Establishing these conservative, bright-line criteria will allow lenders to modify loans, as appropriate, without fear of being penalized. When loans become troubled in a tough economic environment, often the best course for the borrower, lender, and the community is a modification that will keep the loan out of foreclosure. But, as I've discussed, many examiners are penalizing loan modifications by aggressively and arbitrarily placing loans on non-accrual 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. This adverse regulatory classification results in the appearance of a weak capital position for the lender, which dampens further lending in the community and puts a drag on the economic recovery.

I want to emphasize that H.R. 1723 is not an effort to rewrite the accounting rules. Rather, it is an effort to bring examiners back into line with the accounting rules. Specifically, agency guidance on troubled debt restructurings under financial accounting standards provides that a modified loan should be placed on accrual status when there is a sustained period of repayment performance – generally recognized as six months – and collection under the revised terms is probable.

Community bankers enthusiastically support this bill because it resonates with their current experience from examinations. If it becomes law, it will give bankers the flexibility to work with struggling but viable borrowers and help them maintain the capital they need to support their communities. Community banks would welcome additional clarity in other regulatory areas as well, so that they can be confident in their lending and risk management.

**ICBA Supports Study on Examination and Resolution Policies**

H.R. 2056, introduced by Rep. Lynn Westmoreland, would require the Inspector General of the FDIC to study a number of FDIC policies related to the examination of banks and the resolution of failed banks that may contribute to the current difficult environment for banks. ICBA would welcome such a study, as it would focus on many of the concerns that we have identified with the current examination environment. In particular, studying the effect of "paper losses," or "write downs" that cause an institution to raise more capital, and commercial real estate loan "workouts" will be very useful in raising awareness of these concerns, hopefully changing examination practices, and giving momentum to legislation that would directly fix examination problems, such as H.R. 1723.

ICBA fully supports H.R. 2056 and believes it might also be appropriate for the Government Accountability Office (GAO) to work closely with the FDIC Inspector General because the topics to be studied, with the exception of loss sharing agreements, are common to all the federal banking agencies and affect all banks, not only those examined by the FDIC.

**Communities First Act Will Provide Additional Relief**

Finally, I would like to advocate for another important piece of legislation that would help to relieve community banks of certain burdensome regulations they face, both in examination and in compliance, and help community bank customers save and invest. The ICBA-backed Communities First Act (CFA, H.R. 1697) was recently introduced in the House by Rep. Blaine Luetkemeyer and cosponsored by members from both sides of the aisle. ICBA is working to introduce a similar bill in the Senate. Notably, CFA would:

- Increase the threshold number of bank shareholders from 500 to 2,000 that trigger SEC registration. Annual SEC compliance costs are a significant expense for listed banks.
- Require the SEC to conduct a cost/benefit analysis for any proposed accounting change.
- Provide relief from new Dodd-Frank data collection requirements in connection with loan applications from women-owned and minority-owned businesses.
- Extend the 5-year net operating loss (NOL) carryback provision to free up community bank capital now when it is most needed to boost local economies.
- Allow S corporation banks to raise additional capital by increasing the shareholder limit, allowing IRA shareholders, and allowing them to issue preferred stock.

The Senate bill, when it is introduced, may also contain the provisions of H.R. 1723. These and other provisions would improve the regulatory environment and community bank viability, to the benefit of their customers and communities.  We hope that this committee will consider the CFA.

**Closing**

ICBA appreciates the opportunity to testify.  The current examination environment is a serious impediment to the flow of credit that will create jobs and advance the economic recovery.  Legislative solutions are needed to improve this environment.  We encourage you to schedule H.R. 1723 and H.R. 2056 for consideration as soon as practical.

Thank you.

# United States House of Representatives
# Committee on Financial Services

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Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

| 1. Name: | 2. Organization or organizations you are representing: |
|---|---|
| James H. McKillop, III | ICBA |
| 3. Business Address and telephone number: | |
| [redacted] | |
| 4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify? | 5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify? |
| ☐ Yes ☒ No | ☐ Yes ☒ No |
| 6. If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets. | |
| | |
| 7. Signature: James H McKillop III | |

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