LEGISLATIVE PROPOSALS REGARDING BANK EXAMINATION PRACTICES

HEARING

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

OF THE

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CONTENTS

LEGISLATIVE PROPOSALS REGARDING BANK EXAMINATION PRACTICES

Friday, July 8, 2011

U.S. House of Representatives,
Subcommittee on Financial Institutions and Consumer Credit,
Committee on Financial Services,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:32 a.m., in room 2128, Rayburn House Office Building, Hon. Shelley Moore Capito [chairwoman of the subcommittee] presiding.

Members present: Representatives Capito, Renacci, Royce, Manzullo, McHenry, Pearce, Westmoreland, Luetkemeyer, Canseco, Grimm, Fincher; Maloney, Watt, Miller of North Carolina, Scott, and Carney.

Also present: Representative Posey.

Chairwoman Capito. This hearing will come to order.

The purpose of today's hearing is to better understand the challenges the community banks are facing during bank examinations.

I am going to waive my opening statement because we have the sponsors here of two of the pieces of legislation that we are considering. So I am going to give them my time.

And with that, I am going to go ahead and recognize the ranking member, Mrs. Maloney, for an opening statement.

Mrs. Maloney. I want to thank you. And I will put my opening statement in the record, but I just want to welcome the panelists today and thank you for having this hearing, and express my strong support for community banks and for small banks.

I do have serious questions about the bill that would treat nonaccrual loans as if they were accrual loans, if they meet four criteria. I feel that a better way would be to give banks more time to work it out.

I think it is important that we stay on the same GAAP accounting procedures that are in place. And banks should work with their clients to restructure the loans or put them in a way that will make them healthy in the future.

We have to remember that in the past 4 years, we had one of the worst economic downturns in the history of our country. We lost well over $13 trillion in household wealth, unemployment shot up, and jobs became scarce. And we had to take measures, such as the TARP program and others to really help our financial institutions to recapitalize and become stable.

Many of these causes, according to some economists, were due to a lack of capital standards, a lack of any limits on leverage.

During these years leading up to the crisis, under Fed Chairman Greenspan, everyone supported—most of the regulators supported deregulating, lowering standards. Now, the opposite is in place. Most regulators are supporting strong standards for capital and for leverage limits and for building a stronger financial base.

I believe a better way to help our community banks would be to give them more time to work out the challenges they have in this stressful economic time.

I yield back.

Chairwoman CAPITO. Thank you.

I just would ask the members—I am going to try to be stringent on the time allotments for several reasons, because that is a fair way to do it, but also because we are going to have a vote that is coming up around 10:45, that is going to be lengthy. So, we want to move this hearing as quickly as we can so we can get to the witnesses.

We are going to do opening statements by seniority.

So, Mr. Royce is recognized for 1 minute.

Mr. ROYCE. Thank you, Madam Chairwoman.

There was a recent article in the American Banker entitled, "Community Bankers Face a Choice: Sell Out, Fold or Change." And that article noted that the number of banks in 2020 may be half of the current number because of the various factors working against small banks.

Now, you would expect a certain amount of consolidation in a downturn, but many of the problems faced by community banks were inspired by Washington. And I will just go through a few of them.

It was Washington that gave them hundreds of new regulations in Dodd-Frank. It was Washington that decided to enact price controls on interchange fees and limit a critical revenue source for these smaller firms.

It was Washington that propped up their too-big-to-fail competitors, thus expanding the competitive advantage these firms hold in the market, thus advantaging the cost of capital for larger investment banks versus the smaller community banks.

Certainly, many will add overzealous bank examiners to this list. Being from California, I have heard from those community bankers who feel hamstrung by their regulators.

I yield back, Madam Chairwoman.

Chairwoman CAPITO. Thank you.

Mr. McHenry, for 1 minute?

Mr. MCHENRY. In the interest of time, I will yield my time back to the Chair.

Chairwoman CAPITO. Thank you.

Mr. Westmoreland, for 2 minutes.

Mr. WESTMORELAND. Thank you, Madam Chairwoman. I appreciate you calling this hearing and giving me the opportunity to make an opening statement. And I also appreciate your willingness to include my bill, H.R. 2056, in this hearing.

In my opinion, there is no greater threat to our communities than bank failures, especially in my State of Georgia.

Since Chairman Bair last testified before this subcommittee, two more banks have failed in Georgia. Georgia's grand total is now 65 failed banks. To date, 15 banks have failed in Georgia just this year.

I am here today to once again express the profound frustration people in my district have with the FDIC. Banks in Georgia, both strong and weak, big and small, are trying to survive in a market where government is picking winners and losers every day.

The banks that are failing now are from paper losses, and by this I mean that banks are forced to write down assets because of mark-to-market and other regulations which immediately cause a capital call from the regulator.

Often, this occurs on loans that are actually performing. But Georgia is by no means alone with the threat of bank failures. Ten States have had more than 10 failures since 2008. They are Arizona, California, Florida, Georgia, Illinois, Michigan, Minnesota, Missouri, Nevada, and Washington.

Sadly, these States also have some of the highest unemployment and foreclosure rates in the country. The bill I introduced, H.R. 2056, directs the FDIC Inspector General to study FDIC's loss share agreements, banks failing because of paper losses, hardship of being able to modify loans, and the application of the FDIC policies by examiners in the field.

For these 10 States, failure on the part of management to ensure information of policies by examiners on the ground have resulted in continued stagnation in the real estate industry, higher than average unemployment, and the steady pace of bank failures.

This is why my bill, H.R. 2056, and my colleague Mr. Posey's bill, H.R. 1723, are so vitally important. Three years after the events of 2008, 2 years after the recession was said to be over, the regulators testifying today are no closer to find a solution to the bank crisis, even though you say you have all the tools.

I urge the committee to continue to examine this crisis in our communities.

And with that, Madam Chairwoman, I yield back.

Chairwoman CAPITO. Thank you.

Mr. Luetkemeyer, for 1 minute.

Mr. LUETKEMEYER. Thank you, Madam Chairwoman.

I may be one of the few Members of Congress here who has been employed as a bank examiner during my career. And I appreciate the conversation we are having today.

I also want to thank my colleagues from Georgia and Florida for the work on the bills we are about to hear about today. My home State of Missouri is one of the hardest hit for bank closures, and this is an issue that must be addressed.

We also need to recognize that institutions should not be penalized for making good loans to borrowers who have never missed a payment. Our examination environment is an issue I have been concerned about for many years. I continue to hear from my Missouri bankers that the relationship between financial institutions and the regulators seems to have turned into a game of "gotcha."

This is an issue I have raised many times with the various regulatory officials, but it still seems to persist. If we do not begin to consider proposals that will give these institutions targeted relief, then we will continue to see reduced lending and a growing number of unnecessary institutional failures, which will delay any hope of economic recovery.

I look forward to an important discussion today, and I yield back, Madam Chairwoman.

Chairwoman CAPITO. Thank you.

Mr. Canseco, for 30 seconds.

Mr. CANSECO. Thank you, Madam Chairwoman.

Today, we have heard more sobering news about our troubled economy. A mere 18,000 jobs were created in June, and the unemployment rate is now at an unacceptable 9.2 percent.

We were told recovery summer was supposed to be last year, but because of the ongoing regulatory burden on businesses caused by some of the confusing and conflicting regulations we are going to talk about today, it does not appear we are going to have a recovery this summer either or any summer until the regulatory burden is lifted off of small business and community banks in my district, too.

Thank you.

Chairwoman CAPITO. Thank you.

Mr. Fincher, for 30 seconds.

Mr. FINCHER. Thank you, Madam Chairwoman.

Community and small-town banks are major stakeholders in our rural economy. Farmers, small businesses, and manufacturers depend on loans from community banks to make payroll, hire employees, and invest in the equipment.

As a co-sponsor of H.R. 1723, I look forward to hearing from our witnesses today about how this bill will help community banks better provide loans to job creators in our districts who are needing access to capital.

As Mr. Canseco said, 18,000 jobs created, unemployment 9.2 percent. We are heading down the wrong path. So thank you guys for coming today.

Chairwoman CAPITO. Thank you.

Mr. Posey, for 2 minutes.

Mr. POSEY. House Resolution 1723 is the jobs bill that will help our economy recover. It helps our local banks do what they were created to do: make loans to small businesses and homeowners.

I was first exposed to the plight of community bankers when Representative Ron Klein, a former member of our committee, invited me to attend a bankers summit he held in Orlando.

It was there for the first time I learned regulators were placing loans on a nonaccrual basis for such reasons as parents or others having made payments on loans while the borrowers were in between jobs, even though not a single payment was late or missed. Because performing, high-interest loans were modified to a more current rate even though a payment was never late and never missed, and because regulators felt in their opinion that borrowers should not have been able to make the loan payments that they made because the economy was late—again, even though not a single, solitary payment had been late or missed.

Such subjective overregulation makes banks less inclined to loan money to job creation, and results in more foreclosures, more layoffs, and longer unemployment lines. The traditional definition of a performing loan is exactly that: a loan which a borrower is currently repaying on the agreed terms, period. This legislation simply codifies that definition.

The Common Sense Economic Recovery Act has a 2-year sunset provision. So unless it is extended, it is over in 2 years. But it would stop regulatory abuse, create jobs, and help get our economy back on track.

I want to thank you, Chairwoman Capito, for calling this hearing and also thank the great staffs on both sides of the aisle for facilitating it.

I would like to ask unanimous consent for four letters of endorsement to be entered into the record. I have letters of support for H.R. 1723 from the Independent Community Bankers of America, the National Bankers Association, the National Association of REALTORS®, and the Florida Bankers Association.

I thank you, Madam Chairwoman.

Chairwoman CAPITO. Without objection, it is so ordered.

I would also like to enter into the record a statement from the American Bankers Association, along with your request.

Thank you.

And Mr. Grimm, for 1 minute.

Mr. GRIMM. Thank you, Madam Chairwoman. Thank you for holding this hearing.

Thank you for the witnesses for being here today.

The system of credit is a big part of the life blood of our economy. It allows capital to officially flow from those who save to those looking to invest and those looking to expand their businesses, which ultimately creates jobs—we all recognize that during the previous boom, mistakes were made. Lending standards became far too loose and large losses followed.

However, I now fear that the pendulum has swung too far in the other direction. I am deeply concerned that overzealous bank regulators are too quick to force banks to take write-downs against loans that are currently performing. These write-downs lower the amount of credit that these banks can extend into our economy.

I am particularly concerned about the application of mark-to-market accounting rules and how they are being applied to loans that are currently performing.

The lack of credit being created by regulatory policy is stifling our economy's ability to create jobs, as evidenced by the dismal job losses that we have seen. With that, I yield back.

Chairwoman CAPITO. Thank you, Mr. Grimm.

And that concludes our opening statements.

I would like to, first of all, thank the panel for coming today. And I would like to introduce our first panel for the purpose of giving a 5-minute opening statement.

First, we have Mr. James H. McKillop—did I say that right? Thank you—the president and CEO, Independent Banker's Bank of Florida, on behalf of the Independent Community Bankers of America.

Welcome, Mr. McKillop.

STATEMENT OF JAMES H. McKILLOP III, PRESIDENT AND CEO, INDEPENDENT BANKER'S BANK OF FLORIDA, ON BEHALF OF THE INDEPENDENT COMMUNITY BANKERS OF AMERICA (ICBA)

Mr. MCKILLOP. Chairwoman Capito, Ranking Member Maloney, and members of the subcommittee, good morning.

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.

As a banker's bank, I provide lending, investment, and payment services to over 300 community banks in the Southeast.

I have a broad perspective on the challenges faced by community banks, which I am pleased to share with you today. ICBA believes that the two bills to be discussed today, H.R. 1723 and H.R. 2056, will go a long way toward improving the current oppressive examination environment, a top concern of community banks.

The exam environment is discouraging lending at the very time that bank credit is needed to sustain economic recovery. Specific concerns include write-downs of performing loans based on collateral value, despite the cash flow of the borrower, second-guessing of appraisals, and moving the capital goal post beyond what is required by regulation.

While all banks accept the need for balanced regulatory oversight, the pendulum has swung too far in the direction of overregulation.

What is particularly frustrating to us is that field examination practices are often not consistent with the directives from Washington, such as the November 2008 interagency policy statement on meeting the needs of creditworthy borrowers.

That directive cautions against excessive tightening of credit and encourages banks to practice economically viable and appropriate lending. Unfortunately, this policy is often overlooked. Good loan opportunities are passed over for fear of examiner write-down and the resulting loss of income or capital.

ICBA supports H.R. 1723, introduced by Representative Posey, because it will reaffirm existing agency guidance on loan clarifications and bring more consistency to the examination process.

The bill provides that a loan must be put on accrual status if it has been paid on a current basis for the past 6 months, among other conditions.

Establishing 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 of action for the borrower, the lender and the community is a modification that will keep the loan out of foreclosure.

But many examiners are penalizing modifications by aggressively and arbitrarily 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.

I want to emphasize that H.R. 1723 is not an effort to rewrite accounting rules. Rather, it is an effort to bring examiners back into line with accounting rules.

Specifically, agency guidance on troubled debt restructuring provides that a modified loan should be placed on accrual status when there is a sustained period of payment performance, generally recognized as 6 months, and collection under the revised terms is probable.

ICBA also supports H.R. 2056, introduced by Representative Westmoreland, which would require the Inspector General of the FDIC to study examination resolution policies that may contribute to the current difficult environment for banks.

The study would focus on many of the concerns that we have identified in the current examiner environment, such as paper losses and the cause of the institutions to raise more capital, commercial real estate loan workouts.

The study would be very useful in raising awareness of these concerns, hopefully changing examination practices and giving momentum to the legislation that would directly fix examination problems, such as H.R. 1723.

ICBA fully supports H.R. 2056 and believes that it might also be appropriate for the GAO to work closely with the FDIC Inspector General because the topics to be studied are common to all Federal banking agencies and affect all banks.

Finally, I would like to advocate for an additional piece of legislation, the Communities First Act, which would improve the regulatory environment and community bank viability.

Communities First would raise the threshold of SEC registration to 2,000 from 5,000 owners. Another provision would extend the 5-year operating loss carry back to free up community bank capital at this very point in time.

We are pleased that the SBA has bipartisan co-sponsorship and look forward to its advancement in the House.

ICBA appreciates the opportunity to testify. We encourage you to schedule H.R. 1723 and H.R. 2056 for consideration as soon as practical.

Thank you.

[The prepared statement of Mr. McKillop can be found on page 87 of the appendix.]

Chairwoman CAPITO. Thank you.

Our second witness is Mr. Michael Whalen, president and CEO, Heart of America Group.

Welcome, Mr. Whalen.

STATEMENT OF MICHAEL WHALEN, PRESIDENT AND CEO, HEART OF AMERICA RESTAURANTS AND INNS

Mr. WHALEN. Chairwoman Capito, Ranking Member Maloney, and members of the subcommittee, thank you for having me here.

I represent no other institution than, I think, the people on Main Street. Back in 1978, right after I got out of law school, my law school buddies thought I was crazy when I started a little, 100-seat restaurant called the Iowa Machine Shed, in rural Davenport.

It was with sweat equity. And it was small-town bankers who had a belief in my, maybe not in my balance sheet, but in my work ethic and our vision and what we intended to do.

And over the course of 33 years, we have done the American dream. My company today has a nine-figure net worth. I am not here to tell you I am bragging about that, but to really kind of lay the groundwork for what is happening on Main Street.

In a stabilized environment, our debt-to-value ratio is in the 30 percent. We are not leveraged. We are a great, great company to lend money to.

And we decided, as things started to come out of the gloom and doom, that we are really marching to a hell with a heavenly cause, and start to build some new projects, including a six-story Hilton Garden Inn with one of our giant Italian Bakehouses in suburban Kansas City, in Olathe, Kansas, a brilliant growth area and a great site, that I already owned free and clear.

It was really as close to a no-brainer loan as I have ever had in 33 years. I thought, "This is going to be easy."

And they gave us—the community gave us $12.5 million in Economic Recovery Zone Bonds in order to even help facilitate the financing. So, off we went, and met with banker after banker, and laid it out what our company was, laid out the pro forma on this thing. Seriously, this was as good as a deal as I have ever presented to a bank in 33 years.

And almost—I am going to give—I have counted about 24 banks. It continued to have the same dynamic. Enthusiastic reception. Wonderful when they looked at our financials. They would get in there, and the word came back, time after time, "Look, Mike, we are just really scared that if we make this loan, we are going to get second-guessed."

Now, that is the reality on Main Street.

Another project that we are doing right now, a $20 million hotel in East Peoria, Illinois, I am working with a banker. And, basically, they are saying the same things over and over again, "We are fearful that if we make this loan, even though it is a good, solid loan, that we are going to get second-guessed," because they do not like the category.

Now, eventually, in both those situations, I found financing, because our company is really strong.

But I will tell you that if this environment had prevailed back in the 1970s and 1980s when I was trying to get off the ground, we would have been dead in the water.

And that is why I am here. I am not here for my company. I am not here for community banks, but I love them, okay. God bless them. They have stuck with me sometimes when they should not have. I am here for the guy trying to do what I did 33 years ago, which was to get started.

Now, the other thing that I would like to say is this: I deal with a lot of solid banks. And I think that some of the trouble that occurred, particularly on the Wall Street banks and some of the major national banks is, let us say there are two kids in the backseat. One is acting up, one is raising Cain, and the other one is quiet.

And I get the feeling that we are doing the situation where we are walking around and smacking the quiet kid and saying to the one that raised Cain, "You know, you are going to get that if you do not settle down."

I think we have had really good, well-managed banks that have given to fear and that—Pepperdine University, I just happened to come across a study that indicated that they talked to a lot of bankers, through their representative sample study, found 75 percent of the bankers said that they are concerned, they are worried about being second-guessed by regulators.

Sixty-one percent of those bankers said that they did not do a loan they thought they should do, underwriting standards indicated that they should do, but they are scared about getting second-guessed.

And I would like to submit to you that the other 39 percent maybe were not as honest with the response as they should have been.

So what we do have is a crisis on Main Street. And we have to get that straightened out. It is not because of a loan excess.

I just found out—and this is kind of a piece de resistance, because I was calling some of my bankers, that a loan that I had on some undeveloped property. It is fully developed, but it is not, right now, developing any income stream, even though we have been more than capable of carrying the debt service because of the excess cash flow from our other operations, was treated as a nonperforming loan a year ago.

I did not even know it. It was absolutely ridiculous, because we had more than the carrying capability. It was only for that reason that it did not come to a catastrophe.

And that is the kind of thing that is killing job creation in this country.

[The prepared statement of Mr. Whalen can be found on page 93 of the appendix.]

Chairwoman CAPITO. Thank you, Mr. Whalen.

Our final witness on this panel is Professor Simon Johnson, the Ronald A. Kurtz Professor of Entrepreneurship at the Massachusetts Institute of Technology's Sloan School of Management.

Welcome.

STATEMENT OF SIMON JOHNSON, RONALD KURTZ PROFESSOR OF ENTREPRENEURSHIP AT THE MASSACHUSETTS INSTITUTE OF TECHNOLOGY'S SLOAN SCHOOL OF MANAGEMENT

Mr. JOHNSON. Thank you very much.

I would like to make three points, if I may.

The first is to reiterate and reinforce a point made by Mrs. Maloney at the beginning, which is, we should not lose sight of the context here. We are in the aftermath of the most serious financial crisis since World War II, which involved $13 trillion of lost household wealth, as well as a 6 percent, 7 percent drop in employment, from which we are struggling to recover.

I, in that context, would emphasize what I think Mr. Royce said at the beginning, that the major responsibility here lies with the Wall Street banks, the so-called too-big-to-fail banks, that got massively out of control and did enormous damage to the rest of the economy, including to small businesses and to community banks.

So I think it is very important to get that clear. And I hope that we can agree on this issue.

The second point is that a core part of this banking crisis was due to the lack of capital and excessive leverage on the part of the very big banks, but, unfortunately, it has to be said, also on the part of some of the mid-sized and smaller banks that need capital as a buffer against losses.

Personally, I would be attracted to a system in which there were no capital requirements, and banks could choose their own capital levels, because everything we know about unregulated systems of that kind is that banks have much more capital. They fund themselves with much more equity relative to debt in those unregulated systems than they do in our system.

However, I do not think we can go to such an unregulated system, because the experience in the Great Depression with regard to depositor runs was so horrific that I would be surprised if anybody, including from my side of the table or from community banking or from small business would like to go back there.

So, we have a regulated system. We have federally-insured deposits. The FDIC has a responsibility to ensure there is an acceptable level of capital in these banks. And if the banks do not have enough capital, if they run out of equity, if the losses swamp the equity, the bank becomes insolvent and there is a charge to the deposit insurance fund, which, as you know, is funded in the first instance by the banks themselves, but also draws on the credit of the United States Treasury.

Now, I, for one, do not want us to go anywhere near another situation of bailouts or a TARP, Troubled Assets Relief Program, situation, where we are providing capital to private banks in an effort to prevent systemic catastrophe.

It is therefore prudent on the part of the FDIC, the OCC and other bank regulators to ensure the banks have sufficient capital at all times, including in difficult times such as these.

I have reviewed the latest situation, including the testimony submitted by the FDIC and by the OCC today. And it is my assessment as somebody who works on these issues, who has worked on crises around the world—I am the former chief economist of the International Monetary Fund, among other things, and I have worked on crises for more than 20 years.

I think the rules that we have right now in the United States, as explained by the FDIC and the OCC, make sense. They are appropriate.

I understand completely the desire to try and stimulate further jobs in this way. Of course, I would also like more jobs to come back and unemployment to come down.

But I would caution you very strongly against this kind of regulatory forbearance. This leads to trouble. This leads to more losses. This led to much of the losses we also lost in the 1980s that we had from the—ultimately from the S&L crisis.

I agree with Mr. McKillop and with Mr. Whalen that the pendulum in such a situation can swing too far the other way. I do not think that has happened in this case. I do not think that is what is coming out of these rules, as explained by the FDIC.

There is plenty of credit available in this country. There are also banks that are borderline insolvent. I support H.R. 2056, in part because I think the rules have not been fairly applied across community banks and big banks.

And I think the OCC should be pressed very hard on this. I think they have given too much forbearance to the big banks.

I also think, by the way, the FDIC has closed not too many banks, but too few. I think when you are pressed for the GAO to be involved, which I think Mr. McKillop suggested, and I would support, you will find things that perhaps you did not want to find. So be very careful with this.

But I think we should have transparency, as much transparency as possible.

And in closing, I am afraid that I do not support H.R. 1723. I think it will lead to more trouble down the road.

Thank you very much.

[The prepared statement of Professor Johnson can be found on page 64 of the appendix.]

Chairwoman CAPITO. Thank you all.

We will now begin the questioning portion, and I will begin with a question.

Mr. Whalen, you are an entrepreneur. You have obviously created over 30 years a lot of jobs in your time and continue to do this.

In the context of what we are talking about today, because I think that is the bottom line of what we are talking about, when you talked about your frustration of your last project on the commercial real estate deal, do you see this as an inhibitor to job creation for you and those like you that are well-capitalized, that have a long history of job creation and have been able to look at a lot of different financing arenas to move your companies forward?

Mr. WHALEN. Absolutely. We are kind of the canary in the coal mine, because we are well-capitalized, a strong company that has never had a real failure in 33 years. Our track record is outstanding.

And if we are facing this much difficulty, this much fear from these bankers, then I cannot imagine somebody who is still struggling, but still strong to try to build a company.

And we can sit here and we can pay hosannas to the small and medium-sized business people. All of us sit around in the hinterland and watch this from the Beltway, but then you sit there and say, “Wait a minute. Where are the policies that facilitate all the medium-sized persons to try to get off the ground?”

And, Professor, with all due deference, maybe we could have a debate on the macroeconomic situation and the Wall Street situation and the excesses of it, but I think what we are here talking about today is Main Street, usually smaller and regional banks, and the fact that, really, the medicine that should be applied perhaps on Wall Street is being applied in a double dose on Main Street.

And so I am here to probably say what it is like walking on Main Street and not on Wall Street.

Chairwoman CAPITO. How many people would you say you have employed right now, indirectly or directly, mostly, yes?

Mr. WHALEN. Somewhere between 2,500 and 3,000. These projects have put together hundreds of construction jobs.

Chairwoman CAPITO. Is that down from a figure from maybe 5 or 6 years ago?

Mr. WHALEN. No, we did not lay anybody off.

Chairwoman CAPITO. Consistent.

Mr. WHALEN. We did not have to. We hung in there. We did what everybody did; we hunkered down. But as soon as we saw it come back, or start to come back, we went back.

I have what I refer to as a sickness called being an entrepreneur, and I am going to continue to do it.

But when I start to talk to my friends in business and I talk to my bankers—and, of course, none of my bankers wanted me to mention their name, okay?

[laughter]

Chairwoman CAPITO. For obvious reasons.

Mr. WHALEN. —a story—"Mike, I will tell you this story and that story, but do not mention my name." There is a genuine fear, as I said, of being second-guessed on loans.

Here is a good example. If we start a new hotel, it is usually a 2- to 2½-year period while it stabilizes up and achieves the EBITDA level that you would normally have to have to service the debt on a pro forma. There is going to be a period, and a short-term period, where my other operations are going to subsidize that.

If you came in 6 months at the end of the operation of that loan, and said is that on a standalone basis fully capable of amortizing that loan, does it meet things like debt service coverage ratios of 1.2 or 1.3, the answer is, of course not. It has never worked that way.

And if they start to apply these draconian rules, you shut down small and medium-sized businesses.

Chairwoman CAPITO. Thank you.

Now, Professor Johnson, I know that there is a—we all want to get to the same place, I think we acknowledged that, which is full employment, availability of credit.

But we do hear, repeatedly, that while we are hearing the President has a plan for small-business lending through the SBA, is that really occurring on Main Street? I think that is a question we need to ask.

Or are the differences in the applications of capital requirements, etc., inhibiting that program from moving forward? A lot of banks are not even getting involved in that, because they do not want to touch it for reasons that the rules may change or that they are going to be more heavily scrutinized and not be able to meet up to the standards.

So I will give you a chance to respond.

Mr. JOHNSON. Thank you. These are all very good and appropriate questions.

I think we have to ask, why are the banks scared? What are they afraid of?

And the answer is, it must be, that they have relatively little capital, either because they were thinly capitalized to start with or they suffered losses along the way.

I work with a lot of entrepreneurs also, as does Mr. Whalen. I do not think that H.R. 1723 says institutions could disregard currently available borrower financial information. That is very strange in an unregulated, private-sector context. You want to look at the borrower.

Anybody to whom you have lent money, you would like to be able to evaluate that credit on a holistic basis. Disregarding whether or not they can repay you is very strange, and not a good business practice, and not something we should be encouraging.

So I agree with your skepticism on whether the Small Business Administration-type loans can make a difference. I suspect they cannot.

But I do not think we should be encouraging banks to adopt such a break with standard accounting practices actually. That is the FDIC and the OCC interpretation.

I think the rules that we have right now are what we should be applying.

Chairwoman CAPITO. All right. Thank you.

Mrs. Maloney?

Mrs. MALONEY. I want to thank you for having this hearing, and to thank all of our panelists today.

I am concerned about safety and soundness, given what we have just gone through and certainly the financial stability and the effects that it might have on classifying what otherwise would be a nonaccrual loan as an accrual loan under the terms of this bill.

And I am concerned if this would perpetuate the practice of holding inadequate capital relative to risk that participated in and caused the financial crisis.

So I would like to ask Mr. McKillop and go down the line. I am very sympathetic to the challenges that community banks, or some community banks, are facing. And some of them are seeking forbearance, a regulatory forbearance during this financial climate, and I am certainly supportive of it.

I would like to know—and Mr. Westmoreland, I would like to be associated with your comments earlier and be a cosponsor of your bill. I agree that community banks are an important part of every community and played a critical role in our recovery.

Are there other alternatives that could achieve the goal with fewer potential negative implications on safety and soundness and financial stability than would reducing capital requirements?

Could giving more time—are there other ways that we could approach it that would help community banks?

Mr. MCKILLOP. Ranking Member Maloney, there might be. I have been in banking for almost 35 years, and I have been dealing with banks in Florida and Georgia and Alabama for all my life.

And what I have seen through the 1980s period into the 1990s and now here, 2011, is that there is an occurrence following a catastrophe that, by necessity, rallies all the troops.

We have done a very good job in trying to focus in on Dodd-Frank and deal with the major mountaintop issues. But community banks are not the Wall Street banks and the unregulated institutions that caused the Dodd-Frank bill to have to come into play.

We do not believe, ICBA does not believe, and I personally do not believe that Representative Posey's bill changes accounting standards at all. What we are saying in the bill is, "pay attention to those standards, and do not go beyond them in a regulatory environment at the bank level."

I will give you a "for instance": When we have to restructure a loan for a borrower, we must put it on nonaccrual for 6 months. Must. No ifs, ands or buts. That will take place even if the loan continues today, from day one, and continues all the way through that 6-month period.

Now, we hit the 7th month and we start to move into a gray zone. And if documentation in my files does not say that I see how the borrower can continue to make payments, the regulators have been inclined to say, "That loan must stay on nonaccrual," even though the loan is current.

To the degree that I can take it off of nonaccrual, I can put it—

Mrs. MALONEY. Let me ask, so it has to stay on the nonaccrual, even though they are current, and they are asking you to pledge that they are going to pay in the future, but you cannot really pledge, because you do not know everything that is going to happen. Is that basically it?

Mr. MCKILLOP. The documentation that I might have is a year old, from old tax returns. I am still dealing with 2009 tax returns. The law does not require businesses to file until October for 2010.

So, the documentation that the regulators look at says this thing does not support the facts of the loan. And what this bill creates is the payment, the evidence of payment is a greater fact than any documentation deficiency.

Mrs. MALONEY. Thank you very much. My time has expired, but I would like to hear more concrete examples of how this works.

Thank you.

Chairwoman CAPITO. Thank you.

Mr. Renacci, for 5 minutes.

Mr. RENACCI. Thank you, Madam Chairwoman.

Thank you to all the witnesses for being here.

I am concerned about safety and soundness also, but I am also concerned about jobs. And, Mr. Whalen, I appreciate you being here because almost 28 years ago, I started my own business and I created over 1,500 jobs, employed over 3,000 people. And if some of the standards were placed on my business over 28 years that are being placed on businesses today, my business would not be here any longer. And that is a shame.

Now, today my business has been sold and it is still employing over 3,000 people and it is still a success story, and 67 percent of employment is with small businesses like yours. So I thank you for what you do.

In the testimony I heard today, it is interesting—Mr. McKillop, I would agree with you, you have said specifically about what some of the examiners are doing, requiring write-downs or reclassification of performing loans, placing loans on nonaccrual, even though the borrower is current on payments. And I can go on and on.

But, those are issues—I can take you back to my district in Ohio, and I can take you to some small businesses that have lost the ability to refinance their debt because of these same things, even though they have continued to make payments, even though their value, their asset value is greater than their loan. These are things that the examiners are continuing to do. So I appreciate your testimony.

And I will go over to Professor Johnson. You testified on a couple of things that do concern me. And it is interesting, because I do believe we need—you said we need significant capital. I am a firm believer that we need appropriate capital levels.

The question is, and the problem I have, is that the appropriate levels of capital are being determined by regulators who are making decisions in many cases that are dropping the capital levels down in these banks because they are calling loans substandard.

So, I would question when you say "significant," do you really believe that if a loan is being paid, if it is—if the value is in excess of the debt, if the loan is being paid. But I am going to give you an example. If the loan is up for renewal and cannot be paid off, is that a loan that should be substandard and should be classified as reclassified on a bank's balance sheet so that it will reduce the capital?

Mr. JOHNSON. Thank you, Congressman.

I think the rules are very clear. And I also laid out for you in the FDIC testimony to come shortly, and I will quote from that: "If the borrower is expected to repay the loan in full according to its terms, there is no required write-down or place in nonaccrual status, regardless of any deterioration in collateral, for example, the point they are addressing here."

And on the points made by Mr. McKillop, I could link the two, the rules are that after a period of 6 months of demonstration for a modified loan that you—that the borrower can perform, the loan can be removed from nonaccrual status.

I think these are very sensible rules. Even the OCC—which I have to tell you does not have a good reputation with regard to avoiding regulatory capture—says in its testimony that these rules—and I agree with this—would "create regulatory accounting standards that are less stringent than GAAP for regulatory capital services."

I really do not think you want to go there, from a free market, pro-business perspective, this is not a good place to go.

Mr. RENACCI. The problem is, though, when they believe that the loan cannot be paid. And if you ever want to travel back to Ohio, I will take you to many small businesses who have been making payments for 10 years, 20 years, and just because they are only to pay their interest today, the loans are being classified, and that is a problem.

So that is where I am saying there is overreaching, and some of these regulators are coming down on businesses that are creating jobs.

Look, we have a problem today. You heard it this morning with the unemployment rate. It is small business owners like Mr. Whalen's business and many others that are going to be able to produce jobs, and I am extremely concerned that we are taking regulations—and, again, I would say appropriate capital, not significant capital. You used the word "significant" a few times.

The question of whether it is appropriate, significant or enough capital gets to be determined by a regulator who can take a loan and place it as a classified loan and reduce the capital in a bank. And, again, I can probably name you—I am a CPA also—I can take you to 10 of my clients in the past who have had loans that have been classified and they have not been able to borrow because of this situation.

So let us be careful when we talk about significant, appropriate, and then how we determine what loans are classified or not.

So, again, this testimony is near and dear to my heart because it is about jobs. I am concerned that we are taking the small business owners and the opportunities for them to create jobs away by reducing their ability to borrow.

Thank you.

Chairwoman CAPITO. Mr. Watt, for 5 minutes.

Mr. WATT. Thank you, Madam Chairwoman.

First of all, I want to thank the Chair for convening this hearing, because it is really among the most important, I think, and constructive hearing.

I think all of us as Members have heard the complaints about policies being set at the Washington level not playing themselves out in the field at the examination level. And this is a serious concern.

As a general proposition, I am very sensitive to the problem and somewhat favorably inclined to H.R. 1723, Mr. Posey's bill, but I think perhaps the bill may be overreacting too much in the opposite direction. I would say, as a general proposition, I am very favorably disposed to H.R. 2056, because I think a study of this issue would be very helpful and constructive in getting us to the result that we are trying to get to.

My concern with H.R. 1723—and this is what I want to focus on in my questioning—is the part that basically forbids banking regulators from imposing additional capital requirements on loans that would be treated as accrual loans by operation of the bill. I think that is a step too far, because I think the four conditions that are outlined in the bill that create a so-called accrual loan are too proscriptive.

And so, McKillop, I wanted to ask you about that in particular. An accrual loan under this bill would be a loan that is current, no payments were delinquent more than 30 days during the last 6 months, the loans are amortizing, and payments are not being made through an interest reserve account.

Those are the four criteria that would qualify. And if you met those four criteria, as I understand this bill, banking regulators would be forbidden from imposing additional capital requirements.

So, the question I want to focus on is, should not there be some kind of additional out for extenuating circumstances that goes beyond those four criteria? I guess that is my concern. I could conceive of a situation where the loan is current, no payments were delinquent for more than 30 days, the loans are amortizing, payments are not being made through an interest reserve account, but the borrower has robbed Peter to pay Paul, meeting all of those criteria, and the rest of the business is falling apart.

How do we protect ourselves if we pass this legislation against that kind of eventuality, Mr. McKillop?

Mr. MCKILLOP. That is a great question, Congressman, and I am not sure that I can give you a full answer.

Mr. WATT. You recognize it as a problem—

Mr. MCKILLOP. I recognize it as a possible problem. Yes, sir, I do.

The banking regulators and the regulations that we must comply with prescribe standards of capitalization that we must live with. And as we drift to lower and lower levels of capital standard, the degree of our flexibility as management inside the bank is constrained. And at some point in time the regulators, just through the capital standard, can impose increased regulation to cease, to cause there to be a cessation—

Mr. WATT. I do not mean to cut you off. I would love to engage in a long conversation about this, but my 5 minutes is going to run out.

You have acknowledged that it is a potential problem and it is one that we may need to address.

Mr. Johnson—Professor Johnson, do you acknowledge that this could be a potential problem also, and how might we address it? If you can address that quickly?

Chairwoman CAPITO. You would make a quick answer there—please.

Sorry.

Mr. WATT. I am sorry.

Mr. JOHNSON. Of course, there is a potential problem here. I do not think the bill addresses it.

I would ask, if the banks have great opportunities, such as lending to Mr. Whalen, why do not they raise equity? There is plenty of capital out there that wants to lend—

Mr. WATT. You are answering a different question now. I am trying to focus on the specifics of the bill.

Chairwoman CAPITO. The gentleman's time has expired.

Mr. WATT. I have run out of time. I am sorry, Madam Chairwoman.

Chairwoman CAPITO. Thank you.

Mr. McHenry, for 5 minutes.

Mr. MCHENRY. Thank you, Chairwoman Capito.

Mr. McKillop, the research shows that loan balances in 10 out of the last 11 quarters have been lower. I hear from my small businesses who say that their bankers will not lend to them. I hear from bankers who say, "I cannot lend to them because of the regulators." I hear from the regulators who say they are not qualified borrowers.

So there is a circle here. Give me your take on it. And do not give me the standard answer—give me something new, give me something interesting that I have not heard before.

Mr. MCKILLOP. You are not going to be caught on my watch. I believe that there is pressure and uncertainty in the bank boardroom where the examination process, probably for good reasons, has put the bank into a constrained management position.

Loans have gone bad. In Florida and Georgia, we are dealing with unemployment and underemployment exceeding 15 percent. Loans will go bad in that environment. When a loan goes bad, the management mark under an examination goes down. All other gradings go down and many banks go under a regulatory order.

So under a regulatory order, the board of directors is very reticent to move forward. They look around in their community and there is a community where 15 percent is either unemployed or underemployed. That means 20 percent or 35 percent of the businesses are also affected very negatively by the business that those people would be doing. The whole community is in a recessionary environment.

Does that new loan that comes through the books satisfy the regulator? Maybe, maybe not. But if not, when it hits the books of the bank, then it is another loan that is classified. As classified loan volumes grow, more pressure comes on the banker.

So the banker, who is trying to make that community work, is between a rock and a hard place. Okay? The business person is between a rock and a hard place. They need credit. They need the access to credit. In reasonable periods, the banker makes the decision and says, "I will take a chance on you." In today's environment, the regulatory pressure, at least in Florida and Georgia, is such where the bank boardrooms cannot take that chance.

Mr. McHenry. Okay. But to Mr. Whalen's point, which is—Mr. Whalen, I am familiar with your original restaurant. I have been there—fantastic food, great service. Thank you.

But it sounds like Mr. Whalen is sure money. Explain to me his situation and your view. If you have a company that is well capitalized with the ability to pay—

Mr. McKillop. Absolutely.

Mr. McHenry. But a project, as these things are, takes some time to be profitable. So give me your take on it, then Mr. Whalen, I will give you an opportunity.

Mr. McKillop. I believe that the major criteria in Mr. Whalen's case is a guidance issue by the regulators relating to commercial real estate exposure, CRE. Okay? Florida bankers and Georgia bankers and Alabama are very familiar with this. CRE exposure was guidance as it came out several years ago, many years ago now. I believe it was 2005, but I am not positive.

It is now a very bright line. If a banker exceeds exposure to certain CRE, commercial real estate loans as a function of capital, a percentage of capital, and if they exceed that bright line, which has become a regulatory very hard line, even though it still says "guidance" in all the regulations, then the banker comes under increased scrutiny.

Mr. McHenry. My time is short here.

Mr. Whalen, I will give you an opportunity to finish up. I have 20 seconds.

Mr. Whalen. Simply put, we are not necessarily just talking about current loans, but the chilling effect that it is having right now on new job creation. I think that is the concern. For example, if it takes a year for a new hotel to ramp up, and after the first year it falls short of its debt service by a quarter-million dollars, even though I might have $5 million of cash-flow on the other side, the regulators could come in and say, "That loan is nonperforming."

And that basically ignores the way that businesses grow. Things do not start from day one necessarily being self-amortizing. And that is what we are talking about. We are talking about the chilling effect, the fear factor of stopping good solid loans.

Chairwoman CAPITO. Thank you.

The gentleman's time has expired.

Mr. Miller from North Carolina, for 5 minutes.

Mr. MILLER OF NORTH CAROLINA. Thank you, Madam Chairwoman.

I think we all recognize the importance of community banks and community bank lending to small business. I enthusiastically supported the small business lending fund. I offered an amendment in this committee to strengthen that legislation. I am disappointed that program is not really up and running yet and housing starts are one-third of natural demand—natural demand from new household formation and replacement of dilapidated stock, housing stock.

And there are a few markets in the country, although we have an overhang of probably 11 million in the inventory, shadow inventory. But in those housing markets where there is really a demand for new lending for new housing, to loosen up a little bit on community banks so they can lend for acquisition development and construction.

So I understand the importance of small business lending by community banks. I am on it.

But all of you acknowledge that the real crisis 3 years ago was not community banks and there was an enormously concentrated banking industry; 80 percent of banking—of lending capacity at banks was with the 19 banks that got the stress test. And it appears that there is even more concentration now than there was then.

It also appears that regulators have a pretty good idea of what is going on at the community banks. You are just not that complex. That is actually a compliment. But they have hardly a clue still, and they certainly did not know then—they did not know 3 years ago.

The OCC did not know. The Fed did not know. The boards of directors did not know. The CEOs did not really know what all was going on at their banks because they were so enormous and so complex. They were in so many lines of business that created a very questionable alignment of interests, by my lights, often an outright conflict of interests, and that has not really improved.

Dr. Johnson, I know that you have criticized the overall size of banks. Do you think we have a better sense—and generally, I have supported the idea of higher capital for requirements particularly for the biggest banks. But one criticism I have heard is that higher capital does not help you if you do not really know what their assets and liabilities are. And we still kind of do not, or at least some suggest we do not.

Professor Johnson, do we have a handle yet on what is going on with those biggest banks? And do you think—what advantages or disadvantage do you see to the size and complexity of those banks?

Mr. JOHNSON. Thank you, Congressman.

I think that is the elephant in the room, if you like. And I fear that the problems of the big banks are not now behind us. If you look at the situation in Europe, for example, as it is currently developing, there are very big exposures that we have through Wall Street, the banks and actually the money market mutual funds, to some of the serious problems in Europe, and we do not have enough capital in that part of the financial system.

Now, I take your point that we also may not know what are the true assets and liabilities in those banks. And I think we are talking today about various dimensions of collateral damage caused by the failure of those massive banks.

And I think the process of that collateral damage will further the concentration of the system, because the more small community banks go out of business, really go out of business. They really made loans that have gone bad. There is no—ultimately no way you can avoid that, the more concentrated the system is going to be at the end and the worst—the stronger the power of the big 19, or I would say the big six bank holding companies are the ones that worry me the most; and the more danger we are exposing ourselves and our system to down the road.

Mr. MILLER OF NORTH CAROLINA. One criticism of the too-big-to-fail banks is they still have, despite everything we have done, there still is an assumption they would not really be allowed to fail, and they get credit on better terms because their creditors assume that they are going to get paid regardless of what happens to those banks.

Mr. McKillop, what is the competitive effect of that? We may deny it, but the market still thinks it is there—the implicit guarantee that those banks will not be allowed to fail. Does that put you at a competitive disadvantage to those biggest banks?

Mr. MCKILLOP. Congressman, it definitely does. There have been numerous studies over the years on the effects of massive aggregation and huge economies of scale and whether or not that puts a large bank at an advantage to a small bank. A lot of those issues are very difficult to unwind, but if you look at the deposit rates that are paid by the large institutions and compare that against the rates that are necessary to be paid by the small institutions, we have found times where that difference widens dramatically.

I am going from memory. This is not necessarily accurate. But the last study that I remember exceeded a 50 basis point advantage, a half-point advantage in terms of the cost of money. So the inference is that was an extra layer of insurance or too-big-to-fail. You could not fail, so they did not have to pay as much to get the deposit through the door.

Chairwoman CAPITO. Thank you, Mr. McKillop.

Mr. Westmoreland?

Mr. WESTMORELAND. Thank you, Madam Chairwoman.

Professor Johnson, have you had the opportunity to start any businesses up like Mr. Whalen has from scratch?

Mr. JOHNSON. I have certainly not entered the hotel business. I have worked closely with business people in various capacities.

Mr. WESTMORELAND. But not for yourself.

Mr. JOHNSON. I have not—in my own business—

Mr. WESTMORELAND. So you have not employed anybody?

Mr. JOHNSON. I have employed people, but not in the kind of business that we are talking about.

Mr. WESTMORELAND. Right. Have you ever made a loan in a bank?

Mr. JOHNSON. No, I have not made a loan from a bank, although I have worked with bankers closely on exactly those kinds of situations, particularly after crises.

Mr. WESTMORELAND. Thank you.

Let me tell you a little bit about what is going on in my district and with the community banks. We have had banks that have failed that people who have gotten TARP money have come in and taken the banks over. We have also had acquiring banks from Arkansas and other places come in that have a loss-share agreement with the FDIC.

When these banks come in, they will go in and do a fire sale and it lowers all the values in the community. We had one bank that got TARP money, almost $1 billion, came in, had a fire sale, really put it up, did not do foreclosures, put it up at public auction and got about 30 cents, 35 cents on the dollar.

Our community banks had some construction loans in these same neighborhoods. Now, all of a sudden, their values were written down. The builders who were trying to employ people, make a living, were basically put out of business because this bank that got TARP money came in and drove all the values down.

The same thing has happened with banks that come in with a loss-share agreement. The quicker they can flush those loans, the more reimbursement they get. And if they modify the loan, then that loan comes out from under the loss-share agreement, and that bank takes it over. So, there is no incentive to work these out.

And so these community banks, through no fault of their own, to have performing loans, to have good loans and employing people, when the government has either made a deal with an acquiring bank to reimburse them for their losses or gotten the TARP money, they are the ones that have driven the market down and the community banks are suffering.

So we have banks that have been too-big-to-fail, but we have other banks that have been too-small-to-save.

And these community banks—and Professor Johnson—these community banks that you are probably aware of, the most prominent people in the community, even people at ours, have bought stock in there.

Once these community banks are taken over, that wealth—$15, $20, or $30 million—is flushed out of that community, gone forever.

And somebody else is getting those funds, that money, and taking advantage of what these communities have built up.

I have sat down with community bankers and said, give me some specifics.

And, Mr. Whalen, one of the examples you have given about the six-story building—and I have been to Davenport, too, and so I want to compliment you on your food—but had an expansion of a business in my district.

That was a—it had increased its employment 25 percent. It was a $7 million expansion. He was going to buy a million dollars worth of equipment.

And his banker, whom he had been banking with for 30 years, said, "We cannot do it because our commercial real estate portfolio is at a percentage where we cannot make you the loan."

Now, there is something wrong with that. Government is getting in the way of this recovery and we wonder why we are not creating jobs.

Mr. McKillop, these community bankers I am talking to—and every time I talk to the FDIC, they say, give me specifics.

My community bankers do not want to give me—because they are afraid of retaliation. Can you just say something about that? And is this an experience of all your community bankers?

Mr. MCKILLOP. Congressman, yes, it is. When an examination takes place, one of the issues that Congress should understand is that the information in that exam is confidential.

It is—we are not supposed to talk about it, period. And there are legal sanctions that can be taken.

My charter is a little different. I can step out on some issues and talk more clearly. But I cannot say specifically about another bank.

I have seen and heard from my customers—some of my customers are in your district—the same thing, sir, okay? It is a difficult issue, and it is difficult not to generalize. So let us be careful about that.

But the regulatory pressure—

Chairwoman CAPITO. Let me just inform the witnesses and everybody in the room, the vote has been called. It is going to be a very lengthy series of votes.

I would ask the first panel, when I suspend the hearing, to come back. I would really appreciate it, because we have a lot of other questioners, if that is all right.

And I will go to Mr. Scott, and hopefully we can get one more person in before we suspend.

Mr. SCOTT. Thank you, Madam Chairwoman.

Let me just say briefly what is going on in my State of Georgia, which is ground zero for bank failures. We lead the Nation in bank failures.

Just 2 weeks ago, regulators shut down the Mountain Ridge bank in the town of Clayton in Georgia, bringing the number of U.S. bank failures this year to 48. But the startling figure is that in Georgia alone, during this period of 48 banks closing all across the country, 15 of those bank failures this year have been in Georgia. And we are only halfway through this year. It is only July.

As a matter of fact, The Atlanta Journal-Constitution said that the Mountain Ridge Heritage Bank was the 65th bank in our State to fail in the last 2½ years. So it is devastating there.

And that is one of the reasons why I am proud to cosponsor with my good friend, Congressman Westmoreland, House Resolution 2056, which really will get the FDIC Inspector General to take a look at some of the issues that have caused these bank failures, especially the application and effect on consent orders and cease-and-desist orders, and particularly orders that have been enforced uniform—whether or not these orders have been enforced uniformly across the spectrum.

But to zero in on our smaller community banks, one of the real issues—and I would like to, first of all, I think, address this to each of you.

But, Mr. McKillop, since you are here and representing the small bankers, I want to ask you about the repeal of regulation Q.

There is a considerable concern within the smaller community banks in my district and throughout Georgia, probably throughout the Nation, that the new-found ability to pay interest on checking accounts placed them at a competitive disadvantage versus the larger banks.

There is also a concern that this repeal could negatively affect the safety and soundness of community banks. Do you think that the effect of the repeal on community banks was adequately studied before regulation Q was inserted into the Dodd-Frank bill, and would you not feel and agree that a delay of the repeal would be a good idea in order to have time to fully study its impact?

Mr. MCKILLOP. Congressman, you bring up a very good question. I am not sure that I have the resources to be able to answer you appropriately. My bank deals with lots of small banks throughout the Southeast.

And I believe that the change in Reg Q will change the cost of interest rates. I also remember that it was fairly well advertised in advance that a possible change could occur.

So as for the timing and the degree of analysis, sir, I am not qualified, really, to answer.

Mr. SCOTT. Does anyone else have a thought on that at all? Do you feel that the smaller banks, community banks, are at a disadvantage with the larger banks at all?

Would anyone like to express concern about that?

Let me ask you about 2056, then, Mr. Westmoreland's and my bill, and others who have cosponsored it, would you—do you believe that the bill would be an effective way of having the information necessary to eventually prevent bank failures?

If not, in your opinion, what needs to be added to the topics that should be studied by the FDIC to prevent future bank failures?

Does anyone have a comment on that?

Mr. MCKILLOP. Yes, sir. The degree of the study is probably the most important, sir. I am a little skeptical. I have seen Congress bring forward proposals to study things and ultimately the study is either so late or so tardy or so thin—

Mr. SCOTT. Let me ask, as my time is short and I know others want to ask questions. I do not want this opportunity to pass without you giving us, as a representative of the smaller community bank, what do you think we can do to stop these bank failures?

It is a drain in Georgia and across this Nation. What do you think we could do if 2056 is not the answer?

Mr. MCKILLOP. The ultimate fundamental is capitalization, sir. And if we can create an environment that says these banks will be stabilized into the future, they will become viable into the future, they will not be closed immediately, then we could see community banks begin to raise capital.

Today's environment is exceptionally onerous for community banks that have a lot of regulatorily defined impaired or substandard loans.

Mr. ROYCE. [presiding]. Thank you. Without objection, we have a statement from Chairman Spencer Bachus that we will enter into the record, and we will go to Mr. Luetkemeyer for his questions.

Mr. LUETKEMEYER. Thank you, Mr. Chairman.

Mr. Whalen, I want to congratulate you. You may be the best witness I have ever seen in all of the few years I have been here in Congress.

You bring an expertise from what you do. You are pertinent to the issue and your frankness is very refreshing. Thank you very much for being here today.

Mr. McKillop, thank you for the kudos on the Communities First Act. It is a bill that I am handling, and will hopefully have up after the August recess here. And along that line—and you made several comments that are pertinent to today's discussion with regard to the legislative proposal regarding banks' examination practices as the headline for our committee hearing today.

And you have nailed it when you said that the regulatory environment is making it very difficult to do business. Mr. Whalen is an example of that.

What do you see as a—this bill that we are looking at today is one—and the two bills, I guess, are a couple of solutions that we have come up with.

Do you have some other ideas, besides Communities First and some other things that we can do?

Because I think what we have done here with these two bills today, we have some great ideas, I think, for ways that will give some forbearance to some of the activities that are going on.

Mr. MCKILLOP. Congressman, I look at Dodd-Frank, and I say that was a bill that had to come by, had to occur to deal with the too-big-to-fail issue and the problems on regulated institutions.

But at the same time, I look at what is happening now and the trickle-down effect that will be occurring into the future, and I go back to prior conversations with Directors in the FDIC, and I believe that establishing a separate way of examining community banks, a separate examination standard, might be the only thing that we can really implement with some peace.

Mr. LUETKEMEYER. One of the things that I hear regularly from my bankers back home is that there is a huge disconnect between what the folks in Washington are telling us is supposed to be the way that banks are examined and what is really going on out in the field.

I assume that your testimony lends itself to that direction. You agree with that statement?

Mr. MCKILLOP. I agree totally with it, sir.

Mr. LUETKEMEYER. Do we need to say it louder? We have some regulators here in the audience. Do I need to stand on the table today and you want to shout in your microphone to let them know that there is a huge disconnect between what is going on here in Washington and what is really going on out in the field?

Mr. MCKILLOP. Let my yes be yes.

Mr. LUETKEMEYER. Because I have met multiple times with regulators and it does not seem to register.

So thank you for being here today. And, again, if we need to, we will sing this praise from the highest heaven here that this is what is going on and we need it to stop.

But one quick question for the professor. You made the comment awhile ago, sir, that you said that—I would like for you to elaborate on it—that we really need to have no capital, would be a way to go. And then you turned around and said that we need to have no forbearance.

Can you justify those two statements? Can you tell me how they are juxtaposed against each other and make sense?

Mr. JOHNSON. Yes, Congressman.

I did not say no capital, I said no capital requirements. But that does not make sense in a system with deposit insurance.

In pure free market systems, before, for example, in the United States before there was deposit insurance and before the creation of the Federal Reserve, banks routinely had 30, 40, 50 percent equity capital as a share of their assets. So they had a lot more capital.

And one consequence that we should all recognize and—we actually can all agree on is because we now have deposit insurance, banks are able to have less capital, they are protected—

Mr. LUETKEMEYER. So what you are saying is we had—if we had no insurance we would have more capital—or should have more capital—

Mr. JOHNSON. If you look at private banks, the non-insured banks, financial institutions that take the same kinds of risks as banks, small, medium or large, they routinely have 30 percent capital. So that is 30 percent equity funding as a share of the total funding; 30 percent equity, 70 percent debt.

That is not risk-weighted capital. There is no risk adjustment—pure, plain, straight numbers.

And so, we run our financial system with very little capital relative to what you get when you do not have the sort of regulatory-related deposit insurance.

Mr. LUETKEMEYER. Fine. I do not disagree with that. I think that you are probably right.

With regards to no forbearance, that is exactly what we are talking about here today, though, with regards to Mr. Posey's bill—forbearance here, to put in law that is really supposed to be in practice, as was said awhile ago.

Do you disagree with this bill, then? I think you made that statement awhile ago.

Mr. JOHNSON. Yes, I do disagree with the bill, Congressman.

In Texas, in the early 1980s, there was a serious problem with commercial real estate. One response was regulatory forbearing, including through legislation passed by Congress.

Now, the problem was not just in Texas. The problem was not just in the bank that originally had the problem. But by the end of the 1980s, we had what is now known as the S&L crisis that was large and cost the taxpayers hundreds of billions of dollars in order to sort out.

That was a direct result—costs escalated because of the regulatory forbearing.

Chairwoman CAPITO. Thank you.

I thank you for your patience.

We are on a vote. We have about a minute-and-a-half left for the vote, so I think we are going to suspend the hearing. We will stand in recess until after the last vote. We should be back here between 12:15 and 12:45. Some of the staff can give you a more accurate time.

You can go to the glorious Rayburn cafeteria and enjoy a great a lunch.

Thank you.

[recess]

Mr. RENACCI. [presiding]. We are going to call the hearing back to order.

Mr. Pearce, you have 5 minutes.

Mr. PEARCE. Thank you, Mr. Chairman.

Before we were so rudely interrupted, I was going to ask—when I am looking at Mr. Whalen's testimony, I see on page one, he says that the decision to make a loan will be second-guessed by regulators. And then he goes on to make the point that regulators are responsible for the failure to—for the loans to take place.

Then Professor Johnson on page two, number eight, says to blame bank examiners for the lack of lending in a post-crisis economy makes no sense. And so, I would kind of like to drill down just a little bit deeper in that.

Professor Johnson, do you have empirical evidence? I guess if I were going to look to try to figure out the difference, I would look at safety and soundness reviews and compliance reviews. That would be two vastly different approaches. One would be concentrating on the capital and whether the financing by debt or whatever. The other one might be a regulatory approach.

So in your empirical evidence, have you studied the amount of reviews now that are compliance versus those that are concentrating simply on safety and soundness? Which one is dominating in the reviews right now?

Mr. JOHNSON. Congressman, that is a very good and a very fair question. I do not think anybody knows that level of detail on the systematic data.

We do know from the Federal Reserve's senior loan officer's opinion survey, and from the National Federation of Independent Businesses survey of small business economic trends, the predominant fact there is that demand for loans remains sluggish because of the damage to the balance sheet. So I do not—

Mr. PEARCE. I am hearing a completely different thing, sir, in New Mexico small banks. And I am hearing that there is evidence that—I get banks together on phone calls frequently, and they tell me that compliance reviews have replaced safety and soundness, the tediousness of it. And, in fact, those soundness reviews are killing the market exactly the way that Mr. Whalen describes.

They, in fact, tell me that when they used to get a simple mark-up, say, a notation, a write-up for something. Now, they face $50,000 fines. And they tell me, "Why would I loan money on a New Mexico house that I am never going to make $50,000 on that particular loan? Why would I risk making the loan in order to get possibly a write-up, because we left a comma out or because we did not completely fill out the flood insurance?"

Flood insurance in eastern New Mexico is not a high priority item. We have not had rain since last August, and the State is burning up, as you can see on TV. And so, this would lead us to believe a little bit more that the process of reviews is in fact killing the market exactly like Mr. Whalen said.

Now, in your verbal comments, you asked the rhetorical question, why are banks scared. And then you said that they have too little capital.

I, in fact, am hearing from banks every day that they have plenty of capital, and they have loan demand, but they also tell me that if they make one bad loan, that their bank is going to be taken away from them. They point to examples in New Mexico where that has happened.

So, why would a banker risk making a loan that somebody is going to come in and review at some later time that could cause them to lose their entire bank?

I would have you look at Charter Bank and the Bank of the Rio Grande, both of which were operating fairly well until they began to come in and say, "Well, we are going to downgrade this or that," very few non-operating loans.

I think the next point that I would really like to ask about is the procyclical and countercyclical regulatory measures.

Right now, I think that the regulators, and I think you could make a very strong point, that they are pro-cyclical. When things are good, they simply open the door and let them get better instead of trying to check the process and trying to—instead of saying, "Well, let us all slow down just a bit."

And when they start going bad, then they make things go worse by their foreclosures, by their insistence that they close down loans that are still performing. Then, appraisal values go down, and so builders cannot get loans, because the appraisal values have been abnormally pushed lower by the actions of regulators that are calling into question loans that are performing every day.

We recently had a group of—this was about a year ago, as a matter of fact, even before the election—Indian American hotel owners. All came in from a three-State region. Every single one of them had demand requirements that you had to provide $750,000 in capital to loans that had performed flawlessly, never missed a payment.

Those feel like regulatory excesses that are simply doing what Mr. Whalen contends. And your contention, on the other hand, is that it is ludicrous to make that assertion. Would you—I tend to side with Mr. Whalen, and the evidence that I hear every day sides with him. Would you like to comment on that?

Mr. JOHNSON. May I? Again, these are legitimate concerns. Certainly, regulators can become procyclical, as you say, exaggerate the boom and also exaggerate the bust. And certainly, there are convincing anecdotes and instances, examples, but systematically is this what is happening? Have examination standards become tighter?

Mr. PEARCE. When every banker in the State says yes, because I have these conference calls. Do you have any empirical evidence that says it is not happening, that it is only anecdotal? I find that pretty offensive, when you do not come in here with empirical evidence, and you are declaring what I come with, with bankers saying often. I consider that to be offensive that you are saying it is anecdotal.

If you come here as a professor, you bring the empirical evidence for the claims you are going to make, sir.

Thank you. I yield back.

Mr. RENACCI. Mr. Posey?

Mr. POSEY. Thank you very much, Mr. Chairman.

Mr. Pearce, I think, if you look at the written statement, Mr. Johnson looks at the situation in reverse. He seems to view it that the regulators are the good guys and presumes that banks are bad guys, who just want to somehow game the system.

The statement was absolutely silent and failed to address in any way whatsoever regulation, which is the point of this bill and the point of this hearing that we are having here.

Mr. McKillop and Mr. Whalen, I wonder if you could each share with me how important you think cash flows are versus collateral value? Are the regulators focusing too much on collateral value and not enough on cash flows?

Mr. WHALEN. Yes, if we had a situation where the FASB Board did suggest that we would, in effect, go on mark-to-market rules through appraisals, if would have been the end of small and medium-sized businesses. It would have been absolute chaos. How often do you go in to get an appraisal every week, every month, every 6 months?

The irony of it is, is that you can—ups and downs in appraisals, but cash flow is still the mother's milk of repaying a loan. And that is one thing that has occurred here, which is, I think, excessive use of appraisals. You did have excessive appraisals there for a while. We have swung to the other side.

I had a situation where we put in $13.5 million of hard infrastructure into a development. Basically, the appraisal came back unchanged from the year before. I said, "Wait a minute. I just spent $13.5 million. Here is the bill." "Well, you know, it is a tough market."

The point being is I do think that this is exactly that—way too much emphasis on what is the appraisal of the day, the appraisal du jour, and not enough on looking at historical and cash flow trends.

Mr. POSEY. Thank you very much.

Mr. MCKILLOP. At best, the collateral value is generally a secondary source of repayment. The primary source is cash flow. As bankers, we always look for that first.

Mr. POSEY. And is there in banking any better measure of an account, in your opinion, than the simple matter that the payments were made on a timely basis?

Mr. WHALEN. That was the old idea—borrow the money and pay it back.

Mr. POSEY. I get a feeling that there are two kinds of people in this room. There are people who see the problem of arbitrary overregulation, and those that do not. It is just really simple.

And if you do not see the problem, then you will find all kinds of objections to this legislation, because it changes a regulatory environment that some people seem to think is okay and needs to be preserved for whatever reason.

But I just do not see how letting a current debt be left on an accrual basis perpetually, as long as payments are made, can harm anybody. I think that is common-sense legislation and basically what it is going to take to recover.

This is no cost at—unlike some of the big banks that got bailouts, the community banks got bailed on. And most of the community bankers that I am aware of, a majority of the interest in the banks are held by the officers, the directors of the bank, and people in the local community.

There is not a big spread of stockholders across this Nation and around the world whose money they are gambling with. They are gambling with their own money, if they are gambling. They are loaning their own money, more than they are other people's money. And they are accountable for it.

And given the opportunity to work with the homeowner or a small-business man who may be in tough times, they can bring it to a positive conclusion, whereas a heavy-handed, monolithic bureaucrat can come in there and just stomp them out of business.

In my State, unfortunately, there is probably not very much real estate that is worth today what it was 5 years ago. And so if your loan is over 5 years old, and some bureaucratic regulator just decides they need to have a current appraisal, there is a good chance your property is not going to appraise for what it did 5 years ago.

You could essentially take every loan on real estate in our State, probably, and put it on a nonaccrual basis for that reason.

That is bad for Florida, that is bad for the United States of America, and that is bad for the taxpayers.

Thank you.

I yield back.

Mr. RENACCI. Thank you, Mr. Posey.

Mr. Royce, for 5 minutes?

Mr. ROYCE. Thank you, Mr. Chairman.

I would like to ask Professor Johnson a question. And it has to do with a concern that you raised about the ability of the resolution authority that was passed last year to resolve a global financial institution that is in trouble.

Can you briefly explain your concerns regarding this authority as it pertains to these massive financial institutions?

Mr. JOHNSON. Yes, Congressman. I am of the view that were one of the largest banks in the country—Citigroup, for example, or JPMorgan Chase—to get into trouble, this would be very hard to deal with under the resolution authority that the FDIC now has, working with the Federal Reserve, the Treasury and the Financial Stability Oversight Council.

Because there is no cross-border resolution agreement; there is nothing between the United States and the United Kingdom, nothing between the United States and other countries. So there is no way to agree on who has what kind of priority in the event of a failure.

And that would be a source of confusion, very much like what we saw in the days after the failure of Lehman Brothers.

Now, the FDIC has issued a paper of specifics on how they would have handled Lehman differently, and they make some good points in that paper. So my concerns are not so much about the specifics of a Lehman, but it is much more about the global mega banks that, unfortunately, I believe could not be handled through effective resolution at this time.

Mr. ROYCE. One of the challenges we have is that with the too-big-to-fail presumption and with the legislation that we have passed in Dodd-Frank, the implied subsidy or benefit in the market, the lower cost of capital, keeps compounding.

It used to be that the studies showed it was about a 100 basis point advantage for large banks over smaller banks. Now, we have the Kansas City Fed president saying maybe, by today's standards, it has 360 basis points more.

And if you look at the consequences of that, we have a situation now where 2 percent of the industry controls 78 percent of the assets. Before we went into this conundrum, we had 33 percent of the assets concentrated in the big investment banks in the 1990s.

So it seems as though one of the disadvantages for community banks is this lower cost of capital that exists because of the implied government backstop and because of the various actions we took.

And now, with Dodd-Frank, because it is apparently believed out there in the market, and if the Kansas City Fed's right, it has compounded the problem, all of this leading to the question that if this plays out over time, then, as I said in my opening statement, we are going to just continue.

And with it, would not there come an overleveraging, logically, of the largest financial institutions unless something is done along the way in terms of regulation which tried to capture that implied advantage, government backstop advantage.

And if we assume that the reason we are in this is because of that—let me let you—I am going to run out the clock here. Go ahead.

Mr. JOHNSON. I agree with everything you have said. I think that is a completely accurate and sobering assessment.

There are various tools available under Dodd-Frank, including the so-called living will provision. So the FDIC does, in principle, have the power to force big banks to become smaller.

But we have seen no indication that they have done that, and I would be skeptical that there will be political support for them taking those actions.

And, as you say, if we could find a way to remove the funding advantage—I do not think it is quite as big as Tom Hoenig is saying, but it is big, and as Mr. McKillop said it is at least 50 basis points. That is probably closer to 75. That is a big deal in this market.

If you can find a way to tax that or remove that funding advantage, that would be good. But it is very hard to do. And the result almost certainly will be an overleveraging of the too-big-to-fail banks, because of the government backstop, and further financial crisis that will damage, massively, both community banks and small business.

I think nothing could be more important than dealing with the risks to the system posed by today's mega banks.

Mr. ROYCE. Thank you.

Thank you, Mr. Johnson.

Mr. RENACCI. Thank you, Mr. Royce.

Mr. Manzullo, for 5 minutes?

Mr. MANZULLO. Thank you for coming to this hearing. It is unfortunate that we could not have one panel where the regulators sit with the regulated, to have more interaction than is going on.

I am very disturbed over what the regulators are doing. The area I represent in northern Illinois is heavily involved in manufacturing. And I have had manufacturers come to me with an order in their hands from a major, major contractor—an order in hand, wanting work to be done locally.

With the manufacturer going to the bank and asking just for enough money to buy the raw materials, it is called "factoring." And with factoring, the banks have absolute control, because they would write the check to the vendors to the small manufacturer and actually receive the check coming back from the large manufacturer that ordered parts from the intermediary.

And every time this happens, I sit there and I ask myself, why do we work so hard to return manufacturing to America, when the Federal regulators hate manufacturers?

I am going to say that again. The Federal regulators hate manufacturing. They do not trust it. They think that is going to—things are going to fold up, and they actually do not believe that manufacturing is that important.

This is reflected in some of the idiotic statements made by the examiners who, when two of my constituents were turned down on a loan, said to the bank, "You cannot continue the line of credit because those two brothers do not have any reserves left in their sub-S corporation."

That is how stupid the examiners were. You do not have reserves in a sub-S corporation. You distribute the money in a pass-through, the same as an LLC.

And the bank said, "Our hands are tied." I am talking about a 30-year long commitment.

And, Mr. Johnson, when you say in your statement that you cannot blame the examiners—"to blame bank examiners for the lack of lending in a post-crisis economic—economy makes no sense"—you are wrong. The reason that you are wrong is the fact that most of my work is done in manufacturing, probably 70 to 80 percent of time as a Member of Congress.

I talk with these guys every single day. And I also talk to the banks, and I have also talked to the regulators.

And then one day, I talked to the heads of the Fed, the FDIC and the OCC. And here is what they said: "We have not changed policy," which is true. And each one invited me—said if you have a particular loan that you think should have been given, I will look at it personally.

They were not stroking me. The problem is the bank. Every time, the bank refuses to take them up on it because they are fearful of retaliation coming from the examiners.

Now, this stuff has to stop. And it has to come from the top. And I just want to throw that out to you and see if anybody there thinks I am nuts or if you want to agree with me or, Professor

Johnson, the—I think you probably agree with my answer, because the pressure is coming from the top and not just the examiners themselves. Would that be correct?

Do not take all my time. We have two other guys I want to hear from.

Mr. JOHNSON. I think you are raising very serious questions that deserve careful examination, to be sure. I have not seen evidence of this intimidation by regulators to which you—

Mr. MANZULLO. I have. It exists. You cannot deny that it exists. The banks are being hammered by it.

Mr. JOHNSON. I have not seen that evidence myself—

Mr. MANZULLO. Anybody else? Mr. McKillop? Anybody?

Mr. MCKILLOP. Your premise, I think, is right on target. I am obviously not aware of the banks in northern Illinois, but I see similar sorts of things occurring in other aspects of regulatory pressure on community banks quite often.

Mr. MANZULLO. Mr. Whalen?

Mr. WHALEN. You hit it right on the head. I have businesses in your district, by the way.

Mr. MANZULLO. Yes, the machine shop. Good chicken.

Mr. WHALEN. Thunder Bay.

But, I had a banker and he has been in the business for multiple decades. He said, "Mike, I am going to lend this money to your business, but I know next year they are coming in and they are going to put this—have some kind of a watch list, but I do not care." But he is one of the few who was not intimidated.

Mr. MANZULLO. The—I am over?

I yield back. Thank you.

Mr. RENACCI. Thank you, Mr. Manzullo.

Again, I want to thank the first panel for your testimony, and at this time, you are dismissed.

I would also like to call up our second panel of witnesses.

Good afternoon. At this time, I want to introduce individually for the purpose of giving 5-minute opening statements our second panel. Our first panelist is Mr. George French, Deputy Director, Division of Risk Management Supervision, Federal Deposit Insurance Corporation.

STATEMENT OF GEORGE FRENCH, DEPUTY DIRECTOR, POLICY, DIVISION OF RISK MANAGEMENT SUPERVISION, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. FRENCH. Good afternoon, Chairman Renacci, and members of the subcommittee. I appreciate the opportunity to testify on behalf of the FDIC on the condition of the banking industry, our approach to supervision, and some concerns we have regarding H.R. 1723.

The banking industry today continues to face challenging conditions. Loan demand is weak and for some banks problem assets are at high levels. Nevertheless, a number of indicators show signs of a turnaround and the FDIC is cautiously optimistic regarding the outlook for bank performance.

The 4,400 community banks that we supervise continue to play a vital role in credit creation across the country, and especially for small businesses.

Now, before addressing H.R. 1723, I would like to make a few observations about our supervisory process. The FDIC attaches great importance to taking a balanced and fact-based approach to supervising banks in this challenging environment. In reviewing banks' loan portfolios, we rely significantly on validating banks' own credit risk management processes, and most often examiners agree with a bank's assessment of loan quality.

We do not micromanage banks in how they deal with individual customer relationships or how they manage their loan portfolios. The FDIC does not require banks to write-down loans based solely on a decline in collateral values. And in fact, as long as the borrower is expected to be able to repay the loan, no loss on the loan should be recognized.

Another misconception is that once a loan is placed in nonaccrual status, it is stuck there until the next examination regardless of any work-out arrangements. In fact, when a borrower has demonstrated the ability to pay for 6 months, the loan can be returned to accrual status.

We have joined several interagency efforts to clarify these points and to encourage banks to originate and restructure loans to creditworthy borrowers. We have heard from bankers that these statements have helped clear up misconceptions and helped them to become more comfortable extending and restructuring soundly underwritten loans.

I also want to emphasize that to carry out our statutory responsibilities for supervision, we need accurate information about problem assets. We expect the financial statements prepared by banks to adhere to the standards prescribed by the accounting profession for problem loan accounting and loss recognition.

And this is the source of our concern about H.R. 1723. Under that 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 information indicating that it is improbable that the loan would be repaid in full. This would enable institutions to include accrued but uncollected interest income in regulatory capital when collection in full is not expected.

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 would result in an understatement of problem loans on banks' balance sheets and an overstatement of regulatory capital. 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.

Such regulatory capital forbearance would detract from investors' confidence in the reliability of all banks' financial statements. Moreover, experience has been that policies that delay the recognition of bank losses can ultimately increase losses to the FDIC deposit insurance fund and the costs that healthy banks pay for their deposit insurance premiums.

In closing, I would like to reemphasize that the FDIC recognizes the challenges facing banks and their borrowers 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 financial reporting is critical to maintaining a safe and sound banking industry.

With respect to H.R. 2056 directing the FDIC I.G. to study the issues relating to bank failures, I would just like to say that we are always glad to work with our I.G. We value their input. They are an independent organization and I believe they may be in contact with some of your offices regarding their views and specifics on that view.

I would be glad to answer any questions from the committee.

[The prepared statement of Mr. French can be found on page 55 of the appendix.]

Mr. RENACCI. Thank you, Mr. French.

The next witness that I would like to introduce for a 5-minute opening statement is Ms. Jennifer Kelly, Senior Deputy Comptroller for Midsize and Community Bank Supervision, Office of the Comptroller of the Currency.

STATEMENT OF JENNIFER KELLY, SENIOR DEPUTY COMPTROLLER, MIDSIZE AND COMMUNITY BANK SUPERVISION, OFFICE OF THE COMPTROLLER OF THE CURRENCY

Ms. KELLY. Chairman Renacci, and members of the subcommittee, I appreciate this opportunity to explain the OCC's approach in assessing the condition of banks' loan portfolios, including determining whether individual loans should be classified or placed on nonaccrual, and to offer the OCC's views on H.R. 1723 and H.R. 2056.

Access to credit plays a vital role in restoring economic growth and supporting jobs in our communities and we share the subcommittee's view that banks should not be unduly constrained from meeting the needs of creditworthy borrowers.

We are committed to balanced and fair supervision of the financial institutions we regulate and I believe our examiners are striking that balance. OCC examiners assess the quality of a bank's loan portfolio during each examination cycle. The goal of our reviews is to confirm the accuracy of bank management's own assessment of credit quality, not to second-guess or supplant their judgments with ours.

When a borrower's ability to repay a loan becomes impaired, we expect the bank to classify the loan to recognize the increased risk. Examiners confirm management's assessment through transaction testing of specific loans or loan portfolios. Where weaknesses are found, examiners direct bank management to take corrective action.

To provide consistency in the examination process, the OCC and other banking agencies use a uniform risk rating scale to identify problem credit. This regulatory classification system consists of four levels of designation that identify different degrees of credit weaknesses.

We have a variety of mechanisms in place to help ensure that OCC examiners apply our policies in a consistent and balanced manner across institutions. And we spend considerable time and resources providing training and guidance to our examiners on evaluating credit risk.

Loan analysis and accounting principles are focal points of every new examiner's classroom and on-the-job training. One of our primary regulatory objectives is to ensure that the call report a bank is required to publish each quarter accurately reflects the condition of the institution at that point in time.

Accurate and transparent financial statements are essential to allow investors, creditors, and regulators to evaluate a bank's financial condition. Congress recognized the importance of this when it passed 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 resolution of troubled institutions.

When a borrower shows signs of trouble, banks and examiners must consider whether the loan warrants criticism or classification, then whether the loan should continue to accrue interest. And finally, if the loan is subsequently modified, does it need to be reported as a troubled debt restructuring.

The banking agencies' policies for these and other loan accounting issues are detailed in the instructions that banks follow when preparing their quarterly call reports.

Consistent with GAAP, the call report instructions that a loan be put on nonaccrual status when payment in full of principal or interest is not expected, or when 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 a general rule, a nonaccrual loan may be restored to accrual status when 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 when it otherwise becomes well secured and in the process of collection.

With this background, let me briefly offer the 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 the purposes of calculating regulatory capital.

We are concerned that legislation proscribing specific regulatory accounting that is less stringent than GAAPs could mask troubled assets and overstate a bank's capital ratios.

This type of forbearance could diminish investor confidence in banks and undermine a primary objective of the prompt corrective action regime.

H.R. 1723 also requires the Financial Stability Oversight Council to study how to prevent contradictory regulatory guidance on loan classifications and capital requirements.

The OCC shares Congress' interest in assuring that assessments are fair, balanced, and consistent over time and across institutions.

For this reason, we generally coordinate with our regulatory counterparts on the issuance of regulations and supervisory guidance on matters such as capital and capital requirements and loan classifications.

As previously noted, the criteria for loan classifications and loan accruals are set forth in the interagency guidance and the call report instructions.

H.R. 2056 would require the FDIC's Inspector General to study the effects of certain policies that may also pertain to institutions directly supervised by the OCC.

As such, we believe it would be appropriate for the OCC to be given an opportunity to provide comments before the study is finalized. Thank you.

[The prepared statement of Ms. Kelly can be found on page 68 of the appendix.]

Mr. RENACCI. All right. At this time, we are going to recognize members, and I will yield 5 minutes to myself at this point.

I know that both of the organizations do not get up every morning and try and figure out ways to slow down banking and slow down jobs. But that is actually what is happening in the real world out there.

We heard testimony from the bankers earlier. We heard testimony from an independent owner of a business.

And I think I told you my personal experience as a CPA and also a business owner, that the regulators out there are overreaching.

They are doing everything that I know you have said in your conclusion that they are not trying to do and that you do not want to do. But, there is overreach.

And if you came back to my district in Ohio, I could take you to six, seven, eight different businesses that would tell you that I have paid my loans on time. The value of the property is there.

And as a CPA, I have had the opportunity to see those things. So, it is not like they are just telling me that. I have actually had the opportunity to see it, and understand it.

So tell me, from both your perspectives, how do you make sure that this is not happening? You could say here today that your goals are for it to not happen.

But if I was able to take you out into my district to five or six businesses and show you that it is happening, tell me what you do, from each organization, to try and make sure that this is not happening? Because it is. So I would like to hear what your thoughts are on that.

Mr. French first.

Mr. FRENCH. I would like to start by saying that I think, overall, most community banks today—

Mr. POSEY. Can you pull the microphone closer?

Mr. FRENCH. Most community banks today do have a lot of capital, I would say. The typical community bank has more than twice as much capital as it needs to be well capitalized, 2½ times its minimum.

So I think, in many cases, the banks are waiting for a return to robust loan demand. That is what we are hearing from the bankers who come in to meet with us regularly—

Mr. RENACCI. I hate to interrupt you, but I have had 11 bankers in my office who all told me they have the dollars and the demand, but the regulators have—they are concerned about overreaching because of what the regulators are saying.

Mr. FRENCH. We would certainly be concerned as well. We want our banks to lend. We want them to make good loans.

We are not out there looking to close banks. So, what we do is we have our examiners—they have comprehensive training programs.

We go out, on a quarterly basis, to our regional offices and to Washington executives, talk to them about professionalism in dealing with banks.

Mr. RENACCI. Again, but is anybody going out to Main Street, America, and seeing what the actual regulators are doing to some of these small businesses? Because so far, I have not heard that.

Mr. FRENCH. We take great interest in this. We have a small business lending hotline at the FDIC.

We have received about 500 or 600 calls where we investigate, find out what is going on behind those.

We have it processed in our exams, where every risk management exam, we have a structured dialogue with the bankers about obstacles that they are seeing to credit creation.

And we keep track of the answers. And we hope, hopefully, over time, this will help us to get a better sense of where some of the concerns might be—

Mr. RENACCI. But it does sound like you are not testing or sampling. You are waiting for people to come and call the hotline. The problem is most of these individuals are concerned.

Most of these banks are concerned about calling the hotline, because then they are going to be—they know they are, in many ways, they feel they are going to be punished.

Mr. FRENCH. Yes—

Mr. RENACCI. I am—I know we are running out of time.

Ms. Kelly?

Ms. KELLY. I would say that we do a tremendous amount of outreach to bankers in terms of getting out there, talking to them, hearing some of the comments that you are relating to us here as well.

And they do share specifics with us, and we talk through it. We also have an ombudsman, an independent ombudsman at the OCC. Banks can file a formal appeal, if they really disagree with us.

But more often than that, the ombudsman has many conversations with bankers to help better understand what the issues are and get their side of the story and try and resolve things on the supervisory side.

So it is encouraging that dialogue. I hear all the comments you are relaying to me about retaliation. But I can tell you there is an extensive dialogue.

The other thing we have done is quite a few Members of Congress have asked us to participate in different local forums with small businesses and bankers. We always are willing to do that.

We have found those sessions to be very helpful as well in terms of keeping us informed of what the issues are, what the concerns, and trying to be responsive to that.

Mr. RENACCI. But, again, it does not sound like either organization is actually sampling or testing or going out in the field.

Ms. KELLY. I am sorry, I did not speak to that directly. Yes, we do. I have designated credit experts, who are spread across the country. They do quality assurance reviews on a sampling basis.

And when we have a problem bank, a bank that has particular credit problems, we will send those experts in to take a closer look at the work that the examiners are doing.

So that gives us a good sense of how well the examiners understand the policies, and are they applying them consistently.

Mr. RENACCI. Thank you. And just in closing, I can tell you that it sounds like you are trying, but it is not working.

And we really do need—there are business loans out there that are—and businesses who are not able to employ people because their credit has been shrunk, even though they have made payments, their assets are there.

So I hope we can do a little better job in the future, because this is all about jobs and making sure that these businesses have that opportunity.

All right. I am going to recognize Mr. Westmoreland for 5 minutes.

Mr. WESTMORELAND. Thank you, Mr. Chairman, and I have a chart I am going to ask to be put up on the board there.

Mr. French, have you ever worked in a bank?

Mr. FRENCH. No, sir.

Mr. WESTMORELAND. Have you ever been in business for yourself?

Mr. FRENCH. No, I have not.

Mr. WESTMORELAND. Ms. Kelly, have you ever worked in a bank?

Ms. KELLY. No.

Mr. WESTMORELAND. Okay. Have you ever been in business for yourself?

Ms. KELLY. No.

Mr. WESTMORELAND. Mr. French, in kind of relationship to what the chairman was asking, does the FDIC do any postmortem after these closings to review what may have caused the closing?

Mr. FRENCH. Yes. There are a number of things that we do. But we certainly have the Inspector General material loss reviews after closings that, where the loss exceeds a certain threshold.

We also have, for any bank that is in a problem status or about to be put into a problem status, the level of internal review required for that to happen escalates to the regional director level. And—

Mr. WESTMORELAND. I am talking about banks that have closed.

Mr. FRENCH. Yes.

Mr. WESTMORELAND. Do you go in and do a—

Mr. FRENCH. We—

Mr. WESTMORELAND. —postmortem review of what caused it?

Mr. FRENCH. We do both formal and informal lessons learned.

Mr. WESTMORELAND. Okay.

Mr. WESTMORELAND. And how about the OCC?

Ms. KELLY. Yes. The Treasury Inspector General does their own review, and we do an internal review as well. We look at not only what caused the failure, but more importantly, our supervision and do a lessons learned from that, based on the history and the benefit of hindsight, and what we could have done differently.

Mr. WESTMORELAND. So I would not have any problem getting copies of the postmortem reviews of the 65 banks that are closed in Georgia?

Ms. KELLY. The I.G. reports?

Mr. WESTMORELAND. Your report. Does the OCC not do a report, the I.G. does the report?

Ms. KELLY. The I.G. does the report that is a public report, yes.

Mr. WESTMORELAND. So you do not actually go in and look at them yourself? Or you just read the report?

Ms. KELLY. We do. But those are internal documents.

Mr. WESTMORELAND. Okay. But do you go in yourself and actually do an interview with the bankers or try to find out what happened?

Ms. KELLY. We are working with the bankers all the time up to the closing. So we are having constant communication with the bankers up until then.

Do you mean going back and talking to them afterwards?

Mr. WESTMORELAND. Yes.

Ms. KELLY. I would agree with what—

Mr. WESTMORELAND. After it is closed, you might get a different opinion than when they are in fear of being closed.

Ms. KELLY. Okay. But I would agree with what Mr. French said about the levels of review and as the problems progress—

Mr. WESTMORELAND. Trust me. It is a different environment after the banks close than it is when they are trying to fight for their life. The attitude is probably a little bit different.

The information you get will probably be a little bit different.

And, Ms. Kelly, let me say that the most complaints that I have gotten have been about the OCC regulators, very arrogant, almost threatening, almost calling people crooks.

The fact that somebody would get A's on their report cards and talk about how well the bank was managed and then at the next review get F's and talk about how crooked all the directors were, and here again, from both of your standpoints, we have trouble getting a lot of these people to come forward because they are afraid of retaliation.

To me, that is not good. But let me draw your eyes to the chart up here. These are the top 10. And we have been told many times that the reason that we have had so many bank closings is because we have too many banks. And Professor Johnson kind of alluded to that, that there are possibly too many banks.

If you look at the number of banks that we have in Georgia, 261, we have had 65 bank closings. And if you look at our population and the number of banks that we have and compare it to some of the other States, I do not know that we have too many banks.

We have 159 counties in Georgia. And you would assume that at least every county may have at least their own community bank, although I have four counties in my district right now that do not have a community bank because they have been closed. They do not have one.

They have banks from Arkansas and other parts of the country that have come in and assumed these banks that know nothing about the community, and were really sent there to flush some of these loans down.

But I would just like—if you look at Nevada, 45 percent of their banks have been closed. And look at the unemployment rate, look at the serious delinquencies, and their does not seem to be a pattern.

It seems like there would be some type of pattern as to why these banks were being closed. And I do not understand in particular the—why as a result of the banks that have gotten TARP or the loss share agreements going in and destroying the markets in these communities and then the banks that have been there providing for the communities suffer because of the things that those other banks did. They are having to write these loans down.

I will give you another example of government intervention, and let me just close with this. The community—not the community redevelopment, but the stabilization program. I had a call today from a builder. A county had gotten money for the stabilization program to stabilize the neighborhoods. He is building in the subdivision. There are also homes that is already been purchased in this subdivision.

The county came in and bought lots from a bank with this revitalization money, and they are selling the houses for $20,000 less than what they sold for. And the bank has called him and told him that he is going to have to put up more collateral because the values of the homes are less.

Does that make good sense to you? Really, how would the OCC and the FDIC look at that when they go into that bank and the guy cannot put up more collateral, he has paid his interest, he has the same things he has been doing when government intervention has caused that loan to call for more collateral. That is inexcusable.

Mr. RENACCI. Thank you, Mr. Westmoreland. And I yield 5 minutes to Mr. Luetkemeyer.

Mr. LUETKEMEYER. Do you two understand the reason for Mr. Posey and Mr. Westmoreland's bill here today—bills, from the standpoint that they are both the results of the frustration with examiners and the fact that things are not changing? You understand that? You understand why those bills are out there, why we are here today?

Ms. KELLY. Yes.

Mr. LUETKEMEYER. I made the comment in the previous hearing, I can bring Bill Gates here, I can bring in 100 business people just like Mr. Whalen, I can bring in 100 bankers just like Mr. McKillop and they can testify to the same thing.

And I have, over the past 2½ years I have been in Congress, met with the FDIC, the OCC, and the Fed on an annual basis till this year because—nobody will listen anymore and presented the same problem, that there is a huge disconnect between what you think is going on in the field and what is really going on in the field.

I will give you an example. I have a banker—he is not in my district, but he is in my area—who was put on the problem list. His bank was on the problem list. It had never been on a problem list in the history of this bank—never had problems with earnings, never had problems with capital, never had problems with past due. Yet, he happened to be the next bank that was examined after an examiner got ripped for not catching some stuff in the previous exam.

The next day, his was the next bank, and he was put on the problem list. And ever since he has been on the problem list he has never still had a problem with his capital, past due, earnings, whatever.

That is what is going on. And you guys are blind to this. I hope that you understand how significant this problem is, because it is affecting the people who—Mr. French, you made the statement awhile ago that you do not micromanage banks. But do you really understand the effect that you have with the interpretation of the laws, the recommendations that you make and the exam that you have on communities?

Do you understand that?

Mr. FRENCH. We do understand, sir. That is part of why we really want to emphasize to our examiners the importance of taking a balanced and reasoned approach and—

Mr. LUETKEMEYER. How are we going to solve this problem?

Mr. Posey and Mr. Westmoreland are trying to find a way to solve the problem here today. You guys do not agree with this approach, obviously.

What is your solution for how we can find a way to allow the banking community, especially community bankers, because they are the ones that really help our small business and local communities fund the businesses that make this country work.

How do you—what is your solution if you do not like these two bills today?

Mr. FRENCH. Like I said, I think we have a very sluggish, still, a very sluggish economy. And we had a lot of banks with a lot of capital, very liquid balance sheets now after going through this crisis for 3 years, 4 years.

So we do have to keep reinforcing the message that we want banks to make prudent loans. And we do not want—we want to keep pressing the point with our examiners, as we have been doing, that you do not write down a loan based solely on the collateral if the borrower's making his payments. And I think we just need to keep that up.

Mr. LUETKEMEYER. Ms. Kelly what do you think?

Ms. KELLY. Yes, my response would be that a key to economic recovery is making sure that we have a strong banking system. And our responsibility as regulators is to ensure that banks maintain their safety and soundness.

And so it is important when banks are experiencing trouble that they identify those issues and they deal with them early on when there is still flexibility, they still have to work with borrowers who are experiencing some problems, possibly restructure the loan—whatever is the right thing to do.

I would go back to the comment that Ranking Member Maloney made earlier about whether there is a way we can just give people more time. So the earlier that there is a recognition of a potential problem, and the borrower and the banker come together and talk about how there could be a problem with repayment and how can we work through it, the better.

Mr. LUETKEMEYER. I understand that. I have been on your side of the table too.

Ms. KELLY. Yes

Mr. LUETKEMEYER. I have been on both sides of the table. I am kind of unique around here.

But by the same token, you have to understand from your side of the table what the people on the other side of the table are going through and understand that their long-time working relationship with those customers, they know those people. You do not. And yet, you are telling them how to micromanage—whether you like it or not, you are telling them how to micromanage their business. And I think that is unfortunate.

One more question I want to ask you.

Professor Johnson made a comment that the FDIC is closing—is not closing—you are not closing too many banks. You need to close more, closing too few.

What do you think about that comment?

Mr. FRENCH. I do not think we are anxious to close more. I think we are taking them as they come, one bank at a time. And we really—we try to avoid a failure whenever we can. We try to work with the bankers to help them to—in their efforts to reach out, get investors, deal with the issues that they have. But the failure is the last resort, and it is not a good thing.

Mr. LUETKEMEYER. I realize we are—you know—I am hammered on. You get a chance to hammer on him. But thank you very much.

Thank you, Mr. Chairman.

Mr. RENACCI. Thank you, Mr. Luetkemeyer.

I now recognize Mr. Pearce for 5 minutes.

Mr. PEARCE. Thank you, Mr. Chairman.

Ms. Kelly, you have said that bankers have the right to file an appeal whenever there is some write-down, is that correct?

Ms. KELLY. If they choose to do that—

Mr. PEARCE. If they choose to do that.

Does the borrower have that same right?

I find that the banks are more than willing to comply because They are pretty much afraid of the regulators. So they comply. But does the borrower have the right to make an appeal when you do that?

Ms. KELLY. To the OCC?

Mr. PEARCE. To anybody. Can they appeal to God, even? Do you you have a process for them to appeal? Because I think that is where the pressure comes in the situation. I assume that is a "no?"

Ms. KELLY. We have a consumer complaint department that they could go—

Mr. PEARCE. How strong is it? Can the consumer complaint department overturn the regulator?

Ms. KELLY. The bank makes the decision about whether or not to make the loan—

Mr. PEARCE. No, the regulator makes the decision and the bank says, "Yes, we are afraid of you and we are going to do what you said."

So is anybody—does the borrower have the right to appeal your decision to you?

I guess that is a "no."

Ms. KELLY. But it is not my decision.

Mr. PEARCE. The—I would follow up with Mr. Westmoreland's questions. Can I get a copy of the postmortem on Charter Bank in

Albuquerque? I would like to see that. Is that information available to me—your process, your demand?

Ms. KELLY. I would have to check with our attorneys—

Mr. PEARCE. That is a formal request. I would like for you to check with your attorneys.

Ms. KELLY. Absolutely.

Mr. PEARCE. Is that process transparent? That process of closing banks, is it transparent?

Ms. KELLY. What about the process?

Mr. PEARCE. Is it transparent? Do you have it available to people? Is it something that you are proud of? Is it something that you would share readily?

Ms. KELLY. I do not understand what you mean by process. If you could clarify for that.

Mr. PEARCE. The process of closing a bank.

Ms. KELLY. The decision to close—

Mr. PEARCE. The decision and the process.

Ms. KELLY. Our enforcement actions are public.

Mr. PEARCE. Is that transparent?

Ms. KELLY. They are public.

Mr. PEARCE. Then why do you have a gag order on Mr. Werthheim and all the Charter board members? Why did you come in and threaten him that if he did not sign a gag order that you were going to prosecute him? Why do you have a gag order on a simple closing of a bank?

Ms. KELLY. I—

Mr. PEARCE. I would like an answer to that also.

Ms. KELLY. I will have to follow up later—

Mr. PEARCE. I would like an answer to that in writing.

Ms. KELLY. —have to follow up with you on that.

Mr. PEARCE. Mr. French, you declare on page 4 that there are common misconceptions. One is that the regulators require the write downs of loans to creditworthy buyers.

If I provide you one, two, three—if I provide you three people who say that their creditworthy loan was written down because of a regulator, will you retract your statement publicly that it is a misconception?

Mr. FRENCH. I guess we would have to see what—

Mr. PEARCE. No, I am asking if I bring them to you and I provide them to you to talk to you, will you recant this testimony? Because I do not think it is a misconception. I believe that they are a write down. I do not think those groups of three States of Indian hotel owners came and asked me to meet with them in El Paso, Texas, a year ago to complain that they had never missed a payment, and yet you—somebody had caused their loans to be written down. I do not think they were misleading me, not every single one of them.

Mr. FRENCH. My understanding, sir, is that there could be situations, for example, where there is the projects, lending project. Maybe the borrower, his tenants are behind on their rent—

Mr. PEARCE. Every single one of them has—

Mr. FRENCH. —the borrower may come to the bank and say, "I am not going to be able—"

Mr. PEARCE. Yes, I find your comments to be quite hedging, much more hedging than your testimony here.

I go on and read here, “The agencies look to the ability of the borrower to repay.” What criteria do you use to determine if a loan is going to be repaid?

Mr. FRENCH. That is a fact-specific and individual—

Mr. PEARCE. Do you actually use that the payments are received on time and never missed? Is that one of the criteria fact-specific?

Mr. FRENCH. Of course. That is one of the major—

Mr. PEARCE. And each one of these hotel owners had never missed a payment, and they were being asked to come up with $750,000 more capital for a $3 million hotel, and you are telling me that it is not good enough that they have never missed a payment, that there is something else.

And I will tell you that something else had to be the mark-to-market, it had to be the fact that they were being downgraded, exactly what you tell me is not occurring that you describe as a misconception in your report. And I would like to bring enough pressure on you to where you actually acknowledge that there are questions on the other side because your report simply declares it a misconception, you dismiss it.

Mr. FRENCH. I certainly want to acknowledge the serious—

Mr. PEARCE. You mean, you have never heard one person tell you publicly or privately, personally, that their loan was written down? You have never heard that? Never? You have never? Never? You say it is a misconception.

Mr. FRENCH. I have certainly heard of loans being written down.

Mr. PEARCE. But you do not believe them, it is a misconception, you declare it is a misconception.

I would like to continue the discussion in my office some day if you get the chance.

Thank you. I yield back, Mr. Chairman.

Mr. GRIMM. [presiding]. The gentleman’s time has expired.

Mr. Manzullo, you are recognized for 5 minutes for questions.

Mr. MANZULLO. Thank you. I would yield to you, Mr. Chairman, for 30 seconds.

Oh, I am sorry, Mr. Renacci is not there, right? I do not know what happened to him.

Mr. GRIMM. I appreciate it anyway—

Mr. MANZULLO. Thank you.

Ms. Kelly, I discussed with Mr. Renacci, would you be willing personally to meet with the applicants for loans who were turned down? Would you be willing to go out there and personally meet with these people face to face?

Ms. KELLY. Sure. Yes, I would be happy to.

Mr. MANZULLO. Good. I knew you would say that, because the disconnect is so extreme here. If we could find people acting in bad faith, then you can point the finger.

The regulators acted in good faith. The examiners are acting in good faith. The bankers are acting in good faith. And the consumers are acting in good faith. So this is not a matter of good versus evil. It is not “Spy vs. Spy” out of MAD Magazine. It is a matter of the system is not working.

Let me give an example, Ms. Kelly. On page 11 of your testimony you state, way at the bottom, “Examiners are criticizing or borrowers simply”—“Examiners are criticizing loans or borrowers simply because the current market value of their collateral has declined are forcing bankers to write down loans to current distressed market values."

You were a bank examiner, I believe, for 27 years.

Ms. KELLY. Yes.

Mr. MANZULLO. When you—if you went into a bank yourself and looked at their portfolio, and let us say somebody has a million dollar loan on a business and the property value has fallen from a million dollars, say, to $700,000, but the person is otherwise current, what would you do in that case, as the bank examiner?

Ms. KELLY. I would have to look at the specifics of the loan and the borrower's financial information—

Mr. MANZULLO. Let us just say that everything is fine, the loan is fine, the cash flow is fine.

Ms. KELLY. Okay. There is clear information supporting the fact this borrower is going to be able to repay the principal in full.

Mr. MANZULLO. That is correct. No default.

Ms. KELLY. Then I would not write the loan down.

Mr. MANZULLO. Then you need to talk to your examiners, because what they are doing is they go in, in a situation like this, and the examiners are forcing appraisal after appraisal after appraisal. These commercial appraisals are extraordinarily expensive. And the value of the property keeps on going down, but the borrower is in business, he is making it through, he is slugging it out, and then all of a sudden, he gets pressure from the bank. And the bank is saying, "Well, you have—we are going to call your loan, even though you are current," and they blame it on the examiners.

I was going to ask the question, do you understand the frustration going on here, but it is obvious that you do.

Ms. KELLY. I do. I absolutely understand. Bankers are in very difficult times, borrowers are in very difficult times. And bankers have to manage their risk.

And this is why someone made the comment about all the heads of the agencies have said, "If you want to bring us an individual loan, then we will look at it." Because when you tell me this is a creditworthy borrower, I accept you at face value. But, I have not looked at the financial information to determine that, based on that person's financial situation today, that their financial statements support their ability to repay the loan.

Mr. MANZULLO. If I could follow up on Mr. Pearce's question, if an examiner comes in, tells a bank that this loan is risky, and the bank ends up—and the examiners end up classifying the loan, now in that case, where the bank has acted in direct response to the statement of the examiner, does the consumer have recourse against the FDIC or the OCC to reverse that decision?

Ms. KELLY. But the classification of a loan simply reflects the risk that is associated with that asset on the bank's balanced sheets at that time. It does not preclude the banker from continuing to carry that loan, from continuing to work with the borrower. We encourage that. It is just a way for us to reflect the current condition.

Mr. MANZULLO. But it causes the bank to have to put up more reserve capital.

Ms. KELLY. Yes, because it is reflecting the fact that there is greater risk associated with that—

Mr. MANZULLO. And that makes the bank want to get out of that whole transaction altogether.

Ms. KELLY. It may. But if they believe it is someone who has been a customer for a long time and they are going through tough times—

Mr. MANZULLO. But the question was, if that was reversed and the bank does not have to put up more reserve capital, the bank can keep on going and making further loans. So there is no appeal system.

Ms. KELLY. But if there was greater risk associated with that credit and the bank does not reserve for it properly, then it weakens the condition of the bank because if that person is not able to repay the loan the bank has less of a cushion to absorb that loss.

Mr. MANZULLO. Okay. Thank you.

Mr. GRIMM. The gentleman's time has expired.

The gentleman from Delaware, Mr. Carney, is recognized for 5 minutes for questions.

Mr. CARNEY. Thank you, Mr. Chairman.

And first, let me apologize for missing the bulk of this hearing, so I am coming into this conversation at the very end.

I have heard considerable frustration from Members about things that are happening with folks trying to get loans in their States and I have heard, not just today but other days, testimony from the gentleman from Georgia, Mr. Westmoreland, about some of the bank failures in his district. I have quite a bit of sympathy for that. And I want to congratulate him for bringing the resolution forward to look at that issue.

But, I am kind of caught betwixt and between because we have testimony about a lot of banks failing, and obviously that is the case, and I hear the same thing from small-business owners in my State, which is my district, the whole State of Delaware, that they are not able to get loans for working capital, that they have performing loans that are being called, and a whole range of things similar to what you are been hearing from members on the other side.

And we had the distinguished professor from MIT here this morning who talked about the need to be careful about what we would do here with H.R. 1723.

So I think the challenge is really to strike some balance where banks are making prudent loans. Sheila Bair was here not long ago for incredible testimony where she said that they were encouraging banks to make good loans because that is the way banks make money.

What is your perspective on what needs to be done at this point in time, whether the pendulum has swung back too far the other way, what you are seeing in the field. We are still, I suspect, seeing banks that are under stress. And is this second resolution, 1723, as Mr. Johnson said, going too far? How would you characterize that?

Mr. FRENCH. Let me start. We are seeing some signs of improvement in banking performance, looking at it as a whole, in terms of the level of nonperforming loans, while still high, is starting to come down, earnings starting to improve, provisions for loan losses starting to come down, percentage of profitable banks increasing.

We are seeing some peaking of the problem bank list that we have, it is starting to plateau and perhaps looks like it is going to start inching downwards.

We have about 12, 13 percent of the FDIC-supervised banks that are considered problem banks.

Mr. CARNEY. Say that number again.

Mr. FRENCH. About 12 or 13 percent. So 87 percent are not.

So, I think there is a tendency for—when you get to a turning point in the economy it tends to come—you always think you are at the—things cannot get any worse, and that is when they start getting better.

So—

Mr. CARNEY. So as my time is running—sorry for cutting you off, but do you have a view of H.R. 1723?

Mr. FRENCH. Sir, yes, I am sorry. We do not support that because we think it will require us to have regulatory capital that is less stringent than GAAP. And so we do not support that aspect of it.

Mr. CARNEY. So that would be going too far the other way.

Mr. FRENCH. That is our view.

Mr. CARNEY. And it is just not good accounting from your perspective?

Mr. FRENCH. That is correct. We think that it would basically require us to have—that banks have regulatory capital that was less stringent than what they are required to count as capital under GAAP. And we do not think that is a good—

Mr. CARNEY. We heard earlier this morning from a very successful business person from Iowa, I believe, who talked about the difficulty he had and talked about his financials, his balance sheet, which sounded very strong to me. But he had been turned down by, I think he said 12 or 13 banks.

Is there any way to—obviously, I do not know the details, but could you comment on a situation like that, obviously, anecdotal? I hear the same thing again from borrowers in my district. But, as somebody who represents these folks, it gets your attention.

Mr. FRENCH. I would imagine it would. And that gets our attention, too, believe me. And we—

Mr. CARNEY. Sheila Bair said, then let us know who they are. Yes, banks should be making those kinds of loans.

Mr. FRENCH. We have the hotline that I mentioned for borrowers. Business borrowers can call and let us know what is happening out there, what their concerns are. And, hopefully, we will get a better understanding of what the issues are. It is just—

Mr. CARNEY. Thank you.

And I want to thank the Chair—I guess the acting Chair; the Chair is not here—for calling the hearing today.

Mr. GRIMM. Thank you.

And the Chair recognizes Mr. Posey for 5 minutes for questions.

Mr. POSEY. Thank you, Mr. Chairman.

The first thing I would like to do is set the record straight a little bit. This bill has been mischaracterized as changing accounting standards. And late last night, I received correspondence from the American Institute of CPAs, and I want to quote from this correspondence: “It does not legislate accounting standards. You are dealing with regulatory capital issues.”

So, for everyone who has alleged that this changes accounting standards, it is just not true, if you have any respect for the CPAs. And I think they are the authorities on that issue far and away.

Everything would be good, if out in our districts reality reassembled even remotely the picture that you have painted about regulation. Saying that this would preclude you from being able to examine or monitor loans, if you could not put them on nonaccrual basis, it is just not wrong and it is just not true.

You could still monitor. You could still prosecute for fraud. You could prosecute for abuse. There is nothing that would stop you from doing that at all.

And this is not forbearance, if we statutorily define performing loan as a historic performing loan. Too many people want to paint this as forbearance so they can tar and feather it in a public arena. And that is just underhanded and dishonest in my humble opinion.

I agree with you that accurate reporting is critical. And that is accurate both ways. Again, I think it is atrocious that a regulator can say, “Well, we are going to put this on nonaccrual, because we do not think he should be able to make the payments in this economy.”

Maybe they did not calculate it that the people are eating beans or rice or doing whatever it takes to make their payment. But I think that is pretty sad.

You pretty much describe the current state of affairs of regulation being fair, balanced, and realistic. And I think it is just the opposite. You have painted a picture that regulators are all perfect, and everything is in perfect order. Nothing can be done to help create jobs and stop people from having their property foreclosed on.

And I think I just have to disagree with you there. I wonder what testimony of the previous witnesses or the other members of this committee you particularly disagree with or think it is misleading or dishonest, because you speak to us like none of the things they have said is true. And I am inclined to believe it is just the opposite.

We know about the hotlines. We know about the ombudsmen. If you have a problem with the regulator, call the ombudsman. But what happens when a bank calls an ombudsman? He tells the ombudsman how unfairly he is being treated. And the next call made is the ombudsman calling the regulator saying, “Guess what jerk idiot just called me today to complain about you?”

There is retribution out there in our homeland. Trust me. Ask any banker. They will not want to come up here and get more retribution, but it is out there. They have all testified to that pretty much already.

We all know what some of the most fearsome words are to Americans across this great country: “I am from the government. I am here to help you.” And some of the reasons people fear that have been expressed very clearly today here.

It is disappointing to me that you fail to acknowledge even remotely that there is even the minutest problem anywhere and that there is any solution that is needed other than more regulation—regulate them more—and that there is an abundance of capital.

Why weren't these loans being made that people talked about today, if there is an abundance of capital just looking for good loans? It is because they fear the overregulation.

How do you close a bank that has significantly greater assets than it does liabilities? We are probably going to run out of time before you have time to answer that, and with the chairman's permission, I would like to request that you respond to that in writing.

Give me a couple of scenarios as to how you close banks with more assets than liabilities. And do not fail to mention how much of the assets have been put on a nonaccrual basis so that they could not use them to operate the banks.

I want to know how many regulators you have. And I would like to know how many have ever been disciplined for abusing their regulatory authority, if any. What kind of grading do you do on the regulators to make sure that they are fair and balanced?

I hope that you can work out some way to support this solution or another one internally if—

We have run out of time. The bottom line is that if, in fact, you continue just to dispute the findings that have been clearly been put forth by our witnesses and members of this committee, it is just personally very disappointing.

Thank you, Mr. Chairman.

Mr. RENACCI. The gentleman's time has expired.

The Chair is going to make a recommendation, Mr. Posey, that you maybe put those questions, all of them, in writing, so that they can be responded to in writing, because you have gone pretty quickly, and we want to make sure all those questions are answered. So thank you very much.

The Chair recognizes the gentlewoman from New York, Mrs. Maloney.

Mrs. MALONEY. I thank the Chair for yielding and I apologize. It is a busy, busy day with the unemployment numbers coming out, the debt ceiling debates, and all kinds of policy decisions being made, which brings me to a question related, really, to the stagnant economy that we are having.

There has been an austerity program, where there have been many cutbacks. The economy is not growing. We just created 18,000 jobs, similar to last month. To what extent do you think the lack of the loans are people are not applying in this stagnant economy, number one?

And number two, under the Basel program we are now calling upon Europe and other countries to have more stringent capital requirements. That is part of what Chairman Bernanke and our entire economic team is working for. To what extent would relaxing our risk weighting of nonaccrual loans, as this bill would permit, be inconsistent with and undercut those efforts that we have on our national level?

Lastly, I am very sympathetic to the financial crisis that many of our community bankers are facing. Are there other ways that regulators could accommodate time for them to get their house in order or to re-capitalize without moving into close a bank, but working with them to become solvent, so they can become strong and serve the communities?

Thank you. And thank you for your service and for being here today. Thank you.

Mr. FRENCH. Thank you, Congresswoman.

We are—the FDIC is a strong supporter of the effort to basically increase the overall capital requirements of the banking industry, as you know. So we agree with the thrust of what is going on in the Basel process, and we think it is very important for the banking industry to have a solid base of capital that will enable it to be a source of credit to the economy through good times and bad times.

So one of the issues with, as you allude, with 1723 is that it, for a certain class of loans, it says that certain losses that would otherwise be recognized for accounting purposes would not be recognized for capital regulation purposes. And that is inconsistent with the overall direction of where we would like to go in terms of capital.

So in terms of what else we can do, giving banks more time, I think that is very appropriate. The prompt corrective action system really kicks in for a pretty small group of banks. As I said before, most of our banks are not in problem status. Most, when you look at their balance sheets and financial reports, purport very strong capital ratios.

But when that is not the case, we have the prompt corrective action system, where we work with them, hopefully, as early as possible, to address capital—

Mrs. MALONEY. But as I understand it, the prompt corrective action gives them 90 days to correct their situation. And given the fragile economy, that may not be enough time for a good community bank that really would need more time to recapitalize.

So I am wondering, is there flexibility to extend that time, or is it a 90-day cutoff?

Mr. FRENCH. There is flexibility. And I would also emphasize that it is a very small number of banks that ever gets to dealing with that 90-day issue. That is a really low level of 2 percent capital. But once we get that—

Mrs. MALONEY. But when I talk to the gentleman who was speaking earlier from Georgia, he was talking very passionately about 65 banks that have been closed in his great State. And I would assume all 65 of them went through prompt corrective action, right?

And I know that in my State, there have also been a number of community banks and large banks that have closed. So they all went through prompt corrective action. So it is not a small number, when you are representing a community that has one of those banks that is affected. And in some cases, it may be the only bank in the community, so it is really very, very important.

How do you get an appeal from the 90-day to extend? Would you have to legislate that, or can you—is that a discretion of—

Mr. FRENCH. It is built into the statute. And if we think that the bank has a prospect—if we think it is in the best interest of the insurance fund and that the bank is expected to be able to raise the capital, that would have to be something that we really—looks like it is going to succeed.

If it is just a matter of, we are still looking around, and we have been doing that for years and it has been—at some point, you have to make a judgment as to what has the most cost-effective approach.

Mrs. MALONEY. Is it appealable, if a judgment is made to close a bank? Can a bank appeal to a higher person?

Mr. FRENCH. Not being a lawyer, I would want to get back to you on that.

Mr. RENACCI. The gentlewoman's time has expired, but if Ms. Kelly would like to give a response?

Ms. KELLY. I just wanted to add something—I would agree with everything that Mr. French said, but just to add the point that the 90 days is really the very end of the process. If you look at some of the I.G. reviews that have been done at various closings, you will see that our regulatory interaction with a bank that is developing problems starts very early.

And this goes back to the point I made earlier about the sooner that a bank recognizes its problems and starts working constructively on them, the more time and more flexibility they have to solve it.

Mr. RENACCI. Thank you, Ms. Kelly.

The gentlewoman's time has expired. The Chair will yield 5 minutes to himself for questioning.

First of all, thank you, Mr. French and Ms. Kelly. We do appreciate your time in coming to testify. It has been a robust discussion so far.

There is one thing, though, I think we walk away. There cannot be any question or ambiguity in your minds at this point that there is certainly a disconnect somewhere. The passion in the Members is coming directly from the people they represent, our constituents, many of whom are the hard-working people who have created the jobs for decades. And we had a gentleman, I believe his name was Mr. Whalen, who was testifying earlier today, that over 33 years, he built a company, a solid, solid company. And one of his loans on a project that he was doing was written down, even though he made every payment and made every payment on time.

Regardless of how bad the meltdown was, regardless of what we have been through, the pendulum has swung way too far. When that is happening for a successful entrepreneur like Mr. Whalen, and it is a story we are hearing consistently through every part of the country from New York to Iowa to Pennsylvania, Indiana, Florida, throughout the country, we cannot put our heads in the sand and ignore it.

There is a disconnect. Every banker I have spoken to says they are afraid of their regulators. They are saying that loans they would normally—that do fit the guidelines, but they are just not willing to go for it. So when I hear things like, "there is capital out there," they are absolutely right. They are just not lending it.

We heard before bankers are in difficult times. Borrowers are in difficult times. That is accurate. That is true. But I submit to you that the regulators are making it worse, instead of better. And I, for one, completely agree that we need to have strong rules to prevent another financial breakdown or a meltdown or a crisis. But there is a tipping point and we have tipped.

And I do not think that you can have so much consistency among the members of what they are hearing from their constituents without recognizing we have a serious problem. And if it continues we are going to see what we have seen today: unemployment increase yet again.

Something is not working. Something is broken. And it certainly is not the entrepreneurial spirit of the American workforce. It is not the relentless work ethic that built this country. It is the fact that we had some problems, and what the government does to address them is always over-address. We have seen this time and time again.

But I think there is another problem that I have seen as someone who worked in the Federal system for 16 years. I have seen it myself. When there is a problem, those at the top do not want that problem to happen again no matter what because it is their watch. “Not on my watch is that going to happen.”

So they do everything they can, and this in all sincerity, with all good intentions not to allow that to happen again. And they get so focused on making sure it does not happen again that those under them are told in no uncertain circumstances we better not have a pattern of defaults or problems or anything. So everyone goes into CYA mode and everyone clamps down. And what happens is you create an environment that no business can be done.

And the reality is if no business is done, from a regulator’s point of view, you will not have any problems. It is very true. But that is not sustainable for our overall economy. It is not even close to sustainable.

And what is happening now is the frustration level of those who have worked their tails off to build businesses and are passing those businesses on to their children, are seeing it dwindle away and circle the drain. And that is reflected every single day in all the economic forecasts and it is seen in the unemployment rate.

If we do not alleviate and get out of our own way, and allow these entrepreneurs and innovators to access the capital they need, to grow their business, to expand their business, to start their new businesses, I submit to you that we can never recover from this recession.

I would just ask in closing that as you leave here today, I think you have the most noble of intentions. I really do. But I think in the interests of ensuring that we never have another calamity, we have become so laser-focused on the problem that we have restricted business to a point that you are right, we will not have any more financial meltdowns, but we will not have any finances to worry about.

So, I would please ask you to really reflect on that and work with your regulators that are out there making life very difficult for a prosperous economy to grow and to be robust in this country.

And with that, I thank you for your time and your attention, and we will close up.

The Chair notes that some members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses and to place their responses in the record.

The hearing is adjourned.

[Whereupon, at 12:14 p.m., the hearing was adjourned.

A P P E N D I X

July 8, 2011

CHAIRMAN SPENCER BACHUS
STATEMENT
Financial Institutions & Consumer Credit Hearing: "Legislative Proposals Regarding Bank Examination Practices"
July 8, 2011

Thank you, Chairman Capito, for holding this hearing.

Every member of Congress has heard the concerns of small business owners and bankers about overzealous regulators.

No one wants regulators to allow unsafe practices, but no one wants regulators to stifle a potential economic recovery by applying regulatory standards in ways that needlessly inhibit bank lending.

Bank examiners must balance the competing goals of encouraging banks to extend credit with ensuring that the institutions they oversee are acting prudently. They must recognize the risks of over-regulation, and particularly avoid subjecting smaller financial institutions to undue regulatory burdens.

With a struggling economy and high unemployment, our communities need help, and our community bankers and small business owners need some relief from the growing regulatory burdens that impede the creation of new jobs.

EMBARGOED UNTIL DELIVERY

STATEMENT OF

GEORGE FRENCH
DEPUTY DIRECTOR, POLICY
DIVISION OF RISK MANAGEMENT SUPERVISION
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

[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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Testimony submitted to the House Committee on Financial Services, Subcommittee on Financial Institutions and Consumer Credit, hearing on "Legislative Proposals Regarding Bank Examination Practices," July 8, 2011 (embargoed until 9:30am).

Submitted by Simon Johnson, Ronald Kurtz Professor of Entrepreneurship, MIT Sloan School of Management; Senior Fellow, Peterson Institute for International Economics; co-founder of http://BaselineScenario.com; member of the CBO's Panel of Economic Advisers; and member of the FDIC's Systemic Resolution Advisory Committee.[1]

Summary

1) The US is struggling to recover from a massive financial crisis – brought on, in large part, by lax banking regulation, including rules that allowed too little equity capital relative to debt in the financial system.

2) This crisis caused a big surge in unemployment, which is still above 9 percent. The loss of jobs – employment remains down 5 percent from its previous peak – means that millions of consumers have lower income and are consequently unable to pay their debts, including home mortgages. This is the worst recession since the 1930s.

3) During the previous economic boom, many banks made imprudent loans. After any crisis, some bankers inevitably want to "gamble for resurrection" by being allowed to classify bad loans as performing or by making another round of risky loans despite having too little capital. If things go well, the bank becomes solvent again. If things go badly, the additional downside cost is borne by someone other than the banker – in the case of the United States, this would be the FDIC-run Deposit Insurance Fund (DIF) in the first instance.

4) Capital is not something banks "hold" but rather refers to how they fund their loans – i.e., capital is on the liability side, not the asset side, of a bank's balance sheet. Less capital means that loans made by banks are funded with more debt relative to equity. This puts the banks in greater danger of default. In contrast, more equity capital implies more safety – and less risk – for both the equity and the debt issued by the bank.

5) In a distress situation, banks are sometimes subject to what is known as a "debt overhang" problem, meaning that pre-existing debt commitments discourage banks from taking advantage of good lending opportunities. But this is *not* a reason to allow banks to become even more highly leveraged by reducing their capital levels. Instead, such banks should conserve their equity capital – for example by not paying dividends – and concentrate on making responsible loans.

6) Other better capitalized entities can make loans – and there are signs that this is happening, including by new entry into the small business lending sector. This is an appropriate market-based response.

7) Arguments that equity is "expensive" for banks are either incorrect or self-serving. From a broader social perspective, banks and anyone else providing credit should be financed with

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[1] This testimony draws on joint work with James Kwak and Peter Boone. Our updates and detailed policy assessments are available at http://BaselineScenario.com. Rebel Cole provided helpful comments. The views expressed here are personal and not those of any other organization.

relatively more equity and less debt.[2] This is what we need for sustainable growth and job creation.

8) To blame bank examiners for the lack of lending in a post-crisis economy makes no sense. The FDIC has appropriate rules for the classification of loans and should be allowed to continue to apply these.

H.R. 1723

H.R. 1723 "The Common Sense Economic Recovery Act of 2011" proposes to create a legislative constraint on the ability of bank examiners to determine whether a loan is "accrual" or expected to be repaid in full. The intent is to effectively lower capital requirements for banks that have impaired assets, i.e., to allow them to have less equity funding relative to total assets than would otherwise be the case. This would not be a good idea.

In a free market system – without government guarantees – financial institutions fund themselves with a relatively large amount of equity (30 percent is not uncommon), because they need a strong buffer against losses. Investors are not willing to fund a bank that is prone to collapse.

But in a system with deposit insurance, the downside risk for one class of investors – retail depositors – is limited or zero. This encourages banks to fund themselves with more debt relative to equity, which means little capital relative to total assets. This increases the upside payoff to equity – i.e., for a given return on assets, the return on equity is higher when things go well. But it also increases the downside returns on equity, creating more volatility and a higher probability that the bank will become insolvent.

The FDIC and other regulators are charged with ensuring that banks maintain enough capital – i.e., sufficiently high buffers against losses – so they remain solvent. In the case of insolvency, there are typically costs to the FDIC's Deposit Insurance Fund. There can also be significant taxpayer costs, both direct and indirect, from bank failures.

To see the fiscal impact of the finance-induced recession, look at changes in the CBO's baseline projections over time. In January 2008, the CBO projected that total government debt in private hands—the best measure of what the government owes—would fall to $5.1 trillion by 2018 (23% of GDP). As of January 2010, the CBO projected that over the next eight years debt will rise to $13.7 trillion (over 65% of GDP)—a difference of $8.6 trillion.

Most of this fiscal impact is not due to the Troubled Assets Relief Program – and definitely not due to the part of that program which injected capital into failing banks. Of the change in CBO baseline, 57% is due to decreased tax revenues resulting from the financial crisis and recession;

[2] The definitive arguments on this issue are presented in detail by Anat Admati, Peter DeMarzo, Martin Hellwig, and Paul Pfleiderer, "Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is Not Expensive," http://www.gsb.stanford.edu/news/research/admati.etal.html.

17% is due to increases in discretionary spending, some of it the stimulus package necessitated by the financial crisis (and because the "automatic stabilizers" in the United States are relatively weak); and another 14% is due to increased interest payments on the debt -- because we now have more debt.[3]

In effect, a financial system with dangerously low capital levels – hence prone to major collapses – creates a nontransparent contingent liability for the federal budget in the United States.

The last economic cycle – culminating in the financial crisis of 2008 – demonstrated that allowing banks and other financial institutions to reduce their capital levels is dangerous not just for those institutions but also for the system as a whole.[4] Individual banks never take into account the spillover effects caused by low equity capital funding levels – and these negative externalities can be very large.

Repeated boom-bust cycles have also shown that it is very dangerous to allow banks to reclassify their loans as performing when management knows that the loan is not likely to be paid in full.

The rules in this area are clear and well-established.[5] In some ways, the bill duplicates what the FDIC already does. For example, under current practices, after 6 months of performance on a modified loan, the loan can be restored to accrual status.

But classifying loans as "accrual" when they are either not receiving the full interest due or when the institution knows there will be a problem is not a good idea. This will make the bank's capital position look better than it really is and detract from the credibility of their financial statements.

It will also make it harder for the FDIC to implement prompt and appropriate corrective action. Most likely, this measure will increase costs to the Deposit Insurance Fund in the long run. This increases the potential future liability of all banks that have to contribute to this fund.

In addition, modified loans are treated the same way as other loans in the bill – so that if a borrower comes to the bank knowing that he or she will not be able to make the next payment, those loans could still be treated as accrual loans because – under the bill – they are still

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[3] See also the May 2010 edition of the IMF's cross-country fiscal monitor for comparable data from other industrialized countries, http://www.imf.org/external/pubs/ft/fm/2010/fm1001.pdf. The box on debt dynamics shows that mostly these are due to the recession; fiscal stimulus only accounts for 1/10 of the increase in debt in advanced G20 countries. Table 4 in that report compares support by the government for the financial sector across leading countries; the US provided more capital injection (as a percent of GDP) but lower guarantees relative to Europe.

[4] Capital levels were reduced by various kinds of financial innovations – such as moving assets supposedly "off balance sheet" – as well as by lobbying regulators and legislators. Arguably the single more disastrous decision was to allow investment banks to operate with significant more debt relative to their equity. See Simon Johnson and James Kwak, *13 Bankers*, Chapter 5.

[5] See, for example, "Uniform Retail Credit Classification and Account Management Policy", Federal Register 64.27 (February 10, 1999), http://www.access.gpo.gov/su_docs/fedreg/a990210c.html; issued by the Federal Financial Institutions Examination Council.

technically current even though the bank knows that future payments are uncertain. It would be contrary to reasonable safety and soundness criteria for a loan to be treated as accrual if the bank does not expect full repayment of the remaining contractual principal and interest.

The following provisions could be usefully added to the bill, with regard to when a loan can be treated as accrual:

- When the value of the underlying collateral has not fallen below the value of outstanding loan principle plus any accrued interest,
- When the borrower has positive cash flow sufficient to service the loan for the following year.
- When the borrower has not defaulted on any other credit obligations during the previous 12 months.

This bill would also affect the "shared national credit" ("SNC") program, which requires examiners assign the same classification to all loans to the same large borrower. If a borrower has defaulted on a loan from one bank, then a current loan from another bank should be classified no better than the loan from the first bank. If one loan is nonaccrual then the other loan must be nonaccrual. This is simply sensible accounting.

H.R. 2056 "A bill to instruct the FDIC Inspector General to study the impact of insured depository institution failures"

H.R. 2056 calls for a study of the impact of bank failures. This would be helpful, for example in shedding light on how supposedly how "uniform" supervisory enforcement actions have actually been applied across the big four OCC banks relative to thousands of community banks.

In all likelihood the problem is not that the FDIC is closing *too many* banks; it is that the FDIC is closing *too few* banks. Arguably, there are dozens of "zombie banks" that the FDIC has failed to close – even though they are in worse shape than many that it has closed. Conditions of these zombie banks continue to deteriorate, increasing the ultimate cost to the Deposit Insurance Fund.

As far as can be determined by outside observers, the FDIC appears to prefer closing banks for which it has bidders because the Deposit Insurance Fund has limited resources and the FDIC wishes to avoid borrowing from the Treasury.

It is time to draw on experience from the early 1990s and discuss creating another Resolution Trust Corporation to take over the assets of troubled banks, with the charge of rapidly returning them to the private sector.

Of course, such an entity would also be useful should the "extend and pretend" game for one of the big four banks also come to an end.

For Release Upon Delivery
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TESTIMONY OF

JENNIFER KELLY

SENIOR DEPUTY COMPTROLLER

FOR MIDSIZE AND COMMUNITY BANK SUPERVISION

OFFICE OF THE COMPTROLLER OF THE CURRENCY

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.*

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[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.

ICBA
INDEPENDENT COMMUNITY
BANKERS *of* AMERICA

Testimony of

James H. McKillop, III
President and CEO, Independent Banker's Bank of Florida
Lake Mary, Florida

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.

Statement by Mike Whalen

President and CEO of Heart of America Restaurants and Inns

Before the

Subcommittee on Financial Institutions and Consumer Credit

July 8, 2011

Dear Chairwoman Capito, Ranking Member Maloney, and members of the Subcommittee, thank you for the opportunity to speak today regarding today's hearing topic on "Legislative Proposals Regarding Bank Examination Practices." I appreciate the invitation.

Many bankers on Main Street are fearful of making commercial loans that they believe are good, solid loans. They are fearful because of the enhanced scrutiny they have been receiving from federal banking regulators in the past few years since the "financial crisis" began. The bankers fear that even though the loan meets quality underwriting standards, the decision to make a loan will be second-guessed by the regulators for what may be unforeseeable or subjective reasons. The "safe harbor" response is to not make the loan. The result, which does not require a Ph.D in economics to assess, is slower growth and the killing of many new jobs. Americans need jobs and the over-reaction by the banking regulators is stopping people like me from creating jobs.

The conventional wisdom inside the beltway, which causes entrepreneurs like me to viscerally respond, is that soft loan demand coupled with banks sitting on cash, is the root cause of diminished lending. Certainly loan demand is softer than the go – go days a few years ago, but this diminished demand is distinctly amplified by the fear of regulatory backlash.

I started my company in 1978 by opening a small 100 seat restaurant – the Iowa Machine Shed – on the rural edge of Davenport, Iowa. I have built the company starting with sweat equity. Today, Heart of America Restaurants and Inns operates 26 restaurants and hotels in Iowa, Minnesota, and Kansas. I have been turned down by many banks as I have sought to expand over the past year. I am not a rookie in rejection.

Our company is now financially very stable. We survived this last precipitous downturn because we are not high leveraged – we have a low debt to value ratio. We put real equity into projects.

We are currently building a six-story Hilton Garden Inn with our own Johnny's Italian Steakhouse in growing Olathe, Kansas. It is a great brand in a great market. The financial structure was probably the strongest we have ever assembled. It is as close to a no-brainer as it gets. We even had an allocation of over $12 million in Economic Recovery Zone Bonds. When we started our search for the debt component, banks eagerly met with us. They were enthusiastic when we presented the project in detail, but, one by one they sheepishly, apologetically came back and declined, stating they were reluctant to proceed because it was both a commercial real estate deal and a hospitality deal. They feared the reaction of the banking regulators. Over 20 banks said no, all in the same dynamic. We eventually found financing, but as I said, we are a strong company.

We were persistent. Most entrepreneurs probably would not have been so tenacious. How many jobs have not been created because of this regulatory environment?

On June 30th, the Wall Street Journal reported on a recent poll conducted earlier in the month by Pepperdine University stating, "75% of bankers felt increased pressure from regulators and 61% of those bankers reported they have rejected loans they otherwise would have made, to please the federal overseers." I would suggest these numbers underestimate the problem.

I appreciate the efforts of Representative Posey and Representative Westmoreland to address the regulatory problem in the bills they have introduced. I am here today to tell you that the problem is real. There is a need for our elected Representatives to inject some common sense in the way banking regulators have been recently evaluating financial institutions. More jobs will be created and the economy will grow if Congress can start getting regulators to focus on real safety and soundness and not be a part of the problem.

I encourage you to go talk with your hometown bankers, off the record. Hear the story firsthand. My experiences are just a snapshot of a problem across the country.

July 8, 2011

Statement for the Record

on behalf of the

American Bankers Association

before the

Subcommittee on Financial Institutions

of the

Committee on Financial Services

United States House of Representatives

American
Bankers
Association

Statement for the Record

On behalf of the

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Committee on Financial Services

United States House of Representatives

July 8, 2011

Chairman Capito, Ranking Member Maloney, and members of the Subcommittee, the American Bankers Association appreciates the opportunity to submit this statement for the record on legislation recently proposed by Congressman Posey, H.R. 1723, the Common Sense Economic Recovery Act of 2011 and by Congressman Westmoreland, H.R. 2056, regarding the impact of FDIC bank failure resolutions. The ABA represents banks of all sizes and charters and is the voice of the nation's $13 trillion banking industry and its two million employees.

ABA appreciates the effort being made by this Subcommittee – and the whole Financial Services Committee – to deal with the regulatory crisis that banks are facing and to create an environment where banks can extend credit to creditworthy borrowers. Actions taken to enhance the checks and balances related to the authority of the Consumer Financial Protection Bureau is one example of the important work of this Subcommittee.

The recognition of the problems facing banks across this country, and the willingness to address these issues – as Congressman Posey intends with H.R. 1723 – is very important if we are to re-energize the economic engine of this country. While we may disagree with how best to implement changes, there is no disagreement that the industry – indeed the economy – can benefit from changes that stimulate lending, not discourage it. We appreciate the efforts by Congressman Posey to do this and his willingness to work with the industry to find reasonable solutions to the regulatory overload faced by banks today.

There is no question that the last several years have been challenging to businesses (including banks) and individuals. While the official statistics tell us that the recession was over more than two years ago, that is little comfort to individuals, businesses, and banks in communities that are still suffering greatly. Banks are a reflection of their local economies and are not immune to the economic downturn. Job losses and business failures have resulted in greater problem loans and in much higher loan losses. Nonetheless, banks are working every day to make credit available.

Banks' efforts are made more difficult by regulatory pressures that exacerbate, rather than help to mitigate, the problems. The ABA has raised the issue of overzealous examiners in hearings over the last several years and through letters to the banking agencies. While the agency heads in Washington have said the right things about encouraging reasonable judgment by field examiners, we continue to hear that examiners are taking an overly aggressive approach in their analysis of asset quality and are consistently requiring downgrades of loans whenever there is ***any*** doubt about the loan's condition – even in cases where loans are fully performing.

This, we believe, is part of the problem that H.R. 1723 is trying to address by stopping regulators from assigning performing loans to non-accrual status for banking regulatory purposes. Non-accrual loans are generally those where the payment of interest and principal has lapsed or those where full payment of principal and interest is not expected. Congressman Posey is rightfully concerned about how regulatory rules are being applied to classifying "troubled" loans. In some instances, the application of the rules represents overkill and results in the need for banks to raise capital in situations that may be unwarranted.

We all want fair treatment of what is truly a troubled loan. However, the problem is bigger than the question of nonaccruals. For example, how loans are classified as problem assets for regulatory purposes; how those loans are required to be valued (including those loans subject to modifications characterized as "troubled debt restructurings"); and how capital is calculated as a result of these classifications are major issues. How each of these is done can have significant consequences for a bank's ability or willingness to make loans in their communities. Overkill in any of these areas means far less credit will be extended, which translates into slower economic growth for this country.

This seems to be a particular issue with the classification of commercial real estate (CRE) loans. For example, bankers have told us that regulators generally classify the ***entire*** loan if the ***secondary*** source of repayment is impaired – even in cases where the borrower continues to make principal and interest payments. While an impairment of the secondary source – such as a decline in the collateral value of the underlying real estate – does raise concerns about potential losses, classifying the entire loan as troubled makes no sense for many loans. Moreover, the loss on a loan backed by collateral (as is the case with CRE loans) is typically much smaller than the full amount of the loan, and that assessment and any necessary impairment is recorded by the bank under generally accepted accounting principles (GAAP). Even with the drop in the collateral value (which has certainly taken place over the last several years), the property continues to have positive value and the bank would not lose the entire amount of the loan should it ultimately default. Thus, by classifying the entire loan as troubled, rather than just a conservative value of anticipated loss, the extent of the problems are overstated – vastly overstated in some cases.

For example, suppose a bank has a $10 million loan on a commercial property (non-owner occupied and leased) valued at $16 million at the time the loan was made. Even with significant equity by the borrower, the decline in CRE property has been 40 percent on average nationwide. Thus, a current appraisal might have this property valued at $9.6 million. While this is less than the loan, the borrower may – as is often the case – still be making principal and interest payments as promised on the loan. Even if the leasing is slow on the property and even with a conservative discount on the appraisal (in case the property had to be sold quickly or in recognition of still-declining market values), the collateral backing the loan still has considerable value. If the borrower does end up defaulting, the loss would not be $10 million, i.e., the original loan amount. Classifying as troubled the entire $10 million loan dramatically overstates the anticipated loss on this loan if it were to default (as is evidenced by the loss recorded under GAAP) – and the vast majority of such loans will continue to perform as expected and never default. But how this loan and other similar loans are treated by regulators, along with the need in some cases to raise additional capital as a consequence, will dramatically affect the ability and willingness of the bank to lend.

Not only is the level of classified assets overstated, but bankers have reported that the regulators are using fixed ratios of classified loans to capital plus reserves as a determinant of exam ratings and as a driver to require the bank to increase capital levels. Even profitable community banks with capital-to-asset ratios at or above those of their peers – and at or above the regulatory guidelines – and without significant asset quality problems, are being told their capital is inadequate and to increase it.

As capital is particularly scarce in today's environment – particularly for smaller banks – the only course of action is for banks to stop lending and to shrink in order to meet the required capital-to-asset ratio prescribed by the regulators. Banks shrink by making fewer loans. This clearly has a dramatic and negative impact on the bank and means less credit will be provided to creditworthy borrowers.

Exacerbating this problem is that the conclusions and recommendations of local field examiners – who annually visit banks to conduct extensive examinations lasting several weeks – are often being overruled by their superiors at the regional or even national level. Thus, the observations and conclusions by the regulators who have thoroughly examined our banks – and who understand the local markets and the strength and experience of bank management – are overturned by those who we have never personally examined the banks or visited the communities they serve. This has lead to a system where each regulator has an incentive to be tougher than the next.

This has significant consequences for communities. On one hand bank agency heads and Washington policy makers are urging banks to lend, but on the other hand the actions taken are saying don't lend, don't lend, don't lend. This means that good loans to creditworthy borrowers may not be made.

In short, H.R. 1723 is focused on these very serious problems affecting banks' ability to serve their customers and benefit the economy. However, we are concerned about legislating changes in accounting standards, even if they are only intended to be for regulatory use. Banks are issuers of financial statements – upon which our investors rely – as well as heavy users of financial statements of our borrowers. We need to make sure that all parties can rely on the accuracy of financial statements.

Thus, while we cannot support H.R. 1723 as drafted, the legislation is a direct response to very real problems. ABA urges this Subcommittee to use its oversight powers to ensure that the regulators are applying reasonable standards in determining what constitutes a classified loan, and even more importantly, ensure that consequences of the classifications do not inadvertently stop banks from making loans to creditworthy borrowers. We shall also continue to work with Rep. Posey and this Subcommittee on specific proposals to address these concerns.

Regarding Congressman Westmoreland's bill, H.R. 2056, we believe that a careful study of how bank failure resolutions have affected other surviving banks and their communities has merit. There is no question that some areas of this country, including Rep. Westmoreland's home state of Georgia, have suffered greatly from the economic downturn and many banks have failed. How these bank failures are resolved does have an impact on local communities. It can dramatically impact the value of residential and commercial real estate depending on how the assets of the failed banks are disposed of. This, in turn, impacts all property owners and other lenders in the community. We also believe that since the surviving banks pay all the costs of banks that fail – indeed all the costs of running the FDIC – it is important to have an independent validation of resolutions to assure that the FDIC is resolving failures in the least costly way, consistent with current law.

In conclusion, Madame Chairman, we appreciate this Subcommittee's sensitivity to the serious issues that face banks and the communities they serve. We applaud the efforts of Representatives Posey and Westmoreland to bring these issues to light. We look forward to working with these congressmen and this Subcommittee on finding reasonable solutions that will assure credit will flow to communities across our nation.

FLORIDA BANKERS ASSOCIATION

ALEX SANCHEZ
CHIEF EXECUTIVE OFFICER

July 6, 2011

The Honorable Bill Posey
U.S. House of Representatives
120 Cannon House Office Building
Washington, DC 20515

Dear Representative Posey,

The Florida Bankers Association (FBA) is in full support of your bill, H.R. 1723, "The Common Sense Economic Recovery Act of 2011." This bill will go a long way towards creating rational and consistent loan classifications and strengthening bank balance sheets.

Banks are eager to lend in their communities and lead our country's economic recovery; however, this is being hampered by overzealous examiners who are classifying performing loans as non-accrual for reasons unrelated to the payment of the loans. Florida banks, borrowers, and ultimately the state and national economy are penalized as a result of this strategy.

When loans become troubled in a tough economic environment, often the best course for the borrower and lender is a modification that will keep the loan out of foreclosure. In recent years, examiners have penalized loan modifications by aggressively placing loans on non-accrual status following a modification – even though the borrower has demonstrated a pattern of making the newly modified principal and interest payments. Additionally, the examiners are doing the same with current, performing loans that have not been modified. One example of this is a $1.8 million loan, being paid on an office space, that is performing but the regulators have put this loan on non-accrual because they cannot "determine where the cash flow is coming from" on the borrower. This particular bank wants to remain anonymous.

Additionally, H.R. 1723, requires the Financial Stability Oversight Council to conduct a study of how best to prevent contradictory guidance from being issued by the federal banking agencies with respect to loan classifications and capital requirements. The FBA notes that this has caused problems as the regulators adjust policy to meet the challenges presented by our economic realities. However, contradictory policies lead to a paralysis throughout the entire industry with negative economic results.

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July 6, 2011
Page 2

We believe your legislation will prevent adverse, inaccurate and counter-productive loan classifications by establishing conservative, common sense criteria for determining when a loan is performing and providing for a more consistent examination environment. Once again, thank you for filing H.R. 1723.

Sincerely,

Alex Sanchez
CEO

ICBA

INDEPENDENT COMMUNITY BANKERS *of* AMERICA

May 10, 2011

The Honorable Bill Posey
U.S. House of Representatives
Washington, DC 20515

Dear Representative Posey:

On behalf of ICBA's nearly 5,000 community bank members, I write to offer my thanks and strong support for your recently introduced bill, the Common Sense Economic Recovery Act of 2011 (H.R. 1723). This bill will go a long way toward creating rational and consistent loan classifications, strengthening bank balance sheets, and improving the oppressive examination environment, a top concern of community banks.

Community banks are eager to lend in their communities and lead the economic recovery. 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. In recent years, many examiners have penalized loan modifications by aggressively 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. Your bill would prevent adverse, inaccurate and counter-productive loan classifications by establishing conservative, commonsense criteria for determining when a loan is performing and providing for a more consistent examination environment.

Your bill also requires the Financial Stability Oversight Council to conduct a study of how best to prevent contradictory guidance from being issued by the Federal banking agencies with respect to loan classifications and capital requirements. We deeply appreciate your addressing the disease – contradictory guidance – as well as the symptom – overly aggressive impaired loan classifications.

Community bankers are expressing enthusiastic support for your efforts. They're telling us that your legislation resonates with their experience in examination and, had it been law, would have given them the flexibility to work with struggling but viable borrowers and maintain the capital they need to support their communities.

INDEPENDENT COMMUNITY BANKERS *of* AMERICA *The Nation's Voice for Community Banks.*®
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Thank you again. We look forward to working with you to help advance H.R. 1723.

Sincerely,
/s/
Camden R. Fine
President and CEO

cc: The Hon. Spencer Bachus, Chairman, House Financial Services Committee
The Hon. Barney Frank, Ranking Member, House Financial Services Committee
The Hon. John Boehner, Speaker of the House
The Hon. Eric Cantor, House Majority Leader
The Hon. Nancy Pelosi, House Minority Leader
The Hon. Steny Hoyer, House Minority Whip

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NATIONAL BANKERS ASSOCIATION

May 24, 2011

The Honorable Bill Posey
House of Representatives
Room 120, Cannon House Office Building
Washington, D. C. 20515

Dear Congressman Posey:

On behalf of the National Bankers Association (NBA), the voice of minority banking in America since 1927, I would like to offer our strong support of H. R 1723: The Common Sense Economic Recovery Act of 2011.

Congressman, you have captured in your bill the frustrations of community bankers from across America. With simple language , you have addressed the issue of over-zealous examiners unnecessarily and unreasonably second-guessing the judgment of experienced bankers whose track record or upholding the principles of safety and soundness are well-established.

You have correctly refuted many examiners who have classified as non-accrual, loans that are:

- current;
- where no monthly payments on the loan has been more than 30 days delinquent during the previous six months;
- the loan is an amortizing loan;
- and payments being made on the loan are not being funded through an interest reserve account.

Secondly, the problem of home foreclosures would be a far greater problem for the United States economy if banks were not able to allow borrowers the benefit of loan modifications that meet acceptable standards of sound banking practices.

1513 P Street, NW., Washington, D. C. 20005
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Page 2
The Honorable Bill Posey
May 24, 2011

Lastly, thank you for mandating that the Financial Stability Oversight Council use its authority created in Dodd-Frank to prevent so much of the contradictory guidance that results from primary regulators not being on the same page.

Your bill is a practical guide and a mandate from Congress that regulators cease and desist from imposing over-restrictive examinations on community banks who are positioned to help our economy recover if they are able to make loans, using reasonable underwriting standards, without being penalized by their examiners.

Thank you for courageously bringing these issues before the United States Congress. Hopefully, your bill will win swift passage.

Respectfully,

Michael A. Grant

Michael A. Grant, J. D.
President & CEO

Cc: Committee on Financial Services
Congressional Black Caucus
Congressional Hispanic Caucus
Congresswoman Maxine Waters: Attn: Mikael Moore

NATIONAL
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July 7, 2011

The Honorable Shelley Moore Capito
Chairman, Subcommittee on Financial
Institutions & Consumer Credit
United States House of Representatives
2443 Rayburn Office Building
Washington, DC 20515

The Honorable Carolyn Maloney
Ranking Member, Subcommittee on
Financial Institutions & Consumer Credit
United States House of Representatives
2346 Rayburn Office Building
Washington, DC 20515

Dear Chairman Capito and Ranking Member Maloney:

On behalf of the 1.1 million members of the National Association of REALTORS® (NAR), and its commercial affiliates[1], I am writing to you regarding tomorrow's hearing on "Legislative Proposals Regarding Bank Examination Practices." I respectfully request your support of H.R. 1723, the "Common Sense Economic Recovery Act of 2011," introduced by Representative Posey (R-FL). This legislation will direct federal banking agencies to treat current, non-delinquent, and amortizing loans as accrual loans instead of as non-accrual loans, creating more financing options when commercial real estate loans mature and allowing financial institutions to play a more significant role in revitalizing our nation's economy.

Nearly $1.2 trillion of commercial real estate loans with balloon mortgages will mature over the next few years, with very limited options to refinance. For commercial borrowers that are making their monthly payments, a simple term extension or workout in lieu of a refinance makes perfect sense. However, many lenders are currently not offering loan modifications due to pressure from bank regulators. Anecdotal evidence suggests that regulators continue to encourage lenders to write down the value of performing loans and, in some instance, even call the loan if the current value of the property is less than the loan balance. This has further exacerbated the economic downturn by creating defaults in properties that were able to meet, and did meet their debt servicing obligations.

If not addressed, the swelling wave of maturities could place further stress on our nation's already fragile financial markets and overall economy. H.R. 1723 could be instrumental in alleviating this stress by allowing financial institutions more flexibility. NAR encourages the timely enactment of this important legislation, which will halt the adverse re-categorization of performing commercial loans and help to prevent the commercial real estate sector from holding back the nation's economic recovery.

Sincerely,

Ron Phipps, ABR, CRS, GRI, GREEN, e-PRO, SFR
2011 President, National Association of REALTORS®

cc: Members, House Financial Services Subcommittee on Financial Institutions and Consumer Credit

EQUAL HOUSING OPPORTUNITY

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[1] CCIM Institute, Institute of Real Estate Management, REALTORS® Land Institute, and Society of Industrial and Office REALTORS®

Response to questions from the Honorable Bill Posey
by the Federal Deposit Insurance Corporation

Q1. What assertions and observations of the previous witnesses, or Members of this Committee, do you believe to be inaccurate or misleading? Please elaborate.

A1: Two of the previous witnesses, a bank executive and a commercial loan applicant, expressed significant concerns about the bank supervision process and their view of its effect on credit availability. A number of Members expressed similar concerns. While the FDIC does not comment on open institutions or specific customer relationships, we fully understand the concerns raised by these witnesses and the Members. We understand how difficult the current economic environment remains for many and assure the Committee that the FDIC takes these concerns very seriously.

Our testimony accurately described the written policies of the FDIC regarding loan classification and loss recognition. What emerged strongly from the hearing, however, was the view expressed by two witnesses and a number of Members that there is a disconnect between our written policies on the one hand, and examination practice on the other, to the effect that written guidance is either not being followed or that it is being interpreted overly harshly.

Ensuring that examiners follow FDIC policy and providing avenues for bankers to address concerns they may have about the examination process are important parts of our supervision. The answer to Question 10 includes a description of our efforts to ensure policies are being followed consistently in our examinations. As described in the answer to Question 4, we also make sure bankers are aware of a number of avenues that are available to them if they believe they are not being treated appropriately.

The banking environment continues to be challenging, and many institutions are contending with high levels of non-performing assets that require an appropriate level of capital. Our supervisory interaction with these institutions has the goal of returning them to a healthy condition so that failures can be avoided; for most problem banks this goal is achieved. The FDIC understands how hard banks are working to address the effects of the recession, and we have been engaging in a dialogue with our field staff to ensure our supervisory process is consistent and equitable. The FDIC will continue to work with banks to strengthen their financial positions, enabling them to expand lending and contribute to the economic growth of their local communities.

Q2. Can you please objectively quantify the usefulness of the customer hotlines in your agencies? How many (and what percentage of) customers and prospective customers get their issues resolved favorably by calling a hotline?

A2: The FDIC's Call Center responds to inquiries received on its main hotline, 877-ASK-FDIC and its small business hotline 1-855-FDIC-BIZ. The FDIC established the Call Center to be the central point of contact for FDIC customers to receive information responsive to questions relating to the FDIC. Callers include consumers, bankers, small business owners, financial and legal professionals, and state and federal agency personnel. Calls to the small business hotline are handled separately in our Call Center since the nature of the inquiry is different from general consumer calls. In terms of customer satisfaction, the Call Center provides a voluntary satisfaction survey to callers of the general toll free number. The responses to the informal survey show that callers are very satisfied with the Call Center and would recommend the Call Center as a source of information and assistance.

With the goal of one-call resolution, FDIC Call Center staff answer a wide-range of issues and questions. For calls requiring more specialized, in-depth information to address the issue or question, the Call Center directs callers to the appropriate area of FDIC that can provide the information or to the appropriate federal regulatory agency if the matter involves an entity not supervised by the FDIC. When the call involves a complaint about an FDIC-supervised institution, the Call Center provides information about how to file a written complaint so the FDIC can thoroughly review and investigate the matter. For calls received after hours, consumers can obtain the information they are seeking through recorded information on FDIC deposit insurance coverage and other issues. The system allows callers the option of leaving a message to receive a return call on the next business day.

The FDIC Call Center received over 229,000 calls in 2010, and of these, approximately 148,000 were answered directly by Call Center agents. An additional 81,000 callers chose to use a series of prompts to access recorded messages for the information they were seeking. For the first six months of 2011, the FDIC Call Center received 89,000 calls (57,000 were answered by Call Center agents and 32,000 through recorded messages). The most common inquiries based on 2010 data are:

- Inquiries on deposit insurance coverage and the insured status of an institution—53 percent
- Individuals seeking telephone numbers or contacting FDIC subject matter specialists—11 percent
- Inquiries on consumer protection issues, including how and where to file a complaint against a bank—10 percent
- Inquiries about failed or closed institutions—10 percent
- Citizens seeking employment with the agency—5 percent

The remaining calls involved a variety of issues and questions related to non-bank financial entities.

Q3. Can you please objectively quantify the usefulness of the ombudsman in your agencies? How many (and what percentage of) financial institutions get their issues resolved favorably by contacting the ombudsman?

A3: The FDIC Office of the Ombudsman is a confidential, neutral, and independent resource and liaison, providing information and assistance to anyone affected by the FDIC. The FDIC Office of the Ombudsman answers questions about FDIC policies and procedures, provides referrals to subject matter experts within the Corporation, and aids in the resolution of complaints by listening, clarifying issues and working with all parties to reach a solution. FDIC Ombudsman service is an informal process and cannot overturn or make management decisions.

From January 2010 to present, the FDIC Ombudsman received 49 actionable grievances from individual banks, which were resolved, mitigated, or referred to another party for resolution. For purposes of this question, we considered actionable grievances to be specific accusations of wrongdoing, such as "the FDIC assigned my bank an incorrect examination determination." These 49 actionable grievances are a subset of approximately 682 complaints brought to the FDIC Ombudsman by both bankers and members of the public during the same time period (approximately 497 complaints from bankers). Many banker complaints cannot be resolved by the FDIC, such as when bankers request that FDIC formal enforcement actions not be made public, which is required by law. The larger environment of complaints are general, and their subjects run the gamut of economic matters, legislation, regulation, bank closings, examinations, and professional behavior. All complaints by financial institutions brought to the FDIC Ombudsman are resolved, in the sense that they receive an informed response from the Ombudsman or are referred to the appropriate party within the Corporation for resolution.

Recent concerns reported to the FDIC Ombudsman by bankers and the public center around the struggling economy, regulation changes, and examinations perceived to be aggressive. Approximately 1,441 industry representatives contacted the FDIC Ombudsman since January 2010 requesting assistance (49 of which represented actionable grievances). The FDIC Ombudsman staff spoke with 3,126 members of the public about the FDIC and banking matters during the same time period. Ombudsman staff contacted 394 financial industry representatives from January 2010 to the present through outreach visits, telephone calls, and industry-sponsored conferences.

Highlights of the FDIC Ombudsman's work are reported to the financial services industry and the public every six months on the FDIC website at:
http://www.fdic.gov/regulations/resources/ombudsman/feedback1.html

Q4. Do you agree that financial institutions are concerned about retribution if they disagree with examiner decisions or seek an appeal? What steps are in place to mitigate retribution, both perceived and real?

A4: We are deeply concerned about reports that some banks fear retribution from banking regulators over a disagreement with examiners or the filing of a supervisory appeal. FDIC policy prohibits any retaliation, abuse, or retribution by an agency examiner or FDIC personnel against an institution. Such behavior constitutes unprofessional conduct and will subject the examiner or other personnel to appropriate disciplinary or remedial action.

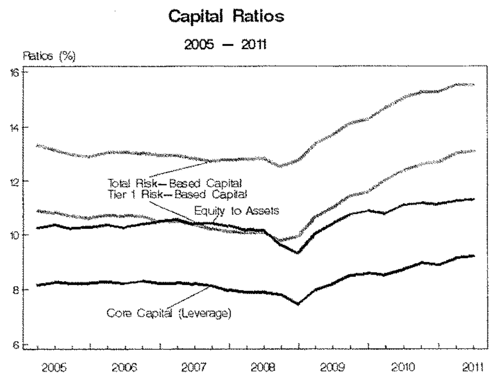
We encourage any institution that believes it was retaliated against to contact the Regional Director for the appropriate FDIC region and the Director of the appropriate FDIC division. For risk management issues, FDIC supervised banks are told they may contact the Director, Division of Risk Management Supervision and for compliance or Community Reinvestment Act issues, banks may contact the Director, Division of Depositor and Consumer Protection via email, telephone, or by mail. An institution also may file a complaint with the FDIC Ombudsman through the same channels explaining the circumstances and the basis for their concern and requesting the complaint be investigated and appropriate disciplinary or remedial action taken. The Office of the Ombudsman will work with the appropriate division to resolve the allegation of retaliation.

The FDIC values the informed perspective of banks we supervise and welcomes the opportunity to discuss questions about examination findings in an open, non-confrontational way. To this end, the FDIC issued Financial Institution Letter (FIL)-13-2011, *Reminder on FDIC Examination Findings*, on March 1, 2011, to reinforce the Corporation's policy that encourages banks to express any concerns about an FDIC examination or supervisory determination through informal or formal channels. We have found that the most effective method for understanding FDIC supervisory conclusions is to raise concerns with the examiner-in-charge or staff in the appropriate field or regional office. Banks can informally contact FDIC offices by telephone or email or request an in-person meeting. If an institution cannot resolve its concerns or believes our regional office is not carrying out FDIC policies, the institution is encouraged to contact our Washington Office. To facilitate this process, we established dedicated email addresses and provided contact names and phone numbers in the March FIL. Most follow-up discussions are successful in resolving the issue; however, if these informal channels do not resolve concerns, a formal appeals process is available. Again, an institution also may contact the FDIC Ombudsman to facilitate the resolution of problems and complaints in a fair, impartial, and confidential manner.

Q5. If it is our position that there is an "abundance of capital" in banks, why aren't more loans being made?

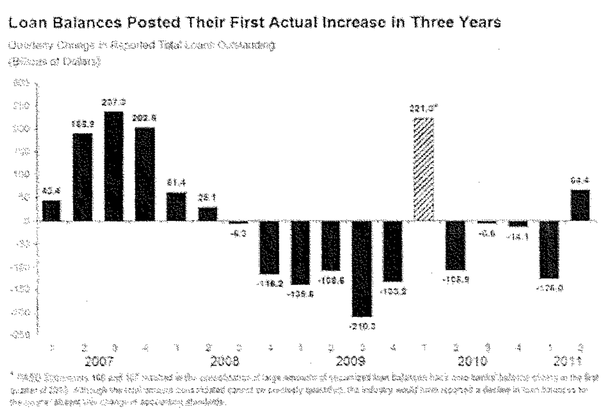
A5: FDIC-insured institutions currently have higher capital ratios than before the recent financial crisis began in 2008. Chart 1 below shows that, as of second quarter 2011, capital ratios for all insured institutions are significantly higher than before and during the recent financial crisis and are well above regulatory minimums. Chart 2 shows that for second quarter 2011, lending volume posted its first increase since 2008, showing some recent increased willingness and ability by institutions to lend. One key factor contributing to reduced credit availability during and after the recent financial crisis has been a tightening of lending standards in response to lessons learned from the recent financial crisis. During recent examinations, our discussions with bank management have identified three primary obstacles to lending: lack of demand from creditworthy borrowers, uncertainties regarding the pace of the economic recovery, and strong competition for good loans. The Federal Reserve *Senior Loan Officer Opinion Survey on Bank Lending Practices* (July 2011) shows some easing of lending standards for loans not secured by real estate; but overall loan demand remains sluggish by historical standards, especially for credits collateralized by residential real estate. In addition, the National Federation of Independent Businesses' (NFIB) survey on *Small Business Economic Trends* (August 2011) shows that "credit supply" is not a problem. In that report, 92 percent of respondents stated that "all their credit needs were met or that they were not interested in borrowing."

Chart 1



Source: FDIC *Quarterly Banking Profile*, Graph Book for June 30, 2011.

Chart 2



Source: FDIC *Quarterly Banking Profile* for June 30, 2011.

In addition to the factors described above, some institutions have curtailed lending to preserve capital and workout existing problem credits. Thus, while banks with favorable CAMELS ratings of 1 or 2 maintained positive loan growth during 2010 and the first half of 2011, banks with unfavorable ratings of 3, 4, or 5 showed declining loan balances throughout this period. Although the environment for banks needing to raise capital remains challenging, it has improved significantly since 2009. In fact, more than 350 insured banks and more than 280 bank holding companies each raised at least $1 million in common or preferred equity during 2010. The vast majority of institutions that have been successful in raising capital are community banks with total assets below $1 billion. Additionally, during the first six months of 2011, more than 160 insured institutions and more than 140 bank holding companies each raised $1 million or more in common or preferred equity.

In summary, banks do have capacity to lend, but continue to face economic and other challenges to prudently increasing lending activity. The FDIC does not instruct banks on which loans to make; that authority is vested with bankers who make their own credit decisions on Main Street every day.

Q6. Please explain how a federal financial regulator is able to close a bank that has significantly greater assets than it does liabilities? Please provide a couple scenarios.

A6: Banks are closed by the chartering authority in accordance with that authority's rules and guidelines. This generally occurs when capital levels—the difference between assets and liabilities as reported under generally accepted accounting principles and regulatory capital standards—become critically deficient, or when the bank is unable to meet its obligations in the normal course of business (i.e., a liquidity failure).

There are two main reasons why reported assets may exceed liabilities at the time of failure. First, Prompt Corrective Action regulations required by the Federal Deposit Insurance Act generally direct the agencies to close banks when the ratio of tangible capital to total assets is less than two percent. This legislative requirement to close banks while reported capital (the difference between assets and liabilities) is still positive is intended to reduce costs to the Deposit Insurance Fund. The other main reason assets may exceed liabilities shortly before failure is in situations where losses were not recognized appropriately on the failing bank's balance sheet.

Upon closing a bank, the chartering authority generally appoints the FDIC as receiver. While insufficient capital or liquidity are the main reasons for closing a bank, there are a number of grounds for appointing a conservator or receiver set forth in Section 11(c)(5) of the FDI Act. These include the following:

- Assets are less than obligations to creditors and others;
- Substantial dissipation of assets or earnings due to--
  (i) any violation of any statute or regulation; or
  (ii) any unsafe or unsound practice;
- An unsafe or unsound condition to transact business;
- Willful violation of a final cease-and-desist order;

- Concealment of the bank's books and records, or refusal to submit the bank's books and records to any examiner or to the appropriate Federal banking agency or State bank supervisor;
- An inability to meet obligations or meet depositors' demands in the normal course of business;
- The incurrence or likely incurrence of losses that will deplete all or substantially all of the bank's capital, and there is no reasonable prospect for the bank to become adequately capitalized (as defined in section 38(b) of the FDI Act) without Federal assistance.
- Any violation of any law or regulation, or any unsafe or unsound practice or condition that is likely to--
  (i) cause insolvency or substantial dissipation of assets or earnings;
  (ii) weaken the institution's condition; or
  (iii) otherwise seriously prejudice the interests of the institution's depositors or the deposit insurance fund.
- Consent to appointment by the bank's board of directors or its shareholders;
- Cessation of insured status;
- Being Undercapitalized as defined in Section 38(b) of the FDI Act, and the bank--
  (i) has no reasonable prospect of becoming adequately capitalized (as defined in that section);
  (ii) fails to become adequately capitalized when required to do so;
  (iii) fails to submit a capital restoration plan acceptable to that agency within the time prescribed; or
  (iv) materially fails to implement a capital restoration plan submitted and accepted;
- Being Critically Undercapitalized as defined in Section 38(b) of the FDI Act; or otherwise having substantially insufficient capital.
- A criminal money laundering conviction under certain provisions of Title 18 or Title 31.

Q7. Please explain the extent to which multiple loans categorized as non-accrual can lead to a bank failure.

A7: A non-accrual loan generally involves a borrower that is more than 90 days past due on payments and is not "well secured" and "in the process of collection," according to Generally Accepted Accounting Principles. Such loans pose an increased risk of loss to the bank, involve higher overhead costs because of enhanced oversight and loss mitigation needs, and do not produce revenue because any payments received are credited to the principal balance. Banks that hold high levels of non-accrual loans often recognize more significant credit losses than other banks, report declines in interest income, and are eventually burdened by non-earning other real estate and repossession holdings. These factors result in lower earnings and capital levels. Persistently high volumes of non-accrual loans can lead to losses that may compromise bank capital and ultimately result in institution failure. The FDIC works closely with banks with high levels of non-accrual loans to ensure appropriate workout processes, reserves, and capital are in place to avoid further financial deterioration.

Q8. Please answer the following questions for each year, 2000-2010:

1. **How many examiners did you employ?**
2. **How many banks did you regulate?**
3. **How many loans were held by these institutions?**

A8: The following chart lists the number of risk management examiners employed by the FDIC and the number of FDIC-supervised banks for year-end 2000 through 2010. The troubled banking environment necessitated hiring additional risk management examiners in 2008, 2009, and 2010, including a significant minority on term appointments. Of the 1,916 risk management examiners employed by the FDIC at the end of 2010, 494 were term employees.

Year-end	Risk Management Examiners			Total FDIC-Supervised Banks
	Perm	Term	Total	
2010	1,422	494	1,916	4,721
2009	1,308	266	1,574	4,941
2008	1,229	97	1,326	5,098
2007	1,127	46	1,173	5,197
2006	1,206	0	1,206	5,220
2005	1,233	0	1,233	5,245
2004	1,312	0	1,312	5,262
2003	1,432	0	1,432	5,318
2002	1,480	0	1,480	5,352
2001	1,437	0	1,437	5,484
2000	1,760	0	1,760	5,616

The federal banking agencies do not collect information regarding the total number of loans held by banks. The following chart shows the dollar volume of loans for FDIC-supervised banks for year-end 2000 through 2010. Total loans increased for every year from 2001 to 2008 but declined in 2009 and 2010. From year-end 2000 to year-end 2010, total loans for FDIC-supervised bank grew 59.5 percent.

Year-end	Total Loans FDIC-Supervised Banks	Change From Prior Period
2010	$1,507 billion	-1.0%
2009	$1,522 billion	-2.7%
2008	$1,563 billion	6.2%
2007	$1,473 billion	0.8%
2006	$1,461 billion	8.2%
2005	$1,351 billion	13.2%
2004	$1,193 billion	8.6%
2003	$1,099 billion	8.0%
2002	$1,017 billion	6.4%
2001	$956 billion	1.1%
2000	$945 billion	NA

Q9. How many bank examiners, if any, have been investigated for over-stepping their authority, protocols, or procedures since 2008? How many have been disciplined or terminated?

A9: The FDIC has not had any situations rise to the level of formal discipline for the type of action referenced in the inquiry. Rather, any minor issues were immediately addressed by FDIC management through employee counseling or other informal steps. The employee behavior was promptly corrected, resulting in the need for no further formal action.

The FDIC maintains high standards of competence and professionalism for its examiners. Each examiner is provided with extensive training and regular, ongoing feedback to ensure the FDIC's examination policies and procedures are followed. The findings and recommendations of each on-site examination are subject to multiple levels of review, which is more fully described below in the answer to Question 10. When received, we also consider and follow-up on comments made by institution management regarding examiner reasonableness and professionalism. Examiner performance and conduct issues are promptly addressed through informal coaching and counseling and, if needed, through progressive steps of formal discipline. Because of the FDIC's high expectations for our examiners and the alignment of employee responsibilities with our mission of ensuring safety and soundness of bank operations, disciplinary actions against examiners are infrequently necessary.

Q10. What kind of grading or evaluations are in place to ensure that bank examiners are fair and balanced?

A10: The FDIC has established a variety of avenues to ensure the integrity of its examination findings and process. The findings and recommendations of each on-site examination are subject to multiple levels of review, at least to the field office level, to ensure quality and accuracy. For "troubled" and other institutions posing higher risk to the Deposit Insurance Fund, such reviews also are conducted by the appropriate regional office and, for "problem" institutions, reviews are conducted at the Washington office level. The review process ensures that the examination report has been prepared in accordance with internal policies and procedures; affirms the accuracy of and support for the assigned ratings; and ensures that the tone of the report is appropriate. Written feedback is provided by the reviewer(s) to the examiner for these areas.

In addition to the review process accorded all examinations, a post-examination survey accompanies the final examination report mailed to the institution. The survey provides bankers with an opportunity to provide the FDIC with confidential feedback. The survey addresses several areas, including examiners and the examination process. Individual survey responses, which are not returned to the examiners, are independently reviewed each quarter by FDIC senior management in the regional and Washington offices. We use aggregate survey results to better understand bankers' experiences with the supervisory process in an effort to maintain an effective and streamlined examination program that avoids unnecessary burden.

Further, bankers are encouraged to contact examination staff at all levels of our supervisory chain. In March of this year, the Directors of the FDIC's Divisions of Risk Management Supervision and Depositor and Consumer Protection set up two special electronic mailboxes for bankers to communicate their concerns with actions or decisions of examiners or the regional offices and to ask for an informal review. Bankers also have access to a confidential and neutral review of questions or concerns by the FDIC's Office of the Ombudsman.

Although informal resolution of disputes with examiners or the regional office is encouraged, a formal appeals process has been established to provide institutions with an avenue for pursuing appeals of material supervisory determinations to the Washington office. An institution that does not agree with the determination rendered by the Division Director may ultimately appeal that determination to the FDIC's Supervision Appeals Review Committee, a committee chaired by one of the FDIC's Board of Directors.

Q11. To what extent are the criteria for classifying loans objective versus subjective?

A11: The FDIC strives for an even-handed approach to examination loan reviews, and much of our on-site work focuses on validating banks' own credit risk-rating conclusions. During each examination, FDIC examiners engage in a fact-based, objective review of an institution's loan portfolio and the effectiveness of credit policies and loan grading processes. In many cases, our examiners agree with the bank's conclusions, and any disagreements about credit grades or adverse classifications are usually exceptions. When analyzing the quality of a loan, our examiners focus on the borrower's cash flow and capacity to repay. If the borrower cannot pay as promised, we consider any secondary sources of repayment to support the loan, such as pledged collateral or personal/corporate guarantees. Importantly, our examiners do not focus on the price of properties from distressed sales. Instead, we evaluate the borrower's cash flow, financial position, and ability to repay the debt.

The definitions of the Substandard, Doubtful, and Loss classifications reproduced below have been in effect since 1949 and, in similar forms, since the early days of the FDIC. Applying these definitions requires an application of professional judgment to the facts at hand in any particular circumstance. On the continuum of subjectivity versus objectivity, we strive to make the classifications as objective as possible without sacrificing the need for judgment to be applied in particular circumstances. We do not believe that a purely formulaic or one-size-fits-all approach to loan classification would be appropriate.

Interagency definitions for adverse asset classifications:[1]

> **Substandard:** Substandard loans are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected.
>
> **Doubtful:** Loans classified Doubtful have all the weaknesses inherent in those classified Substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently known facts, conditions and values, highly questionable and improbable.

[1] *Interagency Policy on Classification of Assets and Appraisal of Securities* (FIL-70-2004, dated 6/15/04). This issuance updated examination procedures that were established in 1938 and subsequently updated in July 1949 and March 1979.

Loss: Loans classified Loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the loan has absolutely no recovery or salvage value but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be affected in the future.

Questions for the Record by Rep. Bill Posey (FL-15)
Financial Institutions and Consumer Credit Subcommittee
July 8, 2011 Hearing
"Legislative Proposals Regarding Bank Examination Practices"

Questions for Panel 2, Mr. George French (FDIC) and Ms. Jennifer Kelly (OCC):

1) **What assertions and observations of the previous witnesses, or Members of this Committee, do you believe to be inaccurate or misleading?**

   Please elaborate.

   The OCC has heard concerns about the role of bank regulators, the basis for examiner classification and accrual decisions, and the effectiveness of communications about our policies and guidance between headquarters and field examiners, as well as with the banks that we supervise. We have heard these concerns directly from the banks and we heard similar concerns voiced by Committee Members and witnesses at the hearing.

   In response, we have worked hard to explain that our primary supervisory goal is to make sure that community banks have the strength and capacity to meet the credit needs of their customers and communities. While some bankers have expressed concerns about our individual supervisory decisions, we strive to make sure that they are fair, balanced, and consistent over time and across institutions.

   My written testimony included considerable detail explaining the OCC's examination philosophy and approach, the measures against which we examine banks, and the guidance we have issued to encourage banks to lend and to work with troubled borrowers. It also intended to clarify the foundation upon which examiner decisions, such as those relating to loan classifications and accruals, are made. My testimony provided detailed responses to some of the specific concerns that bankers have raised with us (and that some Members echoed at the hearing) including: why loans may be criticized; how banks can continue to work with borrowers when their loans are classified; and that loans will not be classified or written down solely because the value of the underlying collateral has declined. I further clarified the basis upon which a determination is made about a loan's accrual status, and 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.

   We encourage frequent and open communication with the banks that we supervise, and we have several channels available that reflect our willingness to discuss bankers' concerns, questions or examination findings with them.

2) **Can you please objectively quantify the usefulness of the customer hotlines in your agencies? How many (and what percentage of) customers and prospective customers get their issues resolved favorably by calling a hotline?**

   The OCC's Customer Assistance Group (CAG) assists thousands of customers of national banks and federal savings institutions with complaints related to applicable banking laws and regulations. The CAG also provides informal consumer financial education on numerous banking topics detailed in "Frequently Asked Questions" listed on our website, www.helpwithmybank.gov.

Our process involves investigation of the complaint, contacting the applicable bank for a response to the disputed issue, and communicating results to the consumer upon completion of our review.

The focus of our Customer Assistance Hotline (1-800-613-6743) includes:

- assisting callers by providing instruction on filing a written complaint via our website, by fax or mail,
- directing callers to the availability of our Frequently Asked Questions, and
- determining who is the appropriate regulator for their financial institution if the OCC is not the primary regulator. If their institution is not a national bank or federal savings institution, we provide the phone number of the appropriate regulatory agency.

During 2009 and 2010, our Customer Assistance Hotline answered approximately 105,000 calls in English and approximately 1,700 in Spanish each year. Call volume for 2011 is projected to reach approximately 90,000 calls in English and 1,800 calls in Spanish. Our objective is to ensure each caller that files a written complaint is treated fairly and in compliance with applicable laws and regulations. As such, we do not track how many complaints are ruled in favor the financial institution or ruled in favor of the consumer. As a result of written complaint activity, bank reimbursements to consumers totaled $15.8 million in 2010, which is up significantly from $9.02 million in 2009. As of June 30, 2011, bank reimbursements to consumers totaled $5.6 million.

3) Can you please objectively quantify the usefulness of the ombudsman in your agencies? How many (and what percentage of) financial institutions get their issues resolved favorably by contacting the ombudsman?

The OCC Ombudsman functions outside the bank supervision area and reports directly to the Comptroller of the Currency. With the prior consent of the Comptroller, the Ombudsman may stay any appealable agency decision or action during the resolution of an appealable matter. The existence of a formal appeals process does not change the core philosophy of the OCC concerning dispute resolution. The agency remains committed to making every effort to resolve disputes arising during the supervisory process fairly and expeditiously, in an amicable, informal manner.

National banks and federal thrifts are encouraged to contact the Ombudsman to discuss any agency policy, decision, or action that might develop into an appealable matter. The Ombudsman's objective in these cases is to seek a resolution to the dispute before it develops into a formal appeal. This avenue provides an opportunity for a financial institution to resolve issues in the most efficient and expeditious manner possible. If banks cannot resolve disagreements through informal discussions, they are encouraged to seek a further review of the OCC decisions or actions that are in dispute by filing a formal written appeal. A bank may seek a review of any agency decision or action, including (1) examination ratings (2) adequacy of loan loss reserve provisions and (3) classifications of loans that are significant to an institution.

In 2010, the Ombudsman opined on eleven formal appeals. Of these eleven, seven (64%) were ruled in favor of the supervisory office, two (18%) were ruled in favor of the bank and 2 (18%) were a split decision between the bank and the supervisory office.

4) Do you agree that financial institutions are concerned about retribution if they disagree with examiner decisions or seek an appeal? What steps are in place to mitigate retribution, both perceived and real?

Our entire appeals process, including procedures in place to prevent retribution, is documented in OCC Bulletin 2002-9, which is available to the public via our website. After the appropriate OCC official renders a decision on an appeal, the Ombudsman will contact the appellant bank to ask whether the bank believes OCC examiners have taken actions against the bank in retaliation for its appeal. The Ombudsman makes these contacts (1) six months after the date of the decision letter, and (2) six months after the date of completion of the first examination of the appellant bank following its appeal. A national bank or federal savings association may, of course, contact the Ombudsman any time during or after the appeal if the bank reasonably believes that an OCC official is retaliating against it for its appeal.

Upon identifying or learning of any possible retaliatory actions, the Ombudsman will investigate the complaint. In the absence of extenuating circumstances, such investigations will be completed within 30 days. If the Ombudsman finds that retaliation has occurred, he or she will forward the complaint to either the senior deputy comptroller for Midsize and Community Bank Supervision or the senior deputy comptroller for Large Bank Supervision (whichever oversees the bank), or to the inspector general. These officials will take appropriate action, including disciplinary action consistent with OCC policies and procedures. In addition, to prevent future retaliation for an appeal, the Ombudsman may recommend to the Comptroller that the next examination of the national bank or federal savings association exclude personnel involved in a ruling appealed by that bank. As noted in my response to question 9, there has been only one instance since 2008 where the Ombudsman's office received a complaint from a bank alleging repercussions due to an appeal.

5) If it is your position that there is an "abundance of capital" in banks, why aren't more loans being made?

As I noted in my April 6, 2011, testimony before the Subcommittee, lending activity has been hampered by the overall economic climate. Many businesses and consumers have made conscious attempts to de-lever their balance sheets and reduce their debt. Weak sales and uncertainty about the economy has also kept many businesses cautious about inventories and investments. Earlier this year, the NFIB Research Foundation, a small business-oriented research organization affiliated with the National Federation of Independent Businesses, published a report on financing small businesses. That report, available at http://www.nfib.com/Portals/0/PDF/AllUsers/research/studies/Small-Business-Credit-Access-NFIB.pdf, noted that while small business financing conditions have deteriorated over the last two to three years, the small business problem has been and remains weak sales, followed by continued problems in the housing and real estate sectors.

Although it is true that many bankers have adjusted and tightened some of their credit underwriting standards, most bankers reiterate that lending is the backbone of their business and that they are seeking to make loans to creditworthy borrowers. The OCC continues to encourage bankers to lend to such borrowers. Ultimately, we believe that a recovery in lending activity will be dependent upon improvement in underlying economic fundamentals. In this regard, there were some positive signs in loan demand in the commercial and industrial (C&I) sector in the first quarter of this year, as the level of outstanding C&I loan balances for national banks trended slightly upward. This trend is consistent with findings from the Federal Reserve Board's April 2011 senior loan officer survey, which reported an increase in demand for C&I and commercial mortgage loans. Likewise, there are some signs of stabilization in the commercial real estate markets with regard to vacancy rates and net operating income. However, given the overhang of problems in these markets, recovery in this sector will likely be slower.

6) **Please explain how a federal financial regulator is able to close a bank that has significantly greater assets than it does liabilities? Please provide a couple scenarios.**

The OCC has the authority to place a bank into receivership on the basis of capital inadequacy, unsafe and unsound practices, illiquidity, and other grounds specified in the Federal Deposit Insurance Act (12 U.S.C. § 191 and 12 U.S.C. § 1821c(5)). The decision to place a bank into receivership is made with great care and must be approved by senior officials at the OCC. We carefully evaluate all the applicable statutory standards including the status of efforts to recapitalize; earnings and liquidity trends; competence of the board and management; and the existence of other factors such as fraud or insider abuse, where delay in closing the bank would increase the cost to the FDIC Deposit Insurance Fund. Our decision to place a bank in receivership is supported by a fully developed administrative record that includes a supervisory analysis of the bank's condition, history, and the applicable grounds for closing, along with a thorough legal analysis of the sufficiency of the supervisory record to support the grounds for closing.

With one exception,[1] the OCC has not closed a bank in the last ten years that had, at the time of the closing, significantly greater assets than liabilities. During that time frame, the OCC has based the decision to close national banks, in part, upon one or more of the following grounds which established that:

The bank was undercapitalized with no reasonable prospect for the bank to become adequately capitalized [12 U.S.C. 1821c(5)(K)(i)];

The bank was critically undercapitalized, or otherwise has substantially insufficient capital [12 U.S.C. 1821c(5)(L)(i) and (ii)];

There has been substantial dissipation of assets or earnings due to a violation of any statute or regulation, or any unsafe or unsound practice [12 U.S.C. 1821c(5)(B)(i) and (ii)];

The bank has incurred or is likely to incur losses that will deplete all or substantially all of its capital, and there is no reasonable prospect for the bank to become adequately capitalized without Federal assistance [12 U.S.C. 1821c(5)(G)];

The bank's assets are less than its obligations to its creditors and others [12 U.S.C. 1821c(5)(A)].

The above grounds formed the basis of the OCC's decision to close banks as a result of deficient or critically deficient capital which resulted from any number of factors, including loan losses and other, non-credit related operating losses. In virtually all cases, at the time the banks were placed in receivership, total assets were only marginally in excess of total liabilities.

[1] On December 17, 2010, the OCC placed Community National Bank, Lino Lakes, MN into receivership based on safety and soundness grounds and the voluntary written consent by the bank's board of directors for the OCC to do so. (12 U.S.C. 1821c(5)(I).

7) Please explain the extent to which multiple loans categorized as non-accrual can lead to a bank failure.

When a loan or borrower shows signs of trouble, there are generally three key accounting concepts that bankers and examiners must consider: 1) whether the loan, for financial statement and regulatory reporting purposes, should continue to accrue interest or, conversely, be put on nonaccrual status; 2) whether, if the loan is subsequently modified, it should be reported as a "troubled debt restructuring" (TDR); and 3) whether the bank has established appropriate loan loss allowances for any loan impairment.[2] The OCC and other banking agencies' standards for applying these concepts are governed by generally accepted accounting principles (GAAP) and are contained in the instructions that banks must follow when filing their quarterly Consolidated Reports of Income and Condition (Call Reports).

Recognition of income not expected to be collected from a borrower misrepresents a bank's financial performance and condition. Therefore, the agencies require banks to make nonaccrual designations in appropriate circumstances consistent with safety and soundness and to ensure comparability among institutions. In accordance with the Call Report Instructions, a loan is put on nonaccrual status when: 1) payment in full of principal or interest is not expected, 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, or 3) it is maintained on a cash basis because of deterioration in the financial condition of the borrower. The nonaccrual designation reflects the borrower's diminished willingness or ability to meet the loan's repayment terms. Therefore, the nonaccrual designation, in and of itself, does not cause a bank to fail; rather, it is a bank's inability to collect principal and interest payments that can lead to failure.

If doubt exists as to the bank's ability to collect the nonaccrual loan's recorded balance, the bank must apply any payments received to first reduce the loan balance. No interest income should be recognized until doubt as to the collectability of recorded principal and interest has been eliminated. At the same time, banks incur administrative expenses and capital charges to maintain these nonaccrual loans on their balance sheet. As a result, a large volume of nonaccrual loans increases expenses. Bank capital is depleted from the associated costs to fund, manage and administer these assets. Multiple nonaccrual loans can accelerate the depletion of capital because the bank does not have interest income to offset the funding and administrative expenses associated with these types of higher-risk assets. As described in the response to question 6, banks with little or no capital, without a realistic chance to be recapitalized, are placed into receivership.

8) Please answer the following questions for each year, 2000-2010

1. **How many examiners did you employ?**
2. **How many banks did you regulate?**
3. **How many loans were held by these institutions?**

Since the Subcommittee's focus is on community banks, my response is focused on the OCC's Midsize and Community Bank Supervision (MCBS) line of business. The number of examiners employed by the

[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.

OCC's MCBS line of business, the number of midsize and community banks supervised by the OCC, and the amount of gross loan volumes from calendar year-end 2000 to calendar year-end 2010 are summarized below. The increase in the number of MCBS examiners beginning in CY2004 reflects the OCC's renewed emphasis on recruiting and hiring to replace projected retirements.

	# of MCBS Examiners	# of MCBS Banks	Gross Loans* (thousands)
CY2000	1434	2181	$416,552,261
CY2001	1261	2104	$419,937,660
CY2002	1240	2057	$429,444,797
CY2003	1229	1990	$461,202,431
CY2004	1246	1907	$516,845,918
CY2005	1283	1822	$550,760,061
CY2006	1312	1729	$599,255,564
CY2007	1353	1647	$649,613,162
CY2008	1411	1554	$641,603,157
CY2009	1488	1484	$594,164,470
CY2010	1445	1403	$576,316,945

*The number of loans made is not readily available. As a result, the volume of loans on the midsize and community banks' books as stated in the Reports of Condition and Income (Call Report) is reflected above.

9) How many bank examiners, if any, have been investigated for over-stepping their authority, protocols, or procedures since 2008? How many have been disciplined or terminated?

The OCC's Ombudsman's office has received one complaint since 2008 from a bank alleging repercussions from examiners because the banker previously filed an appeal. The Ombudsman reviewed the specific examination conclusions and/or actions leading to the allegations. When viewed individually, certain actions taken by the examiners were considered reasonable and consistent with examination processes. However, collectively, three specific actions were determined to contribute to the perception of retaliation. As a result, the Supervisory Office was directed to amend the Report of Examination to delete specific names of individuals that were not relevant to the matter at hand, to confirm the factual basis for citing violations, and to ensure exit meetings are held in locations that are consistent with OCC practice.

Other than the case discussed above, a review of available records did not reveal any instances since 2008 when an examiner has been investigated for over-stepping his or her authority while examining a bank. Instances such as these could also involve the Treasury's Office of Inspector General (OIG). OCC's OIG Liaison has confirmed that there have been no OIG investigations of examiners for overstepping their authority in the conduct of their examination responsibilities or any allegations of such referred to OCC by the OIG for investigation. Accordingly, no examiner has been disciplined or terminated due to a complaint about overstepping their authority.

10) What kind of grading or evaluations are in place to ensure that bank examiners are fair and balanced?

OCC has a rigorous performance management evaluation system. Examiners receive performance evaluations based on standards that assess their knowledge, skills and abilities in the following areas: technical; analytical; organizational; communication (oral and written) and interpersonal; and personnel management. These assessments are done on an ongoing basis.

The performance standards are defined as follows:

TECHNICAL SKILLS: This element measures the development and maintenance of technical knowledge and skills needed to perform the duties of an examiner, i.e., familiarity with OCC policies and procedures, federal banking statutes and regulations, industry trends, and other external factors with an impact on the financial sector.

ANALYTICAL SKILLS: This element measures the application of technical knowledge to reach conclusions and to solve problems. It measures use of judgment and ability to make decisions.

ORGANIZATIONAL SKILLS: This element measures the ability to plan, organize, implement, and monitor assignments, or supervisory activity; manage time; achieve deadlines; take initiative in requesting additional assignments and developmental activities; and recognize and respond to changing priorities and circumstances in both individual and team assignments.

COMMUNICATION AND INTERPERSONAL SKILLS: This element measures the effectiveness of oral and written communication. It measures the ability to listen to differing opinions, negotiate and obtain commitment, and convey information in a clear and concise manner.

PERSONNEL MANAGEMENT SKILLS: This element measures the ability to manage human resources, including training, motivating, and evaluating employees. It measures support for Equal Employment Opportunity, diversity management, and affirmative employment principles, including efforts to provide an environment that is harassment free.

11) To what extent are the criteria for classifying loans objective versus subjective?

The OCC and other federal banking agencies use a common, uniform rating system to classify loans. This system sets forth the following definitions that examiners use and consider when making classification decisions:

Substandard Assets: A substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

Doubtful Assets: An asset classified doubtful has all the weaknesses inherent in one classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

Loss Assets: Assets classified loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future.

Special Mention: A Special Mention asset has 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 and do not expose an institution to sufficient risk to warrant adverse classification.

While these definitions provide a common, uniform framework for classification decisions, decisions about loan classifications cannot be reduced to a simple formula or cookie cutter approach. Examiners must consider the specific facts and circumstances about each loan and borrower when making these decisions. To provide more clarity and transparency on how variations in particular fact patterns may affect an examiner's decision, we have a number of additional resources and guidance for bankers and examiners. The OCC's Rating Credit Risk handbook, available at http://www.occ.gov/publications/publications-by-type/comptrollers-handbook/rcr.pdf provides a framework and guidance to bankers and examiners on the OCC's expectations for credit risk evaluation and the credit risk rating process. An appendix in that handbook provides examples of factors that examiners should consider and address in write-ups of credits. The 2009 interagency guidance on commercial real estate loan workouts, available at http://www.occ.gov/news-issuances/bulletins/2009/bulletin-2009-128a.pdf, provides specific, real world examples that discuss the appropriate classification treatment. The OCC's Bank Accounting Advisory Series, available on our website at http://www.occ.gov/static/publications/BAAS.pdf, provides real world examples of factors that examiners consider when making decisions regarding nonaccruals.

Response to Follow-up Question from the Honorable Ed Perlmutter
Before the Subcommittee on Financial Institutions and Consumer Credit
by George French of the Federal Deposit Insurance Corporation

Q1: You state in your testimony, "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." Does the FDIC have suggestions on ways banks can address the lingering credit quality issues on their books? More specifically, does the FDIC have suggestions on ways banks can raise additional capital from private sources?

A1: The FDIC works closely with financial institutions experiencing credit quality weaknesses as they strive to enhance lending policies and underwriting practices and implement loan workout programs to mitigate loss exposure. Our Reports of Examination often include a variety of recommendations to help institutions improve credit risk management processes. Although the FDIC is not involved in loan decisions or banks' relationships with individual borrowers, we make suggestions to improve credit rating systems, appraisal practices, and conformance with outstanding laws and regulations. We also encourage banks to adopt action plans for problem loans so appropriate repayment strategies can be pursued. By implementing these and other supervisory recommendations, it is the FDIC's experience that institutions are better able to remediate loan quality issues.

Capital augmentation is also an important aspect of addressing credit quality problems. Many institutions have worked to raise capital during the past several years to support unexpected credit and operating losses associated with the recession. Some institutions have been successful in raising capital through offerings to existing shareholders, private placements, and public sales of shares. According to data from the March 31, 2011 Consolidated Reports of Condition and Income, 580 institutions collectively raised more than $9 billion in capital through stock sales or other capital injections in the first quarter of 2011. The Corporation has observed that community banks have been most successful in raising capital by focusing on existing shareholders and other local investors who have a strong knowledge of and keen interest in their local market. The FDIC strongly supports banks' efforts to increase capital levels, and we have provided flexibility and time to complete subscription drives, given the on-going challenges presented by the capital markets.

	# of Bank Failures HQ in State (since 2008)	Total Number of Bank HQ in state (through May 2011)	Unemployment Rate (as of May 2011)	Serious Delinquency (2011 - 1Q)	State Population (2010)	Unemployment Rate (as of May 2011)
Georgia	65	261	9.8% (42)	8.07%	9,687,653	9.8% (42)
Florida	50	242	10.6% (48)	18.97%	18,801,310	10.6% (48)
Illinois	40	596	8.9% (T-31)	10.47%	12,830,632	8.9% (T-31)
California	38	268	11.7% (50)	8.81%	37,253,956	11.7% (50)
Minnesota	16	402	10.3% (T-46)	4.98%	5,303,925	10.3% (T-46)
Washington	16	79	9.1% (T-33)	6.42%	6,724,540	9.1% (T-33)
Michigan	12	135	10.3% (T-46)	7.90%	9,883,640	10.3% (T-46)
Nevada	12	29	12.1% (51)	15.97%	2,700,551	12.1% (51)
Missouri	11	333	8.9% (T-31)	4.89%	5,988,927	8.9% (T-31)
Arizona	10	37	9.1% (T-33)	9.04%	6,392,017	9.1% (T-33)