Testimony of

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On behalf of the

Independent Community Bankers of America

Before the

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The House Financial Services Committee

Subcommittee on Financial Institutions and Consumer Credit

Hearing on

"H.R. 3461: The Financial Institutions Examination Fairness and Reform Act"

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Opening

Chairman Capito, Ranking Member Maloney, and Members of the Subcommittee, I am Noah Wilcox, fourth generation President and CEO of Grand Rapids State Bank and a member of the Executive Committee of the Independent Community Bankers of America. Grand Rapids State Bank is a state chartered community bank with $236 million in assets located in Grand Rapids, Minnesota. I am pleased to represent community bankers and ICBA's nearly 5,000 members at this important hearing on "H.R. 3461: The Financial Institutions Examination Fairness and Reform Act (H.R. 3461)." This bill will go a long way toward improving the oppressive examination environment, a priority concern of community bankers and a barrier to economic recovery, by creating a workable appeals process and consistent, commonsense standards for classifying loans. ICBA is pleased to support H.R. 3461.

In my role at ICBA, I talk to a lot of community bankers in Minnesota and around the country, including a number who have appealed exams. Invariably, those who have filed an appeal have described a process that is arbitrary and frustrating. Appeals panels, or other processes, routinely lack the independence and market expertise necessary to reach a fair, unbiased decision. H.R. 3461 is a good start to improving the appeals process and by doing so it would likely improve exams. Examiners will be more circumspect knowing that bankers have access to a workable appeals process.

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.

In addition, examiners' interpretation of existing law frequently appears to change from exam to exam. A practice that was in compliance one year is questioned the following year. Other community bankers have described a similar experience and we've developed a term for it, "anticipatory regulation," because it seems as though the examiners are trying to get ahead of trends in legislation and regulation before they become law. At a minimum, community bankers need to know what is expected of them and that practices deemed compliant in the past will be acceptable in future exams. 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' contribution 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 or criticism 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.

Appeals of Exam Results Are Costly and Biased

The process for appealing exam decisions, which might offer relief, is instead an additional source of frustration. Appeals are lengthy and expensive. A typical community banker can expect to spend a year or more in appeal and incur as much as $150,000 in legal fees. What's worse, a bias in favor of the examining agency is built into the process. Panels assembled to hear appeals are drawn from the agency and consult closely with the examination team. The Ombudsman whose job is to receive complaints about the exam and the appeal is, again, an employee of the examining agency. Lacking adequate independence, their incentive and their priority appears to be to back decisions already made by the agency. A fair and impartial hearing is difficult if not impossible under these circumstances. The agencies will dispute this, but even the appearance of bias is enough to deter bankers from using the appeals process. Another concern is that the appeals panel is often drawn from other regions of the country. While this is intended to create a degree of separation between the appeals panel and the examiner, it does not provide for expertise in the local market which is essential to fairly evaluating a community bank.

This lack of independence in the appeals process – or even the appearance of such – has another important consequence. Community bankers, however frustrated they are with exam results, do not appeal those results out of fear of retribution. Many community bankers are reluctant to talk publicly about their experiences, let alone undertake an appeal. I've talked to hundreds of community bankers within the last year alone. Frustration with the exam environment is running high, but bankers typically will not share their stories out of fear of retribution, much less will they seek appeals. This is why the small number of appeals does not match the frustration of community bankers over exams. ICBA surveys have consistently shown that exams are a top concern among community bankers.

Under the circumstances, for any community banker who believes that their exam results are inaccurate, unfair, and harmful to their ability to serve their community, the incentive is to not question the results, however unjust, and to absorb their frustration and minimize any disruption to their business. Because too few bankers challenge exam results, examiners have no incentive to improve their performance. A workable appeals process will introduce the right incentives and set the system on a course of self-correction. Examiners will be more circumspect about substantiating their results knowing that bankers have a viable avenue to appeal. As exam quality improves, there will be less need for appeals. And as the economy improves, examiners will feel less pressure to protect themselves through inappropriately rigorous exams. This will set us on a course to restoring the balanced and productive partnerships many community bankers enjoyed with their examiners before the crisis struck.

H.R. 3461 Will Improve the Appeals Process

Taking the appeals process out of the examining agencies, as H.R. 3461 would do, is a positive step. The bill would create an expedited appeals process under which appeals of a "material supervisory determination" contained in a final report of examination would be heard before an independent administrative law judge without deference to the opinions of the examiner or agency. The administrative law judge would make a recommendation to a newly created Ombudsman, located within the Federal Financial Institutions Examination Council (FFIEC), who would make a final decision that would be binding on the agency and the financial institution.

The Ombudsman would also carry out other duties intended to improve the quality and consistency of examinations across all federal banking agencies, including investigating complaints related to examinations, meeting with banks from around the country to discuss their examination experiences, reviewing agency procedures, and reporting annually to Congress on these activities.

While not completely independent of the agencies – FFIEC is composed of each banking agency – I expect that this level of separation between the appeals process and the agencies will provide a measure of distance and insulation that will make it more impartial and that will perhaps raise the comfort level of bankers so that they are willing to use the process. The provisions of H.R. 3461 designed to make final examination reports more timely and requiring agencies to disclose all materials on which they based a material supervisory determination will also be helpful.

ICBA would encourage Members of this Subcommittee to consider taking a harder line by adding provisions to this legislation to bring a higher level of accountability to the regulators and their field examiners. The current system, which grants examiners almost unfettered, unassailable authority, begs for checks and balances. That said, we are pleased to support the provisions of Section 4 of H.R. 3461, as a foundation on which to build a more rigorous appeals process in the future.

H.R. 3461 Will Provide for Consistent, Commonsense Loan Classifications

H.R. 3461will also bring common sense to loan classifications and more consistency to the examination process. The bill provides that, for the purpose of determining regulatory capital requirements, no commercial loan will be placed on non-accrual status solely because its collateral has deteriorated, and a modified loan must be removed from non-accrual status after it has performed for six months. The bill also prohibits an examiner from requiring a new appraisal on a performing commercial loan unless an advance of new funds is involved. Loan classifications in which collateral value has deteriorated would be limited to the amount of the decline in collateral value and the repayment capacity of the borrower. An examiner would not be allowed to require a well capitalized institution to raise additional capital based on a loan classification under this legislation.

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.

The provisions of Section 3 of H.R. 3461 are consistent with agency guidance on troubled debt restructurings providing 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 support the revised examination standards of Section 3 because they resonate with their current experience in examinations. If these standards become law, they 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.

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. We are grateful to this Subcommittee for convening a hearing late last year on the Communities First Act (CFA, H.R. 1697) and giving ICBA Chairman Sal Marranca the opportunity to testify. The Communities First Act was introduced in the House by Rep. Blaine Luetkemeyer and currently has over 70 cosponsors with strong representation from both sides of the aisle. A similar bill has been introduced 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.
- 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.

These and other provisions would improve the regulatory environment and community bank viability, to the benefit of their customers and communities. Again, we thank the Subcommittee for its hearing on CFA and request that the legislation be marked up in the near future.

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. ICBA supports the advancement of H.R. 3461.

Thank you.

United States House of Representatives
Committee on Financial Services

"TRUTH IN TESTIMONY" DISCLOSURE FORM

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

1. Name:	**2. Organization or organizations you are representing:**
Noah Wilcox President and CEO Grand Rapids State Bank	Independent Community Bankers of America
3. Business Address and telephone number:	
[redacted]	
4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?	**5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?**
☐ Yes ☑ No	☐ Yes ☑ No
6. If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.	
7. Signature:	

Please attach a copy of this form to your written testimony.