STATEMENT OF

THE FEDERAL DEPOSIT INSURANCE CORPORATION
by

DOREEN R. EBERLEY
DIRECTOR
DIVISION OF RISK MANAGEMENT SUPERVISION

BRET D. EDWARDS
DIRECTOR
DIVISION OF RESOLUTIONS AND RECEIVERSHIPS

RICHARD A. BROWN
CHIEF ECONOMIST

on

STATE OF COMMUNITY BANKING: IS THE CURRENT REGULATORY ENVIRONMENT ADVERSELY AFFECTING COMMUNITY FINANCIAL INSTITUTIONS?

before the

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND CONSUMER CREDIT
COMMITTEE ON FINANCIAL SERVICES

U.S. House of Representatives

March 20, 2013
2128 Rayburn House Office Building

Chairwoman Capito, Ranking Member Meeks, and members of the Subcommittee, we appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) regarding the state of community banking and to describe the findings of the *FDIC Community Banking Study*, a comprehensive review based on 27 years of data on community banks.[1] We also welcome the opportunity to discuss the reviews by the Government Accountability Office (GAO) and the FDIC Office of Inspector General (OIG) of the causes of the recent financial crisis and the FDIC's supervision and resolution-related responses.

As the Subcommittee is well aware, the recent financial crisis has proved challenging for all financial institutions. The FDIC's problem bank list peaked at 888 institutions in 2011. Since January 2008, 469 insured depository institutions have failed, with banks under $1 billion making up 407 of those failures. Fortunately, the pace of failures has declined significantly since 2010, a trend we expect to continue.

The failure of a bank has the potential to be a highly disruptive event. While the FDIC protects insured depositors and resolves each institution in the least costly and least disruptive manner possible, the customers of a failed bank may still face the need to establish a new banking relationship that meets their financial needs. A bank failure also may be disruptive to a local community if the failure results in an adverse impact on the availability of credit or if distress sales of the failed bank's assets adversely affect local real estate prices.

[1] *FDIC Community Banking Study*, December 2012, http://www.fdic.gov/regulations/resources/cbi/study.html

Given the challenges that community banks, in particular, have faced in recent years, the FDIC last year launched a "Community Banking Initiative" to refocus our efforts to communicate with community banks and to better understand their concerns. The knowledge gathered through this Initiative will help to ensure that our supervisory actions are grounded in the recognition of the important role that community banks play in our economy. A key product of the Initiative was the recently published *FDIC Community Banking Study*, which is discussed in more detail below.

Congress also enacted P.L. 112-88, which mandates comprehensive reviews by the GAO and by the FDIC OIG of the causes of the recent crisis, the supervisory response, and the resolution of failed institutions. Consistent with the *FDIC Community Banking Study*, the GAO and OIG reviews identify three primary factors that contributed to bank failures in the recent crisis, namely: 1) rapid growth; 2) excessive concentrations in commercial real estate lending (especially acquisition and development lending); and 3) funding through highly volatile deposits. By contrast, community banks that followed a traditional business plan of prudent growth, careful underwriting and stable deposit funding were much more likely to survive the recent crisis.

Our testimony discusses the findings of the *FDIC Community Banking Study*, as well as our assessment and response to the reviews by the FDIC OIG and the GAO.

FDIC Community Banking Study

In December 2012, the FDIC released the *FDIC Community Banking Study*, our comprehensive review of the U.S. community banking sector covering 27 years of data. The Study set out to explore some of the important trends that have shaped the operating environment for community banks over this period, including: long-term industry consolidation; the geographic footprint of community banks; their comparative financial performance overall and by lending specialty group; efficiency and economies of scale; and access to capital. This research was based on a new definition of community bank that goes beyond size to also account for the types of lending and deposit gathering activities and limited geographic scope that are characteristic of community banks.

Specifically, where most previous studies have defined community banks strictly in terms of asset size (typically including banks with assets less than $1 billion), our study introduced a definition that takes into account a focus on lending, reliance on core deposit funding, and a limited geographic scope of operations. Applying these criteria for the baseline year of 2010 has the effect of excluding 92 banking organizations with assets less than $1 billion while including 330 banking organizations with assets greater than $1 billion. Importantly, the 330 community banks over $1 billion in size held $623 billion in total assets – approximately one-third of the community bank total. While these institutions would have been excluded under many size-based definitions, we found that they operated in a similar fashion to smaller community banks. It is important to note that the purpose of this definition is research and analysis; it is not intended to substitute for size-based thresholds that are currently embedded in statute, regulation, and supervisory practice.

Our research confirms the crucial role that community banks play in the American financial system. As defined by the Study, community banks represented 95 percent of all U.S. banking organizations in 2011. These institutions accounted for just 14 percent of the U.S. banking assets in our nation, but held 46 percent of all the small loans to businesses and farms made by FDIC-insured institutions. While their share of total deposits has declined over time, community banks still hold the majority of bank deposits in rural and micropolitan counties.[2] The Study showed that in 629 U.S. counties (or almost one-fifth of all U.S. counties), the only banking offices operated by FDIC-insured institutions at year-end 2011 were those operated by community banks. Without community banks, many rural areas, small towns and urban neighborhoods would have little or no physical access to mainstream banking services.

Our Study took an in-depth look at the long-term trend of banking industry consolidation that has reduced the number of federally insured banks and thrifts from 17,901 in 1984 to 7,357 in 2011. All of this net consolidation can be accounted for by an even larger decline in the number of institutions with assets less than $100 million. But a closer look casts significant doubt on the notion that future consolidation will continue at this same pace, or that the community banking model is in any way obsolete.

More than 2,500 institutions have failed since 1984, with the vast majority failing in the crisis periods of the 1980s, early 1990s, and the period since 2007. To the extent that future crises can be avoided or mitigated, bank failures should contribute much less to future

[2] The 3,238 U.S. counties in 2010 included 694 micropolitan counties centered on an urban core with population between 10,000 and 50,000 people, and 1,376 rural counties with populations less than 10,000 people.

consolidation. In addition, about one third of the consolidation that has taken place since 1984 is the result of charter consolidation within bank holding companies, while just under half is the result of voluntary mergers. But both of these trends were greatly facilitated by the gradual relaxation of restrictions on intrastate branching at the state level in the 1980s and early 1990s, as well as the rising trend of interstate branching that followed enactment of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. The pace of voluntary consolidation has indeed slowed over the past 15 years as the effects of these one-time changes were realized. Finally, the Study questions whether the rapid pre-crisis growth of some of the nation's largest banks, which occurred largely as a result of mergers and acquisitions and growth in retail lending, can continue at the same pace going forward. Some of the pre-crisis cost savings realized by large banks have proven to be unsustainable in the post-crisis period, and a return to pre-crisis rates of growth in consumer and mortgage lending appears, for now anyway, to be a questionable assumption.

The Study finds that community banks that grew prudently and that maintained diversified portfolios or otherwise stuck to their core lending competencies during the study period exhibited relatively strong and stable performance over time. Other institutions that pursued higher-growth strategies – frequently through commercial real estate or construction and development lending – encountered severe problems during real estate downturns and generally underperformed over the long run. Moreover, the Study finds that economies of scale play a limited role in the viability of community banks. While average costs are found to be higher for very small community banks, most economies of scale are largely realized by the time an institution reaches $100 million to $300 million in size, depending on the lending specialty.

These results comport well with the experience of banking industry consolidation since 1984, in which the number of bank and thrift charters with assets less than $25 million has declined by 96 percent, while the number of charters with assets between $100 million and $1 billion has grown by 19 percent.

With regard to measuring the costs associated with regulatory compliance, the Study noted that the financial data collected by regulators does not identify regulatory costs as a distinct category of noninterest expenses. In light of the limitations of the data and the importance of this topic in our discussions with community bankers, the FDIC conducted interviews with a group of community banks as part of our Study to try to learn more about regulatory costs. As described in Appendix B of the Study, most interview participants stated that no single regulation or practice had a significant effect on their institution. Instead, most stated that the strain on their organization came from the cumulative effects of all the regulatory requirements that have built up over time. Many of the interview participants indicated that they have increased staff over the past ten years to support the enhanced responsibility associated with regulatory compliance. Still, none of the interview participants indicated that they actively track the various costs associated with regulatory compliance, because it is too time-consuming, too costly, and so interwoven into their operations that it would be difficult to break out these specific costs. These responses point to the challenges of achieving a greater degree of quantification in studying this important topic.

In summary, the Study finds that, despite the challenges of the current operating environment, the community banking sector remains a viable and vital component of the overall

U.S. financial system. It identifies a number of issues for future research, including the role of commercial real estate lending at community banks, their use of new technologies, and how additional information might be obtained on regulatory compliance costs.

Examination and Rulemaking Review

In addition to the comprehensive study on community banks, the FDIC also reviewed its examination, rulemaking, and guidance processes during 2012 with a goal of identifying ways to make the supervisory process more efficient, consistent, and transparent – while maintaining safe and sound banking practices. This review was informed by a February 2012 FDIC conference on the challenges and opportunities facing community banks, a series of six roundtable discussions with community bankers around the nation, and ongoing discussions with the FDIC's Advisory Committee on Community Banking.

Based on concerns raised in these discussions, the FDIC has implemented a number of enhancements to our supervisory and rulemaking processes. First, the FDIC has restructured the pre-exam process to better scope examinations, define expectations and improve efficiency. Second, the FDIC is taking steps to improve communication with banks under our supervision by using web-based tools to provide critical information about changes in regulations, including deadlines for submitting comments on proposed new rules. Finally, the FDIC has instituted a number of outreach and technical assistance efforts, including increased direct communication between examinations, increased opportunities to attend training workshops and symposiums, and conference calls and training videos on complex topics of interest to community bankers.

The FDIC plans to continue its review of examination and rulemaking processes, and is developing new initiatives to provide technical assistance to community banks, which we expect to introduce later this year.

Reviews Required by P.L. 112-88

Under P.L. 112-88, the GAO was tasked with analyzing the causes and impact of a number of elements of the crisis, including: 1) the causes of high levels of bank failures in states with 10 or more failures since 2008; 2) the procyclical impact of fair value accounting standards; 3) the causes and potential solutions for the "vicious cycle" of loan write downs, raising capital, and failures; 4) an analysis of the community impact of bank failures; and 5) the feasibility and overall impact of loss share agreements.

P.L. 112-88 also tasked the FDIC's OIG with reviewing eight specific issue areas: 1) loss share agreements, otherwise known as shared-loss agreements (SLAs); 2) losses at failed banks; 3) examiner implementation of appraisal guidelines; 4) examiner assessment of capital adequacy and private capital investment in failing institutions; 5) examiner implementation of loan workout guidance; 6) the application and impact of formal enforcement orders; 7) the impact of FDIC policies on investments in institutions; and 8) the FDIC's handling of private equity company investments in institutions. The OIG subsequently reviewed and described FDIC compliance with applicable regulatory and supervisory standards in each of the eight areas.

The resulting GAO and OIG reviews were detailed and comprehensive, providing a wealth of information and data regarding the causes of the recent crisis and the FDIC's response. Although the GAO review did not include any recommendations, the OIG made several useful recommendations that are highly relevant to the FDIC's efforts to address the many issues arising from the crisis. The FDIC concurs with all of the OIG's recommendations and is now in the process of implementing them. Detailed descriptions of the FDIC's assessment of the issues identified by P.L. 112-88, the OIG's recommendations and the FDIC's implementation efforts are provided as an Appendix to this testimony.

Conclusion

The recent financial crisis has proved challenging for financial institutions in general and for community banks in particular. Analyses of bank failures during the crisis by the FDIC, its OIG and the GAO point to some common risk factors, including rapid growth, concentrations in high-risk loans, and funding through volatile deposits. In contrast, community banks that followed more conservative business models were much more likely to survive the crisis. The FDIC's extensive study of community banking over a 27-year period shows that while these institutions face a number of challenges, they will remain a viable and vital component of the overall U.S. financial system in the years ahead.

As mandated by statute, the GAO and the FDIC OIG conducted reviews that provided valuable information regarding the causes of the recent crisis and the FDIC's response. The FDIC welcomes the insights provided by the GAO and the OIG regarding the causes of the recent crisis. As described in the Appendix to this testimony, the review by the FDIC OIG also made a number of useful recommendations that the FDIC is now in the process of implementing. We believe that this type of analysis and policy review is an important element of our long-term efforts to maintain a safe and sound financial system and to effectively and appropriately respond when FDIC-insured institutions encounter financial distress.

Appendix

The discussions below correspond to the eight issue areas identified in P.L. 112-88 for review by the FDIC's Office of Inspector General (OIG). Each section includes a discussion of the key policy issues, any recommendations by the OIG and actions being undertaken by the FDIC to implement the recommendations.

Issue 1 -- Shared-Loss Agreements

When the Office of the Comptroller of the Currency (OCC) or a state banking regulator closes an FDIC-insured institution, federal law requires the FDIC to use the least costly method to resolve the failing institution. During the savings and loan and banking crisis of the late 1980s and early 1990s, the FDIC in most cases took control of the troubled assets of failed banks and managed them for eventual liquidation. Although the management of troubled assets in receivership met our statutory responsibilities in resolving failed banks, this strategy was found to have some serious shortcomings. Liquidating assets in receivership can result in significant disruptions for borrowers and surrounding communities, a diminution in the value of assets held under government control, and high losses to the insurance fund. In addition, the FDIC and the Resolution Trust Corporation had to employ over 20,000 people to manage and sell the assets from those bank failures.

An innovation introduced in the early 1990s was the shared loss agreement (SLA), in which the acquiring institution would assume all of the assets of the failed bank in exchange for a partial indemnification against future losses on troubled assets. Under a typical SLA structure, the FDIC would assume 80 percent of future losses on troubled assets, with the acquiring institution assuming the remaining 20 percent. While this partial indemnification against loss would induce risk averse acquirers to take on these troubled assets under private management, and thus keep them out of a government-controlled receivership, it also provided an incentive for the acquirer to maximize net recoveries on those assets – consistent with the fiduciary responsibility of the FDIC.

In the recent financial crisis, the FDIC has made much more extensive use of SLAs to facilitate the prompt transfer of failed bank assets to private management. SLAs were an essential tool to overcome the extreme uncertainty and risk aversion with regard to future loan performance and collateral values, especially early in the crisis. Almost 65 percent of the bank failures since the beginning of 2008 through 2012 were resolved through whole-bank purchase and assumption transactions with SLAs. As of December 31, 2012, the cost savings obtained through using whole-bank purchase and assumption transactions with SLAs, as opposed to more costly resolution alternatives, were projected to be approximately $41.1 billion

The goals of SLAs are to allow as many assets as possible to be kept in the private sector with a lending institution and to have the acquiring institution manage those assets under incentives that closely align the interests of the bank with the interests of the FDIC. Because an acquiring institution has financial exposure to the losses on assets purchased under this arrangement, it has an incentive to utilize a "least loss" strategy in managing and disposing of these assets.

SLAs also address the effect of bank failures on the local market by keeping more of the failed bank's borrowers in a banking environment. The acquiring institution can more easily work with the borrowers to restructure problem loans or to advance additional funding when prudent, helping to avoid a further decline in collateral values in the failed bank's market. Most importantly for the borrowers, the provisions of the SLAs entered into by the FDIC during this crisis require the acquiring institution to consider modifications for nonperforming loans in order to minimize unnecessary foreclosures.

Prospective bidders for failed institutions have the option to bid with or without an SLA. As expected, the number of failing bank resolution transactions conducted with SLAs has begun to decrease as the economy has recovered and as real estate markets have stabilized. In 2010, 130 of 157 bank failures, or 83 percent, were resolved using SLAs. Since then, both the number and percent of failed bank resolutions involving SLAs has declined steadily. In 2011, 58 out of 92 failed bank resolutions, or 63 percent, involved an SLA, as did 20 of 51 resolutions, or 39 percent, in 2012. None of the four failures so far this year was resolved using an SLA.

Term of shared-loss agreements

There are two primary types of SLAs, those applied to single family mortgage loans and those applied to non-single family loans. Single family SLAs have a term of ten years. Non-single family loan SLAs have a term of eight years, consisting of five years of shared-loss coverage followed by three years to allow for recovery payments to the FDIC on the assets for which a shared-loss claim was paid. The long term nature of the agreements is intended to allow for the acquiring institution to maximize the value of the failed bank's assets. As part of that process, banks work with distressed borrowers, attempting to reach a mutually beneficial resolution. The expiration of these agreements does not change the underlying incentives for the acquiring institution to develop new customer relationships and maximize net recoveries.

Management of acquired assets

The SLA requires the acquiring institution's best efforts to maximize recoveries. In satisfying this requirement, the acquiring institution is expected to consider every resolution alternative, including loan modifications. As such, acquiring institutions must undertake loss mitigation efforts prior to taking any foreclosure action. Additionally, the acquiring institution is required to manage and administer each loan covered under an SLA in accordance with prudent business and banking practices and in accordance with the acquiring institution's written internal credit policies and established practices.

The requirement for acquiring institutions to undertake loan modifications is subject to a financial analysis designed to ensure that qualifying borrowers are approved for modification and that such a strategy will maximize long-term recoveries. Because acquiring institutions generally share a portion of any losses, they share the FDIC's interest in pursuing modification in cases where it can be shown to maximize recoveries. Loss mitigation alternatives that increase the value of the loans will likely improve the affordability of the loan to the borrower and thereby lower the probability of default. Loan modifications can help borrowers preserve their stake in their homes and businesses. Collectively, these efforts to avoid foreclosures can help to preserve the viability of the community as a whole, which is also clearly in the best interest of an acquiring bank doing business in that community. All of these considerations point to a strong incentive on the part of the acquiring bank to avoid foreclosure or short sale and pursue a loan modification or restructuring whenever that alternative proves feasible.

Commercial real estate loan restructuring requirements

On December 17, 2010, the FDIC issued *Commercial Loss Mitigation Guidance on Commercial Real Estate (CRE) Loans*, requiring acquiring institutions to pursue a disposition strategy other than foreclosure on a covered asset when an alternative strategy is projected to result in the least loss. For commercial loans that are restructured by an acquiring institution, the loss share reimbursement is based on the portion of a restructured loan that is categorized as a loss. Therefore, an acquiring institution may file a shared-loss claim on a commercial loan based on the market value of the underlying collateral without the need to foreclose.

Residential mortgage modification requirements

SLAs also require the acquiring institution to implement a comprehensive loan modification program, such as HAMP or the FDIC Loan Modification Program, for single-family mortgages covered under the agreement. Modifications improve borrower affordability, increase the probability of performance, and allow borrowers to remain in their homes. Prior to any foreclosure action, the acquiring institution is required to perform and document a simple financial analysis to assess the feasibility of modifying a single family mortgage loan. If a qualified borrower accepts the modification offer, the bank can submit a shared-loss claim to the FDIC. One clear advantage for acquiring institutions to pursue modification is the ability to be paid sooner than might be the case in a foreclosure. Not only must the institution exhaust all loss mitigation options before foreclosure can proceed, but foreclosure and the sale of foreclosed property is a process that can take up to two years or more, depending on the state in which the property is located. Hence, the acquiring institution has a strong incentive to consider and engage in single family mortgage loan modifications where viable.

Monitoring of shared-loss agreements

The FDIC monitors compliance with the SLAs through quarterly reporting by the acquiring institution and through periodic reviews of the acquiring institution's adherence to the agreement terms. If the FDIC determines that an acquiring institution has not complied with the terms of the SLA, including the requirement to consider and engage in loan modifications, the FDIC will delay payment of shared-loss claims until compliance problems are corrected. The FDIC can deny payment of a claim altogether or indefinitely suspend payments for as long as the acquiring institution remains out of compliance with the agreement. The periodic reviews of the acquiring institution are completed onsite, and include: verifying the accuracy of shared-loss claims; ensuring compliance with loss mitigation efforts; testing the acquiring institution's policies and procedures to ensure uniform criteria are being applied to both shared-loss assets and the bank's own legacy assets; reviewing internal audit reports and the external independent public accountant reports to ensure that internal controls are in place; and verifying that adequate accounting, reporting, and recordkeeping systems are in place. Thus far, we have found that the overwhelming majority of acquiring institutions are diligent in their efforts to comply with all the terms of the SLAs.

OIG Recommendation

The OIG recommended that the FDIC develop a strategy for mitigating the impact of impending portfolio sales and SLA terminations on the Deposit Insurance Fund, and that it ensure that procedures, processes, and resources are sufficient to address the volume of terminations and potential requests for asset sales.

The FDIC agrees with this recommendation, and steps are being taken to meet its stated goals. At the same time, we believe that a number of factors, including the provisions of the SLAs themselves, will help to avoid the unnecessary sale of distressed assets and mitigate the market impact once the SLAs are terminated.

For example, the FDIC policy for portfolio note sales provides that: 1) the acquiring institution's right to conduct a portfolio sale is conditional and requires FDIC consent; 2) the evaluation of portfolio sales by the FDIC will include an analysis of alternative collection and modification strategies and a review to determine whether collections would be maximized on an asset-by-asset basis; 3) the FDIC's Loan Sale Advisory Review Committee will review all request for portfolio sales and large individual loan sales to ensure a consistent approach to the approval process; and 4) an acquiring institution is not to rely on portfolio sales as a primary resolution strategy for shared-loss assets.[3]

The FDIC has closely monitored and diligently enforced compliance with the SLAs. We believe that, as a result of our efforts in this regard combined with the aging of the portfolios, a relatively small portion of the original principal balance of non-single family assets covered under SLAs will remain outstanding when the shared-loss coverage periods on those agreements terminate. Since the inception of the program in 2008 through year-end 2012, the total covered principal balance for non-single family assets has already shrunk by over 60 percent, from approximately $139 billion to $54 billion. We project the total covered principal balance to shrink further to approximately $25 billion by the time the shared-loss coverage periods for the remaining non-single family SLAs expire. Furthermore, the majority of the shared-loss coverage periods on the outstanding non-single family SLAs are scheduled to expire over a four-year period (from 2014 to 2017) and over a wide geographic area. To the extent that the balances of covered assets have already declined, and that the expiration of the non-single family SLAs that cover these remaining balances will be spread out over a period of years and across different

[3] The FDIC has repeatedly communicated its expectations regarding the requirements and approval of portfolio note sales to the acquiring institutions in a variety of settings, including the Annual Risk Sharing Conference held in October 2012 and the Georgia Bankers Roundtable Conference held in November 2012. Formal guidance also was issued to all acquiring institutions in a letter dated October 9, 2012.

geographical regions, we do not expect the scheduled expiration of non-single family SLAs to have severe effects on local asset markets.

Some also have expressed the concern that, after the shared-loss coverage periods end, acquiring institutions will sell or otherwise dispose of non-single family assets at distressed prices. However, SLAs do not provide incentives for the acquiring institutions to engage in the "fire sale" of covered assets at the end of the shared-loss coverage period. As these agreements expire, the acquiring institutions will absorb 100 percent of all losses from below market sales or other dispositions, resulting in a hit to capital for these institutions. Further, the FDIC retains rights to recoveries on assets during the recovery period and, as a result, the acquiring institutions remain bound by the requirements of the SLA, including the requirement to maximize recoveries.

The FDIC has committed to conducting a full assessment of the sufficiency of its procedures, processes, and resources for the anticipated volume of portfolio sales and SLA terminations. The FDIC will complete the assessment and deliver its conclusions to the OIG by September 30, 2013.

OIG Recommendation

The second OIG recommendation was that the FDIC research the risks presented by commercial loan extension decisions and determine whether additional controls should be introduced to monitor the efforts of acquiring institutions to extend the terms of commercial loans. We agree with this recommendation.

The FDIC has established an internal national task force that is composed of staff from the Division of Resolutions and Receiverships and the Division of Risk Management Supervision to share information and proactively collaborate on topics such as concerns about shared-loss agreements. In addition, regular collaboration with regulators at the Federal Reserve Board (FRB), the OCC, and the Canadian Office of Superintendent of Financial Institutions has been established to ensure consistency and to facilitate open communication and information sharing throughout the term of the SLAs.

The FDIC is in the process of enhancing its Compliance Review Program to require the evaluation of loan amendments, including maturity date extensions, to ensure that they comply with the SLA provisions governing loan modifications. The goal of this effort is to ensure that any loan modification or refusal to modify a loan is consistent with maximizing recoveries and with the acquiring institution's policies and procedures with regard to legacy loans. Violations of the SLA will not be tolerated. If found, such violations could result in loans being removed from loss sharing and, when appropriate, the clawback of any claims paid by the FDIC. In addition, the Compliance Review Program will target high risk areas, such as sales of real estate owned, where assets could be liquidated in a manner that is inconsistent with prudent management standards and that fails to maximize collections.

The FDIC conducts targeted Loss Mitigation Reviews, which are undertaken in addition to our regularly scheduled compliance monitoring reviews and serve as a mechanism to directly communicate with acquiring institutions as to the requirements of the program. The acquiring institutions are reminded of the contractual obligations of the agreements and expectations for loan modification efforts, as well as the potential penalties for violations of the terms of the SLA. The reviews include, but are not limited to, inconsistent policies on commercial loan term extensions, violations of management standards and permitted amendment provisions, violations of internal bank policy and procedures, and actions that are inconsistent with maximizing collections.

In response to the OIG report, the FDIC has committed to reinforcing previous communications, requiring FDIC compliance monitoring contractors to review a sample of loan modification decisions for maturing loans, and analyzing the costs and benefits of collecting and monitoring trend information on commercial loan modifications. The FDIC will complete these actions and deliver its conclusions to the OIG by September 30, 2013.

Finally, the FDIC will continue to reach out to banks and other members of the public that may have concerns about the impact of the SLAs and their impending terminations. This type of communication will provide us with additional information on the potential issues that could arise as the shared-loss coverage period on the SLAs terminate, and enhance our ability to address these concerns in a timely fashion.

Issue 2 -- Losses at Institutions

According to Material Loss Reviews conducted by the OIG in the aftermath of bank failures, losses at community banks during the crisis were most often caused by management strategies of aggressive growth and concentrations in commercial real estate (CRE) loans, including notably, concentrations in acquisition, development and construction loans, coupled with inadequate risk management practices in an environment of falling real estate values that led to impairment losses on delinquent and nonperforming loans. Another common characteristic of failed banks was reliance on volatile brokered deposits as a funding source.

We are not aware of, and the OIG did not identify, any instances where a bank failed due to supervisor required write-downs of current loans – so-called “paper losses.” When examiners classified loans considered current by bank management, the examiners did so for safety and soundness reasons in accordance with regulatory guidance on classification of loans.

In addition, the application of fair value accounting was not found to have had a significant effect on most community bank failures. Fair value accounting is most often applied to valuations of securities, and since most community banks classify debt securities as available for sale (AFS), the unrealized gains and losses on AFS securities do not impact regulatory capital under current rules.

OIG Recommendation

The OIG study of the losses that led to the failure of community banks during the financial crisis included no recommendations for the FDIC.

Issue 3 -- Appraisals

Interagency supervisory policy establishes that repayment capacity is the primary driver of examination classification decisions.[4] However, as the crisis unfolded, it became clear that the failure to follow prudent underwriting criteria had contributed to the inability of many borrowers to service their loans. For example, many residential borrowers experienced difficulty in making their payments when their monthly loan payment reset to a higher amount, and many commercial borrowers experienced similar financial difficulties due to diminished cash flows from lower sales or reduced operating income. As primary sources of loan repayment declined, lenders were increasingly forced to rely on the value of real estate collateral as a secondary source of repayment. Amid the real estate market distress triggered by the housing bust and resulting financial crisis, rising levels of nonperforming loans and subsequent foreclosures and distressed sales placed additional downward pressure on real estate prices. As the market value of many commercial and residential properties declined to levels below their original estimated value, the proper valuation of real estate collateral became a critical component of evaluating the condition of troubled banks.

Then, as now, the FDIC reviews the appraisal programs of supervised institutions through the analysis of individual appraisals during loan reviews and through the assessment of a bank's appraisal policies and procedures. Examiners use a risk-focused approach tailored to a lender's real estate lending activities and expand the depth of their review when the examination process identifies any areas of concern. The FDIC uses an exception-based process to document noncompliance with appraisal guidance, regulations, and the institutions' valuation program requirements. When no deficiencies are noted relative to the FDIC's appraisal regulations, current guidance requires that a statement to that effect be included in the examination documentation.[5] While the OIG's report found that examiners documented instances of noncompliance consistent with the FDIC's exception-based process, it also noted that examination documentation did not always include the required positive assurance statement.

OIG Recommendation

The OIG report recommended that the FDIC clarify and remind examiners of the supervisory expectations relative to documenting their review of a bank's appraisal program, including the need to include a positive assurance statement when examiners determine that appraisal practices are satisfactory. The FDIC concurs with these recommendations. In response, the FDIC has clarified its examination expectations relative to examiner review of valuations programs, reminded examiners of the requirement to include a positive assurance statement when appropriate, and compliance with this requirement will be monitored within the FDIC's existing internal review control process.

The OIG also recommended to the FDIC, OCC, and FRB that the agencies strengthen requirements for examiner documentation related to the review of appraisal programs. On

---

[4] See *Interagency Appraisal and Evaluation Guidelines*, December 2, 2010, at http://www.fdic.gov/news/news/financial/2010/fil10082.html

[5] See Part 323 of the FDIC Rules and Regulations at http://www.fdic.gov/regulations/laws/rules/2000-4300.html.

February 19, 2013, the FDIC discussed with the OCC and the FRB its strategy to improve documentation by reminding examiners of existing guidance and to monitor compliance as part of our internal control function. The agencies agreed to continue to evaluate whether additional guidance on appraisal review documentation might be warranted going forward.

Supervisory guidance also requires examiners to assess the appropriateness of an institution's Allowance for Loan and Lease Losses (ALLL) within the framework of U.S. generally accepted accounting principles (GAAP). GAAP requires that the ALLL reflect losses which are "probable and estimable;" therefore, bank management must determine an appropriate ALLL level that is supported by reasonable assumptions and objective data. Furthermore, GAAP requires that all credit losses associated with a loan be deducted from the allowance, and that the loss portion of the loan balance be charged off in the period in which the loan is deemed uncollectible. If the ALLL is found to be insufficient during an FDIC examination, we may recommend that management increase the allowance or improve its ALLL calculation methodology to ensure that financial reporting is accurate under GAAP.

The OIG made no recommendations with respect to how examiners follow examination procedures in evaluating an institution's ALLL.

Issue 4 -- Capital

Examiners assess an institution's capital adequacy by considering a number of factors, including: the institution's financial condition; the nature, trend, and volume of problem assets, the adequacy of ALLL; earnings and dividends; management's access to additional capital; prospects and the plans for growth, and past experience in managing growth; access to capital markets and other sources of capital; balance sheet composition and risks associated with nontraditional activities; and risk exposure associated with off-balance-sheet activities. During the crisis, examiners evaluated capital adequacy in accordance with the criteria outlined in the Uniform Financial Institution Ratings System (UFIRS) and applicable standards under the provisions of Prompt Corrective Action. When an institution was successful in raising external capital, examiners incorporated those capital raises into the analysis of capital adequacy and the overall rating of the institution.

OIG Recommendation

The OIG review made no recommendations with respect to the capital issues identified in the statute.

Issue 5 -- Loan Workouts

During the crisis, diminished cash flows associated with commercial properties contributed to sharp declines in real estate prices and made it difficult for many borrowers to make their payments. In such situations, prudent workout arrangements are often in the best interest of the financial institution and the borrower. In response, the FDIC, working with the other Federal financial institution regulators, issued guidance encouraging lenders to work with borrowers experiencing financial difficulty repaying their real estate loans.[6] The guidance states that renewed or restructured loans to borrowers who have the ability to repay their debts according to reasonable, modified terms will not be subject to adverse classification solely because the value of the underlying collateral has fallen below the loan balance. Financial institutions that implement prudent commercial real estate loan workout arrangements after performing a comprehensive review of a borrower's financial condition are not subject to criticism for engaging in these efforts even if the restructured loans have weaknesses that result in adverse credit classification.

OIG Recommendation

While the OIG determined that examiners had successfully implemented three of the four elements of the interagency guidance – those related to loan-specific workout arrangements, classification of loans, and regulatory reporting and accounting considerations -- the review did note a lack of documentation that examiners had reviewed the institution's implementation of the risk management requirements in cases where no exceptions were noted. The OIG recommended that the FDIC remind examiners of documentation requirements related to the review of loan workout programs.

The FDIC concurs with the OIG recommendations. On February 27, 2013, the FDIC reminded risk management examiners of its examination expectations relative to their review of the risk management elements of loan workout programs at supervised institutions.

Issue 6 -- Supervisory Orders

To promote uniformity of practice and to ensure that banks most in need of corrective action receive the appropriate supervisory attention, the FDIC has adopted a policy that presumes that banks with composite UFIRs ratings of 3, 4, or 5 will be the subject of either a formal or informal enforcement action unless there are specific circumstances that would excuse the institutions from such an action.[7] By definition, banks with composite ratings of 4 or 5 have significant problems that warrant formal action, and banks rated composite 3 have weaknesses that, if not corrected, could worsen to a more severe situation. Accordingly, FDIC policy indicates that at least an informal action, such as a memorandum of understanding, be taken against composite 3 rated institutions.

OIG Recommendation

The OIG determined that the FDIC, OCC, and FRB are each following their respective agency's policy with respect to issuing enforcement actions, but noted that those policies differ

---

[6] See *Policy Statement on Prudent Commercial Real Estate Workouts*, October 2009, at http://www.fdic.gov/news/news/financial/2009/fil09061a1.pdf and *Statement on Working with Mortgage Borrowers*, April 2007 at http://www.fdic.gov/news/news/press/2007/pr07032a.html.

[7] See *FDIC Risk Management Manual of Examination* Policies at http://www.fdic.gov/regulations/safety/manual/

somewhat across the agencies. Accordingly, the OIG recommended that the agencies study these differences to determine whether there are certain approaches that have been more successful. The FDIC agrees with this recommendation, and is currently undertaking an internal review of enforcement action trends. We will share the results with the other agencies as part of a joint project to review the effectiveness of enforcement actions the agencies agreed to launch under the Task Force on Supervision, a group of senior supervision officials under the Federal Financial Institutions Examination Council.

The OIG also reviewed whether enforcement actions may have limited credit availability and determined that some enforcement order provisions may have indirectly limited lending. However, the OIG also found that there were important safety and soundness reasons for those provisions and that other factors – such as the weakness in the economy, competition, and a lack of loan demand – impacted lending more. Similarly, the review of whether orders affected the ability to raise capital showed that a bank's ability to raise capital is related more to its condition, earnings, asset quality, and growth prospects than the existence of an enforcement order.

Issue 7 -- Impact of FDIC Policies on Investment

Through various statutes, rules, and policies, and in order to protect the Deposit Insurance Fund, the FDIC is required to consider a number of factors when evaluating applications for entry into banking or expansion of banking activities. The FDIC approved the majority of applications and notices over the review period. In cases where applications were not approved, the FDIC documented its concerns about various aspects of the proposals.

OIG Recommendation

The OIG did not identify instances of the FDIC "steering" potential investors away from failing banks, and made no recommendations for the FDIC with respect to its treatment of potential bank investors.

Issue 8 -- Private Capital Investors

As the financial crisis intensified, the number of problem and failing banks rose rapidly, and these institutions found it increasingly difficult to attract external capital. At the same time, the FDIC found it increasingly difficult to attract bidders to acquire failed institutions. In August 2009, the FDIC Board of Directors adopted the *Final Statement of Policy on Qualifications for Failed Bank Acquisitions,* a policy statement providing guidance to private capital investors wishing to invest in bank holding companies or insured depository institutions formed for the purpose of acquiring failed institutions.[8] Among other things, the policy requires higher levels of capital – namely, a commitment of Tier 1 common equity to total assets of at least 10 percent for a period of 3 years from the time of acquisition of a failed institution – as well as a commitment

[8] *Final Statement of Policy on Qualifications for Failed Bank Acquisitions*
http://www.fdic.gov/news/board/Aug26no2.pdf

for cross-support on the part of institutions making multiple acquisitions, limits on affiliate transactions, and prohibitions on complex, functionally opaque ownership structures.

Overall, private capital investors subject to the statement of policy have played a positive, but relatively small, part in the resolution of failed institutions. As of the date of the OIG's review, a total of 13 private capital investor groups had purchased 36 failed institutions. The FDIC's experience thus far indicates that private capital investors have complied with the statement of policy and have not presented significant supervisory issues.

OIG Recommendation

The OIG had no recommendations with respect to the private capital investment policy.