

February 1, 2012

Testimony of

Albert C. Kelly, Jr.

On behalf of the

American Bankers Association

before the

Subcommittee on Financial Institutions and Consumer Credit

of the

Committee on Financial Services

United States House of Representatives



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Chairwoman Capito, Ranking Member Maloney, and members of the Subcommittee, my name is Albert C. Kelly, Jr., Chairman and Chief Executive Officer, SpiritBank, a \$1.25 billion bank headquartered in Bristow, Oklahoma. I am also the chairman of the American Bankers Association. I appreciate the opportunity to present the views of the ABA on the Financial Institutions Examination Fairness and Reform Act (H.R. 3461). 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 strongly supports H.R. 3461, the bipartisan legislation introduced by Chairman Capito and Ranking Member Maloney. This bill takes a major step toward a more balanced and transparent approach regarding how, and on what basis, decisions are made by the regulatory agencies in the examination process. It also addresses some examiner decisions that have effectively and unnecessarily reduced the amount of capital available for increased lending—particularly to small businesses. We strongly urge its enactment, which would increase banks' ability to help local businesses grow and create jobs.

The banking industry and bank regulators share the same goal: to have a strong healthy banking system that meets the needs of customers in a safe and sound manner. How that is accomplished, however, makes an enormous difference. Because the U.S. banking system is vital to the economic health of our nation, the manner in which it is regulated has a direct impact on the country's economic growth and vitality. The financial crisis has, unfortunately, upset the balance between allowing banks the freedom to make reasoned judgments that effectively and efficiently meet the needs of their customers and the regulators' mission to assure safe and sound banking.

Overly conservative examinations necessarily translate into less credit in local communities, which, in turn, means businesses grow more slowly and create fewer jobs. There is no question that the regulatory pendulum has swung too far in reaction to the financial crisis.

Although no single piece of legislation could deal with the wide range of concerns bankers have about the current supervisory environment, H.R. 3461 takes a major step to restore this balance. It is rooted in fundamental principles of accountability, transparency and quality assurance regarding regulators' decision-making during the examination process. The bill would confirm clear exam standards based on long-established interagency policy and create an independent FFIEC ombudsman to ensure the consistency and quality of all examinations. It provides mechanisms that guard against overly conservative examinations and provides a meaningful path for appeal by banks when there are legitimate concerns that the examination decisions have gone too far.

Enacting H.R. 3461 is critical as it:

- Establishes an independent ombudsman's office to receive complaints, review procedures to ensure consistency and quality of examinations, conduct appeals, and provide recommendations to Congress to improve examinations;
- Establishes a timely, independent, and fair process for banks to appeal examination decisions without fear of retaliation by their primary supervisors;
- Helps improve consistency in the examination process in accordance with regulatory guidance on performing loans, modified or restructured loans, appraisals, classifications and capital requirements;
- Ensures that banks receive timely examination reports that fully document how the agencies arrived at their decisions; and
- Extends protection of privileged communications shared with supervisory agencies to cover the Bureau of Consumer Financial Protection.

I will discuss each of these important provisions in turn.

I. FFIEC Ombudsman Established

One way to foster fair and transparent exams is to ensure that banks have a meaningful avenue of appealing exam findings when a bank disagrees with its examiner. The health of the banking system depends on a supervisory system that fosters appropriate risk-taking by banks, and the supervisory system works best when there is candid, dispassionate communication between bankers and bank regulators about the many issues that arise during a typical bank examination. When issues cannot be resolved during an exam, the need for productive communication only grows. We believe that the mission of the Federal Financial Institutions Examination Council (FFIEC) should be strengthened by improving agency transparency and accountability for uniform application of interagency examination standards and by providing an option to invoke an effective interagency-based supervisory appeals process using an appellate body within the FFIEC.

H.R. 3461 provides such a process which we strongly support. It creates an independent ombudsman's office within the FFIEC that is dedicated to receiving feedback from banks regarding examinations, conducting appeals, reviewing agency examination procedures to ensure consistency and quality, and to recommend to Congress ways to improve examinations.

An important role of an FFIEC ombudsman under H.R. 3461 is to assure that written interagency policies and procedures are being followed consistently in the field. We have often heard from bankers that changes are being made without any formal process, new standards are being applied without banks having a clear understanding of what they are and that some regulators diverge from interagency standards without advance notice to banks in their jurisdiction and without prior interagency deliberation or consensus. Banks should at least be told what ratios and other analytical standards the examiners are applying to measure the adequacy of institution compliance with interagency standards or expectations. Moreover, often these changes are applied differently from bank to bank. H.R. 3461 provides a mechanism to address these concerns.

A transparent program of quality assurance is the key to assuring the FFIEC member agencies are held accountable for consistency. While the prudential regulators have separate programs, the aspiration for achieving uniformity among the FFIEC agencies demands that these programs be coordinated and the results disclosed on a comparative basis using aggregated data. This would be the fundamental responsibility of the FFIEC ombudsman.

II. Right to Appeal Before the FFIEC Ombudsman

By allowing an appeal of material supervisory determinations to the Office of Examination Ombudsman, H.R. 3461 establishes a process for institutions to hold federal financial regulatory agencies accountable to the FFIEC mission of vigorous and uniform supervision. This appellate option serves as a fitting capstone to Congress's charge to the FFIEC to promote examination consistency.

We strongly support the approach in H.R. 3461, which sets up a process to appeal to the FFIEC ombudsman with the opportunity to have a hearing before an Administrative Law Judge (ALJ). This approach combines the adjudicatory experience of the ALJ in developing a factual record about the supervisory issue with the FFIEC ombudsman's statutory mandate (and agencies' efforts) to develop common regulatory standards and supervisory expectations. The result is an authoritative and sound resolution process for a dispute between an institution and a member agency. Having a final and binding decision made by the FFIEC ombudsman provides the appropriate power to ensure that each FFIEC agency will be held accountable for applying regulatory standards and interagency policies and procedures consistently across the industry.

The ombudsman role is well regarded in government administrative process. It is an important means of assuring regulated firms that an agency operates fairly and consistently within its mission. While each of the banking agencies has an ombudsman, the OCC ombudsman stands alone among the banking agencies as an illustration of how it can be an effective model for conducting supervisory appeals. By being independent of the regular supervisory line of authority, the OCC ombudsman affords banks the ability to obtain a review of material determinations by an expert authority that has not previously become committed to the agency position. The OCC's track record demonstrates the efficacy of ombudsman responsibility for supervisory appeals. For instance, the OCC ombudsman reports that out of the dozen appeals in 2010, 64 percent resulted in decisions upholding the supervisory office, 18 percent upheld the bank and the other 18 percent were split decisions.¹

H.R. 3461 provides for a similar process dedicated to a balanced and non-retaliatory approach where the issues have not been pre-judged and leverages this model to finally put some real backbone in the FFIEC's mandate of assuring uniform supervision and a consistent examination process. Some of the key features include:

¹ *Report from the Office of the Ombudsman, 2006—2010 Highlights, June 2011.*

- To assure a fair hearing, the ALJ's decision is based upon an independent review of the agency's action in light of the relevant statutes, regulations and appropriate guidance.
- The decision must be timely, no later than 60 days after the record has been closed to assure that the bank knows where it stands as quickly as possible.
- None of the regulatory agencies, including the agency that is the source of the appeal may take retaliatory action against a bank or any of its officers, employees, service providers or institution affiliated parties for exercising its appeal rights. This includes delaying or denying any action by a regulatory agency that would benefit the bank on the basis that an appeal is pending. For example, a branch application should not be delayed if there is an ongoing appeal of another determination.
- The FFIEC ombudsman must report annually to Congress on issues raised by financial institutions and actions taken on appeals, so Congress can take a real oversight role in assuring that examination results are consistent and fair.

Having an independent appeals process does not open the door for a bank to appeal any examination decision. First, the appeals are limited to a "Material Supervisory Determination" which is defined (as amended by the bill) to include: examination ratings, the adequacy of loan loss reserves, significant loan classifications, and "any issue specifically listed in an exam report as a matter requiring attention by the institution's management or board of directors." These are reasonable areas where differences of opinion are significant and have real economic consequences both for the bank and its ability to serve its community.

Second, it is highly unlikely that a bank would undertake the significant time and effort to appeal unless it truly felt that there was a significant problem to be addressed. Making a formal appeal of an agency decision either by invoking the agency's own process or the new proposed FFIEC process is not a step that is taken lightly. Working cooperatively with their supervisors is the preferred approach by all banks in the normal course of oversight. However, the ability to take exception to material determinations through a process that enables an independent review by those who have not pre-judged the issue is an important check and balance. In fact, the very existence of this appeals process, even if infrequently used, keeps the regular supervisory process fair and accountable. ABA is confident that the vast majority of supervisory matters would continue to be resolved without resorting to a formal appeal as is the case today.

Third, H.R. 3461 does nothing to change any agency's existing appeal process. Rather, it adds an alternative route for a financial institution to deal with an independent entity specifically set up to address examination issues quickly and fairly.

Finally, H.R. 3461 does not undermine the legitimate supervisory authority of the supervisory agencies anymore than the existence of the FFIEC itself does. The procedural independence of the FFIEC ombudsman does not make him or her unaccountable to the Council, which is made up of the member agency heads. To the contrary, the FFIEC ombudsman is committed to the faithful execution of the Council's policies as determined by its agency members. At the end of the day, the FFIEC ombudsman is answerable to the Council for the performance of all duties of the Office of the Examination Ombudsman.

III. Examination Standards

H.R. 3461 ensures consistency in application of the interagency guidance with respect to performing commercial loans, modified or restructured loans, appraisals where no new funds are extended, classification of loans, and additional capital requirements for well-capitalized banks.

Over the last several years, it was not uncommon to hear about inconsistent and unnecessary requirements by examiners. Such an approach has important consequences for banks and their communities. Banks are working every day to make credit available. Those 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, a common refrain from bankers over the last several years has been the overly conservative approach by regulators in their analysis of asset quality and the downgrades of loans whenever there was *any* doubt about the loan's condition—even in cases where loans are fully performing.

For example, many performing commercial loans—where the borrower is making payments as promised—have been accompanied by declines in the value of collateral that backs the loan. Banks have reported that examiners are requiring them to treat these loans as non-accruals. Such a treatment is not consistent with regulatory guidance or the definition of a non-accrual, which generally are those loans where the payment of interest and principal has lapsed or those where full payment of principal and interest is not expected. In some instances, this practice has forced banks

to raise capital in situations that may be unwarranted. H.R. 3461 prohibits the practice of declaring a loan in non-accrual solely as a result of the decline in collateral value.

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. Overly conservative examiner judgments 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) that is 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 some 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.

IV. Timeliness of Examination Reports

Currently, there is no time certain for banks to receive examination reports. While the regulatory agencies endeavor to provide these final reports to banks in a reasonable time period, the fact is it is common for final reports to be issued as long as 10 months after the examiners leave the bank. Moreover, many banks report that there are often surprises in the final report that were never discussed with their institutions. This includes additional downgrades in the components of the overall exam rating and new requirements for corrective action that were unanticipated. Such unexpected decisions are very disruptive to efforts of banks to prudently respond to supervisory concerns.

Changes are often made at the regional or even national level, second-guessing the reasoned judgment of the field examiners. Field examiners, having been overruled at the regional or national level, have every incentive to be even harsher in their next examination. This creates a cycle of

increasing regulatory pressure. Often, the basis upon which further downgrades or determinations are made are not fully documented or disclosed to the bank, making it appear that the decisions are arbitrary and part of an effort of being “tough” to avoid any perception of being too weak. This has significant consequences for communities: it means that good loans to creditworthy borrowers may not be made.

Delayed exam reports adversely affect banking operation efficiencies in two fundamental ways: First, they undermine the ability of banks to expeditiously undertake examiner recommended improvements with which management concurs. Such consensus solutions are characteristic of the exam experience. However, because exam finality remains up in the air, banks cannot confidently rely on the consensus solutions arrived at with their examiners for fear that the ultimate report will remake supervisory conclusions and leave the bank in a “do over” situation—a costly and wasteful result. So improvements are at risk, held up or incompletely pursued until the final exam report is actually received.

Second, in the cases where there are disputed examiner findings, the long delay in obtaining a final position from agency higher-ups creates gridlock at the bank while the effected operations await reliable direction before proceeding with any similarly situated cases that may be subject to challenge. Both of these impacts heighten banker uncertainty, chilling the bank’s ability to make decisions and readily serve the needs of its local community.

Every bank wants a fair evaluation of its financial position and regulatory compliance performance. It must be based on reasoned judgment, backed by facts that are presented in a transparent manner. Where there are areas that need corrective action or improvement, timely exam findings that reflect the understanding gained from the onsite exam are vital. Having timely examination reports is one of the many provisions in H.R. 3461 that help assure basic quality assurance standards and transparency regarding how material supervisory determinations are made.

V. Extends protection of privileged communications to cover the Bureau of Consumer Financial Protection

Banks currently have legal protection that allows them to be comfortable in voluntarily turning over privileged documents upon the request of the banking agencies. The section that affords this protection, 12 U.S.C. § 1828(x), creates a federal standard that protects the sharing of privileged communications with a prudential regulator from the assertion of an imputed waiver. However, the

section is not worded in such a way that it covers the CFPB; therefore, as H.R. 3461 proposes, it should be extended to cover banks sharing similar communications with the Bureau. ABA wholeheartedly supports this provision in the bill.

In addition, ABA recommends that the companion protection afforded by 1821(t) also be amended to explicitly include the Bureau so that further sharing of such privileged communications by the original agency recipient with another supervisor or federal government agency is also protected from any assertion of waiver. Testifying before the House Oversight and Government Reform Subcommittee last week, Mr. Richard Cordray acknowledged that although the Dodd-Frank Act had not included the Bureau among the banking agencies covered by the existing protections, he would support such a change to protect privileged information shared by banks with the Bureau.

Conclusion

Community bankers like me work every day to serve the needs of our customers and your constituents. For many banks, the ability to meet our communities' needs has been hampered by decisions made during the examination process that have effectively and unnecessarily reduced the amount of capital available for lending—particularly to small businesses. These decisions hinder banks' ability to help local businesses grow and create jobs.

H.R. 3461 is the type of legislation that is needed to address this critical issue, particularly for community banks. The bill would clarify certain exam standards and creates an independent FFIEC ombudsman to ensure the consistency and quality of all examinations. H.R. 3461 also would ensure that financial institutions receive timely examination reports that include documentation of the information regulators used to make their determinations. In addition, the bill would create an expedited process for banks to appeal examination decisions without fear of reprisals.

ABA strongly supports H.R. 3461 and appreciates the leadership of Chairman Capito and Ranking Member Maloney in seeking changes that make an enormous difference in banks' ability to meet the needs of their community in a safe and sound manner.