

**Statement of  
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On H.R. 3461:  
The Financial Institutions Examination Fairness and Reform Act  
before the  
Subcommittee on Financial Institutions  
and  
Consumer Credit Committee on Financial Services  
2128 Rayburn House Office Building  
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Chairman Capito, Ranking Member Maloney, and members of the Subcommittee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) about the "Financial Institutions Examination Fairness and Reform Act" (H.R. 3461) and its potential impact on the supervisory process. In my testimony, I will discuss the FDIC's perspectives on how the proposed legislation would affect the bank supervisory process, which helps ensure the safety and soundness of our nation's banks, and the Deposit Insurance Fund (DIF).

The FDIC continually seeks to improve the bank examination process, and we are committed to ensuring that banks understand our examination findings and have the opportunity to discuss, question and appeal those findings if they find it appropriate, both formally and informally. This is a challenging time for financial institutions, and examination findings reflect the difficult economic environment. These economic difficulties, particularly as they affect real estate, have led to credit quality weaknesses that have increased the volume of classified and nonaccrual loans. These credit quality issues require remediation to help ensure that institutions remain solvent and risks to the DIF are mitigated. At the same time, we recognize that banks are working very hard to navigate the downturn. Among other challenges, they have had to increase efforts to work with borrowers who are having difficulty making payments; address earnings compression; and deal with the credit availability needs in their respective communities.

The FDIC shares the Subcommittee's goal of having a strong banking industry that serves as a source of credit to our nations' communities. At the same time, we share the responsibility with our fellow regulators of making certain that insured institutions remain safe and sound and that their financial reports accurately portray their financial condition.

The stated purpose of H.R. 3461 is to improve the examination of depository institutions – also a goal that we share. However, the proposed legislation could mask problems at insured depository institutions and inhibit our ability to require weak institutions to take corrective action – potentially resulting in higher losses to the DIF. Most important, the

bill would constrain the ability of bank supervisors to evaluate and work with banks to address emerging problems while there is still a chance to correct the problems and avoid needless failures.

The bank examination process in the U.S. has evolved over many decades and has been shaped by our collective experience in both good times and bad. Recent experience has reaffirmed an essential lesson of past crises: namely, on-going, robust examination and early supervisory intervention are key to containing problems as they develop. We believe the current supervisory regime helps to promote public confidence by providing for the effective supervision of our nation's banks while protecting depositors and the taxpayers.

### **Ensuring Accurate Portrayal of an Insured Depository Institution's Financial Condition**

The reliability and integrity of regulatory and financial reporting are fundamental to understanding the health and performance of financial institutions. This is especially important when weak economic conditions are causing increased problem asset levels.

Banking supervisors employ a standardized framework to evaluate a bank's risk profile, identify higher-risk assets and business lines, and assess the institution's overall financial health and consumer protection performance. These examination procedures form a toolkit of risk assessment and mitigation activities that help supervisors address problems as they emerge and protect the federal safety net from unnecessary outlays. Assessing a bank's individual risks is a fact-specific process that depends greatly on the institution's risk selection, managerial oversight, and market circumstances. At the most fundamental level, bank supervision requires flexibility and use of expert judgment customized to each bank's profile and risk-taking.

Classification of Loans - H.R. 3461 could impair the banking supervisors' ability to assess and monitor risks by changing the method by which adverse classifications are derived. Adverse classifications represent a specialized analysis of an institution's problem assets. Regulators use these classifications to determine capital adequacy and overall financial health. The process for deriving adverse classification was first developed in the late 1930's and has been refined in successive decades to better monitor risk. The classification system consists of designations that identify different degrees of credit weaknesses. A loan is considered "classified" when it is rated either "Substandard," "Doubtful," or "Loss." A statutory change to the classification process, as described below, would reduce the effectiveness of the metrics that bank regulators rely on to evaluate the condition of institutions, the adequacy of their capital and reserves, the performance of management and the appropriate risk-based deposit insurance premium.

When the financial condition and repayment capacity of a commercial borrower deteriorates, the loan may be subject to adverse classification. In deciding whether to classify a loan, supervisors look first and foremost to the borrower's cash flow and ability

to repay. If the borrower is expected to repay the loan in full according to its terms, the loan would not be classified. If repayment capacity is insufficient, however, the loan may be subject to adverse classification. In certain cases when significant deterioration in the borrower's financial condition is evident, such impaired credits may be viewed as "collateral dependent." For collateral-dependent loans with weakened repayment prospects, examiners typically classify the entire committed balance of the loan due to the uncertainty of repayment, with the portion supported by collateral classified "Substandard" and the amount not supported by collateral classified "Loss."

H.R. 3461 would mandate that the amount of the adverse classification for commercial loans evidencing deterioration in collateral value be restricted to the deficiency relating to the decline in collateral value and repayment capacity of the borrower. Under the proposed statute, the deficiency amount that is classified "Loss" and subject to charge-off appears to be the only portion of the loan that examiners could adversely classify. Thus, while the credit weakness that led to the loan's impairment would still be present, examiners could no longer measure, through the classification process, the portion of the committed balance that continues to pose an elevated risk of credit loss to the bank. This would mask continuing potential problems in the loan portfolio, hindering the examiners' ability to evaluate capital and reserves adequately in relation to problem asset levels or to measure the overall risk the institution may pose to the DIF.

Accurate Financial Reporting – In order to accurately portray their financial condition, banks and other financial institutions have been required for many years to consistently apply uniform criteria and standards for nonaccrual treatment and charge-offs of uncollectible loans in their regulatory filings, especially their quarterly Call Reports. The banking agencies regularly update their regulatory reporting instructions to conform to changes in U.S. generally accepted accounting principles (GAAP), and to enhance the comparability and consistency of reporting across the industry. Supervisors use regulatory reports as a key tool in evaluating the health of individual financial institutions and the state of the industry. Similarly, in the private sector, investors, creditors and others use the reports in making their business decisions relating to a particular insured financial institution.

The current regulatory requirement for reporting nonaccrual loans is that all evidence, both positive and negative, be weighed in reporting loan impairment. This requirement is consistent with GAAP. H.R. 3461 would legislate some of the decision criteria for nonaccrual loan reporting. We believe the bill would in effect create safe harbors that could allow banks to avoid reporting as nonaccrual certain loans for which full repayment is not expected, resulting in an overstatement of income and capital in such instances.

The nonaccrual criteria underlying regulatory reports and loan classification practices also serve as key inputs for identifying and reporting impaired loans in GAAP financial statements prepared for investors. Thus, the use of these criteria and practices by financial institutions also enhance the comparability of their financial statements. The unintended consequence of setting certain reporting criteria in statute is that regulatory

reporting of nonaccrual loans could become de-linked from GAAP requirements.[1] This could diminish the credibility of both regulatory reports and financial statements – potentially resulting in difficulty for institutions to attract investors and raise capital.

In addition, not reporting impaired loans as nonaccrual would reduce the FDIC's ability to price deposit insurance assessments based upon risk and result in healthy institutions having to subsidize troubled institutions. It could also result in higher losses to the DIF by delaying timely regulatory intervention and lowering a bank's allowance for loan and lease losses, and thereby its ability to absorb identified losses.

### **Constraints on Requiring Capital Commensurate with Risk**

Section 1013(b) would also constrain the regulators' ability to require troubled institutions to hold additional capital. This section states that the agencies may not require a bank that is well-capitalized to raise additional capital "in lieu of" actions the bill prohibits with respect to the agencies' identification of nonaccrual loans, requirements for an appraisal, or adverse classification of a loan. Some banks, however, have a large volume of troubled assets and a consequent need for additional capital regardless of whether they are nominally "well-capitalized." We are concerned that these provisions could be used to prevent the agencies from requiring such banks to hold the additional capital that is needed to address the risks in their loan portfolios.

The FDIC and other regulators have longstanding policies that require institutions to hold capital commensurate with risk. Well-capitalized thresholds in the Prompt Corrective Action framework are intended for sound, well-managed institutions that do not pose more than the normal level of risk of failure. However, some lending activities and business strategies are inherently more risky even at well-capitalized institutions. Examples can include subprime lending, high concentrations of poorly underwritten construction and development loans, and elevated levels of problem assets. These risk exposures often require additional capital to protect against loss. Importantly, this is a matter of supervisory judgment that the banking agencies exercise to ensure that institutions benefiting from the federal safety net have an appropriate capital cushion against the risks they face. Lack of adequate capital increases the chance that an institution will fail and the likely cost to the DIF.

### **Proposed New Appeals Process**

The Subcommittee has asked us to comment on provisions of H.R. 3461 that propose a new appeals process for supervisory determinations. The bill would create a separate appeals process through a new Office of Examination Ombudsman within the Federal Financial Institutions Examination Council (FFIEC).

As proposed, the new Office of Examination Ombudsman would not function as a party that mediates disputes between banks and their supervisors. This office would instead have the authority to overturn determinations reached by the independent banking agencies and substitute its judgment for the judgment of the supervisory agency.

Moreover, the administrative process informing the new Ombudsman would be prohibited from deferring to the expert opinions of the examiner or the agency. This lack of deference could have the effect of making all examinations more formal, legalistic, and significantly longer. The administrative process as proposed will likely be enormously expensive for both the banks and the supervisory agencies - the costs of which will ultimately be borne by the banking industry. At the end of the day, the new Examination Ombudsman would have authority, but no accountability or responsibility for the condition of the insured institution or the DIF if the bank ultimately fails.

Further, we are concerned that the processing of the appeals proposed in the bill could delay implementation of important examination findings and corrective measures. We are especially concerned that such delays could further impair the safety and soundness of troubled institutions, which often refuse initially to acknowledge the severity of their problems and thus risk increased losses for the DIF. A few months' delay in implementing corrective measures, particularly in times of precipitous economic decline, can mean the difference between failure and survival for a troubled bank. More fundamentally, we believe the authority granted to this office would compromise the independence of the banking agencies.

### **Current FDIC Appeals Process**

The FDIC is committed to a fair and transparent appeals process including the opportunity for banks to air concerns with the examination process without fear of retribution. Existing FDIC procedures require that at the conclusion of on-site examination work, FDIC examiners discuss their preliminary findings with bank management and the board of directors. Such communication provides bankers with an opportunity to probe the FDIC's conclusions and express the bank's viewpoint on findings, recommendations, and the supervisory process in general. The FDIC follows an open, two-way communication process with financial institutions, and we consider banks' comments about our conclusions in the shared interest of accurately assessing the bank's risk profile, understanding its strategic goals, and serving the local community.

On March 1, 2011, the FDIC issued Financial Institution Letter-13-2011, Reminder on FDIC Examination Findings, which reiterates the FDIC's long-held policy of encouraging banks to express their concerns about an FDIC examination or supervisory determination through informal or formal channels. If an institution is unable to resolve its concerns or believes that our regional office is not correctly following FDIC policies, the institution is encouraged to contact our Washington office. An institution may also contact the FDIC Ombudsman to facilitate the resolution of problems and complaints. No matter how the bank contacts the FDIC, our policy strictly prohibits any retaliation or retribution by any examiner or employee against any institution.

In our experience, 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.[2] After requesting a review by the Director of the Division of Risk

Management Supervision or the Director of the Division of Depositor and Consumer Protection, as appropriate, an institution may appeal the Director's determination to the FDIC's Supervision Appeals Review Committee (SARC). The SARC is chaired by an FDIC Board member and composed of senior-level FDIC officials who are not directly involved in supervisory functions. An institution can request to present its case orally to the SARC and such requests are normally granted. Final SARC decisions are provided to the institution in writing and are published on the FDIC's website after reasonable steps are taken to protect the identity of the appellant institution.

The FDIC's formal and informal appeals processes are comprehensive and fair. They permit a bank to state concerns about supervisory processes and conclusions in a variety of ways, while at the same time not unduly encumbering the FDIC's ability to carry out its critical supervisory and insurance functions. Furthermore, we do not believe that the industry has supported its contention that the existing appeals processes established by each of the agencies in conformance with the Riegle-Neal Act are unfair. The proposed appeal process and powers granted to the Office of Examination Ombudsman are, in our judgment, both unprecedented and unnecessary.

## **Conclusion**

The FDIC appreciates the opportunity to present our perspectives to the Subcommittee today. We are committed to continually enhancing the overall supervisory process, examining banks in a fair and balanced manner, and assuring accurate financial reporting by all financial institutions. We believe this approach provides for the timely recognition of problems, allows regulators and bankers to work together to remediate problems, and helps avoid losses to the DIF.

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[1] Section 37 of the Federal Deposit Insurance Act requires that regulatory reporting principles must be no less stringent than GAAP.

[2] See <http://www.fdic.gov/regulations/laws/sarc/sarcguidelines.html>.

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