H.R. 3461: THE FINANCIAL INSTITUTIONS EXAMINATION FAIRNESS AND REFORM ACT

HEARING

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

OF THE

COMMITTEE ON FINANCIAL SERVICES

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H.R. 3461: THE FINANCIAL INSTITUTIONS EXAMINATION FAIRNESS AND REFORM ACT

Wednesday, February 1, 2012

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

The subcommittee met, pursuant to notice, at 2:01 p.m., in room 2128, Rayburn House Office Building, Hon. Shelley Moore Capito [chairwoman of the subcommittee] presiding.

Members present: Representatives Capito, Renacci, Royce, Manzullo, Hensarling, McCotter, Pearce, Westmoreland, Luetkemeyer, Huizenga, Canseco, Grimm, Fincher; Maloney, Watt, Hinojosa, McCarthy of New York, Scott, Lynch, and Carney.

Also present: Representative Green.

Chairwoman Capito. This hearing will come to order. I would like to inform Members and also the witnesses that we expect a series of votes at 5 o'clock. It is my intention to complete this hearing before the votes, if possible. And so, I would ask Members, as I do every single time, to abide by the 5-minute rule, and the witnesses as well.

Over the last year, the Financial Institutions and Consumer Credit Subcommittee has heard testimony from community banks and credit unions from across the country about the challenges they face in the post-financial crisis world.

We actually did two field hearings as well: one in Wisconsin; and one in Georgia. Throughout these conversations, one common theme has emerged: There is a perceived disconnect between what is said in Washington by Federal regulatory agencies and what is carried out in the field by the Federal institution examiners. It is not limited to one geographic region. We were in, as I think I mentioned, Georgia and Wisconsin. There is a growing chorus of concern about the consistency in the application of examination standards across the country.

The product of these conversations is the legislation that is in front of us today. Ranking Member Maloney and I have crafted H.R. 3461, the Financial Institutions Examination Fairness and Reform Act, to elevate the conversation about potential solutions to three common concerns that have been raised: the time limits of examination reports from the agencies; the independence of the appeals process for institutions; and the issue of Federal agency guidance that is not being followed by examiners. This legislation has garnered strong bipartisan support, due in large part to the growing chorus of concerned Members who are hearing from their constituents.

In order to address these concerns, our legislation proposes to ensure timely responses from agencies, codifies the guidance from the Federal Financial Institutions Examination Council (FFIEC), and creates a new independent examinations ombudsman at the Federal Financial Institutions Examination Council. We have been working with the Federal regulatory agencies on this legislation, and I understand that they have concerns about it, and they are before us today to discuss those concerns. And I am very appreciative of that. I know they are aware of the seriousness of this issue to many of the members of our subcommittee on both sides of the aisle.

And so, we have put forward this legislation as a good faith effort to address many of the concerns that have been raised by Members on behalf of their constituents. Now is the time for all parties to come together to work towards a consensus solution to provide greater clarity in the examination process and a more independent avenue of appeal for financial institutions in case there are legitimate disputes, which there always are, we know, about the outcome of an examination.

It is important for all parties to understand that the frustration we hear from our constituents on these issues is very real. It is small businesses, it is individuals, it is long-time customers, it is new customers, and it is financial institutions that feel—paralyzed is maybe too strong a word, but at least tied with one hand behind their back in certain instances. This legislation will hopefully provide more clarity to the system so institutions have a better idea of how certain issues will be viewed by regulators in the future.

I would like to thank our witnesses for joining us here today. Their input on the merits of H.R. 3461 is invaluable and will assist us as we move through to continue to try to develop solutions to these problems.

At this time, I would like to yield to my good friend and lead cosponsor on the bill, the ranking member of the subcommittee, Mrs. Maloney, for the purposes of making an opening statement.

Mrs. MALONEY. Thank you. I would like to thank the chairwoman for her leadership and for calling this important hearing.

I first want to make it very clear that I support fair, understandable, consistent, and transparent regulation. It is important to protect the public and the overall economy. I wholeheartedly support the regulators being able to do their job by identifying troubled institutions and helping to strengthen their safety and soundness through requirements like regulatory capital and governance changes.

But along with the chairwoman and many members of this committee, I have heard repeatedly from community bankers in the district I am honored to represent, and other community bankers, about the burden they have felt during the crisis and their concerns about examination fairness, particularly as it pertains to commercial loans. They, in many cases, have faced the threat of literally being closed down. And in some cases, they felt that they did not have a fair, independent appeals process. And I believe these are concerns we should address.

Now, we have had numerous hearings in this area. But this good faith work document that we have put forward has generated a lot of concern. It is almost like you have to put a bill in to have people listen to what you are trying to say. And this bill has several important components, one concerning the exam reports and standards; that they match the guidance, that they be consistent. And a loan's classification needs to reflect the true risk of the loan and be consistent with the agency's guidance.

And we are also looking at creating an appeals process, and no one disputes that we need a fair and independent process. We certainly need a route for people to raise concerns and raise their concerns about exam determination, about regulation. And certainly, a transparent process could highlight the areas that need to be improved. In most cases, the current process is an internal appeal directly back to the agency that made the decision in the first place. And in some cases, some institutions fear retaliation.

They do not feel that the process would be fair. They feel that they don't even want to go forward, even if they feel that it was wrongly decided.

And I do want to compliment the work of a former Comptroller of the Currency, Eugene Ludwig, who will be testifying on the second panel today. He literally created an appeals process within the OCC back in 1993, and he told me that they resolved well over 110 appeals that were filed between 1993 and 1996.

And yet in 2010, when we were in a much worse financial situation, there were only 11. So I am interested in hearing from the regulators why they think there has been this kind of decline and why the number of appeals over time has been relatively small in other agencies.

And they call us, but they shouldn't have to call us. They should be able to go back to the regulators and go through a process they feel treats them fairly. I feel that it may be that just the mere existence of an external appeal process which, of course, would be under this FFIEC Unit which the chairwoman described. The bill that we have introduced is very much a starting point, and I am open to any suggestions of ways to make it better.

I am sure that all the members of the subcommittee want to address the concerns of community bankers. The community bankers were real stars in this financial crisis and their response to communities. I welcome the concerns of the panelists today, and I look forward to your testimony.

Chairwoman CAPITO. Thank you.

I would like to recognize Mr. Royce from California for 1½ minutes for an opening statement.

Mr. ROYCE. Thank you. One of the great traits of the banking system that we have here in the United States as opposed to the one in most developed countries around the world is that our system is literally comprised of thousands and thousands of financial institutions and credit unions. And if you contrast that to the system in Europe, or in most developed countries, you have a few massive institutions.

Our system, though, is at risk of devolving into sort of the European model, largely because of the actions of Washington that are stacking the deck against smaller institutions. It was really Washington, D.C., that bailed out and propped up the too-big-to-fail institutions, and in so doing—really by lowering their cost of borrowing, by giving them nearly 100 basis points advantage because of the perception of the market of them being too-big-to-fail—it has led to a situation where they can out-compete and sort of gobble up their smaller competitors.

And it was Washington, D.C., that gave the Dodd-Frank Act the wherewithal here, with these new rules on top of the old ones, to disproportionately burden smaller financial institutions. An additional problem faced by smaller firms is the disconnect between the regulatory community in Washington and the examiners on the ground and what that has meant.

So, I want to just take a minute here and commend Chairwoman Capito for this proposed legislation which I have cosponsored, because I think it goes a long way toward recalibrating the examination process to better allow bankers to be bankers. And it is one of the first in a number of steps we really need to take to level this playing field.

I yield back. Thank you.

Chairwoman CAPITO. Thank you.

I recognize Mr. Scott for 3 minutes for an opening statement.

Mr. SCOTT. Thank you, Madam Chairwoman. Let me thank you and the ranking member for holding this hearing today concerning the Financial Institutions Examination Fairness and Reform Act. This is a very important hearing. Our financial institutions are quite honestly in a crisis in terms of the relationship between them and the examiners.

This bill, of which I might add I am proud to be a cosponsor, will establish a new standard of examinations of financial institutions as well as create a new process for institutions to appeal the regulatory decisions. And I think that if there is one area we need to perhaps spend a little time on today making sure we get it right, is this appeals process that we have.

We want to make sure that it does not cause any delay. And there are some concerns within the infrastructure, that the appeals process as outlined in the bill might cause some delay. So I would be interested to make sure that we get this right.

The bill calls for the establishment of an independent office responsible for investigating concerns about regulatory examiners that have been brought up by these institutions. And, of course, another problem in this is—I represent Georgia and we are the epicenter of bank failures. We realize that a part of that reason was, many of our banks in Georgia did overleverage their portfolios into the real estate lending area.

But there have been some major concerns. We recently had a hearing down in Georgia, in Newnan, Georgia, where one of the major concerns was the level of inconsistency between what the actual examiners were doing out in the field on the ground not following accurately what was coming out of Washington. And so, that is another area we have to get clear, to make sure those who are on the ground are following the guidance that is coming out of Washington in a consistent manner.

In 2011, we had—just this last year we had 92 bank failures. Twenty-three of them—23 of them, that is over 25 percent—were in one State, my State of Georgia. These financial institutions, especially the smaller ones, the community banks, continue to struggle just to stay afloat. And just 2 weeks ago, the FDIC seized Stockbridge-based First State Bank, right in the heart of my congressional district. Another one sort of bites the dust, shall we say.

But H.R. 3461 will ease regulatory burdens on community banks like First State Bank as well as other financial institutions, as the legislation is not limited by asset size. The watchdog created by this bill will have jurisdiction over regulators, and they will hold quarterly meetings to review examination practices. And additionally, the legislation will permit financial institutions to appeal any determinations found by an examiner within 60 days.

Now, these provisions would ease costly regulatory burdens that were put on already-struggling banks—and not only our banks, but our credit unions as well—and will help make sure that our banks and our credit unions—and help ensure their sustainability in the future.

So it is a good bill, it is a good foundation. I look forward to this hearing.

And thank you again, Madam Chairwoman, for hosting it.

Chairwoman CAPITO. Thank you.

Mr. Hensarling for 1½ minutes for an opening statement.

Mr. HENSARLING. Thank you, Madam Chairwoman.

We all know that too many of our financial institutions are fighting an uphill battle: the struggling economy; a monetary policy which is squeezing their profit margins; clearly, Dodd-Frank compliance; the Durbin language, which imposed price controls on their interchange fees; and the new credit allocation czar.

By its own estimate, the Consumer Financial Protection Bureau's (CFPB's) first rule will now require 7.7 million employee hours to implement, and comply with the new rule, as the gentleman from California pointed out, the serial bailouts of their larger competitors. If we are not careful, Madam Chairwoman, we are going to wake up and see more failures and more consolidations of these community financial institutions. That clearly leads to less competition and fewer choices.

We know that our regulators must protect the health of individual institutions, the system as a whole and, certainly, taxpayer-backed deposits. But our community financial institutions are critical—critical to our small businesses, the job engine of America, and we have to do more to wring out some of the uncertainty in this system.

So, Madam Chairwoman, I applaud you and the ranking member for attempting to take us in that direction. I have heard from way too many financial institutions in my district about months and months of waiting to get a final report on their exams, being tied up and stymied waiting for these reports, and then, finally, there being no change.

So I am looking forward to hearing the testimony of our witnesses because I believe the provisions of H.R. 3461 can indeed be helpful.

I thank you, and I yield back.

Chairwoman CAPITO. Thank you.

I recognize Mr. Westmoreland for 1 minute for the purpose of an opening statement.

Mr. WESTMORELAND. Thank you, Madam Chairwoman. And I want to thank you and the ranking member for introducing H.R. 3461. Here we are, another year and another bank failure in my district. I, along with Congressman Scott, represent Georgia. And as you know, Georgia has more bank failures than any other State.

And it is a shame because these banks have been part of the FDIC system. They pay fees. They pay the insurance. And the FDIC should look at them as someone that they need to be a partner with, not somebody that can put them out of business. And I understand that you have been trying to make sure that your policies are implemented consistently across-the-board.

But trust me, that is not the case. I suggest that you get out of Washington and that you go into some of these States and that you talk to some of these people. Because as Congressman Hensarling said, the reviews that they have on exit interviews orally, and then what they get in writing, are sometimes totally different.

And so, we have to do something to help these community banks. Because I cannot tell you the heartache and the financial disaster it causes some of these small communities. So I hope you will quit fighting this bill, embrace it, and show us a way that we can help you use some common-sense things to regulate these banks in our communities.

With that, I yield back.

Chairwoman CAPITO. Thank you.

Mr. Luetkemeyer for 1 minute?

Mr. LUETKEMEYER. Thank you, Madam Chairwoman. And thanks to you and the ranking member for addressing major issues that, despite our repeated calls for action, continue to pose problems for financial institutions.

Even with the passage of this bill and other bills aimed at helping relieve unnecessary regulatory pressure, banks and other institutions will still be subject to rigorous examination procedures and heavy regulation. Regulatory burdens cost banks and credit unions thousands of manhours and millions of dollars each year and divert them from conducting their actual business, which is lending to customers, helping to move our economy forward.

This is an industry that is and should be closely examined, but it is absurd to create an environment that is so rigorous that banks are no longer able to properly serve their customers. It is time to restore certainty to the exam environment and to restore practicality to the way we regulate these institutions. I look forward to a robust conversation today, and I yield back the balance of my time.

Thank you, Madam Chairwoman.

Chairwoman CAPITO. Thank you.

I would like to recognize Mr. Lynch for 2 minutes for an opening statement.

Mr. LYNCH. Thank you, Madam Chairwoman. I also want to thank the witnesses for coming before us today.

First of all, just to begin, I would like to say that I have enormous respect for the sponsors of this legislation. I have worked with both the chairwoman and the ranking member on a lot of legislation since coming here to Congress. This bill will not be one of them, however.

I have grave, grave concerns about a number of the sections in this bill, too many to get into in the short time that I have right now, but I will get into it during the hearing. I do want to associate myself—I had a chance to read all the testimony—with Ms. Kelly's testimony. I think she raised a lot of the concerns that I have. And then I have a few of my own.

But look, I understand the need here for a fair regulatory process that doesn't impinge unfairly upon our banks and financial institutions. The fact of the matter is, however, that we are coming through a very difficult time. We have a lot of banks that are still hurting on their balance sheets and have some very weak assets.

And the answer is not to reduce the standards to protect those banks that are weak. It is to help them regain strength. But it is not to cover this up, and not to paper it over. This is the same argument we had on mark-to-market a couple of years ago, when institutions did not want to have their assets marked down. But we will get into it a little later.

Madam Chairwoman, thank you for the great courtesy that you have afforded me, and I yield back the balance of my time.

Chairwoman CAPITO. Thank you.

Mr. Canseco for 1 minute for an opening statement.

Mr. CANSECO. Thank you, Madam Chairwoman. And thank you, Ranking Member Maloney.

There are several numbers that are very important to keep in mind today, and some of them are these: 30 years ago, there were over 14,000 community banks in the United States, and today there are less than 7,000. The Sarbanes-Oxley Act was projected to cost companies less than $100,000 per year to comply with it. In reality, that figure is over $2 million. And according to the CBO, it will take companies a total of 10.2 manhours per year to comply with Dodd-Frank. Doing simple math, and assuming a minimum wage rate of $7.25 per hour, that is a cost of almost $74 million per year in compliance wages.

Undoubtedly, the greatest burden falls on community banks, and this problem is often compounded by an oftentimes disjointed or unpredictable bank examination process. H.R. 3461 goes a long way towards fixing the process our regulators use to conduct examinations. And I commend the chairwoman and the ranking member for introducing this bill. It is a small but very important step to ensuring that community-oriented banking remains a central part of our economic landscape.

Thank you, and I yield back.

Chairwoman CAPITO. Thank you.

I think that concludes our opening statements, so I would like to now introduce our panel of witnesses for the purpose of giving a 5-minute opening statement.

Our first witness is Mr. Kenneth M. Bertsch, Associate Director of the Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System. I would also like to mention that Mr. Bertsch was kind enough to testify for the Federal Reserve at our hearing in Newnan Georgia. So I appreciate your traveling to Washington to make this testimony.

Mr. Bertsch?

STATEMENT OF KEVIN M. BERTSCH, ASSOCIATE DIRECTOR, DIVISION OF BANKING SUPERVISION AND REGULATION, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. BERTSCH. Chairwoman Capito, Ranking Member Maloney, and members of the subcommittee, I appreciate the opportunity to discuss the Federal Reserve's views on the Financial Institutions Examination Fairness and Reform Act. The Federal Reserve shares the subcommittee's interest in ensuring fair examinations, and providing banks with a robust and transparent process for appealing supervisory determinations.

Accordingly, the Federal Reserve has taken a number of steps to ensure that examination findings are well-grounded in supervisory policy, fully supported, and give due consideration to all relevant information provided by bankers.

We also encourage bankers to discuss with reserve bank supervision management any concerns they may have with the examination process. If bankers still have concerns after talking with supervisory staff, they are encouraged to contact the Federal Reserve's ombudsman and consider filing a formal appeal.

While we support efforts to ensure a fair examination process, some provisions of the proposed legislation appear to limit the ability of examiners to use judgment and may impede, rather than further, the ability of examiners to ensure the safe and sound operation of banking organizations. For example, the proposed bill could be interpreted to prevent an examiner from requiring a new appraisal on a performing commercial loan unless new funds are being advanced.

In some cases, the absence of an updated appraisal would make it difficult for banks to appropriately assess their risk of loss and take actions to protect their financial interests. Similarly, the proposed bill could be read to prohibit examiners from recommending the placement of certain loans on non-accrual status, raising the potential that income could be overstated at some banks.

Some might also interpret the bill as requiring that a loan be returned to accrual status if it is making payments according to its terms, regardless of whether those terms would assure the ultimate collection of the entire principal and interest due. This type of strategy is inconsistent with Generally Accepted Accounting Principles (GAAP), and past supervisory experience suggests it is often unsuccessful and can increase the cost of resolution in the event a bank fails.

The proposed bill also appears to prohibit examiners from requiring a bank that meets the regulatory threshold for being well-capitalized from adding to its capital base. These provisions conflict with the expectations set forth in the recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act.

They also fail to recognize that the regulatory definitions for the various capital thresholds do not take into account the idiosyncratic risks at individual organizations or the potential effects on a bank's capital position, of risk management deficiencies, or concentrations in problem assets.

A key purpose of the proposed legislation appears to be to ensure a strong appeals process and independent ombudsman function for the resolution of bankers' concerns. The Federal Reserve has in place a robust appeals process and an independent ombudsman function designed to provide institutions with a fair and fulsome review of complaints.

We also maintain a strong anti-retaliation policy to protect any person who uses the appeals process or who contacts the ombudsman with concerns. Moreover, the Federal Reserve continues to evaluate methods for improving its ombudsman function and appeals process.

We recognize the concerns expressed by bankers about the supervisory process and are taking steps to respond to them. In 2009, the Board established a subcommittee to focus on supervisory approaches to community and regional banks. This subcommittee is led by Board Governors Elizabeth Duke and Sarah Bloom Raskin.

A primary goal of the subcommittee is to ensure that the development of supervisory guidance is informed by an understanding of the unique characteristics of community and regional banks, and consideration of the potential of excessive burden and adverse effects on lending. In addition, in 2010 the Board established the Community Depository Institutions Depository Advisory Council to provide input on the economy, lending conditions, and other issues of interest to community banks.

Feedback from community bankers has persistently pointed to increasing regulatory burden as a concern. Last year, the Board's Subcommittee on Community and Regional Banks asked that a series of initiatives be developed to clarify regulatory expectations, alleviate regulatory burdens where possible, and reduce the potential that regulatory actions could curtail lending.

In response, Federal Reserve staff initiated a number of projects to enhance provision practices for community banks and alleviate some of the burdens that have been of most immediate concern. Overall, these efforts are intended to ensure a rigorous but balanced approach to safety and soundness supervision that fosters a stable, sound, and vigorous community bank population.

In summary, the Federal Reserve supports efforts to ensure that the examination process is fair, balanced, and consistent, and strives to consistently improve its examination processes.

Indeed, we have already initiated a number of changes to improve and clarify our supervisory policies and practices and, where possible, constrain burden. It is, however, important that the agencies not be impeded in taking steps to ensure the safe and sound operation of banking firms.

We appreciate the subcommittee's invitation to share our views, hope that our comments have been helpful, and would be happy to continue a dialogue on these very important issues.

Thank you.

[The prepared statement of Mr. Bertsch can be found on page 64 of the appendix.]

Chairwoman CAPITO. Thank you. Our second witness is Ms. Sandra L. Thompson, Director of the Division of Risk Management Supervision, the Federal Deposit Insurance Corporation.

Welcome.

STATEMENT OF SANDRA L. THOMPSON, DIRECTOR, DIVISION OF RISK MANAGEMENT SUPERVISION, FEDERAL DEPOSIT INSURANCE CORPORATION (FDIC)

Ms. THOMPSON. Thank you. Chairwoman Capito, Ranking Member Maloney, and members of the subcommittee, I appreciate the opportunity to testify on behalf of the FDIC about the Financial Institutions Examination Fairness and Reform Act.

The FDIC shares the subcommittee's goal of having a strong banking industry that serves as a source of credit to our Nation's 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 reporting accurately portrays their condition.

This is a challenging time for financial institutions, and examination findings reflect a difficult economic environment. These difficulties, particularly as they affect real estate, have led to credit quality weaknesses that have increased the volume of classified and non-accrual loans. Where these credit quality issues are found, corrective action is necessary to help ensure that institutions remain solvent and risks to the Deposit Insurance Fund are mitigated.

We also recognize that banks are working very hard to navigate the downturn. 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 stated purpose of H.R. 3461 is to improve the examination of depository institutions, another goal we share. The FDIC continually seeks to improve the bank examination process, and we are committed to ensuring that banks understand our examination findings. Importantly, this includes the opportunity to discuss and question and appeal those findings if they disagree, both formally and informally.

The bank examination process in the United States has evolved over many decades and has been shaped by our collective experience in both good and bad times. Recent experience has reconfirmed an essential lesson of past crises. Namely, ongoing 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. The bill proposes changes to important supervisory standards and limits our ability to consider all of the facts necessary to assess the credit quality of loans.

The effect of these changes is that banks will no longer be required to recognize troubled assets in an accurate and timely manner. And our examiners will be prevented from considering material risk factors that have long been regarded as essential to assessing the credit risk in a bank's loan portfolio. We are concerned that this could mask problems at insured depository institutions and block our ability to require weak institutions to take corrective action, potentially resulting in higher losses to the insurance fund.

We are also concerned that this will lead to inaccurate financial reporting in banks' regulatory reports since income and capital would be overstated. As a consequence, we would no longer be able to properly determine the institution's condition, the adequacy of its capital and reserves, the performance of management, and the overall risk the institution may pose to the insurance fund.

Under the proposed new appeals process, the Office of Examination Ombudsman within the FFIEC would have the authority to overturn determinations reached by the independent banking agencies. This would give the new ombudsman great authority, but no responsibility for the oversight of the bank or whether the bank survives or fails.

Further, rather than shortening the examination process as the bill proposes, this process could have the opposite effect. My written statement summarizes the benefits of the current classification of loans, accurate financial reporting, and the current appeals process at the FDIC. We believe this approach provides for the timely recognition of problems, allows regulators and bankers to work together to solve problems, and helps avoid losses to the Deposit Insurance Fund.

I would be happy to answer your questions. Thank you.

[The prepared statement of Ms. Thompson can be found on page 140 of the appendix.]

Chairwoman CAPITO. Thank you. Our next witness is Mr. David M. Marquis, Executive Director, National Credit Union Administration.

Welcome.

STATEMENT OF DAVID M. MARQUIS, EXECUTIVE DIRECTOR, NATIONAL CREDIT UNION ADMINISTRATION (NCUA)

Mr. MARQUIS. Thank you, Chairwoman Capito, Ranking Member Maloney, and members of the subcommittee.

The National Credit Union Administration appreciates the invitation to testify on H.R. 3461, the Financial Institutions Examination Fairness and Reform Act. In difficult economic times, depository institutions encounter additional threats to their safety and soundness. As a result, regulators like NCUA must take prompt action to address the identified problems and mitigate emerging risk.

We take these actions in order to maintain the safety and soundness of credit unions, safeguard the National Credit Union Share Insurance Fund, and protect consumer deposits and ensure that taxpayers do not experience a loss. When regulatory actions increase, complaints against the regulator typically arise. NCUA, however, actively works to minimize complaints by comprehensively training our examiners and by encouraging stakeholders to communicate with us.

We have found that an effective exam program requires an ongoing two-way conversation. Direct communication between examiners and credit unions often resolves problems and misunderstandings. When such interactions fail to produce a consensus for resolutions, credit unions have other avenues to voice concerns. Specifically, NCUA has an open-door, multilayered appeals process that provides reconsideration of regulatory decisions.

After appealing to supervisory examiners and regional directors, a credit union may request a reevaluation by our supervisory review committee, an independent interagency appeals panel. Consistent with H.R. 3461, NCUA has already adopted a zero tolerance policy to prevent retaliation against appealing credit unions. Every exam report contains a cover page that explains a credit union's appeal rights and references NCUA's policy on appeals and non-retaliation. This is also available on our Web site.

Further, in accordance with the bill, we have prioritized the timely delivery of findings so that exams are properly completed and credit unions may quickly address smaller issues before they grow into big ones. In short, NCUA already meets several of the standards found in the bill, and we are firmly committed to fairly applying current law in order to protect the safety and soundness and to limit insurance fund losses.

To address the problems the subcommittee has identified, H.R. 3461 would institute new exam procedures, modify accounting practices, and create new appeal venues. Although well-intentioned, the bill could produce at least three unintended consequences.

First, the bill would greatly increase NCUA's costs. The documentation changes, for example, would increase the time spent on exams. The new appeals procedures would add more regulatory layers that would increase costs, without any assurance of greater effectiveness.

To validate individual exam findings for administrative law judges, NCUA would need to write more detailed rules to clarify safety and soundness principles. Moreover, the bill's changes to operations and funding for the Federal Financial Institutions Examination Council would significantly increase NCUA outlays. Ultimately, credit unions have to pay for these increased regulatory expenses.

Second, in its present form, the bill could greatly increase risk to the Share Insurance Fund. For example, an administrative law judge's decision to overturn safety and soundness action due to a lack of knowledge of financial institution operational risk on a forward basis might result in greater insurance fund losses in the future.

Further, the bill's modified exam procedures and expanded appeals rights would delay resolution of safety and soundness issues and allow problems to escalate. The increased time to settle issues runs counter to GAO's recent recommendations that NCUA require early and forceful regulatory action well before capital deterioration triggers prompt corrective action tripwires.

In addition, the commercial loan accounting changes could mask problems, and extend the time before we could take necessary action to mitigate losses in a distressed portfolio. Such accounting changes would also conflict, at times, with financial institutions' reporting requirements under generally accepted accounting principles.

Third, the bill would result in a one-size-fits-all examination system. NCUA currently customizes its reviews based on size, scale and scope of each credit union. The largest bank holding company has more than $1 trillion in assets, yet nearly 70 percent of credit unions have $50 million or less in assets. The requirement to establish consistent exam standards across a wide range of financial institutions would decrease regulatory flexibility and add considerable cost.

In sum, NCUA recognizes that financial services regulators must conduct exams fairly and consistently, and we strive to achieve this standard. NCUA is committed to addressing legitimate concerns about the present exam process, minimizing regulatory conflicts, promoting procedural fairness, and advancing exam consistency.

Later this year, for example, NCUA will adopt a national supervisory policy manual to reinforce greater consistency amongst our exams and regions. We are also committed to working with Congress to explore other ways to address exam concerns.

I look forward to answering any of your questions.

[The prepared statement of Mr. Marquis can be found on page 121 of the appendix.]

Chairwoman CAPITO. Thank you. And our final witness on this panel—I would like to welcome her back; she has been before the committee before, and I appreciate her being here—is Ms. Jennifer Kelly, Senior Deputy Comptroller for Midsize and Community Bank Supervision, Office of the Comptroller of the Currency.

Welcome.

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

Ms. JENNIFER KELLY. Thank you. Chairwoman Capito, Ranking Member Maloney, and members of the subcommittee, I appreciate the opportunity to appear before you to discuss the OCC's perspective on H.R. 3461.

As the Senior Deputy Comptroller for Midsize and Community Bank Supervision, I serve as the senior OCC official responsible for the supervision of approximately 1,700 national banks and Federal savings associations with assets under $1 billion. These community-focused institutions play a crucial role in providing essential financial services to consumers and small businesses in communities across the Nation, as well as supplying the credit that is critical to economic growth and job creation.

The bill contains measures directed at three basic concerns: first, assuring that banks have access to a fair and independent appeals process if they disagree with a regulator's supervisory determination; second, clarifying or revising standards for classification of loans and placing loans in non-accrual status; and third, achieving timely communication of examination results.

My managers and I hold numerous outreach sessions and meetings with bankers to listen, and respond, to their concerns and questions. And we have heard many of the same concerns that you have about the challenges that bankers are facing. We seek to ensure that the OCC's examinations are fair and timely, and that the

OCC is fulfilling its mission of ensuring the safety and soundness of national banks and Federal thrifts by identifying problems at the earliest possible stage and holding institutions accountable for taking timely and effective corrective actions.

While we understand and support the broader objectives of the bill, we believe it could impede our ability to deal with troubled institutions on a timely basis, and would undermine Congress' clear direction that bank regulators identify and promptly address unsafe and unsound practices and that insured depository institutions report their financial condition in accordance with Generally Accepted Accounting Principles, commonly known as GAAP.

The OCC fully supports providing bankers with a fair and independent process for appealing supervisory determinations, and we believe our current appeals process, run by our ombudsman, does just that. The bill's approach to accomplishing that objective would involve creating a new Federal bureaucracy at the FFIEC, and risk disrupting appropriate and necessary supervisory activities by bank regulators.

We believe there are better alternatives without those downsides that would accomplish the objectives of H.R. 3461. We would be happy to work with the subcommittee to frame out an alternative approach.

We also have significant concerns that the standards for non-accrual loans in the bill could result in revenue recognition that is inconsistent with GAAP. FDICIA established that banks must follow GAAP, or standards that are no less stringent than GAAP, in reporting their financial condition.

Congress put this requirement in place in response to the savings and loan crisis, where non-GAAP regulatory accounting masked the deteriorating financial condition of institutions until it became so serious that a massive bailout was needed. The bill would weaken this important standard.

As I have previously testified before this subcommittee, the integrity of financial reporting and regulatory capital is vital to identifying and correcting weaknesses before they threaten a bank's ability to continue to meet the needs of its customers and the communities it serves.

As we have seen during the most recent crisis, it is also essential that supervisors have the ability to direct banks to hold capital commensurate with their risk profile. The bill would, in certain instances, tie the hands of regulators when they believe a bank's risk profile requires more capital.

Finally, we agree that completing and communicating our examination findings on a timely basis is essential. Clarifying those expectations can be a positive step. But flexibility is needed when an exam may not be finished or results communicated for good reasons, such as when a significant policy issue needs further deliberation before a conclusion is reached.

My written testimony discusses the OCC's perspectives and concerns with the proposed legislation in greater detail. I would be pleased to respond to any questions you have about my testimony or other matters relating to H.R. 3461. As I conclude, I would like to reiterate the OCC's willingness to work with the subcommittee to explore alternative approaches that would achieve the goals we share without raising the types of concerns I have identified.

Thank you.

[The prepared statement of Ms. Kelly can be found on page 86 of the appendix.]

Chairwoman CAPITO. Thank you, thank you all. And I would like to begin my 5 minutes of questions.

Listening to the testimony from the four of you, I am kind of wondering if we are in a little bit of an alternative universe here.

From what we are hearing from our constituents and the resultant effect of inability to lend to small businesses and, consequently, inability to create jobs, tightening in inconsistent standards—with the exception of, basically, Mr. Bertsch did say that the Fed had developed a council or a committee to try to respond to community bankers and concerns that they were having—it doesn't seem like—and you mentioned, as well, that some adjustments had been made, although you didn't get specific with what those might be.

But you were at the hearing in Georgia and I think that those who testified on, I believe it was, the second panel after you testified, had conflicting statements as to what they were hearing on the ground and what was the resulting written report, or what the resulting actions were.

So I guess what I am wondering here is we feel—and I think you have heard everybody in their opening statements feel and our constituents feel—that there is a problem here. And I don't really get the impression, with the exception of Ms. Kelly did say that she is willing to work, but without specificity. Is there a big disconnect here?

You kept going back to the safety and soundness argument. That is a logical and great argument. Because, certainly, the safety and soundness of financial institutions is the core of what we believe and what we all want across-the-board in a consistent way on all parties. Because it is not only good for the country, it is good for the institutions, it is good for the constituents, it is good for the small businesses and mom-and-pops that are working with these institutions.

So I guess I would ask Ms. Thompson if you have—are you hearing the same things? You have been before this committee, the FDIC has been before the committee several times and heard the same repeating theme from us as Members of Congress.

Is this a consistent disconnect between what we are seeing on the ground and what you all are seeing going forward?

Ms. THOMPSON. Chairwoman Capito, thank you for the opportunity to respond.

I would say that the FDIC, as the primary Federal regulator for over 4,600 institutions, has heard these comments regularly from bankers and we have really taken steps to try to address some of the things that we have heard. We have heard about inconsistencies between Washington and the field, we have heard about mixed messages.

And one of the things that we have done is to reinforce our policies with our examiners. I personally have nationwide phone calls with my examination workforce. I personally visit all of the regional offices and go to the specific territories, and require our regional directors and our field management to do the same.

We also meet with bankers regularly and we encourage them to address these issues with us specifically. In fact, last year, in March, the FDIC issued a Financial Institution Letter reminding institutions about the appeals process and reminding institutions about our ombudsman. Also, we established a direct e-mail box to me personally, directly to me, for bankers who had specific concerns before, during, or after an examination.

And we are very concerned about the perception. We want to make sure that our examiners are following the instructions that we have given in Washington. And we would like—if you have specific instances, we would be happy to address those instances.

Chairwoman CAPITO. I think, in our bill, we did go to the three instances—the timeliness of the reports; the looking at the commercial real estate assets on a regular-paying customer; even though the assets have fallen in value, how do you treat that on your books? And then, of course, the objectivity of the ombudsman has been an issue.

We heard this in Georgia, that there was a feeling of retaliation. Somebody addressed that in their opening statement, about how they have tried to separate some kind of retaliatory measures.

How are we going to bridge this gap? Ms. Kelly said you are willing to work. Do you have any suggestions on how we are going to close this gap between what you are saying and what we are hearing?

Ms. JENNIFER KELLY. I believe that ongoing communication is the key to this. And going into the economic downturn, that was something we have emphasized with our examiners, I have emphasized with my managers. And we certainly have stepped up our outreach efforts in terms of meeting with bankers. I did a quick count. We had over 50 meetings just in 2011 with bankers about—

Chairwoman CAPITO. But you are hearing the same thing we are hearing?

Ms. JENNIFER KELLY. Yes, we hear complaints. Certainly, there are many more banks that are having problems now, given the economic environment we are in. The examiners are having more critical findings of those institutions.

And if bankers don't agree with the examiner's finding, they raise concerns about that. That is why we get out there, we talk to them, we certainly encourage them. If they feel that the examiner has not laid out the rationale for the conclusion they have reached adequately, then not only do we have our formal appeals process through the ombudsman, but we also have an informal appeal process through the supervisory chain.

And often, many of these issues are resolved just by having further conversations about it, getting higher levels of management in the district involved. I would go back to Mrs. Maloney's comment about—

Chairwoman CAPITO. I am going to stop you there, because I went over my time.

And I am going to let Mrs. Maloney go ahead and begin her questioning.

Mrs. MALONEY. First of all, I would like to thank all the panelists for your public service and for your fine testimony and for raising legitimate concerns.

It certainly is not my intention, in any way, shape or form, to undercut the GAAP accounting principles. We are in an international banking system now and have to have international ways to regulate. And that is one of the reasons we are having Basel I, II, and III. And we certainly don't want to in any way, at least I don't want to, undercut that.

You have raised many concerns that I look forward to working with you on. But I would like to go to the appeal process, and first ask Mr. Bertsch from the Fed, you testified that you have a very robust appeal process. You already have an ombudsman in place. How many appeals, formal appeals, have been lodged with the Fed since the crisis in 2008 to now? Were any any formal complaints lodged?

And also you testified, as did others, that you were concerned that an external appeals process would undercut your supervisory function. Can you think of modifications to the section that would allow some level of independent review but address your particular concern for supervisory function? First, Mr. Bertsch, and then I just want to go down the line.

Mr. BERTSCH. We have had an increase in the number of appeals that we have gotten since 2007. I think we typically had gotten about 5 formal appeals a year, and in 2011, there were 10 appeals.

We believe that the appeals process that we have in place at the Fed is effective in considering appeals. We have a three-level appeals process, as we described in the testimony. And we believe that it results in a satisfactory airing of facts and objective determinations on those appeals.

Mrs. MALONEY. Any comments on Section 1015 and supervisory function?

Mr. BERTSCH. I don't believe that I specifically commented on that in my testimony.

Mrs. MALONEY. Okay.

Ms. Thompson, how many appeals to the FDIC? You were really involved deeply in responding, I believe in many ways, very appropriately to the crisis. Anyway—

Ms. THOMPSON. As stated before, the FDIC has an informal and a formal appeals process.

Mrs. MALONEY. Just the formal one.

Ms. THOMPSON. Through the formal appeals process, since 2008, the FDIC has had 33 formal appeals. Our appeals process goes to our regional office. And if the bank does not agree with that appeal, it would go to the Division Director, me. But the final ability to overturn a supervisory appeal is a committee that is established by our Board of Directors, it is chaired by a Board Member, and it contains persons who are not involved in the supervisory process.

So to the extent an institution has an appeal, they are appealing to the very highest levels of our organization.

Mrs. MALONEY. Would you feel more comfortable with the legislation if the final word was the organization and not totally independent under the FFIEC?

Ms. THOMPSON. I believe our organizations are responsible for the safety and soundness of the banking system. The FDIC is also responsible for insuring deposits. And people work very hard to put their money in a financial institution, and we take that responsibility very seriously.

I think the head of our agency, who is appointed by the President, serves as Chairman of our Board—

Mrs. MALONEY. And we raised that to $250,000 in Dodd-Frank, which is very helpful for community banks.

Ms. THOMPSON. That is exactly correct. But our Board consists of members of the other Federal banking agencies, and they have decided to establish a committee to look at supervisory appeals. And we think that is the appropriate level.

Mrs. MALONEY. Mr. Marquis, I know from my district that the credit unions were not really involved in the crisis. They were not closed. They provided service, and continued functioning through it in a fine and excellent way. So, congratulations. But on the appeals process, do you have appeals?

Mr. MARQUIS. We do a supervisory review committee for formal appeals. We had three last year, and most of them get resolved at the regional director's level. We have had, of course, some strains with industry this year because of the tough economic climate.

If you had asked me how many failures I thought we were going to have a year ago, I thought we would be at a much greater number. But through a lot of hard work between our examiners and CEOs that sometimes push back at each other, they eventually get to resolving the issue. One of the issues on terms of timeliness to go into the outside appeals process, as presented, was the 60 days it takes to file an appeal, 60 days to get to review it, and 60 days to issue a final determination.

And some of our more troubled credit unions, Code 4s, by that time we have already done two additional supervision contacts to make sure that the ball has moved down the field and issues that are of great concern are actually being addressed. So that delay could potentially delay actions in moving credit unions to safety.

Mrs. MALONEY. My time has expired, but if I could have 10 seconds to respond to one point he made, that the economy appears to be improving somewhat. Certainly, the number of complaints on commercial real estate loans and appeals has diminished, at least in my office, and probably many others.

Thank you all for your testimony

Chairwoman CAPITO. Thank you.

Mr. Renacci, 5 minutes for questions.

Mr. RENACCI. Thank you, Madam Chairwoman. I want to thank the witnesses for being here.

I am going to follow up with what the chairwoman was saying. There really does seem to be some inconsistency. And I am going to give you three examples from my district. Three businesses—one of them employed 50 people, one of them employed 35 people, and one of them employed 25 people—and all of them had loans that were put on non-accrual basis. So all of them had issues that some regulator told the bank these were problem loans.

This was done in late 2009, early 2010. This was before I was in Congress. I was a CPA, so I definitely knew those businesses and what was going on. Today, two of those business are not non-accrual anymore because they found another bank to refinance with. One of them is gone.

The one business that is gone cost 25 jobs, yet that property sold for about 85 percent of the loan. So when we talk about the inconsistencies, I would look back to the jobs, the small business owner. Those are the ones who are having the issues.

And we talk about the banks and the appeal process. I think there is a concern with some banks, when I talked to the banks, that they are concerned with the current appeal process. Because they think if they do those things, there will be retribution. And I think that is an issue too, from what I hear.

So I am just telling you what I am hearing from back in my district. But I think it is an interesting story, when you talk about three specific businesses, when you tie it down in my district—and where one of them is gone, 25 jobs are gone, are never coming back, and the other two businesses, the way they were able to survive was by refinancing.

Now, I want to move forward onto this. We have been throwing GAAP out, Generally Accepted Accounting Principles. And as an auditor, as a CPA, somebody who has done certified statements, I understand GAAP. I understand Generally Accepted Accounting Principles. I understand that many times, when I did a financial statement or when my company did a financial statement, you would have a going concern.

But most of the times, those going concerns were because the bank would say the loan was not a collectible loan. Those are the questions I have. Who makes that judgment? How do we make that judgment? How specific are we on that judgment? And those are opinions. Somebody can say that loan will be paid, some will say it won't.

I just gave you three examples where two of them are doing very well right now and employing people. Now, just think if I was doing, or you all were doing, certified audits of those two businesses who were put on non-accrual, you would probably give them, I would give them, a going concern which means I doubt they can stay in business, and the problems that would occur. So tell me a little bit about why you feel this bill is inconsistent.

I will start with you, Ms. Kelly, because I know you were talking about GAAP. Tell me why you feel it would inconsistent with GAAP. Because remember, GAAP is an opinion. And it can be your opinion versus somebody else's opinion.

Ms. JENNIFER KELLY. I would agree with that. GAAP is Generally Accepted Accounting Principles. It is principles-based. And then what the banking agencies have done is, in the call report instructions, we have taken those principles and better defined what we see as the standard for determining income recognition, what is appropriate, and whether a loan should be on an accrual basis or a non-accrual basis.

In the instances that you cited, we would have to look at each situation specifically, and look at the facts and circumstances that are unique to that loan, to decide whether it was an appropriate determination or not. But it is important to understand that what examiners are doing is outlined in the call report instructions. The call reports, which are the quarterly financial reports, are prepared by the banks.

And so when our examiners go in, they are looking at the determinations that the bankers are making about those loans and whether they should be on non-accrual or not, in accordance with the call report instructions. So the examiners are looking at the documentation and discussing the loan with the banker to understand their rationale for keeping it on accrual, and determining whether they feel there is a sound basis for that.

So that is what the examiners are doing. And if they tell the bank that they believe the loan should be on non-accrual, it relates to the income recognition by the bank.

Mr. RENACCI. In these three instances, all three of these loans were making their payments, they were never behind, they were 100 percent on time. So again, the inconsistency would be when I talk to the bank. And in the day, I did talk to the bank and say, "Why are you putting these on non-accrual?" They are saying, "Because the regulators are forcing us to put us on non-accrual."

Ms. JENNIFER KELLY. You mentioned the word "collectability," when you were framing up the question initially. And that is the key piece here. It is not only are the payments current, but it is an assessment of whether there is reason to believe that full principal and interest are going to be collectible on that loan.

Mr. RENACCI. I know my time is running out, but just think of those two instances. That is why I bring out specifics. On those instances, they went—on those two out of three instances, they went non-accrual. And yet they are good loans, 100 percent collectible with another bank right now.

Thank you very much.

Chairwoman CAPITO. Thank you.

Mr. Watt for 5 minutes.

Mr. WATT. Thank you, Madam Chairwoman. And let me make a couple of comments. First of all, I am hearing the same complaints that everybody else has described. Second, I don't agree that this bill is the solution to those complaints, nor will it minimize or reduce the complaints. And it will create some additional complaints, even for the things that it would resolve.

I don't think we can micromanage examinations in this committee, and when we try to do that, I think we do ourselves a disservice. So having said that, there is a lot of arbitrariness going on, and one of those sets of arbitrariness I want to direct to Mr. Marquis because something I think is arbitrary is going on in North Carolina.

I don't know if you are familiar with it or not, but the NCUA has announced that it will examine all 52 North Carolina chartered credit unions, completely separate from the North Carolina Credit Union Division, obviously, as a result of the North Carolina Credit Union Division's decision to allow the North Carolina State Employees Credit Union to release estate CAMEL ratings. There is no rule against that.

This is a North Carolina-regulated entity. And your reaction to it is that we are going to go out and make the life of 51 other businesses, credit unions, miserable because we don't like what the North Carolina Credit Union Division has done with its own member. That seems to me to be arbitrary, and it is the kind of thing that results in the kinds of reactions that you are hearing here. Because arbitrariness doesn't seem to make anybody happy.

So maybe you can explain to me why you think the NCUA has the authority, with a State-chartered credit union, to go on this kind of witch hunt. Because I am really concerned about where we are on this.

Mr. MARQUIS. When we work with our State regulators, we accept their examination to the fullest extent possible. Sometimes, we do joint exams, and sometimes, we do separate insurance reviews. We also have an insurance agreement that every credit union agrees to, which is not to release information that is in our records that has to do with an exam report—

Mr. WATT. There is something in your rules that says this State-chartered entity—

Mr. MARQUIS. Yes, sir.

Mr. WATT. They can't release this CAMEL rating?

Mr. MARQUIS. They can't release it—

Mr. WATT. Either there is or there isn't, Mr. Marquis. Is there something in your rules that prohibits this?

Mr. MARQUIS. Yes, there is.

Mr. WATT. Okay. All right. You are going to send that to me, I am sure.

Mr. MARQUIS. Yes, sir.

Mr. WATT. Okay. Go ahead.

Mr. MARQUIS. And what that does is, when a State uploads an exam report in our system, it is a record available to our use.

Mr. WATT. Okay, but let me accept that. So for the sin of one credit union, you are going to go and subject 51 other credit unions to an extensive examination. That is what you are telling me, and that is rational to you?

Mr. MARQUIS. What we are saying is we can't accept that exam report being uploaded on a system. If they want to release the CAMEL code, States' rights, we don't care. But we can't have that record in our system. And then, we don't have to take exception with that particular union or all of those credit unions.

We do have a concern with CAMEL code release because the other credit unions aren't releasing their CAMEL code. So what does that speak of about the financial condition of those credit unions, since only one of them has been allowed to release that CAMEL code?

Mr. WATT. So you are going to subject every State-chartered credit union in North Carolina to an examination just because one credit union released this CAMEL rating; with the authority, mind you, of the State telling them that they could do that.

Mr. MARQUIS. That is correct.

Mr. WATT. Somebody needs to come and talk to me. Because even though I don't like this bill, we might need to add something to it when it gets marked up that says you can't take that kind of arbitrary action. I think you are way beyond the authority that you have at the Federal level to do this.

Chairwoman CAPITO. Thank you. The gentleman's time has expired.

Mr. Westmoreland for 5 minutes?

Mr. WESTMORELAND. Thank you, Madam Chairwoman, for yielding.

How many times have each one of you all testified at congressional hearings or inquiries? All of you.

Mr. BERTSCH. This is my second time.

Mr. WESTMORELAND. Second time.

Ms. THOMPSON. At least 10 times.

Mr. WESTMORELAND. How many?

Ms. THOMPSON. At least 10 times. Senate and House?

Mr. WESTMORELAND. Yes.

Ms. THOMPSON. A lot.

Mr. WESTMORELAND. Would you say more than 20?

Ms. THOMPSON. No, I would not say that.

Mr. WESTMORELAND. Okay.

Mr. MARQUIS. Three times.

Mr. WESTMORELAND. Thank you. This bill that the chairwoman and the ranking member have come up with has, I think, been a direct result of us hearing from our constituents. And I know, Mr. Bertsch, you have been down to my district. I think you were at the field hearing that we had.

So, this is a direct result of that, and us trying to keep our community banks from inconsistent regulations and hearing one thing from the regulators up here and then hearing something else from our constituents. And no disrespect, but we tend to believe our constituents, especially when the evidence is on their side.

So do you think we can screw up this more than you all have? It is a simple question. We are trying to fix it, you all have not tried to fix it, and it just keeps perpetuating on itself. So do you really think that we can mess it up and cause more bank failures than what has happened so far?

Any one of you? Go ahead.

Ms. JENNIFER KELLY. Sir, as I said before, we work hard. We are out there talking to bankers all the time trying to understand where they feel there are inconsistencies, talk to them about our expectations, whatever actions we need to take to clarify things. So we are continuing to work this issue very aggressively. These are difficult times.

Mr. WESTMORELAND. Do you think that banks need to have the ability to sue the FDIC, in the fact that any complaints that they have? And I will have to tell you, all my bankers, board of directors, and all of them have told me that they are afraid to come forward because of the possible retaliation. Because any complaint about the FDIC is actually handled within the FDIC, or the Board of Governors or wherever it is.

Do you think that is fair, that their day in court, so to speak, is with the same people they are complaining against?

Ms. JENNIFER KELLY. At the OCC, I do believe it is fair. Our ombudsman operates entirely outside the supervision process, he reports directly to the Comptroller, and he has the power to overturn supervisory decisions. And he does do that on occasion—

Mr. WESTMORELAND. How many times would you say he has done that?

Ms. JENNIFER KELLY. In the last year, I think there were five decisions. And two went for the bank and three went for the OCC. The year before—

Mr. WESTMORELAND. Okay. I would like to see some of those.

Ms. JENNIFER KELLY. Yes, sir. They are all posted on our Web site.

Mr. WESTMORELAND. Okay, great.

Ms. JENNIFER KELLY. The decisions include a summary that does not identify the bank, but it identifies the issue. It is about a page long, describing the exact situation and what the decision was.

Mr. WESTMORELAND. Ms. Thompson, how many times would you say regulators have been disciplined from the FDIC, FDIC regulators being disciplined because of a complaint that was filed by a lending institution?

Ms. THOMPSON. First, I don't have the specific answer to your question. But the FDIC takes its responsibilities very seriously, Congressman, and we really want a fair, open, and transparent process. Retaliation is prohibited at the FDIC. And to the extent that a banker would bring that to our attention, I would be dealing with those particular problems and situations.

I really think that our examiners and our staff are professional, and I do believe that they understand that there are difficult circumstances. The economy was horrible. But I do think that the FDIC—

Mr. WESTMORELAND. Ma'am, I am not trying to cut you off. But my question was, how many regulators have been disciplined as a result of complaints filed by banks with the FDIC?

Ms. THOMPSON. I don't know the answer to that, Congressman, I am sorry.

Mr. WESTMORELAND. Could you find that out for me?

Ms. THOMPSON. Yes, sir. I will.

Mr. WESTMORELAND. Because didn't you just say that retaliation was against the FDIC rules?

Ms. THOMPSON. That is correct.

Mr. WESTMORELAND. That is like your dog having his teeth into your neighbor's leg, and you telling your neighbor, "I don't allow him to bite." But thank you very much, and my time has expired.

And I want to thank the chairwoman.

Chairwoman CAPITO. Thank you.

Mr. Hinojosa?

Mr. HINOJOSA. Thank you. Thank you, Chairwoman Capito. I believe this bill represents an accomplishment in bipartisanship. And I thank you, and Ranking Member Maloney, for both of your efforts on behalf of this legislation.

The financial crisis pulled back the curtain on the bank examination process, and it is obvious to me that reform was needed. However, the regulation should not overburden our financial institutions during a time of economic uncertainty, when loans to creditworthy small businesses can spur job creation.

I am especially concerned about overburdensome regs for community banks and credit unions in particular. They were not the cause of the financial crisis, and I don't believe they should be stymied by overzealous regulation agencies. I believe that we will find common ground today, and I believe we can find a regulatory balance to ensure an institution's fiscal health while allowing for enough flexibility to encourage economic growth.

I have two short questions. And I would ask Ms. Sandra Thompson, Director of the Division of Risk Management, FDIC, if she can please give me an answer to these two questions, as well as Ms. Jennifer Kelly, Deputy Comptroller for Mid Size and Community Banks.

I have heard concerns from community banks in my district about the current internal appeals process, specifically, that they have limited options to contest the questionable decision. And we have all brought that up. Additionally, they fear the retribution because they must appeal to the very agency that regulates them.

The question is, what are your objections to the outside appeals process outlined in this bill? And the second part of the question, assuming the creation of an outside appeals process, an ombudsman office, what would be your recommendations?

Ms. Thompson?

Ms. THOMPSON. With regard to your first question, the supervisory appeals take place at the highest level within our agency. We have both a formal and informal process. Our agency is run by a board, and the board established a committee that is chaired by a board member.

The participants on that committee, who have the authority to overturn a supervisory decision, are independent of the supervisory process. So from the highest levels of our organization, they have the authority and the ability to overturn a supervisory decision.

And we believe that because the head of our agency has been entrusted with the safety and soundness of the banking system, and also the deposit insurance responsibilities, that is something we, as an agency, take very seriously. Under the bill, the outside ombudsman will be overturning a decision made at the very highest levels of our agency.

If the bill does go forward, with regard to the ombudsman, that would be located within the FFIEC. It would be very difficult to understand how this entity would have the ability to overturn, but no responsibility for the insured deposits or the people who put their deposits in financial institutions, or the safety and soundness of the institution. Those are tenets of what we do at the FDIC. That is part of our mission.

It is just hard to understand how that would work, how you would have an entity with authority, but with no accountability or responsibility for the health of that institution.

Mr. HINOJOSA. I would like to ask Ms. Jennifer Kelly if she would respond?

Ms. JENNIFER KELLY. Certainly. As I was explaining earlier, our ombudsman operates entirely independently of our supervision line. We feel that provides sufficient independence. We also would share Ms. Thompson's view of we are responsible—supervision of these institutions and the accountability for doing—that needs to stay with the head of our agency in terms of making those decisions.

We also have concerns about the timing. Right now, our ombudsman is committed to resolving and making a decision on any appeals within 45 days. And that is very important because often, in these situations, we are dealing with an institution that has problems and there needs to be supervisory action taken.

So we believe that looking at the way the FFIEC process is laid out, best we can figure it is going to take at least 6 months from filing the appeal to a resolution with a decision by the FFIEC ombudsman. And 6 months in a critically challenged bank, that is a really precious period of time in terms of getting problems resolved.

I would also say on the retaliation point, our examiners believe in the appeal process. They share the information with bankers. Everybody respects the appeal process. In addition, our ombudsman, once he renders a decision, 6 months after that decision is rendered, he contacts the bank personally to talk to them and ask whether they have experienced any retaliation.

And then he makes a second contact 6 months after the first examination activity after the appeal has been decided. So not only do we encourage the bank to come back to us if they have any concerns about retaliation, but he reaches out to them to specifically inquire whether they have any concerns in that area.

Chairwoman CAPITO. The gentleman's time has expired.

Mr. HINOJOSA. Thank you for your response.

Chairwoman CAPITO. Thank you.

Mr. Luetkemeyer for 5 minutes.

Mr. LUETKEMEYER. Thank you, Madam Chairwoman. As we go through this process, it is pretty obvious what is happening here. We had a situation 2 years ago where financial institutions had some problems and we as a Congress ran in there, threw some regulations out there, and thought we were going to solve the problem.

And now, the pendulum has swung the other way. Now, we have a situation where we are overregulating. We are stymieing the economic growth of our communities, and as a result, are running some of our banks out of business one way by being too loosely regulated, now they are being too closely regulated.

We have to find that balance in the middle. And to date, I have yet to hear any of you make that comment, that you recognize that the pendulum is over here on the far left, and it has to fall back to the middle. Do any of you recognize that, or you all think we need to still be way out here?

Raise your hand. Anybody believe we are—too much? Okay. That is why we have the hearing today, and that is why you see the bill in front of us. Because you guys are ready to keep coming down heavy-handedly on all the institutions that you make our small communities the places where people want to go and start their businesses. That is what is happening.

Here I have an example from a local bankers association in Missouri. Director Thomas Curry was given data that showed that one in four banks was being criticized for their HMDA procedures, which is what the rate is for the FDIC. But that is twice the rate of the OCC and the Fed.

Why, Ms. Thompson?

Ms. THOMPSON. Sir, respectfully, we have 4,400 institutions. We have probably 2 or 3 times as many banks. But I do understand that we have been in touch with your office to talk about the HMDA process, which is very important because it involves fair lending issues. And we certainly are open to any discussions you would want to have.

Mr. LUETKEMEYER. Okay. My question is, why is it twice as many of the FDIC exams show problems with HMDA than the other ones? There is none. It is inconsistency of examinations. It is an example right there.

You asked about the FDIC forcing banks to scrub their HMDA accounts. It is ridiculous. They come in and they brag about how many times that they are forcing banks to scrub their HMDA accounts, their book of business. That has to stop. Any response?

Ms. THOMPSON. Sir, we value the dual banking system. We firmly believe in the viability of community banks. The FDIC has established a community bank advisory committee where we hear from community bankers directly. And we are getting ready to launch a huge initiative on community banking.

Mr. LUETKEMEYER. Ms. Thompson, with all due respect, I have been here 3 years. I have a banking background, a regulatory background, so the bankers come to me all the time with their problems and concerns. And I bring them to you, all of you up there.

I have brought issue after issue after issue, and you have never listened to a single thing I have said. Not once have you responded to some of the individual items that we have talked to you about, never. So in 3 years, when we have a bill like this come before us, this is our response to you because you don't respond to us.

How many consumers, Ms. Thompson, do you think read the HMDA forms that are in front of them? Do you have any studies on that to see how many of them actually read those things?

Ms. THOMPSON. No, sir.

Mr. LUETKEMEYER. Don't you think that would be worthwhile?

Ms. THOMPSON. I will forward that to our head of the Division of Depositor and Consumer Protection.

Mr. LUETKEMEYER. Okay. Because it is not a safety and soundness issue, is it?

Ms. THOMPSON. Consumer protection and safety—

Mr. LUETKEMEYER. It is not a safety and soundness issue, is it?

Ms. THOMPSON. They are two sides of the same coin, sir.

Mr. LUETKEMEYER. Ms. Thompson, we have, I think, a lot of concerns with a lot of the banks with the way they are examining and enforcing. I have another situation—I have another minute to go—with regard to home builders. The FDIC and a number of banking regulators are forcing a lot of banks, once they hit 100 percent capital threshold with a particular line of credit—whether it is real estate or real estate development—once they hit that threshold, whether it is good loans or not, they are saying you can't loan anymore.

I have a quote for you right here from Ms. Sheila Bair. I am sure you remember who she is.

Ms. THOMPSON. Yes, sir.

Mr. LUETKEMEYER. Back on May 26th, in response to my question about how the collateral should affect the classification, said, "If the loan's performing, it's a good loan." Those are her words. So when you sit here and tell me—and we see over and over that we have situations where the capital is used as a threshold, rather than the quality of the loans, I think we have a huge problem.

Do you agree?

Ms. THOMPSON. Yes, sir. I agree. And I do think we are looking at that one component. But we also need to look at the borrower's ability to repay the loan as a part of that, as well.

Mr. LUETKEMEYER. Ms. Bair says if it is performing, it is a good loan. Therefore, they have the ability to repay, don't they?

Ms. THOMPSON. That is correct, sir.

Mr. LUETKEMEYER. Okay. And if they have the ability to repay, why do we have to have a threshold? If 100 percent of those loans are good loans, and they are paying, should we have a cap?

Ms. THOMPSON. We need to assess their ability to continue to pay, sir.

Mr. LUETKEMEYER. If they paid through this environment, don't you think they will continue to pay down the road?

Ms. THOMPSON. Yes, to the extent that their loan has not been restructured with a below-market interest rate.

Mr. LUETKEMEYER. Ma'am, I just said they are performing loans.

Ms. THOMPSON. Generally speaking, if it is a performing loan, we don't classify that loan.

Mr. LUETKEMEYER. I am not talking about classification. I am talking about putting caps on banks to be able to loan to certain groups of people, industry groups.

We are putting those artificial caps. There is nothing in the FDIC rules about it. That is an artificial cap that you are imposing, is it not? There is no cap on the FDIC rules about developments, is there.

Chairwoman CAPITO. The gentleman's time has expired. Yes, if the witness has a follow-up answer?

Mr. LUETKEMEYER. Thank you. Thank you, Madam Chairwoman.

Chairwoman CAPITO. Mrs. McCarthy for 5 minutes?

Mrs. MCCARTHY OF NEW YORK. Thank you. And thank you for calling this hearing so we can all, hopefully, figure out how we are going to, certainly, represent our small community banks, our credit unions.

Listening to all of you, and listening to the members of this committee, there seem to be some issues. But I am one of those—this morning, we had a hearing and we had two Governors here. One was a Republican, and one was a Democrat. And both of them were actually on the same page, where we all sit down together, work together and try to come up with solutions.

Because no one is, here, I don't believe on what you are trying to do—and I also don't believe anyone here on this committee is trying to make problems. We are actually trying to solve problems. And so, that means working together and I think that is important.

This particular piece of legislation requires that regulatory agencies develop and apply uniform definitions and recording requirements for non-performing loans. We understand that, mainly because we have just gone through some terrible times and we want to make sure that they are doing the right thing.

Ensuring that standards work for the smallest and the largest financial institutions, and allowing the flexibility to address the unique situations certainly of the smaller institutions, is important. You have your large institutions, you have your small institutions.

You have the same thing with our credit unions. Each one of them has different, unique issues.

And they do. We have seen that over the last couple of years. So do you feel that uniform standards for non-performing loans are achievable? Or is there an alternative way to bring consistency to the loan classification process?

One of the things that I heard from my colleagues, especially with the examiners—and it didn't seem to matter where across-the-board—are they getting enough training, really, on what to look for so they can be working with the banks instead of causing problems? And I will throw that up to everybody.

Mr. BERTSCH. We spend a lot of time training our examiners on how to classify loans. And it is something that takes a lot of time. It is something that we devote weeks of formal training to and a lot of on-the-job training, as well as providing specific guidance to the examiners on how to approach specific situations.

It is very hard to boil down the judgments that examiners need to make and the different circumstances that they encounter into a very short statement of guidance that says, this is how you are going to do it consistently. And I think when we look at the bill, where we think there could be some clarification is making sure that we recognize that there are nuances in terms of how loans are classified and how they need to be thought of from an accounting perspective.

One thing that I would commend to the attention of the subcommittee is the interagency guidance that was issued on prudent commercial real estate workouts. In that guidance, which was 33 pages, we went through very specific examples of how we would approach fact situations for loans. You can see from looking at those 33 pages that the same types of loan can have very many nuances in them.

So what we are concerned about when we talk about the difficulties in taking judgment away from examiners is that there are a myriad of situations that you can encounter. And bankers do the same thing. Bankers, I imagine, would tell you they go through the same process when they evaluate their loans. And that if you ask them to summarize their process in one sentence, they might tell you that is quite difficult to do.

So my point is, we train our examiners very hard. We teach them through in-the-field training. We provide very detailed guidance where we can, such as the prudent workout guidance. We provide extensive information in the CALL Report instructions on how to report and account for loans.

If an examiner needs to know the nuances of non-accrual designation, there are three pages of glossary items specific to non-accrual that address specific items that we have seen over the years. The point overall is that we do believe very strongly that there can be consistency and we do believe very strongly that there should be consistency.

We also recognize—because this is our business, we do it every day—that the circumstances we encounter and the loans that we encounter are very hard to boil down to simple statements or sentences. That is where we would like to work with the subcommittee to try to explain where those concerns come from, and perhaps explain a little bit more about how we train our examiners and how we ensure consistency.

Mrs. MCCARTHY OF NEW YORK. Just quickly, because my time is over already, unfortunately. If the rest of you could—it doesn't have to be a long—listen, this is a very technical bill. If you could send me your answers, I would appreciate it, so that we can certainly work with you and try and come to some conclusion on how we can work together so that you are doing your job. And certainly, our banks and credit unions can work together.

Thank you.

Chairwoman CAPITO. Thank you.

Mr. Canseco, 5 minutes?

Mr. CANSECO. Thank you, Madam Chairwoman.

Good afternoon, ladies and gentlemen of the panel. This is for all of you. On average, how long does it take each of your agencies to complete examinations and report the results back to the financial institutions?

Mr. Bertsch?

Mr. BERTSCH. For a community bank, it takes us an average of 75 days from the start of the exam to the finish. We have a 60-day guideline that we provide our reserve banks from the time of the exit meeting to provide the exam report to the institution. We try very hard to meet that deadline. We hit it in about 85 to 90 percent of the cases.

Mr. CANSECO. All right.

Ms. Thompson?

Ms. THOMPSON. For the FDIC, it is 45 days for risk management, start date to finish. And for compliance only, it is 90 days. Compliance and CRA, it is 120 days.

Mr. CANSECO. Mr. Marquis?

Mr. MARQUIS. All of our exams have to be done, start to finish, within 60 days. And that is mostly accomplished all of the time. Most of them get done in less than 30 days, including issuing the exam report to the credit union.

Mr. CANSECO. And Ms. Kelly?

Ms. JENNIFER KELLY. We try to have the exam report back within 60 days. But as I said in my testimony, there certainly are circumstances where it takes longer than that. And we are not going to rush to issue a report if there is further work that needs to be done.

Mr. CANSECO. So how often would you say your agencies received complaints from financial institutions about delays in the examination procedures? And again, we will start with Ms. Kelly.

Ms. JENNIFER KELLY. I couldn't give you an exact number. We do receive complaints. And in those cases, the appropriate managers follow up directly with the institution.

The other thing I would stress is that we encourage our examiners to have ongoing communication with the bank throughout the exam process so they clearly understand what our findings are, where we are in the process, and what the timeline looks like.

Mr. CANSECO. Mr. Marquis?

Mr. MARQUIS. I can't recall any. But some may have been issued to the regional director, who addressed those issues very quickly.

Mr. CANSECO. Thank you.

Ms. THOMPSON. We receive some complaints. And I don't have the numbers in front of me, but there usually are complex circumstances or an exchange of information in those circumstances.

Mr. BERTSCH. We are aware of complaints on that issue. I can't give you the exact number, but it is an issue that we look at as part of our oversight of the Federal Reserve Banks when they do the exams. We actually are planning this year to do a specific review looking at the processing of exams to respond to information that we are getting that there are some concerns about this.

Mr. CANSECO. And finally to the array, do you all agree that delaying examination reports can have an adverse effect on the industry? And do they cause greater uncertainty, especially for smaller institutions?

Mr. BERTSCH. The timing can be an issue in getting information back to institutions. However, it is very important, in some complex and problematic institutions, to take the time to get the message right and to get the message documented appropriately.

As the subcommittee has impressed upon us today, it is very important that we communicate very carefully and we support very carefully our conclusions. Therefore, there are some instances in which we think it is appropriate to go beyond those deadlines.

Ms. THOMPSON. I would agree with that. I think it is important to get the final report of examination for the record, for the financial condition of the bank, right. And I do think that there are extenuating circumstances where information needs to be exchanged, but I think it is critical to get that final ROE right.

Mr. MARQUIS. Same with us. Timely delivery of an exam report is very critical if you identify problems that need to be corrected. We even do a post-internal control review, as opposed to one before an exam is issued, so that exam report gets in the hands of officials very promptly.

Ms. JENNIFER KELLY. I would agree with the comments of the previous folks. And I would just add that we do have ongoing communication with the bank throughout the process. So it is not that they don't know what we are thinking and what we are working on. They are aware of any issues that we have identified. It is just making sure that the final product that is issued is fully supported.

Mr. CANSECO. Thank you very much.

And now, Ms. Kelly, in your testimony you stated that the OCC's ombudsman does an adequate enough job. So if this is the case, why do the witnesses on our second panel support the creation of an interagency ombudsman, in your opinion?

Ms. JENNIFER KELLY. I believe the—I read the ABA's testimony, Mr. Kelly's testimony. And he actually singled out the OCC ombudsman as saying it was different than the other agencies. So I can't really speak—I think it is better for them to speak to why they—

Mr. CANSECO. But I am just asking you if you have an opinion with regards to that.

Ms. JENNIFER KELLY. Why they are recommending—

Mr. CANSECO. Right, yes.

Ms. JENNIFER KELLY. Obviously, they believe there would be greater independence if it was an interagency process.

Mr. CANSECO. Ms. Thompson, much of the banking industry considers the OCC's interagency process to be the most effective. They attribute this to the fact that the OCC's ombudsman is independent of the supervisory authority. So how does this differ from the FDIC's interagency review process?

Ms. THOMPSON. Our supervisory appeals review committee is established by our Board of Directors. The FDIC, again, is run by a Board and the Board established this committee that is empowered to overturn supervisory decisions.

They are independent and composed of individuals from the highest level. A member of our Board sits on this committee, and no one from the supervision process participates on the committee at all. So the highest level of our agencies can overturn supervisory—

Mr. CANSECO. My time is up, but if I may just follow up here. So what you are saying is that your ombudsman is also independent?

Ms. THOMPSON. Our ombudsman is a mediator between the bank and our agency. The Supervisory Appeals Committee is a committee that is established by—

Mr. CANSECO. I understand that.

Ms. THOMPSON. —the FDIC Board of Directors.

Mr. CANSECO. I understand that. So you are saying that it doesn't differ from the OCC's ombudsman facility?

Ms. THOMPSON. The OCC has a single person. The ombudsman can overturn supervisory appeals with the concurrence of the Comptroller, I believe. And our supervisory appeals committee can overturn supervisory decisions, as well.

Mr. CANSECO. Thank you very much. My time is way up, and I apologize for that.

Thank you.

Chairwoman CAPITO. Thank you.

Mr. Scott, for 5 minutes.

Mr. SCOTT. Thank you, Madam Chairwoman.

I would like to address my questioning on two points as a result of listening to this discussion. One, of course, is the inconsistency that I brought up between what the policies are, we are trying to do here in Washington, and the banks feel that that these examiners on the ground are walking in another direction.

And I would like to get, first of all, your opinions on that. Is that true, Ms. Thompson?

Ms. THOMPSON. We have heard this, and in direct response to this, I know last year we did issue a Financial Institution Letter that we sent to all FDIC-supervised institutions explaining what our appeals process was, and explaining the ombudsman's role. We meet with bankers regularly. Our Regional Directors meet with them and we meet with our field staff regularly because this is of concern to us. We—

Mr. SCOTT. So you have been getting those same complaints?

Ms. THOMPSON. That is correct.

Mr. SCOTT. Okay. Is that true across-the-board for the rest of your regulators?

Ms. JENNIFER KELLY. I would say we hear those general comments. But, obviously, our response to that is, please come to us with specific examples so that we can look into it and figure out where the disconnect occurred. And that is one value of our appeals process; it is an opportunity for the bank to come to us when they feel something is happening locally that isn't consistent.

Mr. SCOTT. And so now we are addressing that in Section 1013 in the bill, and you all are pretty happy with that? Are we moving in the right direction with what we are doing there? You have no problems with Section 1013? I gather that you don't, then. That is very good.

Now, let me ask you about the other issue. And that is this issue that we are trying to resolve in Section 1015, which is this appeals process. And this issue of retaliation, is that a fact? How many complaints do you get on that? And is this a very, very real issue? And what do our bankers, when they come to us and tell us that they fear retaliation—what are you doing to them that gets them into that angst? How are you retaliating against them? And for what?

Ms. JENNIFER KELLY. Speaking for the OCC, I don't believe we are retaliating against them. And as I indicated before, we have processes in place to make sure that bankers have a venue that they can come back to us and indicate if they feel they have been retaliated against. But unless they come and talk to us—

Mr. SCOTT. But, you see, unless we can get to the truth of this retaliation, we really are not putting enough water on the fire. So would you all agree that there is a culture of retaliation, that this is not a figment of these bankers' imaginations? That maybe there is? Because if you all don't say there is, then we can't even get to the solution to the problem.

If they say there is retaliation and there are fearful of it, you have only had 11—let us see, you have had 11 formal appeals in 2010 at the OCC, and other agencies among you had low numbers, as well. Is that indicative of the fact you have so low numbers that the reason why they are so low is that these bankers are afraid of retaliation? I would like to really get on the record, do we have retaliation going on or don't we?

Mr. BERTSCH. We do not tolerate retaliation from our examiners, and we have a process whereby our ombudsman would be in contact with the bankers who file appeals. Or if they want to discuss something confidentially, they can.

Mr. SCOTT. So you are saying that you direct them not to retaliate. My question is, is there retaliation? Not that you all retaliate, but I am simply asking is there evidence that there has been retaliation?

Mr. BERTSCH. I am not aware of a specific—

Mr. SCOTT. Are there none?

Mr. BERTSCH. —retaliation that would cause bankers to fear bringing issues to the attention of the regulators. I do want to point out that a lot of these follow-ups are handled confidentially. They are handled in a separate unit from the supervision function at the Federal Reserve. And the ombudsman has the power to follow up on any concerns of retaliation and bring that directly to a committee of the Federal Reserve Board of Governors for resolution.

I imagine my colleagues have similar setups in their agencies. We hear what you are hearing, that bankers say they are concerned about retaliation. We have safeguards in place to make sure that retaliation doesn't happen. And I think one observation I would make, and that I think my colleagues have been making all day, is that the examination process, in and of itself, is a constant process of comparing what we think our findings are with what the banker's view is and coming to a consensus view on what those issues are.

A lot of these processes are differences of opinion or differences of view. By the nature of the examination process, they are aired during the examination process and then can get aired at several points along the way in exit meetings or through the issuance of reports which may get discussed with the district management, or with us.

So there is a lot of opportunity to resolve differences before a bank goes to the formal appeals process. We believe that what works most effectively is to handle differences in an informal process. It is more timely. It can be more efficient to get to the issue.

And quite honestly, I have worked with examiners for 20 years. They are very concerned about getting things right, about making sure they support their findings, and about doing the right thing. They are very attentive to their—

Chairwoman CAPITO. The gentleman's time has expired.

Mr. BERTSCH. —responsibilities.

Chairwoman CAPITO. Thank you.

Mr. Pearce?

Mr. PEARCE. Thank you, Madam Chairwoman.

Ms. Thompson, if I understood your answer to Mr. Luetkemeyer, that retaliation is prohibited in the FDIC internal regulation, is that correct?

Ms. THOMPSON. Yes, sir. It is.

Mr. PEARCE. Does that mean that you believe that it is not occurring, then? It is against the rules.

Ms. THOMPSON. I believe that our examiners are highly dedicated and very professional. I believe that differences can and have been worked out, not always to everyone's satisfaction.

Mr. PEARCE. And you just don't believe people would break the rule?

Ms. THOMPSON. I would ask that those instances be brought to my attention, and I would handle those—

Mr. PEARCE. Did you know that there are 185 people in your department who don't pay their taxes—$3,155,313, 185 people? That doesn't give me a great deal of reassurance that the FDIC is sitting out there following all its internal rules, when they are not following the basics of paying taxes, which is part of the 99 percent's responsibility, I guess.

And maybe you understand the suspicion with which we regard the reassurances that our constituents are not being nailed up on a wall when we see documents like that. The Federal Reserve Board, by the way, is only 91 people, and $1.2 million, don't pay their taxes in your department.

Ms. Kelly, you had mentioned on page 13 that you are concerned about Section 1013(a)-1. And when I look at the bill, that section is about commercial loans shall not be placed in non-accrual status solely because the collateral for such loan has deteriorated in value. And you are concerned about that provision. Does that mean that occasionally collateral writedowns occur?

Ms. JENNIFER KELLY. I am sorry, could you—you are asking me do writedowns on the loan—

Mr. PEARCE. Do collateral writedowns occur?

Ms. JENNIFER KELLY. The loan balance being written down, or the—

Mr. PEARCE. No, not the loan balance. Are loans classified because of the collateral value?

Ms. JENNIFER KELLY. Yes.

Mr. PEARCE. Yes.

Ms. JENNIFER KELLY. If it is a collateral—

Mr. PEARCE. Ms. Thompson, does that occur at the FDIC?

Ms. THOMPSON. Yes.

Mr. PEARCE. Yes. Yes? Could you state that more clearly? Yes?

Ms. THOMPSON. A loan will not be put into non-accrual just because of the deterioration of the collateral value. I think that if there is a deterioration in the collateral value, that deterioration is written off as a loss.

Mr. PEARCE. It could cause a classification?

Ms. THOMPSON. And the rest is a substandard loan, the remaining loan.

Mr. PEARCE. And substandard would be described how?

Ms. THOMPSON. A classified loan.

Mr. PEARCE. Substandard. What if a loan has never missed a payment? Would that be substandard?

Ms. THOMPSON. That would be performing, and it wouldn't be—

Mr. PEARCE. It is a performing loan, and you are saying that those loans would not be written down?

Ms. THOMPSON. Generally speaking, performing loans—

Mr. PEARCE. Just based on collateral?

Ms. THOMPSON. Generally speaking, yes.

Mr. PEARCE. Generally speaking, yes, they would be? Or yes, they would not be?

Ms. THOMPSON. Generally speaking, a performing—

Mr. PEARCE. Ms. Kelly has said that occasionally it will occur because the asset basis underneath, the collateral basis underneath, is being written down.

Ms. THOMPSON. Sir, if it is a collateral-dependent loan, if the borrower has no ability to repay and the bank—

Mr. PEARCE. Okay. Because in New Mexico, I had a meeting with Indian-American hotel owners who came from Colorado, Texas, Arizona, and New Mexico who had never missed one payment, a whole group of them, who are being asked to provide more cash because the collateral was now being valued at less.

Because, nationwide, hotels were not performing, so as a category they were just simply written down. And you are telling me that does or does not occur?

Ms. THOMPSON. Generally speaking, it should not occur.

Mr. PEARCE. It should not occur.

Ms. THOMPSON. Correct.

Mr. PEARCE. And yet, it does occur. You have just heard Ms. Kelly say that it does occur. So you all have an internal rule that is different than the OCC? Is that right?

Ms. THOMPSON. No we don't, sir. If a loan—

Mr. PEARCE. Because I am seeing it happen, and you are hearing other people up here talk about it happening and you want us to just go away from this hearing that it doesn't happen?

Ms. THOMPSON. Sir, every loan has facts and circumstances that are different. And to the extent that you have a loan and the collateral has depreciated, and there is no ability of the borrower to repay the loan other than the collateral, you classify the deficiency as a loss and the remaining loan is classified as substandard.

Mr. PEARCE. But these loans had never missed a payment.

Ms. THOMPSON. Generally speaking, a performing loan is not classified. But we do have to look at the ability of the borrower to repay the loan.

Mr. PEARCE. If the collateral goes down and you are suspicious that it might not—Mr. French and I had a very engaging conversation, energized conversation, about this very matter is the reason I am trying to get it clear. Because your testimony still widely diverges from what our constituents tell us.

Someday, I might invite you to New Mexico to come sit in on some of these meetings with boards, these stabilizing community banks and thrifts, that I see in Ms. Kelly's testimony. Because we are not seeing that stabilizing occurring that you are talking about.

I yield back.

Chairwoman CAPITO. Thank you.

Mr. Lynch?

Mr. LYNCH. Thank you, Madam Chairwoman. Let me begin by thanking each of you. I think you have done an excellent job in explaining why you insist upon the policies that you do. And let me also thank you for protecting the American taxpayer. That is a lot of what this is about, to make sure that the deposits guaranteed by the FDIC and supported by the good faith in creditor of the American tax payer are not put in jeopardy.

I also want to thank you for your restraint when the gentleman from Georgia asked you whether you thought Congress could mess this up worse than the regulators. Much appreciated. There has been talk here about a pendulum and regulatory enforcement. And look, I am just like everybody else. I get some complaints from my constituents about the way they are being treated.

But I have to admit—I came into Congress in 2001, and I received very few complaints until about late 2007, 2008, when real estate values, commercial and residential, plummeted. And so, the underlying value in some of these projects went in the toilet, so to speak. And so the regulators, in trying to assess the creditworthiness of those borrowers, did a reassessment.

It wasn't the pendulum of enforcement that changed; it was the value of the real estate. Some parts of my district in New England and across the country dropped 35 percent, 45 percent, 55 percent. And so, there was a whole new analysis that had to be done on these commercial loans. So I don't think that the regulatory environment changed. I think that the world around us changed.

And let me say also that in terms of the appeal process, this bill creates a huge new bureaucracy. I know that the bill, in part, creates what they call a new ombudsman. Now I have practiced a fair bit of administrative law in my prior practice, and an ombudsman is someone who is a mediator. They are not allowed to create new law. They are not allowed to enforce the law.

Their decisions are not final and non-reviewable. In this case, under this bill, it should be the supreme examiner, not the ombudsman. Because this ombudsman can set aside—first of all, has a de novo hearing. It receives all the evidence that the court below did. It makes a new decision. It can set aside the agency decisions completely.

And then their decision is final. The ombudsman's decision is final and unreviewable. That is unbelievable. So at least the Supreme Court of the United States, on occasion, remands back for more details. In this case, the ombudsman gets to make the final decision and basically upends all the agency work before him.

We could just get rid of all the agencies and just have this one ombudsman make all the decisions. And by the way, this bill has no resources, no new resources. You are cutting—the Republican budget is cutting the resources for all these agencies. So I don't know where this new ombudsman and this new bureaucracy is going to get the money to do its work. That concerns me greatly.

And I guess I don't have a—I think you have suffered enough with questions today, so I won't ask you a new one. I just want to thank you for your work. I think you are right on. I think, look, you could do your job better, like we all can.

And I am sure there are those cases where our regulators are having a bad day and they overreach, but nowhere near the amount of overreach that is being exhibited here in this bill. So I want to thank you for your patience today. I want to thank you for your good work on behalf of the American taxpayer.

And I yield back the balance of my time.

Chairwoman CAPITO. Thank you.

Mr. Huizenga?

Mr. HUIZENGA. Thank you, Madam Chairwoman. And I, too, know you have been sitting here for a long, long time and I want to move on to this next panel, as well. I am somewhat pleased to hear the outrage from my colleague across the aisle at centralized power in bureaucracies.

I am wondering if we can maybe direct a little of that towards the sort of appointed head of the CFPB and the centralized power that we have put in place there. But that is for another discussions. And I have been stepping in and out; I had a couple of phone calls and other things. I just want to make sure that I understand. Do any one of the four of you support this bill?

Ms. JENNIFER KELLY. No.

Mr. HUIZENGA. No? Okay.

Mr. Marquis? Ms. Thompson? I am assuming your silence means "no."

Mr. MARQUIS. Not in its current form, because it has some very unique unintended consequences that could play out.

Mr. HUIZENGA. Do you concur, both of you? So as we are looking at summaries of this and what sort of the points are, headings such as timely examination reports, you all believe that all of your reports are timely? Yes, I am seeing heads nod?

Mr. BERTSCH.We think they are timely. But as the gentleman just pointed out, we can always keep working on doing our job better.

Mr. HUIZENGA. Okay.

Mr. BERTSCH. —so we can—opportunities.

Mr. HUIZENGA. Okay. And that there are clear exam standards? You all believe that there are clear exam standards, that they are all consistent? Yes?

Ms. JENNIFER KELLY. Yes, I believe there are. But there is a lot of judgment involved in bank examination. It is something the agencies work together to continue to make sure they are as clear as possible.

Mr. HUIZENGA. I think that is what my friend from New Mexico was trying to point out because I hear very similar stories like that. So therefore, there really is not a need to establish an office of an examination ombudsman or to expedite those appeals? You all believe that that is unnecessary?

Ms. JENNIFER KELLY. Yes, OCC does.

Mr. HUIZENGA. Okay. I appreciate your candor. Those don't sound like huge problems to me, short of maybe the ombudsman creation. But I am looking at this and I think, as Mr. Luetkemeyer was saying, there is a sense of frustration oftentimes that what we are hearing from our constituents and try to express is not responded to. And I can tell you, owning a small sand and gravel pit where I have to deal with mine safety and health, MSHA, I talk to other smaller operators who have significant issues.

My inspector is always great. Just ask me. Unless you really want my opinion. There is that exact same sense, and I am seeing some of our friends who are regulated sort of making that exact same face that I would have. They will tell you until the cows come home that everything is fine. They will then tell us that things are not fine, because they are very much afraid of what is going to happen, rules or no rules, of retaliation.

Human nature dictates that there are going to be times—if they are raising a ruckus about the work that someone has done, one of your examiners has done—there, in all likelihood, is going to be a problem for them on the back end. And whether it is those writedown rules—now, I am coming from Michigan, and we have had a decade of challenges—and I am coming out of the construction industry in Michigan, real estate background, construction background.

It is a very difficult environment. And I have my banks, and especially those smaller community banks, saying, "Hey, Huizengas, we know that you are good for it. We have been doing business with you for 60, 70 years as a family. But guess what? Our examiner doesn't want us to have a brand new loader on our books because construction isn't going well in Michigan."

I am betting that you are not laying that out as a prescriptive. That is the judgment part you were talking about, I am assuming. And I guess what the frustration is, and why I believe that why you are seeing it in this particular legislation, is that people are not feeling hurt. They are looking for openness and genuineness, and they don't feel like they are getting that.

So my time is going to be up. I don't know if anybody has a quick response before my time is up, but I want to make sure that we are able to get to this panel. So thank you. And thank you for, hopefully, hearing what we are saying up here.

Chairwoman CAPITO. Thank you.

Mr. Carney for 5 minutes?

Mr. CARNEY. Thank you, Madam Chairwoman.

I yield to my friend from Massachusetts for 1 second.

Mr. LYNCH. I thank the gentleman. Madam Chairwoman, I have here a report by the Americans for Financial Reform, and I would ask that through unanimous consent, it be entered into the record.

Chairwoman CAPITO. Without objection, it is so ordered.

Mr. LYNCH. Thank you.

Mr. CARNEY. Thank you, Mr. Lynch. And thank you to the chairwoman and the ranking member for having this hearing today, and for putting forth and sponsoring this legislation, which I frankly think is a fairly common-sense approach by the Members on both sides of the aisle here in this committee to address frankly the concerns that we have heard from our constituents.

And I am glad that Mr. Huizenga took us through section by section of the bill. Because as I look at it, it is pretty straightforward, pretty simple. And it doesn't, in my view, violate the accounting standards or other things that, frankly, some of the other legislation that has been brought to us by banking institutions, by other interest groups, to address really what is a very difficult problem. And that is the disconnect between the regulators, the agencies at your level and the field examiners.

We had a very interesting and long conversation with Sheila Bair, the former Chairman of the FDIC, when she was here a few months ago. And again, she heard from us, Democrats and Republicans, the same thing. Basically, we were talking about situations, specific situations, that we have been hearing from the institutions in our districts, and it reflected what you heard today.

So we came up with this piece of legislation, which does really pretty simple things that—reports in Section 2, examination standards. I would like to come back to that, the ombudsman and the appeal process. As I heard all of you, you said you didn't like the ombudsman because you had it, and you didn't like the appeal process because you have that, and there is no responsibility that goes with that.

And I understand that and appreciate that concern. So to me, the big issue, I think, is the examination standards; which, as I said, are not at all like some of the things that have been brought to us in pieces of legislation. In fact they are your standards, are they not?

And I heard you say judgment and flexibility. But why is it unacceptable for us to put these standards in here, in the way that it has, to try to bridge the gap that we are hearing from people at your level and from the field examiners and the people that they examine.

So why don't we start on this end. Ms. Kelly?

Ms. JENNIFER KELLY. I will start with that. You are correct that, to a certain extent, there is an alignment with our standards. I have referred before to the call report instructions, but there are many more aspects that have to be considered in terms of the decision about whether to put a loan on non-accrual or leave it in accruing basis.

And that—

Mr. CARNEY. So is it your view that this would not allow you to do that, this legislation?

Ms. JENNIFER KELLY. This ties it to whether payments are being made.

Mr. CARNEY. Right.

Ms. JENNIFER KELLY. And as I discussed earlier, there is also the issue of collectability and whether it is reasonable to believe that full principal and interest is going to be collected.

Mr. CARNEY. I would like to skip over you for a second because you are limited in terms of the commercial lending you can do.

Ms. THOMPSON. Can I use an example concerning prohibiting regulators from requiring more capital for institutions that are well-capitalized? To the extent an institution has a risky, troubled loan portfolio, the proposed bill would prohibit us from requiring additional capital if the institution was well-capitalized.

To the extent that the institution was to enter into, let us say, a risky business line, and the bill would not allow us to require additional capital. It would really limit us using our judgment and prior experiences to make sure that the institution was conducting its activities in a safe and sound manner and that they had sufficient capital to cover any losses.

Mr. CARNEY. Right. So thinking through that, it is a question of additional judgment, I guess, or judgment that would take in other factors. Is there a way that we could address that and maybe cure some aspects of this legislation? There are certain things that you are not going to, I guess, like, which is the independence of the ombudsman in Section 4 and the appeal process in Section 5. And I can understand that.

But I really wanted to hone in on the examination standards. I know my friend, Mr. Renacci, wouldn't want to change accounting standards, as a practicing accountant himself. And we have attempted to try not to do that kind of thing. Is there a way that we can cure this?

Ms. THOMPSON. We are happy to work with the committee on anything that would improve the examination process. But again, we really want to make sure that the flexibility that the examiners have is preserved in terms of dealing with the individual facts and circumstances surrounding institutions and loans. There are 7,000 institutions in this country. Every one of them is different. Every loan is different.

Mr. CARNEY. My time has run out. Thank you for your willingness to do that. And I hope you understand the tension that we are feeling from those in our banking institutions that we represent, and the disconnect between the field examiners and the advice that you have given.

Thank you, Madam Chairwoman.

Chairwoman CAPITO. Mr. Manzullo is recognized for 5 minutes.

Mr. MANZULLO. Thank you. How many on this panel are going to stick around to hear the next panel? Would you do that? I know you are busy. It is important because the victims are behind you, and they should have an opportunity to speak and have you listen to them.

But I want to share with you where, in the testimony by Mr. Marquis, there is I think one of the most outrageous and arrogant statements I have seen in my entire life before this committee. Go to page 9, please, and I am going to read it for you. "H.R. 3461 would greatly raise NCUA's administrative costs."

It talks about how "the legislators' expansion of the existing definition of material supervisory determination would make virtually all examiner findings, recommendations, and action plans subject to formal appeal." Listen to this, what you said: "In response, NCUA examiners would need to document each and every finding with specific references to NCUA rules and regulations."

You tell me what is wrong with that. The Sixth Amendment, sir, requires—says that "an accused shall be informed of the nature and cause of the accusation." Anybody who is charged by your organization has an absolute obligation to tell the bank or credit union exactly, according to the rules and regulations, what they have done wrong.

Why did you put that in your testimony?

Mr. MARQUIS. Yes, sir. We do reference all of our rules and regulations for violations and safety and soundness issues where there are statutory violations. There are a lot of issues that we issue through guidance or examination procedures that deal with internal or operational risk of a credit union. All of the operational risk issues of a credit union are not documented in a regulation.

Mr. MANZULLO. Then, they should be. Because you are saying they are doing something wrong. Then why shouldn't you cite chapter and verse as to exactly why they are doing it wrong? Is that asking for too much?

Mr. MARQUIS. But if we had a rule and regulation for every operational issue we encounter under safety and soundness, we would have an awful lot of regulations.

Mr. MANZULLO. Now you know what the banks feel and the savings & loans. Let me just read to you some of the testimony, which I hope you stick around and listen to. Ken Watts, on CUNA, he says, "Twenty-seven percent of the respondents reported dissatisfaction with the recent exam because the examiners would offer their best practices rather than legal and regulatory requirements."

Eugene Ludwig of Promontory says, "Regulations grow like barnacles on a ship." No one knows what is going on. The examiners can't tell them what they are doing wrong. They ask for something in writing, nobody quotes chapter and verse on it.

Take a look at the ABA, Albert Kelly: "To ensure a fair hearing, the ALJ's decision is based upon an independent review of the agency's action and by the relevant statutes, regulations and appropriate guidance."

If you look at the testimony coming up of NAFCU, she says that "notwithstanding changes of regulations, the standards by which a credit union is evaluated, examinations should not change from exam to exam." The big problem here is the fact that they don't know what to do.

If somebody does something wrong, you have an obligation, sir, in writing, to let them know exactly what they are doing wrong. And you are not doing that, and that is what the bill says. If they are doing something wrong, then you tell us which regulation and which law they are violating. Is that asking for too much?

Mr. MARQUIS. We do discuss with them what the elements of risk are.

Mr. MANZULLO. No. Would you answer my question, please?

Mr. MARQUIS. Do we tell them what regulation they are violating? We don't have—

Mr. MANZULLO. Yes.

Mr. MARQUIS. We do not have a regulation for every operational risk issue in a financial—

Mr. MANZULLO. Then that becomes the independent judgment of the regulators that floats from regulator to regulator? You don't have any standards?

Mr. MARQUIS. We do have exam standards, sir.

Mr. MANZULLO. Those might be exam standards. But you are complaining because NCUA examiners would need to document each and every finding with specific references to NCUA rules and regulations. Is that asking for too much? Yes or no?

Mr. MARQUIS. Yes, it is, when we talk about regulations that pertain to operational risk issues that are not actually contained in a regulation, per se. And they are generally done under the judgment of the risk—

Mr. MANZULLO. Under the judgment of the risk.

Mr. MARQUIS. —on a balance sheet that is—

Mr. MANZULLO. On a balance sheet.

Mr. MARQUIS. —very different based on management's capabilities, and the size and scope of the institution.

Mr. MANZULLO. But that would be—then it would violate a rule and regulation. Isn't that correct?

Mr. MARQUIS. Not necessarily.

Mr. MANZULLO. Oh.

Mr. MARQUIS. We don't have a regulation that says that you want to write loans in a concentrated level, all to substandard borrowers. That is a—

Mr. MANZULLO. No, I can—

Mr. MARQUIS. —a concentration risk that exists that becomes a problem.

Mr. MANZULLO. I can understand. But the purpose of legislation is so these people know why they are being written up. I had a ridiculous situation occur with a community bank, a partnership. Two brothers, 30 years at the same bank, were denied a line of credit. You know why? The regulator said, you didn't have any surplus left in your Sub-S corporation. It had all been spun out to the brothers.

That is the type of stuff we hear over and over again. But I would challenge you. This is why they are upset. And I would also ask you to stay here and listen to the people who are going to testify. Are you willing to do that, the four of you? Is anybody here wiling to listen to them?

Ms. Thompson?

Ms. THOMPSON. Yes, I will.

Mr. MANZULLO. Mr. Bertsch?

Mr. Marquis?

Mr. MARQUIS. Sure.

Mr. MANZULLO. Ms. Kelly? All right. So let the record show that the panel, the first panel, will be present for the entire testimony of the second panel. Thank you.

Chairwoman CAPITO. Should I take attendance?

Mr. MANZULLO. Yes.

[laughter]

Chairwoman CAPITO. Thank you. I want to thank the witnesses. It has been lengthy. And I appreciate your willingness to hang in with us and answer what I think are very important questions.

So I am going to dismiss the first panel and ask the second panel to come up. And I will be back in a few minutes.

[Recess.]

Chairwoman CAPITO. Back to order please. I would now like to welcome the second panel. I would like to introduce them individually for the purpose of making a 5-minute opening statement. Our first witness is Mr. Albert C. Kelly, Jr., chairman and CEO, SpiritBank, on behalf of the American Bankers Association.

Welcome.

STATEMENT OF ALBERT C. KELLY, JR., CHAIRMAN AND CEO, SPIRITBANK, AND CHAIRMAN, THE AMERICAN BANKERS ASSOCIATION (ABA)

Mr. ALBERT KELLY. Thank you very much, Chairwoman Capito, and Ranking Member Maloney. My name is Albert Kelly, and I am president and CEO of SpiritBank in Bristow, Oklahoma, and this year's chairman of the American Bankers Association.

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

The banking industry and bank regulators share the same goal, to have a strong 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 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.

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

H.R. 3461 takes a major step toward a more balanced approach. It is rooted in the fundamental principles of accountability, transparency, and quality assurance regarding how and on what basis decisions are made by the regulatory agencies in the examination process. Let me touch on a few of the many key provisions in this important bill.

One way to foster fair exams is to ensure there is a meaningful avenue to appeal exam findings when a bank disagrees with its examiner. H.R. 3461 addresses this by establishing an independent ombudsman's office as part of the FFIEC, which is made up of the bank agency heads.

The FFIEC's congressional mandate is to provide for the uniform application of interagency examination standards. We believe that a timely and independent appeal process, which includes the opportunity to have a hearing before an administrative law judge, will hold the banking agencies accountable to this mandate.

The bill does not change any agency's existing appeals process. Instead, it adds an alternative route for banks to deal with an independent entity set up to address exam issues quickly, fairly, and consistent with interagency standards. It is the opportunity to take an appeal, not the frequency of appeals, that makes the process an effective check and balance.

ABA is confident that the vast majority of supervisory matters would continue to be resolved without resorting to a formal process, as is the case today. H.R. 3461 also helps improve consistency in the application of interagency guidelines. Over the last several years, it was not uncommon to hear about inconsistent and unnecessary requirements by examiners.

For example, banks have reported that examiners have required them to treat many performing commercial loans, where the borrower is making payments as promised, as non-accruals solely because of decline in collateral value. Such a treatment is not consistent with regulatory guidance or the definition of a non-accrual.

We all want fair treatment of what is truly a troubled loan. However, the problem is bigger than the question of non-accruals. There are many related issues. How loans are classified as problem loans for regulatory purposes, how those loans are required to be valued, including those loans subject to modification characterized as troubled debt restructurings, how capital is calculated as a result of these classifications, these are all major issues.

The consequences are broadly felt. Even profitable community banks with capital ratios at or above those of their peers, and above regulatory guidelines, are being told their capital is inadequate and to increase it. This inevitably impacts banks' ability to meet the credit needs of their communities.

In conclusion, community bankers like me work every day to serve the needs of our customers and your constituents. H.R. 3461 would make an enormous difference in banks' ability to meet the needs of all of our communities. We strongly support the legislation and urge its enactment.

I am happy to answer any questions. Thank you.

[The prepared statement of Mr. Kelly can be found on page 75 of the appendix.]

Chairwoman CAPITO. Thank you. Our next witness is from my native West Virginia, and he does a great job of representing the West Virginia Credit League. So I would like to welcome Mr. Kenneth Watts, president and CEO, West Virginia Credit Union League, on behalf of the Credit Union National Association.

Welcome, Ken.

STATEMENT OF KENNETH WATTS, PRESIDENT AND CEO, WEST VIRGINIA CREDIT UNION LEAGUE, ON BEHALF OF THE CREDIT UNION NATIONAL ASSOCIATION (CUNA)

Mr. WATTS. Thank you. Chairwoman Capito, Ranking Member Maloney, and members of the subcommittee, thank you very much for the opportunity to testify in support of H.R. 3461.

On the whole, the exam process appears to work fairly well for many credit unions. However, steps must be taken to address real problems that some credit unions have with examinations. CUNA has been raising these concerns with NCUA for years.

Attached to our testimony are principles that CUNA developed over a year ago which address real problems that credit unions have had with their examiners. This demonstrates there is a disconnect between NCUA board policies and examiner practices. While no piece of legislation is perfect, H.R. 3461 is a firm step in connecting board policies to examiner practices.

The bill would grant credit unions access to the information used in the examination decisions. It would codify certain examination policy guidance. It would establish an ombudsman at the Federal Financial Institutions Examination Council to which financial institutions could raise concerns regarding their examination. And finally, the legislation would establish an appeals process before an independent administrative law judge.

We are particularly pleased with the proposed Office of Examination Ombudsman, as well as the independent examination appeals process. These two steps could go a long way toward improving dispute resolution and alleviating some, but not all, of the concern regarding retaliation and prospects for success in the appeals process.

While we are very supportive of this legislation, we have several recommendations designed to strengthen it. First, the legislation proposes deadlines for exit interviews in examination reports. Currently, NCUA generally meets or exceeds these deadlines. We hope the subcommittee will modify the bill to ensure that these deadlines do not become standard practice for regulators with a history of completing exit interviews and exam reports in less time than proposed.

Next, the legislation will make available, upon the request of the credit union, information relied upon by examiners when making material supervisory determinations. In our view, this is information that credit unions should not have to ask for. It should be available to them as a matter of course. We encourage the subcommittee to remove the requirement that a credit union must ask for this information.

With respect to the provisions for examination standards in Section 3, we encourage Congress to carefully consider potential unintended consequences resulting from the prescriptive nature of this language. In this regard, the provision requiring the regulators to develop and apply identical definitions and reporting requirements for non-accrual loans concerns us.

We believe this language should be modified to allow NCUA to take into consideration the unique structural characteristics of credit unions. While we are very supportive of the creation of the examination ombudsman at the FFIEC, we have recommendations in this area as well. As currently envisioned, the examination ombudsman would receive complaints or concerns from financial institutions.

To enhance the effectiveness of this office, we suggest it design and implement a voluntary survey to be completed by a financial institution at the conclusion of the examination process. Further, this office should routinely ensure that no retaliatory actions have been taken against an institution. As part of this function, the ombudsman should also reach out to institutions it has not heard from to ensure they are being treated fairly.

Section 4 of the bill directs the ombudsman to review examination procedures to ensure that policies are being followed and adhere to the standards for consistency established by the FFIEC. We suggest the language be modified to take into consideration the unique structural characteristics of credit unions, as well as the level of risk represented by an institution's operations, size, and other relevant factors.

Finally, whenever the regulatory or compliance burden changes, the cost of implementation is borne by the regulated entities. Recent history suggests that these costs for credit unions go only in one direction—up. Given the circumstances that have prompted Congress to consider legislation of this nature, few credit unions would view it as a net positive if the benefits of the legislation were accompanied by increased costs to credit unions.

We encourage the subcommittee to add language directing the regulators to identify the additional costs associated with implementing this legislation and reduce expenses elsewhere. Over the last several years, NCUA has significantly increased its budget. With the financial crisis behind us, the improvements sought by this legislation could be paid for through reductions in expenses at the agency.

Chairwoman Capito and Ranking Member Maloney, credit unions face a real crisis of creeping complexity with respect to regulatory burden. It is made all the more challenging by examination practices. H.R. 3461 would help make the exam process fairer and more consistent. We appreciate your leadership in sponsoring this legislation.

We look forward to working with you as the bill moves through the legislative process, and I would be happy to answer any questions the subcommittee may have.

[The prepared statement of Mr. Watts can be found on page 147 of the appendix.]

Chairwoman CAPITO. Thank you. Our next witness is Mr. Noah Wilcox, president and CEO, Grand Rapids State Bank, on behalf of the Independent Community Bankers of America.

Welcome, Mr. Wilcox.

STATEMENT OF NOAH WILCOX, PRESIDENT AND CEO, GRAND RAPIDS STATE BANK, ON BEHALF OF THE INDEPENDENT COMMUNITY BANKERS OF AMERICA (ICBA)

Mr. WILCOX. Thank you, Chairwoman Capito, Ranking Member Maloney, and members of the subcommittee. As you said, my name is Noah Wilcox. I am president and CEO of Grand Rapids State Bank in Minnesota, and also a member of ICBA's executive committee. I am pleased to represent community banks and ICBA's nearly 5,000 members at this important hearing today.

The Financial Institutions Examination Fairness and Reform Act, H.R. 3461, will go a long way toward improving the oppressive examination environment by creating a workable appeals process and consistent common-sense standards for classifying loans, among other provisions. ICBA is pleased to support H.R. 3461.

Invariably, those who have filed an appeal have described a process that is arbitrary and frustrating. Appeals panels routinely lack the independence and market expertise necessary to reach an informed, fair, and unbiased decision. A fair and effective appeals process would provide relief from an exam environment that is discouraging lending at the very time that bank credit is needed to sustain the economic recovery.

Specific concerns include write-downs of performing loans based on collateral value regardless of the cash flow of the borrower, second-guessing of appraisals, changing an unpredictable interpretation of existing laws, and moving the capital goalposts beyond what is required by regulation.

While all banks accept the need for balanced regulatory oversight, the pendulum has swung too far in the direction of overregulation. Good loan opportunities are passed over for fear of examiner write-down or criticism and the resulting loss of income and capital. The appeals process, which might offer relief, is instead an additional source of frustration.

A typical community banker can expect to spend a year or more in appeals, and incur as much as $150,000 in legal fees. What is worse, a bias in favor of the examining agency is built into this process. Panels assembled to hear appeals are drawn from within the agency and consult closely with the examination team. Lacking adequate independence, their incentive and their priority appears to back decisions already made by the agency.

Bias, or even the appearance of such, as well as fear of retribution is enough to deter bankers from using the appeals process. This is why the small number of appeals does not match the frustration of community bankers over exams. Taking the appeals process out of the examining agencies, as H.R. 3461 would do, is a positive step.

And while not completely independent of the agencies, the FFIEC being composed of the five banking agencies, I expect this level of separation between the appeals process and the agencies will provide a measure of distance and some insulation that will perhaps raise the comfort level of bankers so that they are willing to use the process.

ICBA would encourage members of this subcommittee to consider taking a harder line by adding provisions to the legislation that would bring a higher level of accountability to the regulators and their field examiners. The current system, which grants examiners almost unfettered, unassailable authority, begs for checks and balances.

That said, we are pleased to support the appeals provisions of H.R. 3461 as a foundation on which to build a more rigorous process. ICBA also supports provisions of H.R. 3461 that would create more consistent and common-sense criteria for loan classifications and capital determinations.

Among other provisions, no commercial loan would be placed on non-accrual status solely because its collateral has deteriorated, and a modified loan must be removed from non-accrual status after it has performed for 6 months. Also, an examiner would not be allowed to require a well-capitalized institution to raise additional capital based on loan classifications under this legislation.

Establishing conservative bright line criteria will allow lenders to modify loans as appropriate, without fear of being penalized. Often the best course for the borrower, the lender, and the community is a modification that will keep the loan out of foreclosure.

But many examiners are penalizing modifications by aggressively and arbitrarily placing loans on non-accrual status following a modification, even though the borrower has demonstrated a pattern of making contractual principal and interest payments under the loan's modified terms. If these standards become law, they will give bankers the flexibility to work with struggling but viable borrowers and help them maintain the capital they need to support their communities.

ICBA appreciates the opportunity to testify today. The current examination environment is a serious impediment to the flow of credit that will create jobs and advance our economic recovery. Legislative solutions are clearly needed to improve this environment. ICBA and I support the advancement of H.R. 3461.

Thank you.

[The prepared statement of Mr. Wilcox can be found on page 163 of the appendix.]

Chairwoman CAPITO. Thank you, Mr. Wilcox.

Our next witness is Ms. Jeanne Kucey, president and CEO, JetStream Federal Credit Union, on behalf of the National Association of Federal Credit Unions. Welcome.

STATEMENT OF JEANNE KUCEY, PRESIDENT AND CEO, JETSTREAM FEDERAL CREDIT UNION, ON BEHALF OF THE NATIONAL ASSOCIATION OF FEDERAL CREDIT UNIONS (NAFCU)

Ms. KUCEY. Good afternoon, Chairwoman Capito, Ranking Member Maloney, and members of the subcommittee. My name is Jeanne Kucey, and I am testifying today on behalf of NAFCU, where I serve on the board of directors. We appreciate the opportunity to share our views on H.R. 3461, the Financial Institutions Examination Fairness and Reform Act.

I am the president and CEO of JetStream Federal Credit Union, headquartered in Miami Lakes, Florida. JetStream has $126 million in assets and serves more than 16,000 members.

Credit unions were not the cause of the financial crisis, yet often feel the effect of punitive measures designed to reel in the practices of bad actors and other financial institutions.

Part of the response to the economic crisis was to create new layers of regulations and institute more aggressive enforcement of existing law. Regulators have increasingly tightened examination standards. For example, since the start of the crisis, examination cycles for credit unions have gone from 18 months to 12 months.

Having examiners visit an institution creates a burden in itself, as credit unions must dedicate staff time and resources to prepare and respond to the examination. NAFCU supports effective exams that are focused on safety and soundness, and flow out of clear regulatory directives.

However, the examination process by its very nature can be inconsistent. Regulatory agents in Washington try to interpret the will of Congress, examiners in the field try to interpret the will of their agency, and financial institutions often become caught in the middle.

Many credit unions, including mine, have positive professional relationships with their examiners. We believe that this type of working relationship is important in having a successful process focused on safety and soundness. To that end, NAFCU has prepared a White Paper to help our member credit unions work with the NCUA and their examiners, and I would ask that a copy be inserted into the record with my testimony.

Unfortunately, not all institutions have a positive relationship with their examiner, and thus there are four areas where Congress can help improve the examination process. First, congressional intent. Congress must make its intent clear to regulators.

Second, transparency. Transparency is critically important to our Nation's regulatory agencies to promote safety and soundness. Regulations, and any subsequent guidance, must include clear, tangible criteria which credit union executives can follow. Credit unions should have access to all materials and guidance that examiners use or reference during examinations.

Third, consistency. Maintaining a consistent supervisory and examination environment is vital to ensuring compliance with both safety and soundness, as well as consumer protection regulations. Notwithstanding changes in regulation, the standards by which a credit union is evaluated should not change between exam cycles.

Additionally, regulators should ensure that their regulations are consistently applied from one examiner to another. Credit unions struggle to comply with fluctuating standards when based on an examiner's reliance on informal guidance. This ultimately increases compliance costs, without any clear benefit.

Fourth and finally, the examination appeal process. The appeal process has a number of inherent flaws, including the exclusion, in most instances, of a review by an independent third party at any level of the process. Currently, the regulator serves as the prosecutor, judge, and jury. An independent review process could help ensure objectivity and avoid conflicts of interest.

Several provisions in H.R. 3461 will address our concerns, as it will improve transparency and consistency in a meaningful manner. In conclusion, I would note that NAFCU supports effective and necessary regulation that provides a clear, tangible benefit to credit unions and their members.

NAFCU believes that the legislation under consideration is a positive first step in improving the examination process. Introducing an independent third party to the appeal process will ensure that consistent standards are applied and will help bring more certainty to the examination process.

Thank you again, Chairwoman Capito, Ranking Member Maloney, and members of the subcommittee for the invitation to testify before you today, and I would welcome any questions that you may have.

[The prepared statement of Ms. Kucey can be found on page 104 of the appendix.]

Chairwoman CAPITO. Thank you. Our final witness is Mr. Eugene Ludwig, founder and chief executive officer, Promontory Financial Group, LLC. Welcome.

STATEMENT OF THE HONORABLE EUGENE A. LUDWIG, FOUNDER AND CHIEF EXECUTIVE OFFICER, PROMONTORY FINANCIAL GROUP, LLC

Mr. LUDWIG. Thank you, Madam Chairwoman, Ranking Member Maloney, and members of the subcommittee.

I want to thank you for inviting me to comment on this significant piece of legislation which addresses important issues of balance and fairness in the supervisory process. I would like to commend you, Madam Chairwoman, Ranking Member Maloney, and the other members of the subcommittee for your concern for this topic, and in particular for your giving serious consideration to the expanded use of ombudsman programs as part of the Federal financial regulatory and supervisory system. I will focus my remarks today on the ombudsman issue.

America is blessed with an uncommonly capable group of financial supervisors, examiners, and regulators at our Federal agencies. As Comptroller of the Currency, a Member of the Board of the FDIC, and Chairman of the FFIEC, I spent 5 years surrounded by members of this group and had daily occasion to be impressed with their dedication, energy, and commitment to the tasks before them. Their efforts, and the efforts of their peers at other agencies, remain essential to the health of the U.S. financial system and the well-being of the American people.

Nonetheless, every human system has its flaws. People make mistakes or differ in their judgments, and regulators are no exception.

At regulatory agencies, identifying and rectifying mistakes is, of course, important to the particular institutions and individuals affected. However, it is also incredibly important to the financial system as a whole and the integrity of these important regulatory mechanisms.

With this in mind, in 1993, while leading the OCC, I created the first formal ombudsman program at any financial regulatory agency. The program was successful. Four years later, when I appeared before this very committee, that ombudsman and his staff had resolved 110 formal appeals and facilitated resolutions in 359 additional cases.

In the time since, such agencies as the Federal Reserve, the FDIC, the FHFA, and NCUA have followed the OCC's example. Ombudsman programs recognize the strength of the supervisory relationship. They do not encourage laxity, nor should they.

I am a very big believer in sound regulation and supervision of our financial system. We need tough, but clear and fair, financial rules, not just to protect consumers, but also to ensure the quality of our banks and the health of our economic system.

What H.R. 3461 proposes—what could be described as a "super-ombudsman"—is a new authority to review a broad array of supervisory activities at all the banking agencies. The notion of an interagency ombudsman is thoughtful and has considerable merit, worthy of the very serious consideration that you are wisely giving it.

I would suggest a few modifications to the concept you have proposed. Since the Federal regulatory agencies already have ombudsman programs with talented and experienced people involved, I would suggest that the new super-ombudsman play more of a coordinating role among the ombudsmen at the regulatory agencies, and act as a safety valve or an appeals mechanism.

Another, perhaps even better, way to achieve the same goal, and one that might involve less new governmental expense, would be the creation of a new, permanent ombudsman task force at the FFIEC with a rotating chairperson responsible for its work. The task force would be made up of all the financial agency ombudsmen. And its work, along with the work of the individual ombudsmen, would be reportable to the Council and to Congress. The Council could help achieve the same goals of uniformity, quality control, and right of appeal as I suggest for the super-ombudsmen.

I am also sympathetic to concerns raised by the agencies that, as proposed, a super-ombudsman would not be responsive to the heads of the financial regulatory agencies. Accountability to the agency head was, and remains, the cornerstone of the OCC ombudsman program.

Agency heads have ultimate responsibility for the safety and soundness of the institutions their agencies supervise, and those heads should have the final say on agency matters. The legislation could clarify and ensure this responsibility without vitiating the effectiveness of the new ombudsman function.

I would also suggest, Madam Chairwoman, that the new ombudsman function should also have the responsibility of reviewing regulations to try to achieve the most effective application of legislative mandates in the least burdensome fashion. This effort is important, and must be continual.

Times change, and the rules that were once effective fall out of date or prove inefficient and need adjustment. Involving the ombudsman process, perhaps ombudsman-by-ombudsman, agency-by-agency, in looking again at rules that may be out-of-date, I think would advance the cause of effective supervision.

Accordingly, I very much favor the advancement of the ombudsman concept that this committee has thoughtfully raised. I want to thank you very much for the opportunity to address the subcommittee on this important subject, and I look forward to answering your questions.

[The prepared statement of Mr. Ludwig can be found on page 117 of the appendix.]

Chairwoman CAPITO. Thank you. I would like to thank the panelists, and I would like to begin the questions myself.

The question we heard—and we heard this sort of repeatedly with the first panel on the subject of the ombudsman—they, talking about their individual review processes. And several members mentioned the incidences of retaliation.

So I would like to ask Mr. Wilcox and Mr. Kelly and Mr. Watts and Ms. Kucey, really, have you heard of instances of retaliation by bank examiners? And what form does that take? Is it overt, subtle or whatever?

Mr. Wilcox, if you will speak to that?

Mr. WILCOX. Thank you. Not specific concerns, other than what has been widely reported in the media as recently as yesterday.

There are some banks that have alleged that. I have not talked with them directly, but I would answer your question this way. What I do hear repeatedly from hundreds of bankers from coast to coast, in all 50 States, is their frustration, but their inability or paralysis about doing something because they are afraid of what is going to happen to them.

And as a result, I have been asked by Members of Congress, both in the House and the Senate, to gather examples, to bring specific examples—

Chairwoman CAPITO. Right.

Mr. WILCOX. —to you.

Chairwoman CAPITO. Right.

Mr. WILCOX. And bankers will say, "No way. I am not going to put my name with that, absolutely not."

Chairwoman CAPITO. Right. We ran into that in the field hearing in Georgia.

Mr. Kelly?

Mr. ALBERT KELLY. Thank you, Chairwoman Capito. I think, from my standpoint, many of the situations that the bankers encounter are subject to just a judgment determination, as was talked about in the prior panel. And I think that the concern is, much as Mr. Wilcox has said, something can go one way or something can go another. And if I object too strenuously, it is going to be very difficult to keep myself out of the next problem.

And so I would say that be it reality or be it perception, it is a very, very strong feeling that bankers have that they don't really have, in many cases, the ability to object and to have a meaningful determination of something that probably was not as negative as it is posed to be.

Chairwoman CAPITO. Yes.

Mr. Watts?

Mr. WATTS. I would concur with those sentiments. We hear a great deal, not just in West Virginia, but in access to meeting on committees with CUNA around the country, that these are common problems. And credit unions bring these up readily and frequently.

Chairwoman CAPITO. The issue of retaliation, specifically?

Mr. WATTS. But there is a concern, there is a frustration—not so much the retaliation, but the concern with the exam process. We encourage them to go through the channels that are currently in place and communicate either with NCUA, or through a survey that CUNA has, to be able to gather this information.

They are fearful of putting the name on anything for the fear of what may come back to them. And even though we try to encourage them that it would be anonymous, there is this perception that the information will be obtained and they will find out who they are, and consequently there will be some retaliation.

So in effect, the number of complaints is very small. But that is, in my view, because of the fear of retaliation.

Chairwoman CAPITO. Right.

Ms. Kucey, did you have a comment?

Ms. KUCEY. I definitely agree with what the other panelists have said. I think if you are a CEO and you have a contentious relationship with your examiner, and you are under examination and regulatory pressure, just the fear of retaliation is enough to keep you from voicing your concerns.

Chairwoman CAPITO. Okay, thank you. I would like to—yes, I only have a minute left. So I will ask you the next question, then you can—I wanted to know. A lot of our concern is that this is hampering the banks' ability to really expand this economy.

And is part of the 8.5 percent unemployment that we are sort of stuck in a result of the banks' hesitancy and reticence to lend because of the regulatory environment?

Mr. Kelly?

Mr. ALBERT KELLY. Just briefly on your prior question, the ABA has established an independent survey that is done after an examination. And we share that information, or in the process now of sharing that information with the regulator so that you know it is anonymous. But we do have that information and we are trying to build a better bridge.

Chairwoman CAPITO. Okay.

Mr. ALBERT KELLY. I think that there are a number of things—obviously the economy is such that it is still floundering. And so, it is sometimes hard to really find a good loan. But I believe also that there is much less exuberance on the part of banks to embrace the risk that they may have embraced in the past.

When we talk about increased capital standards, in many cases smaller banks, most community banks, in reality, can only increase capital in this environment by shrinking. That is the only way their percentage goes up.

And so, I think you see a lot of banks, that their strategic plan is to shrink the bank. One of the ways you do that is you don't make as many loans. So that would be my response, is that I think that there is certainly less vigor in making loans today.

Chairwoman CAPITO. All right.

Mrs. Maloney for 5 minutes?

Mrs. MALONEY. Thank you. I want to thank all of the panelists for being here. And I would like to ask Mr. Ludwig, in your testimony you raised one of the concerns that we heard from all of the regulators, that the final word should be what with the agency that has the responsibility of enforcement, of safety and soundness, of making the decisions to make the system work.

So I think that you are in harmony with what they were saying to us in their prior testimony, every single one of them. I want to congratulate you for beginning, in 1993, the ombudsman system, when you were the Comptroller of the Currency of OCC. But how has it changed since then? Why do think the number has gone down so dramatically?

It has gone down dramatically from your time at OCC, but all of the other agencies were even lower than the OCC. And what is your assessment of the appeals process now?

Mr. LUDWIG. Congresswoman Maloney, I think that is an excellent question. The fact is the whole process has evolved, and in a lot of ways has gotten ever more professional. So there has been a step forward here in the whole ombudsman process in the Federal Government.

However the concerns that people have, I think, are real. There is a natural human tendency to worry about making an appeal against your supervisor. One of the things that we did during my time, which I would certainly suggest to the agencies, is to affirmatively encourage the banks to make appeals, and make clear through business with the examiners that there just absolutely can't be any retaliation, that it would be a real violation of agency practice.

I spent a lot of time myself vigorously pursuing that, and I would encourage the new heads of these agencies to do that. One thing that they did do at the Comptroller's office, which may be true of the other agencies, is, after my time there was a discouraging, if not prohibition, of bringing matters to the ombudsmen if they were part of an enforcement action or pending enforcement action.

I personally think that is a mistake. I think many of the issues that have become most contentious actually are headed towards enforcement issues. I think having the ombudsmen as a safety valve to hear virtually everything is a good thing.

Mrs. MALONEY. Also, the prior witnesses, the regulators, were concerned that the external appeals process would hamper the agencies and make them less efficient. What is your response to that, and do you believe a bank should be required to exhaust the internal appeals process before seeking an external review?

Mr. LUDWIG. I think having a coordinating function, whether it is a super-ombudsman or a task force at the FFIEC, that can be a safety valve when people really feel strongly about a matter and don't feel they are getting redress at their own agency is a good thing. And I think that is perfectly consistent with giving the agency head, at the end of the day, the final say.

Just allowing that transparency, that opportunity to be heard and have flexibility, I think would add a lot of value.

Mrs. MALONEY. There was also a lot of concern about cost, particularly in this time where we are facing tremendous financial constraints. Could you comment on the cost, what you feel it would be? And do you prefer the task force approach in this situation?

Mr. LUDWIG. The OCC ombudsman program during my time had three people and I think, by the end of my time in office, had heard close to 1,000 formal and informal appeals. So in and of itself, it wasn't an expensive process. And I think one could do the same at the FFIEC level by way of coordination.

But whether it is a super-ombudsman or a task force, there is a lot to be said for doing it as a first step as a task force, with many of the same attributes that are in this statute. But getting the ombudsman together as a consistent matter, and having a head of that task force rotate among the agencies, I think would take the whole process a step forward.

Mrs. MALONEY. Also, many of the regulators expressed concern on codifying the guidance. And they repeatedly expressed a concern to maintain a certain degree of flexibility. Do you share that concern?

Mr. LUDWIG. I think what you and the chairman of the committee and subcommittee is doing here is really very important. Oversight hearings, and this is partially by way of oversight, add tremendous value, just like a board of directors to a corporation.

And asking these important questions—even at a granular form as you have been doing on loan review and supervision and the actual supervision practices—is enormously important in terms of the integrity of the process. I myself am a little wary of hardwiring things. I think taking a next step, asking the questions, studying them and perhaps at some point hardwiring these rules.

But the problem of hardwiring is, the world changes. And it lacks a certain amount of flexibility. I think by way of direction, oversight, review, encouragement of these agencies to take a look at these matters, I think that will be responded to and you will have fulfilled a major function.

Mrs. MALONEY. Thank you. My time has expired.

Chairwoman CAPITO. Mr. Renacci, for 5 minutes.

Mr. RENACCI. Thank you, Madam Chairwoman. And I want to thank the members of the panel. I want to get back a little bit to retaliation, but not stick on it too long.

My colleague, Mr. Scott, made a comment about how few appeals there were. And as a previous business owner in the nursing home business, I can tell you that when we had regulators and surveyors walk in, we did not appeal because we were fearful of what would occur the next time they walked in.

So it is interesting. Because it is human nature, and there is nothing wrong with that. It is human nature, and I hope that many of the agencies who are here today will realize that—that it is human nature, and it is going to occur.

With that said, Mr. Ludwig, you were talking about—and I am trying to figure this ombudsman program because I like the idea of an independent. But you were talking about a super committee. Do you like an independent versus an internal better, a combination? Because I am thinking an independent would lessen the retaliation.

Mr. LUDWIG. I am kind of inclined towards a combo in coordination as a next step, sir. I think the ombudsman programs have taken a big step forward with the Federal Government. Now, it has taken many years. I was in office almost 20 years ago now when we started this thing. So it has been a bit of a time, but there have been steps forward.

Allowing an appeals process, an independent appeals process which could be taken if things are egregious, I think does add value. But taking a step to basically vitiate the current programs and take them out of the agencies, I think has the disadvantage of discouraging what has evolved into a back-and-forth that adds value.

Now, I do think encouraging insisting upon no retaliation, both of the committee in terms of oversight, asking the agency heads to redouble their efforts to ensure that doesn't happen, adds a lot of value. I don't think I would go so far as a complete independent ombudsman at this time, but I think your oversight in this area is important.

And I understand that human nature is, you are very reluctant to do it. And that is why I think it is up to the agency head and the agency to be very vigorous in making clear to the supervisee and to the examiners that retaliation is not acceptable.

Mr. RENACCI. Ms. Kucey, you also talked about an appeal process, an independent third party. Do you agree with what Mr. Ludwig is saying, or do you believe it should be an independent third party?

Ms. KUCEY. We believe it should be an independent third party, for the reasons brought up by this panel and also brought up by several of you.

Mr. RENACCI. Okay.

Mr. Wilcox, there seems to be a clear disagreement between regulators and bankers as to whether a loan should be placed on non-accrual status. Do you believe the regulators are at least being consistent when they place a loan on non-accrual status, without retaliation?

Mr. WILCOX. I will answer it this way. A lot has changed in the field examination process during the past several years. We used to see at least part of the examination team exam after exam after exam. So there was some level of market expertise, some understanding of our financial institution and the surrounding economic environment, which led to a better dialogue about those kinds of things and the types of loans that might be discussed regarding non-accrual.

Today, I would say the last three, maybe four exams that we have had it is a rotating cast of characters who have no concept of task accounting in Minnesota, no concept of Grand Rapids State Bank. And as a result, we spend a lot of time trying to educate them about what is happening. And those are factors in the non-accrual.

I hear from colleagues across the country of loans that have positive cash flow and they are 20-year customers and have never missed a payment, but in the current economic environment the real estate or the equipment, something, has devalued. And that is being criticized and classified, which has other implications for the organization in terms of capital and other regulatory implications, other than just the classification.

Mr. RENACCI. Do you feel timely payments are being considered at all in classifications?

Mr. WILCOX. Not consistently.

Mr. RENACCI. So there is some inconsistency. Mr. Ludwig, many—no, I am going to go back to you, Mr. Wilcox. So in your testimony, you state that community banks were facing up to $150,000 in legal fees as a result of the current appeals process.

Do you think the appeals process proposed in this bill would save community banks money, or would it increase costs?

Mr. WILCOX. I think to the extent that you can make this independent. And, frankly, I would suggest more of a firewall than this bill proposes and create it independently, outside of the FFIEC, so that you do have some insulation, which really takes out the issue of retaliation. When they are separated from the agency and, potentially, as Mr. Ludwig commented, with that streamlining, you could potentially reduce the cost.

Mr. RENACCI. Mr. Kelly and Mr. Watts, do you believe it should be independent or part of the organization?

Mr. ALBERT KELLY. I believe that it should be independent.

Mr. WATTS. I definitely believe it should be independent.

Mr. RENACCI. All right. Thank you, gentlemen.

Chairwoman CAPITO. Mr. Watt, do you have any questions?

Mr. WATT. Thank you, Madam Chairwoman. I actually came back hoping to hear Mr. Ludwig's testimony, because generally when he testifies, I want to be in the room and hear what he has to say. We have been longtime friends and I admire and respect him.

I note that you spent a lot of time talking about the ombudsman part of this bill. And I don't want to take you out too far, but it sounds to me like you don't think the rest of this bill—or maybe you think the rest of the bill hardwires, as you said, things a little bit too much. Am I misreading what you are saying?

Mr. LUDWIG. I have a lot of respect for the issues raised in this bill. I think it is an excellent effort on the part of the subcommittee, the ranking member, and the chairman to focus on real issues that bankers have to deal with day to day.

But I think by way of oversight, other than the ombudsman issue and by way of direction, asking the agencies to review these matters with some care and oversight, and allowing some flexibility here, is probably a little better than hardwiring it. One might come to the conclusion at the end of today that there is not enough serious review of these issues by the agencies.

One feels frustrated, and goes to the hardwiring. I don't think we are there yet, and I think allowing for flexibility has some advantage. But I certainly commend the subcommittee for the oversight. And I think even putting in legislation and direction to review these matters with care adds a lot of value.

Mr. WATT. All right. I thought that is what I heard you saying, and I don't disagree with that.

Mr. Watts, you were in the room when I asked the NCUA representative about a situation in North Carolina. Were you in the room?

Mr. WATTS. Yes, sir, I was.

Mr. WATT. Do you have any particular feelings about what the NCUA is doing to those 51 credit unions in North Carolina?

Mr. WATTS. It is a fairly recent development, and I can't say that I have a significant amount of knowledge about it. There is a coordination of effort between the State regulator and the Federal regulator for credit unions. And it is unfortunate that that coordination has eroded and dropped down to a level beyond what you would hope it would be.

It is unfortunate that the other credit unions in North Carolina that were State-chartered and federally-insured were impacted as they were. And beyond, sir—

Mr. WATT. They haven't been impacted yet, but they are about to be if the regulator goes and uses this as an excuse to start auditing them. That seems, to me, to be completely unnecessary. Maybe

I am missing something, which is why I am asking if I am overstating my concern here.

Mr. WATTS. I don't have any additional insight that would lessen your concern.

Mr. WATT. All right. It is great to see all of you. I am sorry I missed your testimony. I had another commitment, but I appreciate your being here, and it is always good to see my good friend, Mr. Ludwig.

Mr. LUDWIG. And thank you, Mr. Watt, for those very kind remarks. I am honored by them.

Mr. WATT. I didn't mean to ruin your reputation by saying good things about you in public but sometimes I should adhere to the adage. I can say good things about you or bad things about you, whichever one will help you the most.

[laughter]

I yield back, Madam Chairwoman.

Chairwoman CAPITO. Thank you.

Mr. Luetkemeyer, for 5 minutes.

Mr. LUETKEMEYER. Thank you, Madam Chairwoman. Just kind of quickly, I apologize for missing some of the earlier testimony. But Mr. Kelly and Mr. Wilcox, can you tell me whether the present ombudsman program is working?

Mr. ALBERT KELLY. I am sorry?

Mr. LUETKEMEYER. The present ombudsman program that the different agencies have, is it working very well?

Mr. ALBERT KELLY. I believe that we noted in our written testimony that we thought that the OCC—the general view of the ABA is that the OCC's program is the most effective. I think the lack of use of some of the programs are kind of reflective of the fact that they don't enjoy the independence that is stressed in the bill.

Mr. LUETKEMEYER. And cost. Is that an issue? Is cost an issue here?

Mr. ALBERT KELLY. I am sure that cost is somewhat of an issue. But I would say that the independence is much more than the cost, quite frankly.

Mr. LUETKEMEYER. Mr. Wilcox?

Mr. WILCOX. When I listen to the number of concerns I hear from my peers around the country, and then I listen to the numbers that were talked about on the first panel, I am pretty stunned, quite frankly. And I would—

Mr. LUETKEMEYER. Five or six complaints and probably in your neighborhood you probably have five or six folks who would love to appeal something.

Mr. WILCOX. I am sure you probably hear from more than that on a daily basis. But those numbers tell me that it is not being effective.

Mr. LUETKEMEYER. Yes.

Mr. WILCOX. It is not comfortable. They don't feel safe, or that it is going to be a wise use of their time to pursue that. That is the conclusion that I can draw, based on those numbers.

Mr. LUETKEMEYER. As we are going through the process here, we are trying to form a bill that is going to try and give some regulatory relief to your institutions. What else would you put in there if you had the opportunity? What other problem do you see that we are not addressing in here, or that you think would be something that we need to address or to recognize and perhaps come up with a solution for?

Mr. Kelly?

Mr. ALBERT KELLY. I think, first of all, I would say I think this is an excellent start. I think that we also believe that what may be called the penalty box needs to be reviewed, which is banks that end up under some type of various and sundry investigation are immediately prohibited from doing acquisitions and other things.

And we think that would be a valuable piece to suspend because that is akin to you are going to be punished before you have your day in court, so to speak. And so I think that really ties up a number of banks that fall into that. At least that is what I have been told by a number of banks that have fallen into that path.

Mr. LUETKEMEYER. Yes. Just to follow up on that, one of the banks in my area has a CRA exam that has been extended for almost 3 years. As a result of that, they can't go out and expand with new branches or can't go out and purchase an additional facility.

So it really hampers their ability to deliver services and expand your operation. Is that kind of what you are talking about?

Mr. ALBERT KELLY. Yes, that is what I am talking about. And that can go to a number of things—

Mr. LUETKEMEYER. Right.

Mr. ALBERT KELLY. — be it a fair lending exam or CRE, whatever it may be.

Mr. LUETKEMEYER. Right. Okay.

Mr. Wilcox?

Mr. WILCOX. It is a good start, this bill. I think the independence issue, and taking that a little further, is something that I think deserves a hard look. In addition to that, expanding on the kind of transparency that is lacking today in terms of material supervisory determinations that examiners arrive at when they conduct an examination.

For example, I hear lots of reports from friends and peers all over the country that they have been asked to allocate more dollars to their loan loss reserve. But when asking the regulator that is there at the exit interview or during the field examination to explain the formula, they are not given that information.

If you are being asked to write a check that is $300,000 or $400,000 or $500,000, as an owner, as a CEO, I think you are perfectly entitled to understand how that math works. And that is just one simple example. There are lots of arbitrary decisions, or at least they appear arbitrary.

And I think the communication and the transparency would go a long way to bettering that relationship, and putting bankers and regulators back on a path of working together and not having an adversarial relationship that seems to be developing.

Mr. LUETKEMEYER. I know over the course of discussions with my local bankers—and, in fact, this past week I was discussing it with the president of a very large regional bank in my area. And there is some testimony that has occurred in this committee already with regards to the costs that the banks are incurring as a result of compliance with all the regulations that are coming out.

And it has reached the point where it is almost every time you hire one person, you have to hire one more person to do compliance. Is that what you see in the banks in your area, Mr. Kelly and Mr. Wilcox?

Mr. ALBERT KELLY. The compliance area is certainly an area of expansion. And I think for all banks, we are no different. The ability to comply with the complexity of the regulations that are coming out in a very, very rapid-fire order, we are charged with doing. And so, we have staffed that up, and it is an expensive thing to do.

Mr. LUETKEMEYER. Mr. Wilcox?

Mr. WILCOX. If I may?

Mr. LUETKEMEYER. Okay.

Mr. WILCOX. I would concur. It is expanding. I would say our compliance cost has probably doubled in the last 24 months. That is non-revenue. It is great we are adding a job or two, but it is non-revenue-producing and challenging for the bank, and that will continue to be the trend.

Mr. LUETKEMEYER. And that is a cumbersome problem for the community banks, especially because they don't have the ability to spread those dollars out like a big—

Mr. WILCOX. That is right.

Mr. LUETKEMEYER. Thank you, Madam Chairwoman, for your indulgence.

Chairwoman CAPITO. Mr. Scott?

Mr. SCOTT. I am glad that some of the regulators are still here because we sort of had a he said-she-said situation. And, I asked early about this retaliation and I just want to get a clear answer because I think we need to have the truth on the table of exactly what has happened.

If there is a culture of this, we need to know it. It may be something, and then we need to make sure that we have the proper tools in place in this bill that will eliminate that. Because as I see it, I think the financial institutions feel that they believe that the existing internal agency appeals process is limited, and then they feel that they don't have a recourse properly presented to them if they feel they got a wrong decision.

And then this appeals process is in a way in which you feel if you do try to appeal it, they will retaliate. Is that a fair assumption of where we are? So tell me. We have two representatives of the banks and, I think, credit unions here. Is there retaliation? Give this committee an example of what that is, and let us get that on the table. Is it happening? Regulators are saying it isn't.

Mr. ALBERT KELLY. Thank you, Mr. Scott. What I would say would be, as earlier stated, there is certainly, in the banking industry, a concern that they will worsen their situation by making too much or by objecting to a particular point.

Mr. SCOTT. Do you have any evidence or facts where that has actually happened?

Mr. ALBERT KELLY. As I mentioned earlier, we have at the ABA coordinated to get examination results. As far as an improved environment, what is that? And I believe we have instances where we can provide to the committee our results, just as we provide them to the regulatory agencies.

Mr. SCOTT. Anyone else?

Mr. WILCOX. If I may, I think retaliation is a little bit of a perception issue. It may be perceived on the bankers' side as retaliatory or retribution. And the regulators may see that as a logical next step, not retribution. But I think the core of the problem, and the issue that is stymieing this and making it difficult to move forward, is simply the fear of it. What if?

And because there is so much concentrated power with each regulatory authority—my bank has been in business for 98 years. And every time I have an exam, even though we are well-managed and we are in good shape, I know that if we did something wrong, they have the power to put the chains on my doors and put our business out of business.

They hold that kind of power. That alone puts pause in somebody's mind to say, "Hmm, how hard would you really want to push if there was an issue?"

Mr. SCOTT. That is very good. That is what I meant. You have given a pretty good example. Do you believe that this ombudsman, or the mechanism we have in the bill, will suffice to bring this pressure of retaliation or whatever that is—that is what I am getting at.

It bothers me for my bankers to come and say, "We are going to be retaliated against," or, "We have been retaliated against." And it is like I don't know what a challenge it is here today to get anybody to give an example of that. And we have a bill here. One of the issues we are trying to address is how do we prevent that and make sure that there is no retaliation if we can't get either side to tell us what it is?

Mr. WILCOX. Sure. And I think one way to improve upon that—this is a good first step. You have a partially independent ombudsman process. Making it more independent may help, but the thing that you could add to that, that would really bring this full circle is a degree of accountability and a review process to hold the regulatory agencies accountable for their actions.

That process doesn't exist today, and the bankers have no way to initiate that kind of recourse unless they want to really fully gamble.

Mr. SCOTT. Do you feel that the ombudsman's part of this bill will suffice for that? Or we need to do something additional?

Mr. WILCOX. I think you could strengthen it. It is a good first step, but building in accountability, some measures and processes of accountability for the regulatory agencies, in addition to independence for the appeals process, would help that matter greatly.

Mr. SCOTT. Mr. Watts?

Mr. WATTS. Yes, sir. From a credit union standpoint, NCUA has an ombudsman, but it does not deal with appeals. So this would be a significant improvement. Now, there is an appeals process and there is an opportunity for a credit union to be able to file for and have their particular case reviewed and there is a process that is followed. But the ombudsman is not the one that does that.

This would actually allow for a much more specific opportunity by a third party, to be able to review any issues that come before it. So this is a much-improved process if this were adopted for credit unions.

Mr. SCOTT. Good. Thank you.

Mr. RENACCI [presiding]. Thank you.

Mr. Canseco, from Texas, for 5 minutes.

Mr. CANSECO. Thank you, Mr. Chairman.

Thank you very much for coming here today and offering your testimony. One thing I hear over and over again as I talk to Texas bankers, and also from around the country, is the difficulty they have in putting together a 5-year plan for their bank. There is simply too much uncertainty over upcoming rules and they don't know how best to prepare their bank to compete in the future.

Mr. Kelly, how would the provisions in this bill better prepare SpiritBank or the members you represent in preparing a 3- or 5-year plan for their bank?

Mr. ALBERT KELLY. Portions of the bill, I believe, give additional certainty as to how certain things are treated. I think that certainly would be very helpful to any bank that is planning, relative to either loan growth or to managing some of the assets that they currently have.

I think, likewise, trying to build a better regulatory environment, which I think is the intent of everyone from the regulatory panel to the bankers, is something that this bill provides; that there is something that actually is an independent voice out there where you can say, "I don't really think this is the right way that this has been handled. Can we have an independent view of it?"

99.9 percent of the banks out there want to please their regulators and want to stay on good terms with their regulators, and do not want to either risk irritating them or try to swim against the tide. But this gives something that allows them to have an—if it so breaks down to the point that they feel they need redress, this would allow them to know that they are able to work their plan and it be the plan that, hopefully, they will be able to take through to fruition.

Mr. CANSECO. Has SpiritBank increased its compliance staff since 2008?

Mr. ALBERT KELLY. Yes, sir, we have. We have increased our internal audit significantly, we have increased our compliance area with additional staff, and we have a chief risk officer who has that exclusive title, as well. So all of those things have been added.

Mr. CANSECO. And is that true with what you hear from some of your members?

Mr. ALBERT KELLY. I think all of our members would say that they are trying to prepare for the compliance; not only the compliance applications by the additional regulations that are being promulgated that certainly are required to be done. It takes an awful lot of time to be sure you are in compliance.

Mr. CANSECO. And what have they told you about compliance costs? Is it the same as what you are experiencing at SpiritBank?

Mr. ALBERT KELLY. Yes. I think the industry itself is seeing an increase, necessarily. When you have a 2,380-page bill, that is Dodd-Frank, that requires the regulators to promulgate regulations and procedures, and then you have heightened regulations—we have talked about the HMDA logs and things such as that.

Those areas are very focused upon, and banks have really no choice but to prepare to increase their compliance costs.

Mr. CANSECO. In your relationship with bank examiners, what have been the most significant challenges for your bank, and how would they be addressed in H.R. 3461?

Mr. ALBERT KELLY. I think when it comes to our bank, when we are talking about—all banks have disagreements relative to classification. There is never a right-size-fits-all. From a standpoint of the non-accruals, I would guess, from our standpoint, we have generally tried to follow what the regulatory agencies would follow.

I think that the—so I don't have and haven't had, necessarily, disagreements with those particular points. I think that this bill would help greatly if, in fact, we talk about the fact that when you have a piece of collateral and you know that firm value, to classify the entire balance is, as we have stated in our written testimony—it is as much a negative overstatement as we heard earlier saying you are overstating earnings.

You have a piece of property that is worth, as we said in our testimony, $9.5 million, and you have a $10 million loan, yes, you have an impairment of half a million dollars. But do you really classify the whole thing if it is performing?

And that is something that I think, today, those loans all get classified. And those obviously have a large impact on your capital and a large impact on your standing.

Mr. CANSECO. Can you offer any suggestions for improving H.R. 3461?

Mr. ALBERT KELLY. As I told the gentleman from Missouri, I think that if we were able to include provisions there that would allow the suspension of the penalty box for those banks that have ongoing disputes so that they can expand, and should they have opportunity and they can go into different lines of business during that period of the dispute, I hear that from a number of a banks, that they feel like they have been put on the sidelines, which becomes punitive.

Even if they end up being successful in whatever dispute that might be, they still miss the opportunity. In some cases it stretches over several years. So I think that would be extremely helpful, to have that in there.

Mr. CANSECO. Thank you very much, Mr. Kelly.

My time has expired.

Mr. RENACCI. Thank you.

I want to thank the panel for their testimony today. Before closing, I would like to ask unanimous consent to submit for the record the testimony of David Baris, executive director, American Association of Bank Directors. Without objection, it is so ordered.

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

This hearing is adjourned

[Whereupon, at 5:17 p.m., the hearing was adjourned.]

A P P E N D I X

February 1, 2012

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February 1, 2012

Statement of

Kevin M. Bertsch

Associate Director

Division of Banking Supervision and Regulation

Board of Governors of the Federal Reserve System

before the

Subcommittee on Financial Institutions and Consumer Credit

of the

Committee on Financial Services

U.S. House of Representatives

February 1, 2012

Chairwoman Capito, Ranking Member Maloney, and members of the Subcommittee, I appreciate the opportunity to appear before you today to discuss the Federal Reserve's perspective on H.R. 3461, the "Financial Institutions Examination Fairness and Reform Act." The Federal Reserve supervises more than 5,000 bank holding companies and 825 state-chartered banks that are members of the Federal Reserve System (state member banks). As of July last year, it also assumed responsibility for the supervision of more than 430 savings and loan holding companies. The Federal Reserve shares the subcommittee's interest in ensuring a fair examination process and providing banks with a robust and transparent process for appealing material supervisory determinations with which they disagree.

Accordingly, the Federal Reserve has instituted a number of steps to ensure that examination findings are well grounded in supervisory policy, fully supported, and give due consideration to all relevant information provided by bankers. First, all examination findings are subject to a thorough review by the management of each Reserve Bank before being finalized. These reviews encompass an evaluation of all significant findings of the examination. They also focus particular attention on ensuring that examiner conclusions with which bank management has raised concerns or expressed disagreement are accurate and give appropriate consideration to relevant information presented by banking organizations.

In addition, Board staff analysts assigned to monitor bank supervision activities sample recently completed examination reports to assess compliance with policies and support for examiner conclusions. These analysts also conduct periodic reviews of specific examination activities to assess their compliance with supervisory policy and standards. As we become aware of particular concerns being raised by bankers, we focus our reviews of examination activities on ensuring that examiners are appropriately addressing the areas of concern. For example, because bankers have been raising significant concerns about the treatment of commercial real estate workout loans by examiners, we have focused particularly on evaluating examiners' treatment of these loans in recent years. To reinforce sound examination approaches and respond to issues raised by bankers, we have also offered significant, targeted training to examiners on many supervisory issues. These include a number of issues that are addressed by the bill under discussion today, including proper determinations of accrual treatment, the circumstances under which new appraisals may be required, and the proper classification of commercial loans.

The Federal Reserve also encourages bankers to discuss with Reserve Bank supervision management any concerns they may have. We find that many differences of perspective can be resolved through open, constructive dialogue. If bankers still have concerns after talking with Federal Reserve supervisory staff, they are encouraged to contact the Federal Reserve Board's Ombudsman, who operates independently of the supervisory process and can address concerns on a confidential basis and provide information to the banker on how to file a formal appeal of material supervisory determinations.

Indeed, the Federal Reserve has already taken steps to respond to many of the particular concerns addressed by the proposed legislation and is committed to taking additional steps as needed to assure a balanced and fair examination process. In the remainder of my remarks today, I will begin with comments and observations on the proposed legislation's requirements for examinations. I will then discuss the Federal Reserve's examination appeals process and Ombudsman function. Finally, I will briefly describe some of the steps the Federal Reserve has taken in recent years to enhance its communication with community and regional banks as well as some actions it is initiating to respond to feedback from these institutions.

Comments on Provisions Addressing Examination Practices

A number of the steps that would be required under the proposed legislation have already been adopted by the Federal Reserve. For example, Federal Reserve examiners discuss and share with bank management and directors the information relied upon to support material supervisory determinations during the course of examinations and in exit meetings. In addition, the banking agencies already use common definitions and reporting guidelines for nonaccrual loans as detailed in the instructions for the financial reports of condition and income (Call Reports) that banks must file each quarter.

Several other provisions of the bill that prescribe specific supervisory or accounting treatments appear to limit the ability of examiners to use judgment in certain circumstances. As drafted, these provisions may impede, rather than further, the ability of examiners to ensure the safe and sound operation of banking firms. For example, the proposed bill could be interpreted to prevent an examiner from requiring a new appraisal on a performing commercial loan unless new funds are being advanced. The appraisal regulations of the federal banking agencies allow examiners to require a bank to obtain a new appraisal on an existing loan when there is sufficient reason to believe a bank's collateral position has deteriorated materially and could expose the bank to current or future losses. This could occur, for example, when a property collateralizing a loan loses a major tenant or when a borrower's cash flow is under pressure and a loan is becoming more dependent on the value of collateral for repayment. In these situations, an updated appraisal is often essential to determining the steps a bank should take to assure repayment of all principal and interest due. Often, banks order new appraisals in these situations without prompting by examiners to assess the likelihood of loss and determine whether other steps should be taken to obtain more collateral from the borrower or restructure a loan to protect the bank's financial interests.

Similarly, the proposed bill specifies that a commercial loan cannot be placed on nonaccrual status solely because the collateral has deteriorated in value. Federal Reserve examiners do not currently require commercial loans to be placed on nonaccrual status solely because collateral has deteriorated in value. We want to make sure it is clear, however, that a loan with collateral that has deteriorated in value may be placed on nonaccrual status if there is other material information that suggests that the bank may not receive all principal and interest due under the terms of the loan. Placing a loan on nonaccrual status would be appropriate, for example, in cases in which a borrower's reported cash flows had fallen below the amount required to service the loan and the value of the collateral supporting the loan had fallen to a value below the amount due to the bank. By not placing such a loan on nonaccrual status, a bank would be overstating its income and understating the volume of its problem assets.

The proposed bill would also require that restructured commercial loans be returned to accrual status when borrowers have demonstrated the ability to perform for six months. Current supervisory guidance similarly allows a loan to be returned to accrual status when the borrower has shown a sustained ability to perform for a reasonable period of time, typically six months. However, there are circumstances when this treatment is not appropriate. For example, a bank may restructure a loan with a periodic debt service payment that can be serviced by cash flow provided by the underlying collateral, but without sufficient cash flow to repay the loan over a reasonable amortization period. In this situation, the ultimate collection of the entire principal and interest remains in doubt and the loan would not be considered performing. This type of strategy is inconsistent with generally accepted accounting principles, and past supervisory experience suggests it is often unsuccessful and can increase the costs of resolution in the event a bank fails. In 2009, the Federal Reserve and the other agencies affirmed these supervisory expectations in the Prudent Commercial Real Estate Workout Guidance.[1]

The proposed bill also appears to prohibit examiners from requiring a bank that meets the regulatory threshold for being "well capitalized" under the prompt corrective action provisions of federal law to raise additional capital. These provisions conflict with the provisions recently enacted in the Dodd-Frank Wall Street Reform and Consumer Protection Act, which require the federal agencies to consider the risk that banking firms—including those that are well capitalized under current regulatory definitions—pose to the financial system and impose enhanced supervisory requirements on those firms. These provisions also fail to recognize that the regulatory definitions for the various capital thresholds were designed to apply generically to banking firms and do not take into account the idiosyncratic risks at individual firms or the potential effects on a bank's capital position of risk-management deficiencies or concentrations in problem assets. Therefore, meeting these predefined thresholds does not imply that a bank has no need of further capital. Indeed, during the recent downturn, many communities experienced such sharp drops in real estate prices that local banks that entered the crisis at or above the "well-capitalized" thresholds found existing capital levels inadequate to cover emerging loan losses. Prohibiting examiners from encouraging additions to capital at such banks during the recent crisis could, we think, have resulted in significantly higher losses to the deposit insurance fund.

[1] See Board of Governors of the Federal Reserve System (2009), "Federal Reserve Adopts Policy Statement Supporting Prudent Commercial Real Estate Loan Workouts," press release, October 30, www.federalreserve.gov/newsevents/press/bcreg/20091030a.htm.

Perspective on Provisions Regarding Appeals and the Ombudsman Function

A key purpose of the proposed legislation appears to be to ensure a strong appeals process and independent Ombudsman function for the resolution of bankers' concerns about the fairness of the supervisory process. The Federal Reserve has in place a robust appeals process and an independent Ombudsman function designed to provide institutions with a fair and fulsome review of complaints. Currently, the Federal Reserve's rules provide any party affected by our supervisory process with three successive levels of appeal. First, the management team of a banking firm may appeal any material supervisory determination to a review panel composed of Reserve Bank staff that were not in any way responsible for the original supervisory determination. This panel typically is made up of experienced supervisory staff from Reserve Banks that were not involved in the supervisory determination and that were selected after consultation with Federal Reserve Board staff. The banking firm may submit to this panel any information that the firm believes is relevant to the determination and may appear before the panel to provide information orally.

If the bank's management team feels its concerns are not satisfied by this panel's decision, the banking organization may make a second appeal to the president of the relevant Reserve Bank. This review focuses on ensuring that the deliberations of the initial review panel were objective, complete, and followed specified procedures. Again, the banking organization may submit any additional information it believes is relevant to the decision. If needed, a third review can be requested. This third review is undertaken by the member of the Board of Governors with oversight responsibility for the Federal Reserve's Banking Supervision function.

As noted previously, the Federal Reserve also has an Ombudsman to provide banks with a means of raising issues regarding the examination process that are maintained in confidence. The Ombudsman also will provide information regarding the appeals process.[2] The Ombudsman provides a neutral, independent, objective facilitator and mediator for the resolution of issues and complaints related to the System's regulatory and supervisory activities. The Ombudsman actively works with banking firms that have concerns about examinations and other supervisory matters, and works independently from the supervisory chain of command. The Ombudsman has broad authority to mediate complaints, including the authority to refer matters to the appropriate Federal Reserve Board committee.

The Federal Reserve maintains a strong anti-retaliation policy to protect any person who uses the appeals process or who contacts the Ombudsman with concerns. The Ombudsman reaches out to every institution that has filed an appeal within six months after the appeal has been decided to inquire whether retaliation has taken place. The Ombudsman also has broad authority to investigate claims of retaliation. Where appropriate, and when corrective action has not been taken, the Ombudsman reports retaliation complaints to the appropriate Federal Reserve Board committee.

The Federal Reserve continues to evaluate methods for improving its appeals process. At the same time, it has been our experience that most disagreements regarding supervisory matters are resolved promptly and informally through direct discussion between the Reserve Banks and the affected institutions, and we would not want to discourage this means of resolution.

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[2] For more information, see the "Ombudsman for the Federal Reserve System" webpage at www.federalreserve.gov/aboutthefed/ombudsman.htm.

Efforts to Address Regulatory Burdens

We recognize the concerns expressed by bankers about the supervisory process and are taking steps to respond to them. The nation has just experienced an extraordinarily difficult financial crisis and continues to recover. As you would expect in these conditions, examiners have identified many supervisory concerns and are working with banking firms to address these concerns.

In recent years, the Board has taken a number of steps to enhance its communication with community banks to ensure that their views on the supervisory process are considered. In 2009, the Board established a subcommittee to focus on supervisory approaches to community and regional banks. This subcommittee is led by Board Governors Elizabeth Duke and Sarah Bloom Raskin. A primary goal of the subcommittee is to ensure that the development of supervisory guidance is informed by an understanding of the unique characteristics of community and regional banks and consideration of the potential for excessive burden and adverse effects on lending. In addition, in 2010, the Board established the Community Depository Institutions Advisory Council (CDIAC) to provide input on the economy, lending conditions, and other issues of interest to community banks. Members include representatives of banks, thrift institutions, and credit unions serving on local advisory councils at the 12 Federal Reserve Banks. One member of each of the Reserve Bank councils is selected to serve on the CDIAC, which meets twice a year with the Board in Washington, D.C.[3]

Feedback from community bankers has persistently pointed to increasing regulatory burden as a concern and threat to the viability of the community bank model. Last year, the

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[3] See the Board's "Community Depository Institutions Advisory Council" webpage at www.federalreserve.gov/aboutthefed/cdiac.htm.

Board's subcommittee on community and regional banks asked that a series of initiatives be developed to clarify regulatory expectations, alleviate regulatory burdens where possible, and reduce the potential that regulatory actions could curtail lending. In response, Federal Reserve staff initiated a number of projects to enhance supervision practices for community banks and alleviate some of the burdens that have been of the most immediate concern.

Several of these projects aim to revise or clarify guidance. These include initiatives to reiterate when supervisory rating upgrades may be considered for community banks recovering from the effects of the recent crisis, to enhance the transparency and consistency of assessments of the adequacy of banks' allowances for loan and lease losses, and to clarify capital planning expectations for community banks. Others projects aim to improve our examination processes by reviewing exam preparation procedures to ensure that report findings are clearly communicated and fully consistent with information provided to bankers during exit meetings, developing and adopting common technology tools across the System to improve efficiency and potentially reduce burden on supervised companies, and evaluating applications-processing procedures to enhance transparency and identify opportunities for streamlining. And more projects are under consideration. Overall, these efforts are intended to ensure a rigorous, but balanced, approach to safety and soundness supervision that fosters a stable, sound, and vigorous community bank population.

In summary, the Federal Reserve supports efforts to ensure that the examination process is fair, balanced, and consistent and strives to continuously improve its examination processes. Indeed, we have already initiated a number of changes to improve and clarify our supervisory policies and practices and, where possible, constrain burden while still ensuring a safe and sound banking industry. It is important that the agencies not be impeded in taking steps to ensure the safe and sound operation of banking firms.

We appreciate the subcommittee's invitation to share our views, hope that our comments have been helpful, and would be happy to continue a dialogue on these very important issues.

February 1, 2012

Testimony of

Albert C. Kelly, Jr.

On behalf of the

American Bankers Association

before the

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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:

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[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.

For Release Upon Delivery

2:00 p.m., February 1, 2012

TESTIMONY OF

JENNIFER KELLY

SENIOR DEPUTY COMPTROLLER

FOR MIDSIZE AND COMMUNITY BANK SUPERVISION

OFFICE OF THE COMPTROLLER OF THE CURRENCY

Before the

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

COMMITTEE ON FINANCIAL SERVICES

U. S. HOUSE OF REPRESENTATIVES

February 1, 2012

Statement Required by 12 U.S.C. § 250:
The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Introduction

Chairman Capito, Ranking Member Maloney, and members of the Subcommittee, I appreciate the opportunity to appear before the Subcommittee on Financial Institutions and Consumer Credit to discuss the Office of the Comptroller of the Currency's (OCC) perspectives on H.R. 3461, "The Financial Institutions Examination Fairness and Reform Act."

As the Senior Deputy Comptroller for Midsize and Community Bank Supervision for the OCC, I serve as the senior OCC official responsible for community bank supervision. The OCC supervises approximately 1,700 national banks and federal savings associations with assets under $1 billion. These community-focused institutions (collectively referred to as "banks" in my testimony) play a crucial role in providing consumers and small businesses in communities across the nation with essential financial services as well as the credit that is critical to economic growth and job creation.

H.R. 3461 contains measures directed at three basic concerns: 1) assuring that banks have access to a fair and independent appeals process if there are disagreements about a bank regulator's supervisory determinations; 2) clarifying or revising standards for classification of loans and placing loans in nonaccrual status; and 3) achieving timely examinations and communication of examination results.

My managers and I hold numerous outreach sessions and meetings with bankers to listen and respond to their concerns and questions, and we have heard many of the same concerns that you have about the challenges bankers are facing. We seek to ensure that the OCC's examinations are fair, balanced, and timely, and that the OCC is fulfilling its mission of ensuring the safety and soundness of national banks and federal thrifts by identifying problems at the earliest possible stage and holding institutions accountable for taking timely and effective corrective actions. While we understand and support the broader objectives of H.R. 3461, we believe provisions of the bill in its current form could impede our ability to deal with troubled institutions on a timely basis and would undermine Congress's clear direction that regulators[1] identify and promptly address unsafe and unsound practices at depository institutions.

First, let me emphasize that the OCC fully supports providing bankers with a fair and independent process for appealing supervisory determinations. We think our current appeals process, run by our Ombudsman, does just that. H.R. 3461's approach to accomplishing that objective would involve creating a new federal bureaucracy at the Federal Financial Institutions Examination Council (FFIEC) and risks disrupting appropriate and necessary supervisory activities by bank regulators. We believe there are better alternatives – without those downsides – that would accomplish the objectives of H.R. 3461, and we would be happy to work with the Subcommittee to frame out an alternative approach.

Second, we have significant concerns that the standards for nonaccrual loans in H.R. 3461 could result in revenue recognition that is inconsistent with generally accepted accounting principles (GAAP). The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) established that banks must follow GAAP, or standards that are no

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[1] Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, §§ 121, 131-32, amending the Federal Deposit Insurance Act, 12 U.S.C. §§ 1831n, 1831o, 1831.

less stringent than GAAP, in reporting their financial condition. Congress put this requirement in place in response to the savings and loan crisis, where non-GAAP regulatory accounting masked the deteriorating financial condition of institutions until it became so serious that a massive bailout was needed.[2] H.R. 3461 would slacken this important standard.

The integrity of financial reporting and regulatory capital is vital to identifying and correcting weaknesses before they threaten a bank's ability to continue to meet the needs of its customers and the communities it serves. Those standards must not be compromised. As we have learned in the most recent crisis, it is also essential that supervisors have the ability to direct banks to hold capital commensurate with their risk profile. H.R. 3461 would, in certain instances, tie the hands of regulators when they have determined that an institution's risk profile warrants a larger capital buffer.

Finally, we agree that completing and communicating our examination findings on a timely basis are essential if we expect bankers to initiate appropriate corrective action to address problems or deficiencies identified by examiners. While clarifying expectations regarding examination timing and communication can be a positive step; as H.R. 3461 recognizes, however, there needs to be flexibility to accommodate situations where an exam may not be finished, or results not yet communicated, for good reasons, such as when an issue raises significant policy issues that need further deliberation before a conclusion is reached.

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[2] A June 1991 Congressional Budget Office Staff Memorandum concluded that a policy of regulatory forbearance increased the eventual bill for resolving failed thrift institutions by about $66 billion. *See:* CBO Staff Memorandum, *"The Cost of Forbearance During the Thrift Crisis,"* June 1991.

Before elaborating further on each of these areas, I want to briefly report on the overall condition of national community banks and federal savings associations. While we have been through an extremely difficult economic cycle, I am pleased to report that conditions are beginning to stabilize for most community banks and thrifts. Through the third quarter of last year, noncurrent loan levels for most loan types have begun to stabilize or trend downward, and returns on assets and equity for many of these financial institutions have improved. However, their operating environment remains challenging. Lending activity, which is the primary revenue source for these institutions, continues to be hampered by the overall economic downturn and net interest margins continue to be strained. Given these challenges, some of these institutions will continue to face significant problems. In these cases, the goal of our supervisory actions is to restore the bank or thrift to health and, if that is not possible, to seek an orderly and least cost resolution.

Despite the financial crisis and the deep recession, three quarters of the community banks and thrifts we supervise have satisfactory supervisory ratings, reflecting their sound management and strong financial condition. These institutions have successfully weathered the recent economic turmoil by focusing on strong underwriting practices, having timely and accurate recognition of problem loans, and maintaining strong capital buffers. These are basic tenets of sound banking practice.

With this as background, let me discuss in greater detail my perspectives and concerns with the three major provisions of H.R. 3461.

Fair and Independent Appeals Process

My management team and I encourage community bankers who have concerns about a particular examination finding to raise those concerns with his or her examination team and with the district management team that oversees the bank. Nonetheless, we also recognize the need for bankers to have an independent channel to raise and discuss their concerns outside of the direct supervisory process. Because of this, the OCC established an Ombudsman's office before it was required by statute. This office provides a venue for bankers to discuss their concerns informally or to formally request an appeal of examination findings.

H.R. 3461 would augment the agencies' existing Ombudsman offices with a separate and independent Office of Examination Ombudsman that would operate as a component of the FFIEC.[3] This office would be authorized to investigate complaints and receive appeals directly from bankers. It would also be charged with holding periodic meetings to obtain feedback from bankers on examination policies and practices and to conduct a regular program on examination quality assurance for all examination types conducted by the federal regulatory agencies.[4]

These provisions of H.R. 3461 would create a new federal bureaucracy – a program office in the FFIEC that will need to be funded and staffed. It also could have

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[3] The FFIEC is an interagency body with six voting members: a Governor of the Board of Governors of the Federal Reserve System, the Chairman of the Federal Deposit Insurance Corporation, the Chairman of the Board of the National Credit Union Administration, the Comptroller of the Currency, the Director of the Consumer Financial Protection Bureau, and the Chairman of the State Liaison Committee. The Council's activities are supported by interagency task forces and by an advisory State Liaison Committee, comprised of five representatives of state agencies that supervise financial institutions.

[4] Certain provisions, such as quality assurance reviews of examination practices, would not apply to the Consumer Financial Protection Bureau or state financial regulators.

the unintended consequence of substantially prolonging and adding complexity and costs to the examination process. We believe there are better ways to achieve an effective and independent appeals process that would not involve these downsides. The alternatives we envision would provide an independent and empowered appeals process within each agency. This maintains appropriate agency accountability for the actions it ultimately takes, and would avoid creating a process that could forestall needed corrective actions for up to six months or longer.

In its 2011 policy position paper[5] and in previous correspondence[6] with the OCC, the American Bankers Association (ABA) noted that an effective ombudsman-run agency appeals process has several important characteristics: 1) independence, functioning outside of the supervision area with a direct reporting line to the head of the agency; 2) the authority to suspend or overrule an exam finding, subject only to the final determination by the agency head, and authority to conduct an independent review of post-exam surveys; 3) expertise and sufficient staff that is seasoned and well-respected within the agency; and 4) established processes and time frames following the resolution of an appeal and again after the next examination to see if the bank perceives any examiner retribution, with reports of such reviews provided to the head of the agency and the head of supervision. The ABA also noted the value of having more informal means for a banker to appeal examination findings and to identify issues or practices where there

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[5] A copy is available at: http://www.aba.com/Issues/Issues_ExaminationReview.htm.

[6] Letter from Wayne A. Abernathy, Executive Vice President, Financial Institutions Policy and Regulatory Affairs, American Bankers Association, to John C. Dugan, Comptroller of the Currency (January 31, 2008).

appears to be a disconnect between the agency's stated supervisory policies and how those policies are being implemented in the field.

We support the principles for an open and fair appeals process as outlined by the ABA. Indeed, these characteristics are consistent with the OCC's current approach, which works well.

National banks and federal savings associations currently can file appeals with the deputy comptroller that oversees their local supervisory office or directly with OCC's Ombudsman's office. If a banker disagrees with the decision of an appeal filed through the supervisory channel, the banker may subsequently appeal the matter to the Ombudsman.

The OCC's Ombudsman is fully independent of the supervisory process, and reports directly to the Comptroller, not to a supervisory committee or other group that must ratify his decision. In this regard, the OCC's Ombudsman has direct decision-making authority and is empowered to obtain directly whatever information he believes is needed to make a decision. The scope of the Ombudsman's authority includes examination ratings and findings, including items identified in an examination report as a matter requiring attention, the adequacy of loan loss reserves, and appropriateness of loan classifications. With the consent of the Comptroller, the Ombudsman may stay any appealable agency decision or action during the resolution of an appealable matter. The Ombudsman also reports weaknesses in OCC policy to the Comptroller, and makes recommendations regarding changes in OCC supervisory policy. The OCC's Ombudsman is a seasoned national bank examiner with over 20 years of experience and is supported by a dedicated staff of other seasoned bank supervision professionals.

To provide transparency to the appellate process, the Ombudsman's office provides a summary on the OCC's public Web site of every formal appeal it receives and its disposition.

We encourage national banks and federal thrifts to contact the Ombudsman to discuss any agency policy, decision, or action that might develop into an appealable matter. The Ombudsman's objective in these cases is to seek a resolution to the dispute before it develops into a formal appeal. This avenue provides an opportunity for a financial institution to resolve issues in the most efficient and expeditious manner possible.

OCC examiners respect the role the Ombudsman's office plays in the OCC's supervisory process and are familiar with the process for filing and reviewing an appeal of examination findings. They are trained to share that information with bankers when circumstances warrant. The Comptroller and I have made it clear that we will not tolerate actions or statements by an examiner that may suggest that a banker would be subject to any type of retaliation or retribution should he or she raise concerns about their institution's examination. As an additional safeguard, the OCC's Ombudsman's office contacts each appellant bank approximately six months after a decision is rendered to ask whether the bank believes OCC examiners have taken retaliatory action against the bank. In general, this process is completed within 30 days. If the Ombudsman finds evidence that retaliation has occurred, he will refer the complaint for appropriate follow-up.

In addition to administering the OCC's formal appeals process, the Ombudsman's office also assists the agency by administering an optional, confidential questionnaire that bankers can fill out at the end of each of our examinations. This questionnaire helps us to collect candid feedback on the strengths and weaknesses of our examination processes. Bankers send their responses to the Ombudsman's office to ensure their confidentiality. Depending on the response, the Ombudsman's office may contact the banker to discuss his or her concern or to gather more information. The Ombudsman's office analyzes and shares aggregate responses internally on a semi-annual basis. This feedback is valuable in identifying areas where we may need to make improvements or determine whether there may be "mixed messages" between headquarters and the field.

We welcome the opportunity to share these experiences with the Subcommittee in exploring alternatives to H.R. 3461's approach to an independent appeals process.

Standards for Nonaccrual, Loan Classifications, and Capital Determinations

Assessments of a bank's credit quality as reflected in its nonaccrual and loan classification policies and decisions, and the bank's ability to weather unexpected losses through its capital planning and capital buffers are core elements in ensuring the safety and soundness of financial institutions. H.R. 3461 attempts to provide more clarity and consistency in the regulators' application of nonaccrual, appraisal, classification, and capital standards by, among other provisions, setting forth limitations on when a loan could be placed on nonaccrual status and when a restructured loan would have to be removed from that status. In these cases, it also would prohibit the agencies from directing a bank that meets the Prompt Corrective Action (PCA) definition of "well capitalized" to raise additional capital – regardless of the institution's risk profile.

As I have previously testified, [7] the OCC is committed to providing clear and consistent standards for loan classification and nonaccrual status, and I appreciate the constructive dialogue that I and others at the OCC have had with members of the Subcommittee and their staff on these important issues. Nonetheless, we are concerned that the standards set forth in H.R. 3461 could have several harmful consequences.

First, I would like to provide some clarity regarding the agencies' loan classification and nonaccrual policies. As stated in the agencies' October 2009 policy statement on prudent commercial real estate (CRE) loan workouts, loans that are adequately protected by the current sound worth of the borrower or underlying collateral generally are not adversely classified,[8] i.e., not graded "substandard," "doubtful," or "loss."[9] The policy statement also acknowledges that examiners should not adversely classify performing commercial loans solely because of a decline in value of the underlying collateral as long as there is not a well-defined weakness that jeopardizes repayment. If a loan is classified, bankers and examiners need to consider whether the bank should continue to accrue income on the loan. The determination as to whether a loan should be placed in nonaccrual status is primarily based on an assessment of the collectibility of both principal and interest. Collectibility is the primary basis for these

[7] *See:* Testimony of Jennifer Kelly before the Subcommittee on Financial Institutions and Consumer Credit, Committee on Financial Services, July 8, 2011.

[8] *See: Policy Statement on Prudent Commercial Loan Workouts,* available at: http://www.occ.gov/news-issuances/bulletins/2009/bulletin-2009-128a.pdf, page 7.

[9] The criteria for these classifications can be found in Appendix 4 of the 2009 CRE policy statement, page 33.

nonaccrual policies, because GAAP prohibits the recognition of income if collectibility is not reasonably assured.[10]

Determining whether a loan payment, either principal or interest, is collectible requires judgment on the part of the banker. We are concerned that attempts to impose bright line statutory standards fail to recognize this.

We agree that both collateral value and delinquency status, among other factors, should be considered when assessing whether a loan and interest income are collectible. However, neither of these considerations in and of themselves are sufficient to appropriately assess collectibility. These decisions require an understanding of the loan's term and structure and the borrower's historical and future ability to repay both principal and interest – factors that require considerable judgment based on each loan and borrower's specific facts and circumstances. Removing this judgment from the examination process, the OCC believes, could constrain an examiner's ability to ensure that bankers are preparing financial statements that accurately reflect the condition of their loan portfolio and conform to GAAP. Tying the hands of examiners on these core supervisory judgments, in our view, undermines an essential element of the supervisory process.

As the agencies noted in the 2009 CRE guidance, as the primary sources of loan repayment decline, the importance of the collateral's value as a secondary repayment source increases. We are concerned that H.R. 3461 oversimplifies this important

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[10] In accordance with GAAP, the recognition of income involves consideration of two factors: (1) being realized or realizable, and (2) being earned. The first consideration is generally more difficult for financial institutions because it requires an assessment of collectibility. If collection is not reasonably assured, recognition of income, including interest income, is not appropriate.

distinction. H.R. 3461's treatment of commercial loans where there has been a decline in collateral values highlights this problem. For example, the bill adds to the FFIEC Act of 1978 (the FFIEC Act) a new section 1013(a)(1) which directs that a commercial loan shall not be placed in nonaccrual status solely because the collateral for such a loan has deteriorated in value. This is problematic because for many CRE loans the collectibility of the loan is inextricably linked to the value of the collateral, as the sale of the collateral is the primary or sole source of the loan's repayment. In these cases, understanding the current value of the collateral is critical to assessing the collectibility of both principal and interest. Continuing to recognize interest income on such loans despite evidence that the income will never be collected in cash is inconsistent with GAAP.

H.R. 3461's treatment of when a loan could be removed from nonaccrual status presents similar concerns and potential inconsistencies with GAAP as it focuses solely on a borrower's current performance. As previously noted, while a borrower's current performance is certainly a key variable in making an assessment of collectibility, a banker must also consider the borrower's continued capacity to meet the loan's terms in the future. For example, it is common for many construction loans to be structured with an "interest reserve" for the construction phase of the project, with the lender recognizing interest income from the reserve. Proceeds from the sale of lots, homes, buildings or permanent financing based on stabilized occupancy are used for the repayment of principal, which includes any draws from the interest reserve that have been capitalized into the loan balance. However, if the development of the project stalls and bank management fails to evaluate the collectibility of the loan, interest income will continue to be recognized from the initial interest reserve and capitalized into the loan balance even though the project is not generating sufficient cash flows to repay the principal. In such cases, the loan will be contractually current but collection of principal and interest may not be reasonably assured.

In both instances, the bill would require a divergence from GAAP that could result in the overstatement of income and therefore, regulatory capital. As noted before, similar consequences of regulatory accounting practices were prevalent in the savings and loan crisis that led Congress to pass FDICIA.

Section 1013(b) of the FFIEC Act added by H.R. 3461 would prohibit the regulatory agencies from requiring a financial institution that is "well capitalized" to raise additional capital in lieu of an action prohibited under Section 1013(a). A lesson learned from the recent crisis is that the PCA definition of "well capitalized" does not provide a sufficient capital buffer to maintain a bank's viability in the face of higher levels of risk. This is especially true for community banks that may have a concentration of exposures to certain types of borrowers or industries and geographic areas. We also know that raising capital becomes more difficult as a bank's condition deteriorates and that declining capital ratios often are a lagging indicator of increasing risk in the bank's assets. That is why we direct banks with significant concentrations, or deteriorating asset quality that may pose a risk to their capital, to increase capital before their capital levels breach regulatory minimums – at a stage when they are able to take action to ensure that they can continue to lend to sound borrowers. Such determinations, however, are not made arbitrarily or unilaterally by an individual examiner. Directives to increase capital require multiple layers of management review and concurrence at the OCC.

Restricting the ability of bank regulators to direct institutions with higher risk profiles to hold higher levels of capital undermines a key provision of PCA and is contrary to the recommendation of the Government Accountability Office that the agencies consider additional measures – including higher capital thresholds – to require early and forceful regulatory action to address unsafe banking practices.[11]

Section 1013(c) of the FFIEC Act added by H.R. 3461 would also require the agencies to develop and apply identical definitions and reporting requirements for nonaccrual loans. In this regard, I would simply note that the agencies already have uniform loan classification standards. Likewise, the agencies' Call Report Instructions set forth common definitions and standards for determining when a loan should be reported as nonaccrual for financial reporting purposes.

Timely Examination Communications

H.R. 3461 would establish statutorily mandated time frames for conducting exit interviews and issuing reports of examinations. Exit interviews – and thus completion of the examination – would generally be required within nine months after the start of the examination, and a final examination report issued no later than 60 days after the later of the exit interview or the provision of additional information by the bank. While the OCC shares the goal of ensuring timely and efficient examinations, we are concerned that hardwired statutory deadlines could have unintended consequences. We are particularly concerned that such mandates could undermine our objectives of ensuring that all

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[11] *See:* GAO, *Bank Regulation: Modified Prompt Corrective Action Framework Would Improve Effectiveness,* GAO 11-612 (Washington D.C.: June 2011).

relevant information about a bank's condition is considered before we reach and issue final conclusions. Similarly, when an examination raises complex policy or legal issues, it is critical that our policy and legal staff have sufficient opportunity to review and provide direction. Such deliberations may often involve consultations with our regulatory colleagues to help ensure consistency in our supervision.

H.R. 3461 would allow an exception to these provisions by providing written notice to the bank and the proposed FFIEC's Office of Examination Ombudsman. The involvement of the proposed external Ombudsman in this facet of bank supervision simply accentuates the concerns we have expressed about the creation of a new bureaucracy and unduly complicating and delaying necessary examination activities. Indeed, engaging an Ombudsman's office at this stage could taint an Ombudsman's independence should a bank want to file a formal appeal once a final report is issued.

It may be helpful to briefly describe the OCC's processes to ensure open and frequent communication with the banks we supervise, before, during, and after our on-site examinations. Our goal in maintaining ongoing communication is to avoid surprises or misunderstandings about the OCC's assessment of, or expectations for, a bank and to keep bank management fully informed of our supervisory activities. Our examiners meet with bank management at the start of each examination to discuss the purpose and scope of the examination and to answer any questions that bank management may have. Throughout the examination, examiners hold periodic meetings with bank management to discuss and seek clarification about potential issues. Such communication helps to prevent misunderstandings and allows bank management to provide additional information on substantive issues.

Examiners review their preliminary examination conclusions and potential matters that require attention with bank management before leaving the bank. If there are open issues, examiners will generally provide bank management with an opportunity to provide additional information before the formal examination report is completed and issued. While examiners will typically establish a deadline for providing the additional information to allow timely finalization of conclusions, we do not have arbitrary time frames for management responses, and we will generally work with bank management teams that have shown a commitment to being responsive. We will not however, allow bank management to unnecessarily delay finalization of our conclusions in order to forestall necessary corrective actions.

Once an examination is completed, and any additional information from bank management has been received and considered, we strive to complete and issue our formal Report of Examination as quickly as possible. Examination conclusions for problem banks receive additional levels of review. While this additional level of review may lengthen the time required to issue the report, we believe it is an important safeguard to ensure consistency and balance in our examination decisions. In these cases, our local offices keep bank management informed of the status of the review process. If material changes are made as a result of this review, we will meet with bank management to discuss those changes before the final report is issued and to give bank management an additional opportunity to present their perspective on the findings and to address any factual errors we may have made. When the Report of Examination has been finalized and issued to the bank, the Examiner-in-Charge and an OCC manager with direct responsibility for the supervision of the institution will meet with the board to review the findings, answer questions, and discuss any required corrective actions, including the OCC's plans for supervisory follow-up on those issues prior to the next examination.

Conclusion

In conclusion, let me reiterate the OCC's strong commitment to fair, timely, and balanced supervision, and our willingness to work with the Subcommittee to explore alternative approaches that would achieve goals we share, without raising the types of concerns we have identified.

NAFCU

Testimony of

Jeanne Kucey

President and CEO of JetStream FCU

On behalf of

The National Association of Federal Credit Unions

Before the

House Financial Services Committee

Subcommittee on Financial Institutions and Consumer Credit

United States House of Representatives

February 1, 2012

Introduction

Good afternoon, Chairman Capito, Ranking Member Maloney, and Members of the Subcommittee. My name is Jeanne Kucey, and I am testifying today on behalf of the National Association of Federal Credit Unions (NAFCU). Thank you for holding this important hearing. We appreciate the opportunity to share our views on H.R. 3461, the *Financial Institutions Examination Fairness and Reform Act.*

I am the President and CEO of JetStream Federal Credit Union, headquartered in Miami Lakes, Florida. Jetstream has $126 million in assets and serves more than 16,000 members in our seven locations, including one in Puerto Rico. I also serve on the Board of Directors of NAFCU.

Prior to joining JetStream, I was President and CEO of Retail Employees Credit Union in Atlanta, Georgia. I have more than 20 years of executive level experience including serving as both Vice President of Operations at Atlanta City Employees Credit Union and Vice President at San Diego County Credit Union.

NAFCU is the only national organization that exclusively represents the interests of the nation's federally chartered credit unions. NAFCU is comprised of over 800 member-owned and operated credit unions. NAFCU member credit unions collectively account for approximately 62 percent of the assets of all federally chartered credit unions.

Background on Credit Unions

Historically, credit unions have served a unique function in the delivery of necessary financial services to Americans. Established by an Act of Congress in 1934, the federal credit union system was created—and has been widely recognized—as a way to promote thrift and to make financial services available to all Americans who would otherwise have limited access to financial services. Congress established credit unions as an alternative to banks and to fill a precise public need—a niche that credit unions fill today for nearly 94 million Americans.

Every credit union is a cooperative institution organized "for the purpose of promoting thrift among its members and creating a source of credit for provident or productive purposes." (12 U.S.C. §1752(1)). While more than 75 years have passed since the *Federal Credit Union Act* (FCUA) was signed into law, two fundamental principles regarding the operation of credit unions remain every bit as important today as in 1934:

- Credit unions remain singularly committed to providing their members with efficient, low cost, personal service; and
- Credit unions continue to emphasize traditional cooperative values such as democracy and volunteerism.

The nation's approximately 7,200 federally insured credit unions serve a different purpose and have a fundamentally different structure than banks. Credit unions exist solely for the purpose of providing financial services to their members—while banks strive to make a profit for their shareholders. As owners of cooperative financial institutions united by a common bond, all credit union members have an equal say in the operation of their credit union—"one member, one vote"—regardless of the dollar amount they have on account. These singular rights extend all the way from making basic operating decisions to electing the board of directors. Federal credit union directors also generally serve without remuneration—a fact epitomizing the true "volunteer spirit" permeating the credit union community.

Today, credit unions continue to play a very important role in the lives of millions of Americans from all walks of life. As consolidation among financial depository institutions has progressed with the resulting de-personalization in the delivery of financial services by some large banks, the emphasis in consumers' minds has begun to shift not only to services provided but also—and in many cases more importantly—to quality and cost. While many large banks have increased their fees and curtailed customer service as of late, credit unions continue to provide their members with high quality personal service at the lowest possible cost. This is evidenced, most recently, as thousands of Americans turned to local credit unions after several large national banks proposed new fee increases.

Current Examination Process

Credit unions were not the cause of the financial crisis, yet often feel the effect of punitive measures designed to reel in the practices of bad actors and other financial institutions.

Part of the response to the economic crisis was to create new layers of regulations and institute more aggressive enforcement of existing law. In order to aggressively enforce new and old regulations and to avoid a repeat of the crisis, regulators have increasingly tightened examinations standards. For example, since the start of the crisis, examination cycles for credit unions have gone from 18 months to 12 months. Having examiners visit an institution adds its own burden to the institution, as they must dedicate staff time and resources to prepare and respond to the examination.

NAFCU supports effective exams that are focused on safety and soundness and flow out of clear regulatory directives. However, the examination process, by its very nature, can be inconsistent. Regulatory agencies in Washington try to interpret the will of Congress, examiners in the field try to interpret the will of their agency, and financial institutions often become caught in the middle as they try to interpret all three as they run their institution. Unfortunately, the messages are not always consistent. NAFCU members have long had issues with the examination process, as have other regulated entities. NAFCU supports efforts to help reduce the regulatory burden on credit unions. This is one of the reasons that NAFCU urges the committee to consider improvements to the examination process.

Many credit unions, including mine, have positive professional relationships with their examiners. We believe that this working relationship is important in having a successful examination process focused on safety and soundness.

Unfortunately, not all institutions have this positive relationship with their examiner. It is with this in mind that we believe that consistency, the handling of guidance versus regulation, the management of examiner expectation and managing the exam relationship are all areas where improvement in the examination process could occur.

Areas where Congress can help improve the examination process through H.R. 3461 and beyond include:

Congressional Intent

Identifying and adhering to Congressional intent is key to the proper promulgation and implementation of regulations. Congress must make its intent clear to regulators. One result of the rhetoric and regulations stemming from the *Dodd-Frank Wall Street Reform and Consumer Protection Act* has been a message to regulators to conduct draconian supervision and apply rigid parameters in examinations. As a result, credit unions find themselves using precious resources trying to navigate a new and unfamiliar exam process while simultaneously trying to guide their member-owners through the worst financial crisis since the Great Depression.

While we agree that the unregulated bad actors that caused the crisis are in desperate need of regulations to curtail their risky and abusive practices, credit unions certainly do not fall in that category. Unfortunately, credit unions now face many of the same costly and burdensome regulations as the bad actors, in addition to a restrictive examination environment.

Transparency

Ensuring transparency in government is a laudable goal embraced by many members of the Committee and the Administration. Transparency is critically important at our nation's regulatory agencies. The standards of a regulatory regime must be articulated with a level of clarity and definition that provides for as little ambiguity as possible. We believe there are two ways to go about this.

First, regulations and any subsequent guidance must include clear tangible criteria which credit union executives can follow. Furthermore, credit unions should have access to all materials and guidance that examiners use or reference during examinations. Since credit unions do not have all the guidelines used by examiners, it is understandably difficult to comply to the extent that the credit union or the NCUA may prefer.

Second, credit unions should always receive constructive feedback in regard to issues an examiner may identify. Some credit unions have reported receiving unclear or inadequate responses. In other instances they have received information that is inconsistent with published examination guidelines. Improving this process should help both the examiner and the institution.

Ultimately, more transparency in the regulatory process will lead to more consistency and promote safety and soundness throughout the system.

Consistency

Maintaining a consistent supervisory and examination environment is vital to ensuring compliance with both safety and soundness as well as consumer protection regulations. Notwithstanding changes in regulation, the standards by which a credit union is evaluated during examinations should not change from examination to examination. Unfortunately, this is not always the case and credit unions are too often left guessing which particular business area will receive the most emphasis by an examiner. For example, while one examiner may find mortgage lending to carry the most importance, another may place emphasis on business lending.

Additionally, regulators should ensure that their regulations are consistently applied from one examiner to another. Inconsistent application of laws and regulations among examiners increases uncertainty. This increased uncertainty adds another unnecessary layer of difficulty for credit unions to maintain the highest levels of compliance.

More importantly, it is also unclear how an examiner will evaluate compliance. In addition to actual regulations, the NCUA also routinely provides "guidance" in any one of a number of different forms. Some examiners treat the guidance as just that; a tool to be used for credit unions to comply with regulations or implement best practices. Some examiners, however, treat the "guidance" as if it were part of the regulation itself, and consider failure to comply with the guidance as something roughly equal to failing to comply with the regulation. Examiners' misuse of and misplaced reliance on guidance documents is an increasing concern for credit unions. More should be done to ensure that all examiners treat both regulations and guidance consistently and for the purpose each was issued. Asking credit unions to comply with fluctuating standards, based on each individual examiner's reliance on informal guidance, ultimately increases compliance costs without any clear benefit.

Examination Report Appeal Process

NAFCU understands that some of our concerns cannot be addressed by regulators. Generally, NCUA and its examiners do a satisfactory job, but every inconsistency that forces credit unions to divert more resources to compliance reduces their ability to better serve their members. This ultimately translates to lower interest rates on savings, higher interest rates on loans, and in some cases, the inability to extend credit to a member that would receive credit otherwise.

It is with this delicate balance in mind that NAFCU urges reforms to the current appeal process. The appeal process should provide an opportunity to identify inconsistencies and serve as a quality assurance check. The existing appeal process does not promote either. It is worth noting that NCUA should not be blamed for the shortcomings of the appeal process. The true issue is the structure of the process.

NCUA currently serves as the prosecutor, judge, and jury. Under the existing process, if an examiner makes a determination to take action against the credit union, the credit union must first address the issues with the examiner. The second step is to contact the supervisory examiner, who evaluates the facts and reviews the analysis. If the issue is still not resolved, the credit union may send a letter to the regional director.

After the previous steps have been taken, if the appeal concerns a material supervisory determination, the credit union may appeal to the NCUA Supervisory Review Committee. Material supervisory determinations are limited to: (1) composite CAMEL ratings of 3, 4, and 5 and all component ratings of those composite ratings; (2) adequacy of loan loss reserve provisions; (3) loan classifications on loans that are significant as determined by the appealing credit union; and (4) revocations of Regulatory Flexibility Program (RegFlex) authority. The

NCUA Supervisory Review Committee consists of three regular members of the NCUA's senior staff appointed by the NCUA Chairman.

The appeal process has a number of inherit flaws, not the least of which is the exclusion (in most instances) of a review by an independent third party at any level of the process. Under these circumstances it is almost impossible to avoid conflicts of interest and approach each situation objectively. A number of issues result from this lack of independent review.

Any regulatory agency would be hesitant to support an appeal of an internal decision. Undoubtedly, and understandably, agency officials have more faith in their examiners than the regulated entity. Overturning the decision of a field examiner could be extremely difficult for a supervisory examiner or regional director, especially in the absence of clear cut evidence that an examiner has acted in conflict with agency guidance. Approving an appeal may reflect poorly on the examiner and possibly the supervisory examiner or regional director. For example, NCUA's Supervisory Review Committee, which is comprised of senior staff of the agency, could unintentionally be influenced by the impact that overruling an examiner could have on the agency. It is clearly evident that at some point in the appeal process, the appeal needs to be heard by someone without any interest in the outcome.

Consumer Financial Protection Bureau

H.R. 3461 will help foster a stronger relationship between the CFPB and the financial services industry by encouraging a transparent and consistent examination process. Certainly, the legislation will have a similar impact on all financial regulators, but the impact with regard to the

CFPB is magnified because it is a new agency with little to no precedent on which to rely. As institutions are examined and interact with the CFPB, providing clear guidance as to the basis for material supervisory determinations will help institutions comply with this new regulatory landscape.

H.R. 3461, the Financial Institutions Examination Fairness and Reform Act

Several provisions in the *Financial Institutions Examination Fairness and Reform Act* will address concerns with the examination process. We support this bill as it will improve transparency and consistency in a meaningful manner. A provision in Section 2 of the legislation would require examiners to disclose all examination and other factual information relied upon in support of a material supervisory determination. This would help ensure that regulatory guidance is being applied consistently. NAFCU strongly supports this provision; however, it can be improved by removing the requirement that financial institutions request this information. This information should always be provided to financial institutions upon completion of the examination process.

The establishment of the Office of Examination Ombudsman in the Federal Financial Institutions Examination Council will promote consistency and eliminate the current conflict of interest inherent in the process. Currently, for some issues, such as certain cease and desist proceedings, there is a formal independent appeal process available to credit unions. However, an expanded right to appeal all actions to an administrative law judge will ensure that appeals receive an independent review.

Disclosure of the information used in support of a material supervisory determination combined with an independent review of appeals will assist in exposing any disconnect between the guidance given by agency leadership in Washington and field examiners.

Finally, as the committee considers this legislation, we ask that you ensure the costs associated with these improvements are not simply passed on to credit unions and other financial institutions. There are many ways to enhance the efficiency of the examination process to help offset any potential cost increases that may arise as a result of these much needed reforms. In some instances the establishment of a new office or increased disclosure can provide a reason for increased assessments on financial institutions or requests for additional taxpayer funds that may not be necessary. With the fiscal situation facing our country, we must ensure every segment of government is maximizing all available resources.

Conclusion

In conclusion, I would note that NAFCU supports effective, demonstratively necessary regulation. We believe that credit unions should have a respectful non-adversarial professional relationship with examiners. We do not support new regulatory burdens that detract from credit unions serving their members without providing a clear tangible benefit.

NAFCU believes the legislation under consideration is a positive first step in improving the examination process and we support it. Introducing an independent third party to the appeal process will ensure that consistent standards are applied and will help bring more certainty to the examination process.

Thank you again, Chairman Capito, Ranking Member Maloney, and Members of the Subcommittee for the invitation to testify before you today. We appreciate the opportunity to share our views on H.R. 3461, the *Financial Institutions Examination Fairness and Reform Act.*

PROMONTORY

STATEMENT OF

EUGENE A. LUDWIG
FOUNDER AND CHIEF EXECUTIVE OFFICER,
PROMONTORY FINANCIAL GROUP, LLC

BEFORE THE

UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND
CONSUMER CREDIT

FEBRUARY 1, 2012

STATEMENT OF

EUGENE A. LUDWIG
FOUNDER AND CHIEF EXECUTIVE OFFICER,
PROMONTORY FINANCIAL GROUP, LLC

BEFORE THE

UNITED STATES HOUSE OF REPRESENTATIVES COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

FEBRUARY 1, 2012

Madam Chairman, Ranking Member Maloney, members of the Subcommittee, thank you for inviting me to comment on this significant piece of legislation, which addresses important issues of balance and fairness in the supervisory process. I would like to commend you, Madam Chairman, Ranking Member Maloney and the other members of this Subcommittee, for your concern for this topic, and in particular for your giving serious consideration to the expanded use of ombudsman programs as part of the federal financial regulatory and supervisory system. I will focus my remarks today on the ombudsman issue.

America is blessed with an uncommonly capable group of financial supervisors, examiners and regulators at our Federal agencies. As Comptroller of the Currency, a member of the Board of the FDIC, and Chairman of the FFIEC, I spent five years surrounded by members of this group and had daily occasion to be impressed with their dedication, energy, and commitment to the tasks before them. Their efforts, and the efforts of their peers at other agencies, remain essential to the health of the U.S. financial system and the well-being of the American people.

Nonetheless, every human system has its flaws; people make mistakes or differ in their judgments, and regulators are no exception. At regulatory agencies, identifying and rectifying mistakes is of course important to the particular institutions and individuals affected. However, it also has an important effect on the financial system as a whole, increasing public confidence in the fairness and balance of our regulatory mechanisms.

With this in mind, in 1993, while leading the OCC, I created the first formal ombudsman program at any financial regulatory agency. The program was intended to improve communications between supervisors and supervisees, and to give banks an opportunity to present concerns about their examination findings and other supervisory matters. We appointed an especially capable, fair-minded person to head the office; gave him the discretion to supersede any agency resolution or action on an appealable matter; and most importantly, worked hard to eliminate any prejudice towards those who brought concerns to him. Four years later, when I appeared before this Subcommittee, that Ombudsman and his staff had resolved 110 formal appeals from national banks and facilitated resolutions in 359 additional cases. In the time since, such agencies as the Federal Reserve, FDIC, FHFA, and NCUA have followed the OCC's example.

Ombudsman programs recognize the strength of the supervisory relationship—a strength that, in some ways, is even greater than the bonds of marriage. There are no divorces in banking. Without a polite, professional relationship marked by mutual respect, communication can deteriorate in a way that benefits no one. When an issue does arise, such a negative dynamic increases the time and expense of reaching a resolution, as well as the risk of an adverse event in the meantime. By keeping the lines of communication open, and by offering each party a better understanding of the other's concerns, financial agency ombudsmen make supervisory efforts all the more effective.

Ombudsman programs do not encourage laxity, nor should they. I am a very big believer in the sound regulation and supervision of our financial system. We need tough but clear and fair financial rules not just to protect consumers, but also to ensure the quality of our banks and the health of our economic system.

However, a strong ombudsman system helps to maintain consistent, high standards of conduct, a challenge that is more important now than ever. Regulatory agencies have long had tremendous discretion and power over the supervision of financial institutions, but their remit has grown steeply over the last several decades. Recent reforms, including elements of the Dodd-Frank Act, have provided regulators with new tools that can make our financial system more trusted, resilient, and innovative. But the dramatic increase in quantity and complexity of financial regulations could increase both the likelihood and the cost of regulatory error. The supervisory process sometimes leads to actions that involve re-grading loans, changing business practices, and even submitting to formal court orders. We are in the midst of great change, and it is not surprising that Congress would want to revisit ways to ensure supervisors are making the right call.

What H.R. 3461 proposes—what could be described as a "super-Ombudsman"—is a new authority to review a broad array of supervisory activities at all the banking agencies. The notion of an interagency Ombudsman is thoughtful and has considerable merit, worthy of the very serious consideration that you are wisely giving it.

I would suggest a few modifications to the concept you have proposed, to capture the advantages while avoiding excess bureaucracy and cost. Since the federal regulatory agencies already have Ombudsman programs with talented and experienced people involved, I would suggest that the new "super-Ombudsman" play a coordinating role among the Ombudsmen at the regulatory agencies and act as a "safety valve" or appeals mechanism. In such an arrangement, the super-Ombudsman would (i) work to ensure consistency and high quality of agency Ombudsman efforts, and (ii) hear cases that an agency Ombudsman refuses to hear or where an appeal is lodged.

Another way to achieve this same goal, and one that might involve less new governmental expense, would be the creation of a new, permanent Ombudsman Task Force at the FFIEC.

The task force would be made up of all the financial agency Ombudsmen, and its work, along with the work of the individual Ombudsmen, would be reportable to the Council and to Congress. The Council could help achieve the same goals of uniformity, quality control, and right of appeal as I suggest for the super-Ombudsman.

I would also suggest, Madam Chairman, that whether it be a "super-Ombudsman" or an "Ombudsman Task Force," the new mechanism—and indeed the existing agency Ombudsman—should also have the responsibility of reviewing regulations, to try to achieve the most effective application of legislative mandates in the least burdensome fashion. This effort is important and must be continual. Times change, and rules that were once effective fall out of date or prove inefficient, and need adjustment. Involving the super-Ombudsman or the Ombudsman Task Force in this effort could inject a strong dose of regulatory harmonizing into the process.

Regulations grow like barnacles on a ship: New circumstances and new lessons learned give rise to new rules. Once those rules are established, they are rarely removed. A conscious and concerted effort to scrape away the excess can make the system safer and more efficient. Where agencies and supervisees have to comply with out-of-date or ineffective regulations or guidance, they have less time to focus on what matters most: the safety and soundness of the system. Too many barnacles on the hull of a ship can sink it. And too many rules, particularly where they do not efficiently fulfill a needed function, can hurt the financial system.

Accordingly, I very much favor the advancement of the Ombudsman concept that this legislation embodies. I urge this Subcommittee and Congress generally to think broadly along the lines of what this bill and its authors are proposing. Both Congressional leaders and the President have listed regulatory reform among their priorities, and a broader use of regulatory Ombudsmen is an effective way to achieve it, fostering a stronger financial system and a healthier American economy.

Thank you again for the opportunity to address the subcommittee on this subject; I look forward to answering your questions and hearing your comments.

Embargoed Until Delivery
2:00 p.m. EST
February 1, 2012

STATEMENT OF

DAVID M. MARQUIS
EXECUTIVE DIRECTOR
NATIONAL CREDIT UNION ADMINISTRATION

BEFORE THE
HOUSE FINANCIAL SERVICES SUBCOMMITTEE ON
FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

HEARING ON H.R. 3461, THE FINANICAL INSTITUTIONS
EXAMINATION FAIRNESS AND REFORM ACT

WEDNESDAY, FEBRUARY 1, 2012

I. Introduction

Chairman Capito, Ranking Member Maloney, and Members of the Subcommittee, the National Credit Union Administration (NCUA) appreciates the invitation to offer our views on H.R. 3461, the Financial Institutions Examination Fairness and Reform Act.

Introduced by Chairman Capito and Ranking Member Maloney, H.R. 3461 seeks to improve the examination process for depository institutions by, among other things, making available to financial institutions the information used to make examination decisions and codifying certain examination policy guidance. The bill also would create an ombudsman at the Federal Financial Institution Examination Council (FFIEC) to which financial institutions could raise concerns with respect to their examinations. Additionally, H.R. 3461 would establish an appeals process before independent administrative law judges overseen by the FFIEC ombudsman.

In the invitation to testify, the Subcommittee has asked NCUA to comment on the need for reforming the examination appeals process. The invitation also requests NCUA's views on whether H.R. 3461 appropriately and effectively reforms the examination appeals process. Finally, the Subcommittee has inquired about the need to amend the legislation to better achieve the bill's objectives.

In difficult economic times, depository institutions will encounter additional stresses. As a result of these pressures, safety and soundness problems will increase, and financial services regulators, including NCUA, will take prompt action to address the identified issues and mitigate emerging risks. NCUA takes these actions in order to maintain the safety and soundness of credit unions, safeguard the National Credit Union Share Insurance Fund (NCUSIF) from losses, protect consumer deposits, and endeavor to assure that taxpayers not experience a loss.

When regulatory actions increase, complaints against the regulator typically rise. NCUA believes that credit unions should have an effective appeals system that works to resolve legitimate concerns and protect against reprisals. NCUA also works to minimize complaints by comprehensively training our examiners and encouraging stakeholders to communicate with us before, during, and after an examination.

This written testimony will provide general background about NCUA and NCUA's existing examination process. It will also highlight the strengths of NCUA's current appeals process, which we believe respects credit unions, and brings fairness to our actions and determinations.

Most importantly, this statement will outline how the implementation of H.R. 3461, as introduced, could produce a number of unintended consequences, including increased administrative costs, higher insurance premiums, and less examination flexibility. To pay for these higher costs, credit unions will likely lower interest rates for deposits and increase interest rates for loans. As a result, consumers will ultimately bear the costs of this legislation, and NCUA expects that the time to resolve emerging issues in credit unions will be greatly extended. The increased time to settle issues, however, runs counter to the recent recommendation of the Government Accountability Office (GAO) that NCUA "require early and forceful regulatory action" well before capital deterioration triggers the statutory tripwires of prompt corrective action.

II. About NCUA

NCUA's primary mission is to ensure the safety and soundness of federally insured credit unions. NCUA performs this important public function by:

- examining all federal credit unions;
- participating in the supervision of federally insured, state-chartered credit unions in coordination with state regulators whenever possible; and
- insuring federally insured credit union members' accounts.

In its statutory role as the administrator of the NCUSIF,[1] NCUA provides oversight and supervision to 7,179 federally insured credit unions. These federally insured credit unions represent 98 percent of all credit unions and serve 91.4 million credit union members.[2]

III. NCUA's Current Appeals Process

NCUA recognizes that our examination process, like that of every other financial institution regulator, can be improved and enhanced. As such, we are constantly working to refine our examination methods and practices. Moreover, NCUA actively works to minimize complaints about the examination process through comprehensive training for our examiners on proper examination procedures, effective communication, and the need to remain objective and respectful at all times. We also encourage credit unions to communicate with us throughout the examination process. Effective communication between the regulator and the regulated can often resolve problems on the frontlines and avoid the need for pursuing appeals.

In working to protect deposits, keep the credit union system safe and sound, and maintain a strong insurance fund, NCUA must ensure that every federally insured credit union operates in accordance with the law, in the best interest of its members, and that its officers and directors are held to the highest fiduciary standards. The NCUA examiner is at the forefront of these regulatory efforts, making sure every federally insured credit union meets these requirements.

NCUA holds our examiners accountable for their findings, which is why they must conduct thorough reviews. This accountability, however, should not prevent an ongoing dialogue between credit unions and examiners. Consistent with the timelines contained

[1] Congress established the NCUSIF in 1970 as part of the Federal Credit Union Act (P.L. 91-468) and amended the NCUSIF's operations in 1984 (P.L. 98-369). The NCUSIF operates as a revolving fund in the U.S. Treasury under the administration of the NCUA Board for the purpose of insuring member share deposits in all federal credit unions and in qualifying state credit unions that request insurance. As of November 30, 2011, the NCUSIF had total assets of $11.7 billion dollars.
[2] NCUA does not oversee approximately 150 state-chartered, privately insured credit unions. The term "credit union" is used throughout this statement to refer to federally insured credit unions.

in H.R. 3461, NCUA also prioritizes the timely delivery of examination reports by examiners so credit union management and boards can take prompt action to address problems. For this reason, credit unions should maintain continuing discussions with their examiners to solve problems before the issuance of examination findings.

When ongoing, two-way communication fails to produce a consensus for resolution, credit unions have other avenues to voice their concerns. Specifically, NCUA has adopted an appeals system to consider and resolve legitimate problems. This system allows credit unions to appeal examination findings through formal and informal channels, including to our Supervisory Review Committee.[3] To prevent unnecessary conflicts and appeals, NCUA examiners do their best to provide regular feedback to credit unions, and NCUA encourages credit union management to engage with our examiners before receiving the final report.

When examination problems arise, NCUA recommends that credit union management first engage directly with their examiners to resolve these issues. Direct communication often resolves issues like implementation timelines and the imposition of new controls. By talking to each other, the parties frequently can come to a meeting of the minds, or, at the very least, a better understanding of the issues involved. This step can be effective when there is disagreement over the facts, conclusions, or tone of the examination report.

Should the discussions with the examiner fail to produce a solution acceptable to the credit union, NCUA advises credit unions to contact the supervisory examiner, who will evaluate the facts and review the examiner's analysis. At this time, each NCUA supervisory examiner oversees about 9 examiners and roughly 93 credit unions.

If consultations with the supervisory examiner do not resolve a problem, a credit union may appeal the issue to the regional office in which it is located (there are five

[3] The Riegle Community Development and Regulatory Improvement Act of 1994 (P.L. 103-325) required each federal banking agency and NCUA to establish an independent, intra-agency appellate process. NCUA created its Supervisory Review Committee in response to the Riegle Act's mandate.

throughout the nation). Credit union management would initiate this appeal by sending a letter to the regional office. The regional director would then weigh the facts involved and reach a decision.

Should the regional director fail to find common ground with a credit union, a credit union may contact NCUA's Supervisory Review Committee as the next step in the appeals process. This independent panel comprised of three senior NCUA professionals, none of whom is involved with the examination process, considers and makes recommendations on a variety of issues. Primarily, though, it handles appeals on examination CAMEL ratings, the adequacy of loan loss reserve provisions, and classifications on loans that are significant to an institution. A credit union may then appeal a decision of the Supervisory Review Committee to the NCUA Board.

A credit union's ability to seek redress is in no way limited to the procedures outlined above. Informal dispute resolution mechanisms include writing to NCUA's Office of General Counsel about legal issues or NCUA's Office of Examination and Insurance about safety and soundness matters. When warranted, credit unions may also contact NCUA's Office of the Inspector General.

Moreover, consistent with a requirement of H.R. 3461, NCUA has already taken steps to ensure that credit unions may appeal without fear. To protect credit unions from examiner reprisals, NCUA has instituted a zero-tolerance retaliation policy. Examiners may not take action against a credit union for using any formal or informal appeal channel. Moreover, every exam report provides information on the appeals process and reference to our non-retaliation policy. NCUA's policy is also available on our public website.

IV. Addressing Examination Problems Promptly

As noted earlier, NCUA works to prevent problems in the examination process and minimize complaints by credit unions. NCUA's supervisory examiners play an important role in this regard. NCUA deploys these supervisors in the field with our examiner staff to ensure that NCUA has decision-makers in place at credit unions when problems emerge. The ability of our supervisory examiners to get immediately involved in the examination process often resolves issues as they arise and before they approach the level of a major complaint.

Sometimes an examiner's actions may lead to a problem, and the supervisory examiner must step in to resolve the matter. For example, during a routine examination at one troubled credit union, the supervisory examiner attended the exit meeting. During the meeting, the supervisory examiner observed considerable stress and at times hostile comments from the credit union's leadership. Management had concerns about the decision to keep the credit union in troubled status because of a failure to fully resolve all of the problems identified in prior examinations. As the meeting progressed, the discussions became strained. The supervisory examiner also observed a loss of objectivity from the examiner, so the NCUA supervisory examiner stepped in, changed the meeting's tone, and directed the rest of the joint conference. Subsequently, the supervisory examiner counseled the examiner on more appropriate ways to handle the situation.

In another case, the manager of a small credit union complained to the supervisory examiner about the lack of respect demonstrated by the examiner. As a result, the supervisory examiner joined the onsite portion of the examination. The issue arose from the examiner's practice of walking into the manager's office without knocking, and using the photocopier or pulling loan files independently without seeking the manager's assistance. Given the limited space, the credit union had located both the copier and loan file cabinets in the manager's office. The supervisory examiner, upon observing the interaction between the examiner and the manager, counseled the examiner, and instructed him to knock and respectfully request the use of the photocopier and access to the records needed for the examination. The supervisory examiner resolved the issue onsite and before the issues escalated to a formal complaint.

As much as we would like to believe that all credit union officials have the best interest of their credit union and its members at heart, some, unfortunately, do not. It is in these instances that examiners often receive criticism for being too tough. Yet, this is when an NCUA examiner performs at his or her best. The following two examples detail an instance when a difficult examination led to the uncovering of fraud and one case when anger by a credit union to its lowered CAMEL rating was appealed unsuccessfully, only to have the credit union realize the situation was far worse than it had imagined.

In one credit union, the CEO openly displayed hostility toward the team of examiners, causing the examiners to work under duress during most of the fieldwork. The CEO repeatedly challenged the examiners, questioning why they needed certain information, and frequently quoting policy from the NCUA examiner's guide. Although the manager often degraded examiners as lacking sufficient knowledge, the examiners maintained their professionalism throughout the examination. During a review of key employee accounts, the examiners noted a single, unusual deposit in the CEO's personal account. After further investigation, the examiners discovered that the CEO had funneled tens of thousands of dollars from a sweep account for several years.

In some instances, an NCUA examination will identify a problem at a credit union for which management will at first express doubt, but later express appreciation. At a large credit union, for example, examiners observed inappropriate responsiveness to the recent mortgage market crisis. A key problem involved the use of a valuation methodology inconsistent with current economic conditions. During the examination, the credit union's management openly challenged NCUA's conclusions and expressed anger about the downgrade to a troubled CAMEL code.

After an unsuccessful appeal, NCUA examiners performed a new supervisory contact at this credit union. During the contact, the credit union indicated that it had not only adopted NCUA's recommendations, but it also admitted that the conditions about which NCUA examiners had warned were worse than imagined. The credit union's management subsequently took very drastic actions to reverse the financial erosion of the credit union. In this case, the credit union did not initially agree with the examiner and challenged the exam. Calling the credit union's attention to the problem and requiring management to take action when it did, however, likely saved this credit union from failing.

V. Current Economic Environment and the Regulatory Response

NCUA is aware of and understands the pressures that financial institutions must confront on a daily basis, particularly during difficult economic times. As a result of the recent financial crisis, credit unions have experienced historically high default rates, although these rates have begun to decline since peaking in 2009. Additionally, difficult economic periods can lead to increased fraud at credit unions. Falling home prices, unemployment, and lower investment returns have also affected the bottom lines of credit unions in recent years.

Despite these and other challenges, credit unions have weathered the economic crisis relatively well. The industry's net worth ratio has increased from 9.89 percent in December 2009 to 10.15 percent in September 2010. Over the same time period, the system's return on average assets has jumped from 0.18 percent to 0.66 percent. NCUA continues to closely monitor the industry's performance in order to make adjustments to the agency's examination program aimed at identifying emerging risks and addressing problems on a forward-looking basis.

As noted earlier, credit unions will encounter additional threats to their safety and soundness during periods of economic uncertainty. In response, NCUA must take prompt actions to address the identified problems and mitigate emerging risks. We take these actions in order to maintain the safety and soundness of credit unions, safeguard the NCUSIF, protect consumer deposits, and ensure that taxpayers never experience a loss.

When regulatory actions increase, there typically is an associated increase in complaints against the regulator. Through the mechanisms noted earlier in this testimony, NCUA works to minimize complaints and address appeals expeditiously when they occur. Moreover, NCUA has had in place since 1995 a non-retaliation policy to ensure that credit unions can raise concerns without fear of experiencing retribution from the regulator.

VI. Analysis of H.R. 3461

To address issues identified in the Subcommittee's recent hearings, H.R. 3461 would institute new examination procedures, modify accounting practices, and create new appeal venues. Although well intentioned, the bill in its current form could produce a number of unintended consequences. Our testimony will focus on three of these unintended consequences—increased administrative costs, higher risks for the NCUSIF, and the imposition of an inflexible, one-size-fits-all approach in the examination of financial institutions.

Increased Costs for NCUA

First, H.R. 3461 would greatly raise NCUA's administrative costs. For example, the legislation's requirements to index and produce information supporting a finding would increase the time spent on examinations. The legislation's expansion of the existing definition of a "material supervisory determination" also would make virtually all examiner findings, recommendations, and action plans subject to formal appeal. In response, NCUA examiners would need to document each and every finding with specific references to NCUA rules and regulations. Additionally, at a time when NCUA is actively moving to shorten the timeframes and curtail regulatory burdens for the smallest credit unions, H.R. 3461 would force examiners to spend more time on these examinations.[4]

[4] In order to better align agency resources with industry risks, NCUA is implementing the Small Credit Union Examination Program (SCUEP) that shifts examination hours away from smaller federal credit unions with a record of sound performance and towards those credit unions that present more risk to the NCUSIF. The SCUEP is limited to

Today, NCUA operates with an extremely efficient organizational approach. We deploy our subject matter experts as a shared resource and do not assign these experts to every examination. This organizational structure reduces costs to the agency and these reduced costs are passed on to the industry.

Examinations requiring the assistance of a subject matter expert may occur through direct in-person participation or via informal consultation through phone conversations and email exchanges with the examination team. While many of these interactions are consultative in nature, they could be considered a portion of the source for reaching conclusions in an examination. If so, then the bill's documentation requirements would result in the need to index and share these sources—email chains, notes of conversations, and phone logs—with the credit union. NCUA, therefore, believes that the bill, as introduced, could be disruptive to our existing internal consultation process and possibly stimulate greater appeals to examination findings, both increasing risk to the NCUSIF and costs to the industry. The changes may also cause examiners to seek subject matter experts in less significant risk cases as a defensive measure to ensure that issues are not challenged. In either event, the net result would be higher administrative costs for the agency.

Moreover, the legislation's provisions to create additional appeals processes would add more regulatory layers that would increase costs without any assurance of greater effectiveness. Again, this change would cause examiners to fully document each and every finding, and examination costs would increase.

Currently, much of an examiner's findings are based on sound judgment and sound business or industry practice. The changes proposed in the bill, however, would likely cause NCUA to issue numerous new prescriptive regulations in order to provide examiners with sufficient support for prudential-related concerns that are currently

federal credit unions with $10 million or less in assets that received a CAMEL composite rating of 1, 2, or 3 at the last examination. The target average examination time for SCUEP examinations is 40 hours.

scaled using professional judgment, based on the size, complexity, and level of risk within the individual credit union. The need to issue new rules and regulations would run counter to NCUA's Regulatory Modernization Initiative adopted in response to Executive Order 13579.[5]

For example, there is no hard-and-true formula about proper asset diversification. Today, if an examiner looks at a credit union's books and sees too many mortgages with only a three percent down payment or inappropriately large mortgages, he or she will warn of overconcentration in the exam report. If, however, a credit union appealed this finding to an administrative law judge as allowed under the bill, NCUA could not point to the violation of a specific regulation, other than citing the fact that overconcentration is an unsafe and unsound practice.

H.R. 3461 would therefore require NCUA to set all such limits in regulation, leaving the examiner with less flexibility. These new regulations would require increased time and resources to implement. Such new regulations would also limit diversity in credit union business models and increase administrative burdens and compliance costs.

Moreover, NCUA would need to significantly increase legal staff in response to allowing credit unions to appeal examination findings to administrative law judges. These cases may also include expert witnesses and would tie up the examiner, the supervisory examiner, and regional management. As a result, NCUA would likely need to hire additional staff to make up for the lost time of preparing and testifying in addition to the new attorneys. NCUA has further apprehensions that H.R. 3461, in its present form, could lead to frivolous appeals, and such appeals would increase costs NCUA's operational costs and cause the loss of significant amounts of time. The Subcommittee may therefore want to consider adding safeguards to prevent this problem.

[5] In issuing Executive Order 13579, President Obama ordered independent regulatory agencies to periodically review existing significant regulations for those that may be "outmoded, ineffective, insufficient, or excessively burdensome, and to modify, streamline, expand, or repeal them" accordingly. Through the Regulatory Modernization Initiative, NCUA is working to improve the regulatory environment by ensuring that NCUA rules are in sync with the modern marketplace, clearly written, and targeted to areas of risk. NCUA is also working to eliminate regulations that limit flexibility and growth without jeopardizing safety and soundness.

In addition, the bill's ombudsman and operational funding formula changes would significantly increase NCUA's expenditures for the FFIEC.[6] NCUA has historically paid for one-fifth of the FFIEC's operations. H.R. 3461 correctly removes the Office of Thrift Supervision from shouldering a portion of the FFIEC budget, but the bill fails to reassign this share to the FFIEC's newest member—the Consumer Financial Protection Bureau (CFPB). As reflected by the 2012 FFIEC budget, CFPB is now fully participating in the cost-sharing of the FFIEC expenses. Left unchanged in the bill, NCUA's expenditures for the FFIEC's costs and expenses will increase from 20 percent to 25 percent.

The bill also requires the FFIEC to establish an ombudsman and appeals process involving administrative law judges. This change would likely result in a large addition to the FFIEC staffing levels depending on the number of requests for reviews and the time needed to investigate complex issues. In short, these changes would increase the costs of all FFIEC members that pay for the FFIEC's activities.

In previously requiring NCUA and federal banking agencies to establish independent, intra-agency appeals panels, Congress placed limits on the issues that financial institutions could appeal. Specifically, the Riegle Community Development and Regulatory Improvement Act of 1994 stipulates that credit unions may only appeal determinations related to examination ratings, allowances for loan and lease losses, and classifications on loans significant to a financial institution. H.R. 3461, as introduced, would expand the definition of a material supervisory determination to include any issue specifically listed in an exam report as a matter requiring attention by the institution's management or board of directors. This change would encourage appeals on virtually any and all issues because there would be no limitations on such actions.

[6] NCUA Board Chairman Debbie Matz became the FFIEC Chairman in April 2011. The FFIEC chairmanship has a two-year term.

In sum, NCUA expects the administrative and regulatory costs imposed by H.R. 3461 to be considerable. Ultimately, credit unions and their members would pay for these increased expenses.

Increased Risks for the NCUSIF

Second, H.R. 3461 in its present form appears likely to greatly increase risks to the NCUSIF. Increased risks to the NCUSIF would result in higher insurance losses and higher premiums for credit unions in the future.

The changes to examination standards dealing with commercial loan non-accrual status and restoration to accrual status, for example, have the potential to mask problems and extend the time before NCUA may take needed supervisory action. Specifically, the new Section 1013 of the Federal Financial Institutions Examination Council Act of 1978 proposed in H.R. 3461 essentially codifies in statute income recognition and loan loss provisioning rules more appropriately within the purview of the accounting standards-setters. If adopted, such practices may result in a credit union continuing operations beyond a point where NCUA would normally take action to mitigate insurance losses because of a hindrance in full transparency around loan non-performance. This change could keep NCUA in the dark about existing credit risk at credit unions. As a result, the NCUSIF would likely incur larger insurance losses.

The bill's provisions on non-accrual status are generally consistent with current accounting and financial reporting practices. Yet, because these provisions create bright lines that may permit financial institutions to ignore other available information about the borrower that should be properly factored into evaluations of a commercial loan's collectability, there is a risk that some institutions may game the system by structuring loans in a way to make it more difficult to properly provision for losses. For instance, the ability-to-perform language in the restoration to accrual paragraph goes beyond current practice when the commercial loan does not have monthly repayment terms. Under current practice, financial institutions must evaluate the probability that the loan will be repaid according to contract terms. Financial institutions must also value the loan accordingly using generally accepted accounting principles (GAAP). Likewise, to maintain accrual status, the loan should be well secured and in the process of collection. Any restructured loan must generally remain in non-accrual status for six months and the borrower must demonstrate repayment performance under the modified terms before the loan can be returned to accrual status.

To ensure harmonization with GAAP, the Subcommittee may want to clarify these issues. In this regard, the Subcommittee may wish to consider the views of the Financial Accounting Standards Board (FASB) before moving forward with consideration of the bill. FASB would be in a position to provide full insights on financial reporting impact of the proposed bill.

The new Section 1013(a)(3) is unclear, in part, because the provision fails to specifically refer to a refinance in the language limiting a new appraisal for a commercial loan. The section, however, suggests the institution is taking action. In cases where an institution is involved in a loan restructuring with no cash out, the bill would prohibit NCUA from expecting the credit union to evaluate risk exposure through requiring appraisals of the properties in question. Historically, a bank or credit union would normally require a new appraisal as part of its underwriting on the modified loan. More current value information is critical to appropriately assess the reserving needs for impaired loans.

The limitations on obtaining a new appraisal would likely increase the risk of loss to the NCUSIF because NCUA would have less knowledge about the value of collateral on an impaired loan. When a credit union depends solely on the sale of collateral for repayment, the proper valuation of the collateral—often obtained through a new appraisal—is critical to assessing risk and capital exposure.

The new Section 1013(c) would further require NCUA and the banking regulators to develop identical definitions and reporting requirements for non-accrual loans. FFIEC agencies would therefore have to develop and apply a uniform definition to all financial institutions, regardless of size or activities. For many years, NCUA has tied the definition of non-accrual to GAAP, as required by the Credit Union Membership Access Act of 1998 (P.L. 105-219). In January, the NCUA Board issued for public comment an accounting Interpretative Ruling and Policy Statement that will further modify the definition of non-accrual. The bill's requirements to apply identical definitions and reporting requirements for non-accrual loans would have a real impact on NCUA, and a significant change in this area could have a material cost impact on every credit union requiring needed changes to data processing systems.

NCUA also has concerns that the administrative law judge and FFIEC ombudsman appeals processes would produce greater uncertainty in the examination process. For example, the recommendations of administrative law judges and the decisions of the FFIEC ombudsman do not have to accord deference to agencies' actions and could result in the overturning of precedent. Additionally, the bill does not contain procedures for handling instances when two different administrative law judges issue two different recommendations in substantially similar cases. Besides problems related to inconsistency, an administrative law judge's recommendation to overturn a safety and soundness action due to a lack of knowledge of financial institution operational risk on a forward-looking basis might result in greater insurance losses in the long term.

In addition, NCUA is greatly concerned that any appeals to an administrative law judge could lead to public hearings with no confidentiality granted to the subject matter unless the bill is further clarified. Public hearings featuring the release of confidential supervisory information could easily become reported by the press or posted on the internet and, in the worst case, cause members to rethink their choice in financial services providers in an institution that NCUA is working to strengthen.

NCUA has continued to emphasize and reinforce a forward-looking view of risk to effectively steer institutions away from catastrophic outcomes. This examination approach requires an examiner to prospectively consider the long term and future impact of current decisions and trends when making recommendations or developing action plans based on those judgments. Under the proposed law, we believe examiners would become less inclined to make a more forward-looking assessment of risk. Instead, they would approach nuanced institutional business models with an assessment that is less tailored to the unique business model, strategy, and consumer base of a specific institution.

NCUA also believes that the proposed appeals system could increase the risk of NCUSIF losses through delayed action as the process advances. Additionally, the legislation's independent appeals process would sidestep the critical communication process and dialogue that occurs between examiners, NCUA's leadership, and regulated institutions. As a result, NCUSIF risks could increase.

Moreover, the increased time to settle issues runs counter to a recent GAO recommendation that NCUA "require early and forceful regulatory action" well before capital deterioration triggers prompt corrective action.[7] The provisions in H.R. 3461 would require greater documentation for all examinations to insure proper preparation for any appeals to an administrative law judge or the FFIEC ombudsman for potential appeals.

In sum, unless modified, H.R. 3461 could significantly increase risks for the NCUSIF, and credit unions would pay higher premiums for the associated losses.

One-Size-Fits-All Examination Approach

Third, H.R. 3461 would produce a one-size-fits-all system for financial institution supervision as a result of the requirement to establish consistent examination standards across regulators. This change would decrease regulatory flexibility and add considerable costs, especially for small credit unions.

[7] See *National Credit Union Administration: Earlier Actions Are Needed to Better Address Troubled Credit Unions* (GAO-12-247).

NCUA currently customizes its reviews based on the size, scale, and scope of each credit union. This customization of examinations provides flexibility and helps to decrease examination costs for the smallest of credit unions.

The largest bank holding companies have more than $1 trillion in assets, yet nearly 70 percent of credit unions have $50 million or less in assets. The requirements to establish consistent examination standards across regulators will decrease regulatory flexibility and require similar treatment for all institutions regardless of size.

The smallest credit unions offer basic banking services like taking deposits and making small personal loans to members. Many of these credit unions have a very small or part-time staff, along with very limited resources that are already imposed upon during examinations. These small credit unions would be harmed by the implementation of uniform examination standards for all banks and credit unions.

NCUA has been actively working to reduce the regulatory burden on credit unions and develop a forward-looking regulatory approach that seeks to anticipate the risks to which individual credit unions are subject. NCUA is concerned that the requirement of consistent industry-wide examination standards contemplated in H.R. 3461 would reverse these efforts to ease the regulatory burdens of smaller credit unions.

VII. Conclusion

In sum, NCUA recognizes that financial services regulators must conduct exams fairly and consistently, and we strive to achieve this standard. NCUA is also committed to addressing legitimate concerns about the present exam process, minimizing regulatory conflicts, promoting procedural fairness, and advancing exam consistency.

Later this year, for example, NCUA will adopt a National Supervisory Policy Manual to replace regional policies that dictate procedures. In addition to enhancing the consistency of NCUA examinations, this manual will retain the necessary flexibility that examiners need when conducting examinations of both the largest and smallest credit unions, which range in size from less than $1 million to more than $45 billion.

While economic conditions and business models change, regulators must work to ensure that the institutions they oversee are well aware of the risk of their business and are properly protected against losses when circumstances change. NCUA must also balance competing concerns in order to protect safety and soundness and limit risks to the NCUSIF.

As introduced, H.R. 3461 would significantly increase administrative costs and insurance risks, and decrease regulatory flexibility. NCUA respectfully requests that the Subcommittee carefully weigh these concerns against the laudable goals of increased transparency and additional rights for financial institutions. The Federal Credit Union Act requires NCUA to ensure that credit unions are operated in a safe and sound manner. NCUA believes that this legislation will make that mission much more expensive and difficult.

The additional appeals processes would also create new conflicts in exams and encourage frivolous legal challenges. The Subcommittee might consider inserting provisions that impose penalties for appeals deemed to be frivolous by the ombudsman or the administrative law judge and also make such appeals possible only after the existing appeals process has been exhausted. While this does not address all of NCUA's concerns with these provisions, these improvements will go a long way to reducing unintended consequences.

NCUA is committed to working with Congress to explore these issues and other ways to address concerns about the examination process. We look forward to your questions.

EMBARGOED UNTIL DELIVERY

STATEMENT OF

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DIRECTOR
DIVISION OF RISK MANAGEMENT SUPERVISION
FEDERAL DEPOSIT INSURANCE CORPORATION

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

February 1, 2012
2128 Rayburn House Office Building

Chairman Capito, Ranking Member Maloney, and members of the Subcommittee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (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.

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

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.

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

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 it 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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TESTIMONY OF
KEN WATTS
PRESIDENT AND CHIEF EXECUTIVE OFFICER
WEST VIRGINIA CREDIT UNION LEAGUE
ON BEHALF OF
THE CREDIT UNION NATIONAL ASSOCIATION

BEFORE THE
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT
COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES

HEARING ON
H.R. 3461, THE FINANCIAL INSTITUTION EXAMINATION FAIRNESS AND REFORM ACT

FEBRUARY 1, 2012

Testimony of
Ken Watts
President and Chief Executive Officer
West Virginia Credit Union League
On Behalf of
The Credit Union National Association
Before the
Subcommittee on Financial Institutions and Consumer Credit
Committee on Financial Services
United States House of Representatives
Hearing on
H.R. 3461, the Financial Institution Examination Fairness and Reform Act
February 1, 2012

Chairman Capito, Ranking Member Maloney, Members of the Subcommittee:

Thank you very much for the opportunity to testify at today's hearing in support of H.R. 3461, the Financial Institution Examination Fairness and Reform Act. My name is Ken Watts, and I am President and Chief Executive Officer of the West Virginia Credit Union League.[1] I am testifying today on behalf of the Credit Union National Association (CUNA).[2]

CUNA strongly supports H.R. 3461 and, while it is not a perfect piece of legislation, we view it as a firm step in the right direction toward ensuring the federal financial institution regulatory agencies (regulators) conduct fair exams which are consistent with the law and regulation and ensure safety and soundness.

H.R. 3461 would make available to financial institutions the information used to make decisions in their examination; codify certain examination policy guidance; establish an ombudsman at the Federal Financial Institution Examination Council (FFIEC) to which financial institutions could raise concerns with respect to their examination; and, establish an appeals process before an independent administrative law judge.

[1] The West Virginia Credit Union League represents 100 state and federally chartered credit unions headquartered in West Virginia, which serve 377,800 members.
[2] CUNA is the largest credit union advocacy organization in the United States, representing nearly 90% of America's 7,300 state and federally chartered credit unions and their 93 million members.

The Need for This Legislation

Credit unions strongly support fair and appropriate safety and soundness regulation and oversight to protect the financial resources of credit unions and their members; to minimize costs to the National Credit Union Share Insurance Fund (NCUSIF) borne by all federal insured credit unions; and to preserve credit unions as unique institutions, offering meaningful choices to consumers in the financial marketplace. On the whole, the exam process appears to work fairly well for many credit unions. However, steps must be taken to address real problems that some credit unions have with examinations.

CUNA has been working very closely with its member credit unions in an effort to provide resources for them regarding the examination process and to make them aware of the dispute resolution process when they feel the facts of their situations justify challenging examiner directives. Based on a number of concerns raised by credit unions regarding examination issues, in January 2011, CUNA published a report focusing on the duties and responsibilities of credit union officials and examiners in the examination process. As part of this report, CUNA developed a list of credit union examination rights, which has become known as the "Credit Union Bill of Rights." The list of examination rights, which we have attached to the testimony, includes many items inspired by experiences credit unions have had during their examinations.

Simply stated, an examiner's chief duties are to review a credit union's financial performance and compliance with applicable regulations, and to assess how well the credit union is managing its risks. Credit unions have the right to manage risk without being directed by examiners to eliminate it. In that regard, regulators should address the supervision and examination of credit unions in a professional manner, taking into full account legal requirements credit unions must meet as well as the need for credit unions to have reasonable flexibility to serve their members well. Likewise, credit union boards and management must meet their responsibilities, including supervisory requirements and their fiduciary duties to the credit union's members.

While the issues regarding the examination process and examiners are perennial, the number of concerns credit unions have raised regarding examinations increased appreciably with the onset of the current economic crisis. In late 2010, CUNA informally surveyed several of its members regarding examination experiences. One-in-five credit unions reported dissatisfaction with their previous exam; 27% of respondents reported dissatisfaction with their most recent exam. One of the more common concerns among credit unions is that examiners tended to focus too much on their own view of best practices rather than on legal and regulatory requirements. Respondents who expressed concerns also frequently indicated that the examiners did not listen well and carefully consider alternative approaches; did not offer helpful advice; did not allow enough time for management to review their findings before bringing issues to the attention of the board; did not use their time well; and often failed to cite legal authority for directives, which at times seem arbitrary to the credit unions.

Credit unions have also told us that the state and federal examination dispute resolution processes are not as clear or as helpful as they should be. There is a palpable fear of retaliation among credit unions, notwithstanding "non-retaliation policies" that agencies may have. Of the credit unions that responded to our survey, only 3% actually used the appeals process during their last two exams, but over one-in-five (21%) indicated that they wanted to appeal but did not. Two-thirds of the credit unions that wanted to appeal indicated they did not appeal for fear of retaliation by examination staff. Nearly the same number indicated they did not appeal because they did not believe it would make a difference in outcome. Over one-third of credit unions who had examination concerns did not appeal because they were not aware of the process.

While this legislation will not solve all of the problems that credit unions face when dealing with their examiners, we are hopeful that the attention that Congress gives to this issue will lead the NCUA and the other regulators to take steps to ensure that examiners treat credit unions fairly and that they acknowledge credit unions should have the flexibility to manage risk, consistent with legal and supervisory requirements.

We are particularly pleased that the legislation would create an office of examination ombudsman at FFIEC and establish an independent examination appeals process before an administrative law judge. These two steps could go a long way toward improving this process and alleviating some, but not all, of the concern regarding retaliation and prospects for success in the appeals process.

Recommendations

While we are very supportive of this legislation, we recommend the Subcommittee consider the following enhancements designed to strengthen it:

- The proposed deadlines for exit interviews and examination reports should not become standard practice for regulators with a history of completing these in less time than proposed.
- Information relied upon by examiners when making material supervisory determinations should be made available to examined entities without a requirement that the financial institution request the information.
- The exam standards in section 3 of the legislation should be carefully considered to ensure that there are no unintended consequences resulting from the prescriptive nature of this language.
- The provision requiring the regulators to develop and apply identical definitions and reporting requirements for non-accrual loans should be modified to take into consideration the unique structural characteristics of credit unions.
- The examination ombudsman should be directed to design and implement a routine survey for financial institutions to complete on a voluntary basis at the conclusion of the examination process, to report to the ombudsman on their examination experience.
- The examination ombudsman should routinely follow up with financial institutions that have raised issues with respect to or appealed examination findings to ensure that there have been no retaliatory actions taken against the institution. The ombudsman should also reach out to institutions it has not heard from to ensure they are being treated fairly in the examination process.
- The language directing the examination ombudsman to review regulators' examination procedures to ensure that examination policies are being followed and adhere to the standards for consistency established by the FFIEC should be modified to take into consideration the unique structural characteristics of credit unions, as well as the level of risk represented by an institution's operations, size and other relevant factors.
- Regulators should be directed to identify the additional costs associated with implementing this legislation, and reduce expenditures elsewhere within their budgets by the same amount. Further, we encourage the committee to direct the FFIEC to divide the cost of implementing this legislation among the regulators on a pro-rata basis so that for example, the NCUA is not assessed for the costs incurred by other regulators.

Examination Reports and Exit Interviews

Section 2 would require regulators to provide a final examination report to the financial institution no later than 60 days after the exit interview for an examination or the provision of additional information relating to the examination, whichever is later. This section also would require the exit interview to be conducted within nine months of the commencement of the examination.

Credit unions report that the NCUA generally meets or exceeds these deadlines already, and by a substantial amount. We recommend adding language to ensure that the deadlines proposed by this legislation do not become the new standard for regulators which have a history of more timely completion on examination processes.

Availability of Information Relied Upon When Making Material Supervisory Determinations

Section 2 also requires regulators to include in the final examination report an appendix listing all examination or other factual information that examiners relied upon when making material supervisory determinations, upon the request of the financial institution.

Credit unions deserve to know what information was used by examiners during the course of the examination. The bill in its current form would permit credit unions to request this information, but we believe that the examiners should furnish this information as a matter of course. We recommend eliminating the requirement that financial institutions request the information.

Further, as we have noted, credit unions report that some examiners have required them to take action or have made determinations that either were not required by or went further than what is required under law or regulation. We recommend that the Subcommittee consider requiring regulators to provide information on a regular basis to the FFIEC on the extent to which examiners identify the specific legal basis under which any material supervisory determination is made.

Examination Standards

Section 3 includes several provisions related to examination standards and the treatment of certain loans; these provisions appear consistent with FFIEC guidance issued in 2009. We support the intent of including this language in this legislation, which is to ensure that the policy guidance issued by Congress and the regulators in Washington is applied as intended by the examiners in the field. While we have concerns with the prescriptive nature of the language in this section, we recognize that if there were not so many concerns regarding the examination process, it would not be necessary for Congress to consider such language.

One provision of Section 3 with which we would request further consideration is the provision requiring the regulators to develop and apply identical definitions and reporting requirements for non-accrual loans. While it is important for there to be consistency among the regulators' examination processes, we believe the NCUA should have some flexibility in this area given the unique structural characteristics that differentiate credit unions from banks. In fact, just last week, the NCUA issued a proposal that would provide for much more accurate reporting and regulatory treatment of troubled debt restructurings (TDRs); if adopted, the NCUA would no longer require TDRs that are performing to be treated as delinquent, although they would continue to be reported at TDRs.

Office of Examination Ombudsman

Section 4 would establish an office of examination ombudsman at the FFIEC to receive and investigate complaints from financial institutions concerning examinations, practices and reports. This office would also be responsible for reviewing regulators' examination procedures to ensure that examination policies are being followed and adhere to the standards for consistency established by the FFIEC. This section also includes an annual report to Congress on several of the issues addressed by this legislation.

We strongly support the establishment of this office at the FFIEC, and would recommend the following three changes to this section.

First, the ombudsman should be directed to design and implement a routine survey for financial institutions to complete on a voluntary basis at the conclusion of the examination process, to report on their examination experience to the FFIEC. The NCUA presently conducts such a voluntary survey; other regulators may as well. We would hope that this survey would be made available to the financial institution as part of the final examination report. We believe that credit unions would be more comfortable in completing such a survey if it were collected by an ombudsman once removed from the NCUA. Further, we would hope that the results of this survey would be aggregated and reported to Congress in the annual report required under this section.

Second, the legislation includes language designed to prohibit retaliatory action against a financial institution that complains about or appeals an examination finding. We recommend the Subcommittee takes an additional step to assuage the real concerns that financial institutions may have regarding the utilization of the complaint or appeal process by directing the ombudsman to routinely follow up with financial institutions that have raised issues with respect to or appealed examination findings to ensure that there have been no retaliatory actions taken against the institution. This type of action may reduce the concern regarding retaliation that some financial institutions may have, notwithstanding the prohibition against retaliatory action.

Third, we have concerns related to the language directing the ombudsman to review regulators' examination procedures to ensure that examination policies are being followed and adhere to the standards for consistency established by the FFIEC. As we have noted, credit unions have unique structural characteristics that differentiate them from banks. We question whether this language would sufficiently enable the NCUA to establish examination procedures that take into consideration these characteristics. Furthermore, we believe there is merit to permitting regulators to establish examination procedures that take into account the risk, size and complexity of the institution. The examination of a $7 million credit union should not necessarily follow the same procedures as the examination of a $45 billion credit union or one of the largest banks. We believe that all financial institutions of similar size and structure have every right to expect consistency of treatment, but examination practices should be tailored to the type and size of institution.

Cost of Implementation

Whenever there are changes to the regulation or compliance burden, the cost of implementation is borne by the regulated entities. History suggests that these costs for credit unions go only in one direction: up. We anticipate that several of the provisions of this legislation would result in increased costs for the NCUA, which regrettably would be passed on to credit unions, and ultimately credit union members if Congress does not include language to guard against this result. Credit unions already pay a substantial amount to fund regulators and to comply with ever-increasing regulatory requirements.

Given the circumstances that have prompted Congress to consider legislation of this nature, few credit unions would view this legislation as a net positive if the benefits of the legislation were accompanied by increased costs to credit unions. We encourage the Subcommittee to add language directing the regulators to identify the additional costs associated with implementing this legislation, and reduce expenditures elsewhere within their budgets by the same amount. Over the last several years, the NCUA has proposed significant increases in its budget. We have confidence that the improvements sought by this legislation could be paid for through reductions in expenses at the agency.

Further, the NCUA staff has brought to our attention their concern that the cost to FFIEC of implementing this legislation would be divided equally among the members of the Council notwithstanding the fact that the number or nature of the inquiries and appeals of Council members' decisions may not be equal. We share this concern: each regulator should contribute its fair share toward to the cost of implementing this legislation. We encourage the Subcommittee to include language that divides the cost to the FFIEC of implementing this legislation among the regulators on a pro-rata basis, based on each regulator's actual costs of implementation.

Conclusion

Chairman Capito, as the economy struggles to recover from the recent financial crisis, credit unions face a crisis of creeping complexity with respect to regulatory burden which is made all the more challenging by examination practices that are, in some cases, based on policy guidance and examiners' view of best practices rather than regulation and law, and an examination dispute resolution process under the auspices of the regulator employing the examiner. H.R. 3461 would help make the exam process fairer and more consistent. We appreciate your leadership in sponsoring this legislation. We look forward to working with you as the bill moves through the legislative process. I would be happy to answer any question the Subcommittee may have.

I. CUNA's List of Credit Union Examination Rights (with Commentary)

1. Credit unions have the right to manage risk without being directed by examiners to eliminate it. Authorized by NCUA *Examiner's Guide* (NEG) page 1-3.

   Commentary: As the *Examiner's Guide* points out, examiners should not "insist that a credit union eliminate risk but, instead, should ensure that credit unions identify and manage their risks. The desired reward for taking risk is stable profitability and increased net worth. Credit unions must balance risk and reward responsibly."

2. Credit unions have the right to respectful conduct from the examiner. NEG pages 21-3 and 21-4.

   Commentary: Credit unions, as well as regulators, expect examiners to act professionally—which they do most of the time, according to credit unions. However, if a credit union feels that an examiner has stepped over the line in terms of conduct involving the credit union, the credit union should report the incident to the supervisory examiner or regional office, without fear of retaliation.

3. Credit unions have the right to be examined by well-trained, competent examiners who understand the unique characteristics of credit unions. NCUA *Strategic Plan 2011-2016*, pages 1 and 2.

   Commentary: Strong safety and soundness depends, in large measure, on capable supervision. Examiners who are well-suited for their jobs in terms of experience, expertise, and conduct help support safety and soundness and strengthen the credit union system.

4. Credit union officials have the right to meet and discuss examiner findings, conclusions, directives, and any administrative actions with the examiner, or privately among themselves without the examiner present. Credit union officials should be able to have management staff present at the officials' discretion. NEG pages 1-11, 1-15, 21-2, and 21-3.

   Commentary: According to NCUA's *Examiner's Guide*, examiners are instructed to provide time throughout the examination process for discussion with management and officials regarding developments and findings in the examination. Examiners are encouraged to provide credit union officials with a draft copy of the examination report and give officials sufficient time to review it before the joint conference or exit interview. As the *Examiner's Guide* notes, "Nothing presented at the joint conference, exit interview, or in the examination report should surprise the [credit union's] officials." It is equally important that credit union officials not surprise examiners and that they take advantage of opportunities to meet with examiners and discuss issues throughout the examination process.

5. Credit union officials have the right to question and seek corrections to examiner findings, conclusions, and directives. NEG page 1-15.

   Commentary: Accuracy is an essential component of strong safety and soundness regulation. Examiners are human and all humans make mistakes. It is not only appropriate but very important that credit unions work with their examiner to ensure all reports are as accurate and timely as possible and that all directives are based on accurate information.

6. Credit union officials have the right to provide alternatives and/or additional data, conclusions, and solutions to address problems identified by the examiner. NEG pages 1-11, 2-3, 3-10, and 21-6.

   Commentary: According to the *Examiner's Guide*, examiners are not expected to dictate credit union policies but rather should work with credit union officials to reach a favorable outcome. The *Examiner's Guide* emphasizes cooperation and coordination between examiners and credit union officials, which should include flexibility for credit union management to provide alternative perspectives and data as well as alternative solutions to problems—as long as such alternatives are factually based and appropriate for the situation.

7. Credit union officials have the right to know the specific authority or legal basis for an examiner's directive, and this authority should be provided by the examiner in the exam report or directive. NEG page 20-7.

   Commentary: The *Examiner's Guide* makes it clear that examiners must be willing and able to provide to credit union officials the legal authority for the action they are suggesting or directing the credit union to take. In addition, examiners do not have flexibility to insist on actions or policies that are counter to or inconsistent with statutes, agency policy, or GAAP.

8. Credit union officials have the right to receive clearly written examination reports on a timely basis. Any other directives and

notices from the examiner should also be clearly communicated in writing. NEG page 20-1.

Commentary: Credit unions should not be expected to comply with directives that are not in writing. In order for the credit union's record of performance, including efforts to address problem areas, to be as accurate as possible, directives should be provided in writing to the credit union and included in the credit union's examination history.

9. Credit union officials have the right to have examination reports, findings, directives and administrative actions that are based on all relevant facts, including current data. NEG page 1-27.

   Commentary: The examination report should present a current, factual picture of the credit union's financial performance and risk management. When material problems arise that the examiner expects the credit union to correct, the record must include a complete and well-documented accounting of the problems and the efforts by the credit union and the examiner to address them fully.

10. Credit union officials have the right to be evaluated on their own strengths and weaknesses and not solely on the basis of regulator concerns about trends or general problems in the credit union system or within their peer group. NEG page 3-5.

    Commentary: While examiners must be mindful of problems and conditions in their regions and even across the country, it is essential for the accuracy of each credit union's examination report that the examiner's assessment of a credit union reflects an accurate depiction of the performance and operations of the credit union under review.

11. Credit union officials have the right to be evaluated for progress toward objectives that are realistic and achievable, proportionate to the risk presented and the resources of the credit union, and in the timeframe established with the credit union. NEG page 3-11.

    Commentary: Goals and directives that are not realistic are counterproductive and undermine safety and soundness. Examiners should not arbitrarily set requirements that the credit union cannot meet but rather there should be coordination and cooperation between the credit union's officials and the examiner regarding goals that are achievable within an acceptable amount of time for both the examiner and the credit union.

12. Credit unions have the right for their examination findings and directives to be risk prioritized. NEG pages 1-1 and 20-1.

    Commentary: Examiners are directed to focus their reviews and reports on applicable risks, and those activities that present the greatest risk receive the most attention. A standard procedure that the examination findings and directives must be listed in order of their importance based on the amount of risk presented is fully consistent with the risk-focused examination process.

13. Credit union officials have the right to appeal examiner findings, conclusions, or directives without fear of retaliation from their regulator.[1]

    Commentary: It is clear that under the *FCU Act*, agency policy and practice, credit unions have the right to appeal "material supervisory determinations, including decisions to require prompt corrective action" to the NCUA Board. As discussed in this Section, matters that may be appealed include, for example, cease and desist orders, removal of officials, and conservatorships. Credit unions also have the right to appeal material examination report findings, conclusions, and directives from the examiner. Documents of Resolution and LUAs are not generally "appealable" because they are technically voluntary agreements, but the credit union should be able to appeal to the regional director as part of the DoR or LUA negotiation process.

14. Instructions on how to appeal examiner findings, conclusions, or directives should be detailed on every examination report form that is provided to credit unions. NEG page 17-1.

    Commentary: NCUA's process for allowing an appeal is far from clear. NCUA and state regulators should ensure that all examination report forms which examiners provide to credit unions include sufficiently detailed information as to which issues may be appealed

[1] *See, e.g.*, 12 U.S.C. §1790d(k) (addressing PCA appeals); NCUA, Interpretive Ruling and Policy Statement (IRPS) 02-1 ("Supervisory Review Committee"), *available at* http://ncua.gov/Resources/RegulationsOpinionsLaws/IRPS/2002/IRPS02-1.html; NCUA, IRPS 95-1 ("Guidelines for the Supervisory Review Committee"), *available at* http://ncua.gov/Resources/RegulationsOpinionsLaws/IRPS/1995/IRPS95-1.html.

or challenged and the process for making such an appeal. CUNA and the Leagues are pursuing greater transparency in the appeals process.

15. Credit union officials have the right to record meetings with examiners and other agency personnel and other regulatory proceedings related to the examination (subject to confidentiality). NEG page 21-2.

    Commentary: The *Examiner's Guide* states that credit unions often use tape recorders to record their meetings at the joint conference, and that the NCUA examiners usually agree to the request, and may request a copy of the tape or transcript. A recorded meeting provides an objective transcript of the discussion between the examiner and the credit union officials.

16. Credit union officials have the right to have a representative, such as an attorney or League representative, present during meetings with the examiner and other regulatory personnel. NEG page 21-6.

    Commentary: The *Examiner's Guide* states that credit union officials have the right to invite other persons to the joint conference, and that an examiner will rarely object to the attendance of any outside individual. Proper communication about the attendees in advance will facilitate the meeting.

17. Credit unions have the right to have any published orders—at least consent orders—address only facts and not conjecture or speculation by the examiner. NEG pages 20-1, 20-6, and 30-3.

    Commentary: Any published orders must be based on the facts in an examination report that are reviewed by the credit union. The *Examiner's Guide* states that the examination report must have proper documentation to support an examiner's findings and conclusions. For the confidential section of the report, examiners should only cover pertinent matters that are based on fact, and not "statements based on gossip or hearsay."

18. Credit unions have the right to confidential, non-discoverable communication with their legal counsel regarding examination issues.

    Commentary: There are longstanding legal principles in this country regarding attorney-client privilege that also apply to a credit union's management and officials in regard to examination and supervisory issues. [2]

19. Credit unions have the right to develop and use "high-level" policies, which should be separate and distinct from detailed procedures. NEG page 21-5.

    Commentary: Examiners should not dictate broader credit union policies, but rather should lead and persuade officials to proper action. Credit union management and officials have the right to use business judgment in developing their policies.

20. State credit unions have the right to a lead examiner that is a state regulator, consistent with the credit union's charter type. NEG page 22B-3.

    Commentary: NCUA appears to be compelled to accompany state regulators during the examination of state-chartered credit unions, particularly on federal "hot button" issues such as MBL and indirect lending. Thus, it is important that the lead examiner be comparable to the credit union's charter type. It is also important that the state regulator—not NCUA—be responsible for assigning the credit union's CAMEL rating during an examination.

21. Credit union officials have the right to know the timing of when their regulators, such as NCUA, will publish an LUA. NEG page 29-10.

    Commentary: This right does not address whether NCUA should publish an LUA, it simply addresses the need for notification of when the LUA will be published. Currently, credit unions are learning about publication by either checking NCUA's website or, more likely, via NCUA's mass emails—which can be unintentionally inflammatory. NCUA should follow the lead of a number of state regulators that inform the credit union on when publication will occur.

22. Credit union officials have the right to defer to their certified public accountant (CPA) if there is a disagreement between the officials and

[2] *See, e.g., Upjohn Co. v. United States*, 449 U.S. 383, 386-99 (1981); *Clarke v. Am. Commerce Nat 'l Bank*, 974 F.2d 127, 129-30 (9th Cir. 1992); 12 C.F.R. § 747.24(c) ("Privileged documents are not discoverable. Privileges include the attorney-client privilege, work-product privilege, any government's or government agency's deliberative-process privilege, and any other privileges the Constitution, any applicable act of Congress, or the principles of common law provide.").

their regulator regarding issues related to U.S. generally accepted accounting principles.[3] NEG pages 5A-4 and 7-28.

Commentary: Credit unions over $10 million in assets are required to follow GAAP and a credit union's CPA is responsible for ensuring that the credit union's activities and financial statements are in compliance with GAAP. Therefore, rather than the regulator becoming involved in the specific accounting issues of numerous credit unions, the examiner should not seek to override the credit union's CPA when disagreement on accounting issues arise, absent clearly erroneous guidance from the CPA. Such practice will benefit not only the credit union but also the regulator by freeing up its resources.

23. Credit union officials have the right to communication (i.e., discussion of draft findings) with their examiner prior to final issuance of the examination report. NEG page 21-1.

Commentary: The NCUA *Examiner's Guide* states that examiners should set aside "time periodically to discuss with management and officials developments in the examination." NEG page 21-1. In addition, an examiner should provide "credit union officials and management sufficient time to review it before the joint conference or exit interview." NEG page 20-1.

24. Credit unions have the right for directives from examiners (including verbal and written comments) to be consistent with agency policy, such as NCUA's letters to credit unions. NEG pages 3-1, 6-15, 6-16, 6-20, 7-35, 9A-18, and 10-1 - 10-14.

Commentary: While this seems like an obvious right, this is frequently raised by credit unions across the country. NCUA examiners must follow the guidelines in the Letters to Credit Unions. For example, the *Examiner's Guide* states that credit unions must follow Letters to Credit Unions in areas such as CAMEL ratings, risk-based lending, and risk management.

[3] *See* U.S.C. 1782(a)(6).

INDEPENDENT COMMUNITY BANKERS *of* AMERICA

Testimony of

Noah Wilcox

President and CEO of Grand Rapids State Bank

Grand Rapids, MN

On behalf of the

Independent Community Bankers of America

Before the

Congress of the United States

The House Financial Services Committee

Subcommittee on Financial Institutions and Consumer Credit

Hearing on

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

February 1, 2012

Washington, D.C.

Opening

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

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

Oppressive Examination Environment

The current oppressive exam environment is hampering lending at the very time that bank credit is needed to sustain the economic recovery. While all banks accept the need for balanced regulatory oversight, the pendulum has swung too far in the direction of over-regulation. There is an unmistakable trend toward arbitrary, micromanaged, and unreasonably harsh examinations. Specifically, examiners are:

Requiring write-downs or reclassification of performing loans based on the value of collateral, disregarding the income or cash flow of the borrowers;

- Placing loans on non-accrual even though the borrower is current on payments;
- Substituting their judgment for that of the appraiser;
- Criticizing the use of certain types of non-core funding such as Federal Home Loan Bank advances and brokered deposits including certificate of deposit account registry service (CDARS) reciprocal deposits, which are used to distribute a large deposit across a network of banks so that it does not exceed the deposit insurance limit at any one bank; and
- Moving the capital level goalposts back beyond stated regulatory requirements.

Community bankers nationwide have reported that bank regulators are often demanding significant capital increases above the minimum regulatory levels established for well-capitalized banks. For example, some examiners are requiring banks to maintain minimum leverage ratios as high as 8 to 9 percent (versus the 5 percent required by regulation) and minimum Tier 1 risk-based ratios as high as 10 percent (versus the 6 percent required by regulation). To bankers, the process appears arbitrary and punitive. A moving and unpredictable capital goalpost makes it nearly impossible to satisfy capital demands in a difficult economy and capital marketplace. As a result, bankers are forced to pass up sound loan opportunities in order to preserve capital. This is not helpful for their communities and for overall economic growth. All bank lending requires judgment and calculated risk. If regulators work to squeeze every ounce of risk out of the system, they will only succeed in stemming the flow of credit to local economies and threatening bank viability. There has to be a reasonable regulatory balance.

In addition, examiners' interpretation of existing law frequently appears to change from exam to exam. A practice that was in compliance one year is questioned the following year. Other community bankers have described a similar experience and we've developed a term for it, "anticipatory regulation," because it seems as though the examiners are trying to get ahead of trends in legislation and regulation before they become law. At a minimum, community bankers need to know what is expected of them and that practices deemed compliant in the past will be acceptable in future exams. We understand that examiners have a difficult job, and the stakes were raised sharply after the financial crisis. But I believe many examiners have overreacted, with adverse consequences for banks and the economy.

Before the crisis, examiners frequently worked in partnership with the banks they examined. They were a resource in interpreting often ambiguous guidance. Where corrections were needed, opportunity was given to make them, and compliance was a mutual goal. This is the best means of achieving safety and soundness without interfering with the business of lending. Today, these relationships are too often adversarial. Understandably, an examiner does not want to be blamed for the next crisis. Examiners are not evaluated on banks' contribution to the economy. At all costs, they want to avoid a bank failure that would put a black mark on their record. As a result, the examiner's incentive is to err on the side of writing down too many loans and demanding additional capital. The current crisis was not caused by a failure to adequately examine community banks.

Additionally, bankers used to receive prompt feedback following their exams which they could act on immediately as part of the exam process. Today, detailed examination reports often arrive months after the examiner's visit, with little opportunity for the banker to sit down with the examiner, go over the results, and respond to the examiner's concerns on the spot.

The misplaced zeal and arbitrary demands of examiners are having a chilling effect on credit. Good loan opportunities are passed over for fear of examiner write-downs or criticism and the resulting loss of income and capital. The contraction in credit is having a direct, adverse impact on the economic recovery. Exams could be greatly improved by being made more consistent and rational. This would encourage prudent lending without loosening standards.

Appeals of Exam Results Are Costly and Biased

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

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

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

H.R. 3461 Will Improve the Appeals Process

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

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

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

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

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

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

Establishing these conservative, bright-line criteria will allow lenders to modify loans, as appropriate, without fear of being penalized. When loans become troubled in a tough economic environment, often the best course for the borrower, lender, and the community is a modification that will keep the loan out of foreclosure. But, as I've discussed, many examiners are penalizing loan modifications by aggressively and arbitrarily placing loans on non-accrual status following a modification – even though the borrower has demonstrated a pattern of making contractual principal and interest payments under the loan's modified terms. This adverse regulatory classification results in the appearance of a weak capital position for the lender, which dampens further lending in the community and puts a drag on the economic recovery.

The provisions of Section 3 of H.R. 3461 are consistent with agency guidance on troubled debt restructurings providing that a modified loan should be placed on accrual status when there is a sustained period of repayment performance – generally recognized as six months – and collection under the revised terms is probable.

Community bankers support the revised examination standards of Section 3 because they resonate with their current experience in examinations. If these standards become law, they will give bankers the flexibility to work with struggling but viable borrowers and help them maintain the capital they need to support their communities. Community banks would welcome additional clarity in other regulatory areas as well, so that they can be confident in their lending and risk management.

Communities First Act Will Provide Additional Relief

Finally, I would like to advocate for another important piece of legislation that would help to relieve community banks of certain burdensome regulations they face, both in examination and in compliance, and help community bank customers save and invest. We are grateful to this Subcommittee for convening a hearing late last year on the Communities First Act (CFA, H.R. 1697) and giving ICBA Chairman Sal Marranca the opportunity to testify. The Communities First Act was introduced in the House by Rep. Blaine Luetkemeyer and currently has over 70 cosponsors with strong representation from both sides of the aisle. A similar bill has been introduced in the Senate. Notably, CFA would:

- Increase the threshold number of bank shareholders from 500 to 2,000 that trigger SEC registration. Annual SEC compliance costs are a significant expense for listed banks.
- Provide relief from new Dodd-Frank data collection requirements in connection with loan applications from women-owned and minority-owned businesses.
- Extend the 5-year net operating loss (NOL) carryback provision to free up community bank capital now when it is most needed to boost local economies.

- Allow S corporation banks to raise additional capital by increasing the shareholder limit, allowing IRA shareholders, and allowing them to issue preferred stock.

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

Closing

ICBA appreciates the opportunity to testify. The current examination environment is a serious impediment to the flow of credit that will create jobs and advance the economic recovery. Legislative solutions are needed to improve this environment. ICBA supports the advancement of H.R. 3461.

Thank you.

Appraisal Institute®
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February 1, 2012

The Honorable Shelley Moore Capito
Chairman
Subcommittee on Financial Institutions and Consumer Credit
2443 Rayburn House Office Building
Washington, DC 20515

The Honorable Carolyn Maloney
Ranking Member
Subcommittee on Financial Institutions and Consumer Credit
2332 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Capito and Ranking Member Maloney,

On behalf of the 25,000 members of our professional organizations, thank you for the opportunity to submit a statement for the record, and share the perspective of the real estate appraisal profession on H.R. 3461, the Financial Institutions Examination Fairness and Reform Act. Our organizations support the goals of H.R. 3461, namely promoting consistency of bank examinations and due process, and we are supportive of any efforts that would enhance consistency in the interpretation and understanding of the guidelines and regulations.

Within the realm of appraisal, bank appraisal departments and appraisers themselves have often faced inconsistent interpretations of the *Interagency Appraisal and Evaluation Guidelines* and other applicable guidelines, such as the *Policy Statement on Prudent Commercial Real Estate Loan Workouts*. For instance, the area of "subsequent transactions" (modifications, refinancings, etc.) is confusing and has seen inconsistent statements from the regulators, some contending that an appraisal is required when there is a material change in market conditions, when the Guidelines themselves determine something different[1]. The addition of an ombudsman may be helpful to addressing some of these concerns. We also support due process and an administrative appeals program in connection with disputes regarding valuation or appraisal methodology.

While we support the overall goals of H.R. 3461, one area of concern relates to Sec. 1013(a)(3) of the legislation, which we fear will unnecessarily tie the hands of bank examiners in protecting safety and soundness. Specifically, Sec. 1013(a)(3) is inconsistent with *Real Estate Lending* regulations, the *Interagency Appraisal and Evaluation Guidelines*, and the *Policy Statement on Prudent Commercial Real Estate Loan Workouts* as introduced in that it would prohibit any reappraisal of a performing loan *even if* examiners identified safety and soundness concerns. We do not believe that federal bank examiners should have their "hands tied" on issues of fundamental importance to safety and soundness.

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[1] According to a 2008 presentation by a Federal Reserve official, "*A subsequent transaction (even with the advancement of new monies) may be exempted from the appraisal requirement, but a bank must obtain or perform an evaluation. If there has been obvious and material changes in market conditions or physical aspects of the property that threaten the adequacy of the bank's collateral protection, the transaction does not qualify for exemption and the bank must obtain an appraisal.*" See Slide 16 at http://www.fdic.gov/regulations/resources/minority/events/interagency/presentations08/Siddique.pdf The 2010 Interagency Appraisal and Evaluation Guidelines state: *A subsequent transaction is exempt from the appraisal requirement if no new monies are advanced (other than funds necessary to cover reasonable closing costs) even when there has been an obvious and material change in market conditions or the physical aspects of the property that threatens the adequacy of the institution's real estate collateral protection*. See Page 46 at http://www.ncua.gov/News/Press/NW20101202InteragencyAppraisal.pdf

In our view, Sec. 1013(a)(3) may not be necessary because current regulations and guidance do not require reappraisal of performing loans. Under the regulations, outside of the safety and soundness trigger, a new appraisal is not required for a loan workout or refinance unless there are new monies involved ***and*** there has been a material change in market conditions or the physical aspects of the property. Otherwise, an "evaluation" is acceptable. In this regard, including Sec. 1013(a)(c) may confuse a matter that is already settled through existing regulations.

Consistent Value Definitions
One set of issues that deserves consideration within the context of the bill are definitions of value used by federal bank regulatory agencies. We believe examinations would be made more consistent through the establishment of clear value definitions. Specifically, bank risk assessment of troubled loans would be enhanced greatly by obtaining both *Market Value* and *Liquidation Value* under commonly accepted definitions. A definition of *Disposition Value* may also be beneficial, as appraisals are commonly ordered with two or more values, and there are distinct definitions for all three.

While Market Value is essential to understand the position of the credit, Liquidation Value can enhance the decision making of banks during loan workouts by establishing worst case scenarios for the bank. This is essential to making determinations on whether it is better to foreclose on the property or conduct a loan workout. Such appraisal assignments are common today, but not recognized in regulations. Yet, if a bank orders a valuation product with such a value as part of the scope of work, our members have reported that examiners have demanded it be used in lieu of Market Value.

Such demands are not appropriate and lead to unnecessary write downs of loans. A clarifying amendment defining the appropriate use of Liquidation Value and prohibition against using it to classify the loan would help improve overall bank risk management activities.

Definition of Performing Loan
An additional recommendation that would help enhance consistency in regulations, and protect safety and soundness, would be to define "Performing loan", as it is not currently defined in regulation or guidance. The Policy Statement on Prudent Commercial Real Estate Loan Workouts makes clear that loans should be based on "reasonable terms." As such, we suggest the following definition:

> *For the purposes of this subsection, all performing commercial loans shall be based on reasonable loan terms and the cash flow potential of the underlying collateral or business and be paying as agreed to those under contract.*

Thank you for the opportunity to speak on the record, and we look forward to working with you on passage of H.R. 3461.

Sincerely,

Appraisal Institute
American Society of Farm Managers and Rural Appraisers

Statement of BancVue, Ltd.

Hearing on H.R. 3461, Financial Institutions Examination Fairness and Reform Act

Committee on Financial Services

United States House of Representatives

February 1, 2012

BancVue, Ltd. ("BancVue") is pleased to provide this statement in connection with the hearing on H.R. 3461, *Financial Institutions Examination Fairness and Reform Act*. BancVue supports community financial institutions and assists them in competing against large financial institutions by providing innovative products and services. For the reasons set forth below, BancVue strongly supports H.R. 3461 and encourages lawmakers to pass the legislation with two minor modifications.

Regulatory compliance continues to grow in complexity. However, lawmakers have long recognized the importance of consistency in the development and application of banking regulations. In fact, the *Federal Financial Institutions Examination Council Act of 1978* established the FFIEC to "prescribe uniform principles and standards for the Federal examination of financial institutions," "make recommendations to promote uniformity in the supervision" of financial institutions, and "promote consistency" in examinations.[1]

At BancVue, we support the compliance efforts of community financial institutions and want to assist them in meeting Federal regulatory requirements. Likewise, we believe that the Federal regulatory agencies strive to apply Federal regulatory requirements in an appropriate manner, and support their efforts to educate and cooperate with financial institutions regarding regulatory requirements. However, inconsistencies that have arisen in the application and enforcement of the Federal regulatory requirements have given rise to confusion, frustration, and counter-productivity for many financial institutions and examiners alike.

I. The Timeliness of Examination Reports provisions will improve the consistency and timeliness of the examination process.

While community financial institutions' experiences vary, the general view appears to be that examinations are continuing to get longer and less timely, with sometimes significantly extended time periods between the information request, the initial onsite visit, the conclusion of the onsite work, the exit interview and the completion of the final report. We believe that the requirements in the bill for an exit interview to be held within 9 months after commencement of the examination, and for the final examination report to be provided to the institution within 60 days

[1] Federal Financial Institutions Examination Council Act of 1978 § 1002, 12 U.S.C. § 3301 (1979).

after the later of the exit interview or the institution providing additional information, will improve the delays and timeliness issues that financial institutions are experiencing in examinations.

II. The establishment of the Office of Examination Ombudsman and Right to Appeal Before an Independent Administrative Law Judge will aid both regulatory agencies and financial institutions in understanding and applying the regulations in a consistent manner.

Over time, the regulatory requirements have become increasingly complicated and challenging to apply. Some complexities have arisen from the regulatory requirements themselves, while some have arisen from the inconsistent application and enforcement of the regulatory requirements between the agencies. For example, the Federal Reserve indicated in its Consumer Compliance Outlook publication that an overstated APR could result in a financial institution being required to redisclose its early Truth in Lending disclosure on mortgage loans.[2] However, after a considerable number of conversations with financial institutions, we have found no evidence that other agencies are applying the regulatory requirements in this manner.

Similarly, consistent application and enforcement of the regulatory requirements can become extremely difficult when one agency writes the rules but other agencies are required to enforce it. For example, there appeared to be significant variations in how the different agencies enforced the RESPA regulations written by HUD. Financial institutions that sought assistance in trying to comply with the RESPA rules were faced with the conundrum of getting advice from HUD, which did not examine them, or getting advice from their examining agency, in which case the response was often that the agency could not advise on another agency's regulation. The consolidation of the rulewriting responsibilities of consumer protection laws within the Consumer Financial Protection Bureau should simplify and streamline inconsistencies within the regulations. However, enforcement of the CFPB's rules by the primary regulatory agencies could cause considerable confusion about the proper interpretation and application of the regulatory requirements if efforts are not made to ensure consistency between the agencies.

Below are quotes from community financial institutions that have experienced difficulty with the application or enforcement of the regulatory requirements firsthand:

> "Our exam this past summer...was a dual exam between the Federal Reserve and the New York State Banking Department. The exam included Compliance, CRA and Fair Lending. The exam lasted 4-5 weeks (they came, left and then returned so the exact number of days is unclear) and the number of people ranged from 6-8. We had an excellent rating prior to this exam... The compliance examiners come in with unlimited budgets and correspondingly unlimited time to search our

[2] Ken Shim, *Mortgage Disclosure Improvement Act: Corrected Disclosure for an Overstated APR*, Federal Reserve Consumer Compliance Outlook (1st Quarter 2011).

files for errors that prove exactly what? That our people are guilty of clerical errors? As the forms become more numerous they are assured of finding more errors if only due to the size and complexity of the additional requirements. And it still comes back to the basic question of for what purpose? The cost has to be enormous in relation to what they could possibly find in our institution and thousands of similar institutions throughout the U.S." *Alden State Bank, Alden, NY*

"We have received examination criticism that was inconsistent with what prior examiners found, inconsistent with what was found in prior examinations by the same examining body, and inconsistent with guidance from our regulator. We did not attempt to get assistance from the senior exam staff at our regional agency office, appeal the findings, or get assistance from our ombudsman. The inconsistency of the examination has made it extremely difficult for us to understand what is expected of us and comply with the expectations of our examiner, [and] anticipate what will be considered to be noncompliant in upcoming examinations that was considered to be compliant in the past." *This institution has requested that we omit their name but has allowed us to provide it upon request.*

"We received a Document of Resolution (DOR) during our 2010 exam, requiring us to dramatically reduce activity in a portion of our business. While the issues cited were taken care of and outstanding concerns were far less when reviewed during our 2011 exam, the DOR remained in place, although with a slightly less severe outcome than the previous year. We specifically asked the examiners when the DOR would be lifted or what we need to do before it would be lifted. They replied that we couldn't get it lifted, that it will come down to the determination of the examiners to lift the DOR. There needs to be a framework in which a [financial institution] can prove they have remedied a situation to the point where the examiner has to lift the DOR, not simply go on the judgment of an examiner at some future point in time." *The institution has requested to remain anonymous.*

"My financial institution has not tried to appeal a decision from our regulator. The appeals process does not appear to us to be independent. The appeals process appears to be similar to being bullied in elementary school and your only appeal [is] to the bully's mother. As a result, we did not feel that it would help us resolve the dispute with our examiner...Typically in the past if the examiners found areas of concerns they would identify the area of concern and make suggestions on how to improve in these areas. Now, minor infractions are met with severe criticisms and or penalties...The exam process now seems to be totally adversarial...I am not opposed to a regulated financial system but the players in our system need to work together to keep our system safe, sound and profitable. At this time one of the players in this system is not accountable to the others and this is creating problems that we will be a long time in overcoming unless we return to the sense of cooperation that we have had in the past." *The institution has requested to remain anonymous.*

Several financial institutions expressed a desire to comment but chose not to due to concerns about potential retaliation.

We strongly support Sections 3 and 4 of the bill because they should add an extremely important and often missing element of consistency between regulators in the examination process. Under the bill, the Office of Examination Ombudsman will be responsible for obtaining feedback from financial institutions about their examination experiences, investigating complaints about the examination process, conducting quality assurance of all examination types, processing certain supervisory appeals, and ensuring that examination procedures are consistent between the regulatory agencies. These critical responsibilities will help increase consistency within the examination process itself.

Further, the bill's appeals process for obtaining a hearing with an Administrative Law Judge provides an impartial, independent means for financial institutions to seek recourse for material examination issues, as well as a way for the Ombudsman to identify variations in how the agencies may be enforcing the regulations. This insight into potential enforcement inconsistencies, combined with the Ombudsman's responsibilities relating to consistent examination procedures, could provide an exceedingly effective means of improving consistency in the interpretation and application of the regulatory requirements.

III. BancVue Recommends Two Minor Clarifications to the Bill in Order to Strengthen its Effectiveness.

BancVue believes that H.R. 3461 will be very effective in improving the timeliness and consistency of the examination process. However, there are two clarifications that we believe will further improve the effectiveness of the proposed legislation.

a. Section 1014(d)(3) should be revised to require the Ombudsman to review all supervisory guidance, not just the examination procedures, of the Federal regulatory agencies.

While examination procedures are widely used when performing examinations, banking and credit union examiners also look to a variety of other agency guidance, such as:

- Interagency guidance;
- Supervisory guidelines; and
- Supervisory articles, bulletins and other publications.

As a result, inconsistencies can arise even when examination procedures are consistent between regulatory agencies. We recommend that the reference to examination procedures in Section 1014(d)(3) of the bill be modified to state that the Ombudsman shall "review examination procedures *and other supervisory material* of the Federal financial institutions regulatory agencies."

b. An additional provision should be added to Section 1015 to clarify that the Right to Appeal Before an Independent Administrative Law Judge is available without regard to whether a financial institution has utilized its regulator's intra-agency appeals process.

We interpret H.R. 3461 to provide financial institutions with the right to appeal all material supervisory determinations that are included in a final examination report, regardless if the institution sought relief through its primary Federal regulator's intra-agency appellate process. We do not encourage financial institutions to seeking relief through multiple channels in order to get a result that they desire. However, we are concerned that any administrative procedures that will be developed to implement the bill's right to appeal before an independent Administrative Law Judge could require a financial institution to meet additional requirements before exercising its right, such as seeking recourse with its primary Federal regulator before seeking relief through the appeals process. In order to reduce the risk that this important right to appeal will not be inadvertently hampered when it is implemented, we recommend that a statement be added to Section 1015 indicating that a financial institution is not required to seek relief from its Federal regulatory agency prior to requesting a hearing with an Administrative Law Judge.

Thank you for the opportunity to express our support for H.R. 3461 and voice the experiences of some of the community financial institutions that we serve. We believe that the bill will be extremely effective in improving the examination experience as well as the consistency with which the Federal regulatory requirements are interpreted, applied, and enforced. Such consistency will provide financial institutions and examiners with more clarity, thereby improving examiners' ability to understand and communicate regulatory requirements and financial institutions' ability to meet them.

<u>**Questions for Kevin M. Bertsch, Associate Director, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, from Representative McCarthy:**</u>

The legislation requires regulatory agencies to develop and apply uniform definitions and reporting requirements for non-performing loans. Ensuring that standards work for both small and large financial institutions, while also giving the agencies flexibility to continue to address unique situations of smaller institutions is vital.

Do you feel uniform standards for non-performing loans are achievable, or are there alternative ways to provide for consistency of the loan classification process?

For many years, the banking agencies have utilized uniform classification definitions for key asset types, including commercial loans, retail loans, and investment securities. In addition, as set forth in interagency Call Report instructions, the agencies have long relied on U.S. GAAP to guide bank financial reporting on asset categories that are often included in definitions of "nonperforming," such as nonaccrual loans, loans past due 90 days or more, and troubled debt restructurings. From time to time, the agencies have also issued supplemental interagency guidance to enhance the consistency with which classification definitions are being applied for specific asset types, addressing, for example, classification of commercial real estate loan workouts in 2009. We believe that uniform regulatory standards for non-performing loans are achievable. At the Federal Reserve, we have taken steps to promote consistency by ensuring that examiners are well-trained on classification and financial reporting requirements, supporting examiners with staff that have accounting expertise and can respond to questions about appropriate accounting treatment as needed, and reviewing selected examination reports and work-papers to ensure consistency with existing guidance.

Questions for the Record
Financial Institutions Subcommittee Hearing
"HR 3461 – The Financial Institutions Examination Fairness and Reform Act"
February 1, 2012

Rep. Carolyn McCarthy (NY-4)

Panel 1 – to all witnesses:

The legislation requires regulatory agencies to develop and apply uniform definitions and reporting requirements for non-performing loans. Ensuring that standards work for both small and large financial institutions, while also giving the agencies flexibility to continue to address unique situations of smaller institutions is vital.

Do you feel uniform standards for non-performing loans are achievable, or are there alternative ways to provide for consistency of the loan classification process?

Uniform standards for "non-performing loans"[1]

Yes, uniform standards for nonperforming loans are achievable and in fact are currently used in interagency policies and regulatory reporting instructions. For example, nonperforming loans are generally loans that have been placed in nonaccrual status. The *Federal Financial Institutions Examination Council (FFIEC) Consolidated Reports of Condition and Income* (call report) instruction glossary establishes criteria for when a loan should be placed on nonaccrual status and when a nonaccrual loan should be restored to accrual status. All institutions required to file a call report must apply these nonaccrual standards. The OCC strives for consistent application of these uniform nonaccrual standards within our agency through training, internal guidance and quality assurance reviews.

It is important to note, however, that all classified loans are not necessarily nonperforming loans, under interagency regulatory definitions. The determination to put a loan on nonaccrual status is independent of the loan classification. Classification decisions require judgment and an understanding of the loan's term and structure and the borrower's historical, current, and future ability to repay both principal and interest – factors that require careful consideration and analysis based on each loan.

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[1] Nonperforming loans are considered loans that are 90 days or more past due plus loans on nonaccrual.

Consistency on Loan Classification Process

Uniform Definitions

The federal banking agencies have uniform definitions for assets adversely classified as well as those assets listed as special mention.[2] These long-standing definitions were included as an attachment to the October 2009 *Interagency Policy Statement on Prudent Commercial Real Estate (CRE) Loan Workouts* (policy statement). The policy statement states that loans adequately protected by the current sound worth of the borrower or underlying pledged collateral generally are not adversely classified. The policy statement further directs that examiners should not adversely classify performing commercial loans solely because of a decline in value of the underlying collateral as long as there is not a well-defined weakness that jeopardizes repayment.

Examiner Training

Each agency has ongoing training programs in place to ensure the loan classification process is consistent. The agencies also offer through the FFIEC a variety of courses for examiners to ensure consistent application of the agencies' loan classification policies. These courses include: Advanced Cash Flow Concepts and Analysis; Advanced Commercial Credit Analysis; Cash Flow Construction and Analysis from Federal Tax Returns; Distressed Commercial Real Estate; and, Real Estate Appraisal Review.

Commercial Credit Policies

To further promote loan classification consistency across the agency, the OCC has commercial credit lead experts (lead experts) in each OCC district and a commercial credit policy division headquartered in Washington, DC. The lead experts are experienced commissioned examiners with extensive commercial credit knowledge and skill in applying the uniform classification guidelines, and are members of the OCC's National Commercial Credit Committee that meets each quarter. The lead experts share information across districts and confer on a routine basis to ensure that the uniform classification guidelines and the OCC's supervisory policies are consistently and appropriately applied in our examinations. They work with our credit policy division to provide policy clarification and support to examiners and bankers, and to respond to questions and emerging issues. They also work with the OCC's district management teams on the application and execution of quality control reviews performed throughout the districts to ensure consistent application of the interagency loan classification definitions.

Examination Quality Control

Loan classifications and accrual determinations are reviewed and discussed by examination teams with sign off by the examiner-in-charge before finalizing bank examinations. This promotes consistent application of the interagency loan classification guidelines. Each district conducts ongoing quality assurance reviews to uphold the consistent application of classification standards. The OCC also conducts periodic national calls to discuss supervision requirements

[2] Comptroller's Handbook "Rating Credit Risk" April 2001 and Banking Bulletin 93-35 "Interagency Definition of Special Mention Assets"

and expectations. These calls are led by senior management and include speakers with subject matter expertise. For example, the September 2011 call focused on troubled debt restructurings, specific valuation allowances, other real estate owned, and other topics. The February 2011 call included a review and discussion of the interagency appraisal requirements.

Banker Outreach and Appellate Process

In addition to these internal and interagency efforts to promote consistency, the OCC also provides classification guidance directly to bank management and directors through OCC outreach functions. For example, the OCC conducts bank director workshops to educate bank directors on various risk management practices, including credit.[3] The credit workshop is designed for strengthening credit risk understanding and is presented to outside directors of national community banks and federal savings associations.

The OCC appeals process provides a means for bankers to have an independent review of classification decisions with which they disagree.[4]

[3] Credit Risk: A Director's Focus (multiple locations)
[4] National Bank Appeals (June 2010)

NCUA's Responses to Questions for the Record
House Financial Services Financial Institutions and Consumer Credit Subcommittee
Hearing on H.R. 3461, the Financial Institutions Examination Fairness and Reform Act
February 1, 2012

Question Submitted by Congresswoman Carolyn McCarthy

- **Are uniform classification standards achievable or is there an alternative way to bring consistency to the loan classification process for non-performing loans?**

In response to your question, I would like to emphasize, first and foremost, that commercial lending represents less than 10 percent of all lending activity in credit unions and amounts to $37.2 billion in lending activity on an industry asset base of $961 billion. Additionally, NCUA's response refers to the commercial lending activities of credit unions and not consumer lending activities, as the testimony and related questions focused on commercial loans. NCUA also believes the intention was to discuss non-accrual loan classification approaches, as well.

All of the federal regulators, including NCUA, participated in the development of the 2009 *Interagency Guidance on Prudent Commercial Real Estate Loan Workouts*.[1] This authoritative guidance for credit unions details prudent best practices for commercial loan restructures and refinances. While this guidance is not incorporated in regulation, it provides a flexible prudential framework for financial institutions without creating undue regulatory burden or constraining institutions with varying degrees of risk, complexity, and diversity within their business models and commercial loan portfolios.

NCUA has also issued a Supervisory Letter in January 2010 entitled *Current Risks in in Business Lending and Sound Risk Management Practices*.[2] This supervisory release identified NCUA's evaluation of risk in the industry, and set expectations for appropriate risk-management practices, as well as areas of focus by examiners.

NCUA trains examiners on the job and through formal classroom training on commercial lending practices and techniques. NCUA also makes use of specialized examiners with enhanced commercial loan training in our most sophisticated and largest commercial lending credit unions.

Finally, it is important to emphasize that a classification methodology is primarily a vehicle to ensure that loan valuations are correct for financial statement presentation. Those valuations ensure that users of the financial statements, including investors and depositors, have a transparent view of the true financial condition of a financial institution. Any approach that

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[1] See http://www.ncua.gov/Resources/Documents/LCU2010-07Encl.pdf as well as NCUA's Letter to Credit Unions 10-CU-07

[2] See http://www.ncua.gov/Resources/Documents/LCU2010-02Encl.pdf as well as See NCUA's Letter to Credit Unions 10-CU-02

clouds transparency would prove counterproductive and could have the effect of creating greater uncertainty in the marketplace.

Identical Classification for Non-Performing Loans

The classification of a commercial loan is, by nature, judgmental and requires both the financial institution management and examiner to evaluate collectability of a loan under unique circumstances related to that specific loan. Differences between loans, institutional underwriting practices, or even geographic concentration risks can vary significantly from one loan to another and one institution to another. It would be very difficult to apply a rigid set of identical standards across regulators when the conditions affecting the classification of a commercial loan can vary widely. As a result, the judgment of management and the examiner are critical to the effective classification of non-performing loans.

Currently, NCUA places the responsibility on credit unions to establish an appropriate classification policy that meets the complexity, size, and risk profile of the institution's commercial loan portfolio. Credit unions are further expected to consistently apply the methodology.

NCUA instructs examiners to evaluate the rigor and appropriateness of the credit union's methodology given the complexity, size, and risk profile of the institution's commercial loan portfolio. NCUA's evaluation will often include testing on individual credits, which can lead to conflict with management over a classification methodology. As mentioned earlier, NCUA's Letter to Credit Unions that circulated the *Interagency Guidance on Prudent Commercial Real Estate Loan Workouts* provides authoritative guidance to credit unions and examiners alike.

Identical Classification for Non-Accrual Loans

H.R. 3461 also would require the establishment of identical definitions and reporting requirements for non-accrual loans. The creation of "bright line" statutory requirements for financial reporting may grant relief during trying economic periods. Such laws, however, may have the opposite effect in periods of economic growth. Additionally, any legislative changes that could blur the public perception that financial statements are not transparent could result in a negative market effect.

The interagency *Policy Statement on Prudent Commercial Real Estate Loan Workouts* outlines policy considerations that should govern and inform credit unions' non-accrual and classification decision processes based on the size and complexity of the institution.[3]

[3] Currently, credit unions have the freedom to develop their own loan grading schematic. NCUA does not impose specific standards on credit unions, but provides guidelines to credit unions in a 2006 Interagency ALLL Policy Statement through an Appendix entitled *Loan Review Systems.* Examiners review a credit union's loan grading system as it provides important information on the collectability of the portfolio for use in a number of areas within the examination process. NCUA realizes loan grading assessments by their very nature involve a high degree of subjectivity. And NCUA has observed that a credit union's ability to estimate identify nonperforming loans and estimate credit losses on specific loans and groups of loans should improve over time as substantive information accumulates regarding the factors affecting repayment prospects. Therefore, our examiners should generally accept management's assessments when evaluating the appropriateness of the credit union's loan grades, and not seek

NCUA's approach provides greater flexibility to credit unions to adapt to changing economic conditions. NCUA's approach also ensures that credit unions maintain autonomy in making loan performance judgments based on all the available facts and circumstances affecting loan collectability and performance.

The establishment of a statutory "bright line" to inform judgments that by their very nature require judgment may permit credit unions to ignore other available information about the borrower in consideration of true loan collectability. Less transparency or incomplete analysis can reduce the reliability of financial statements which could prove destabilizing.

NCUA's existing agency guidance allows for credit union and examiner judgments, but cautions examiners on a number of issues addressed in the proposed legislation. The existing guidance, when appropriately implemented, strikes the appropriate balance for all stakeholders.

Many of the concepts revolving around non-performance and non-accrual are also founded in Generally Accepted Accounting Principles (GAAP). Any legislative changes that conflict with GAAP have the potential to reduce transparency on the financial performance of a financial institution and could result in additional administrative burden of maintaining both a statutory and a GAAP financial statement presentation.

NCUA respectfully submits that the way to achieve consistency in the loan classification/grading, loss provisioning, and non-accrual processes is to strengthen consistent implementation of existing interagency guidance.

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adjustments when management has effectively incorporated reasonable and properly supported assumptions, valuations, and judgments into the evaluation process; and analyzed all significant qualitative or environmental factors that affect the collectability of the portfolio as of the evaluation date in a reasonable manner.

TESTIMONY OF DAVID BARIS

EXECUTIVE DIRECTOR, AMERICAN ASSOCIATION OF BANK DIRECTORS

BEFORE THE

US HOUSE SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

NEWNAN, GEORGIA

AUGUST 16, 2011

Good morning Chairwoman Capito, Ranking Member Maloney and members of the Subcommittee. Thank you for the opportunity to submit this statement for the hearing record.

The American Association of Bank Directors provides advocacy, informational and educational support for bank and savings institution directors.

Your hearing today and previous hearings on the bank examination process on July 8 and May 26, 2011 are extraordinarily important. They help to shed light on a process that often is shrouded in secrecy. Bank examiners can make life and death discretionary examination decisions. Public pronouncements by federal banking agency heads, while made in good faith to make the process more transparent, may not always be consistent with what may happen during and after an examination of an individual bank.

The federal banking agencies have had virtually unbridled discretion in how they examine banks.

Until recently, Congressional oversight of the bank examination process has been limited and lacked depth.

Banks may appeal examination results to the Ombudsman of the agency that examines them, but many banks are reluctant to appeal for fear of retribution and others decide not to because they do not believe that the Ombudsman is truly independent of the agency.

Banks have no statutory right to appeal adverse results of an examination to a federal or state court.

The examiners in the field as well as some of their supervisors realize that if they err on the side of stringency, they will not be criticized. But they know that the Inspectors General of the respective federal banking agencies will criticize them for not having identified problems earlier in banks that ultimately failed. The reports of the Inspectors General frequently criticize the primary federal banking regulator of the failed bank for not having identified and acted on deficiencies earlier, but never criticize the regulator for being too stringent.

Bank examiners have discretion on a wide array of matters, including whether to classify a loan, whether to place a loan in nonaccrual even though it is performing, and to substitute their own ALLL methodology for that of the bank. This is so even though a bank might have had reasonable systems and controls in the bank to make reasoned determinations of their own, or may have relied on qualified third party auditors or loan review advisors for their determinations.

Many of these decisions are judgment calls based on the facts and circumstances of the individual bank. It matters a great deal as to the extent to which examiners allow banks to exercise reasonable discretion in exercising their good faith judgment.

During good times, examiners tend to give bankers some leeway in applying reasonable judgment as to these matters; but when the economy weakens, there is a greater tendency to substitute the examiners' judgment for that of the bankers. This is unfortunate since examiner judgments can make a recession deeper and longer than it needs to be. That is because a bank's financial condition will often dictate whether it can make loans to those who reside and do business in their community and because the uncertainty and unpredictability of examiner judgments make banks less willing to lend except in limited circumstances involving extraordinarily strong borrowers.

Another disincentive to lend is the risk of personal liability that bank directors face from enforcement actions and suits by the FDIC following a bank failure. AABD recently advised bank directors to stop approving loans until the FDIC satisfactorily provides a "safe harbor" under certain circumstances for bank directors who approve loans. The FDIC has declined the offer. Outside directors are generally individuals with no bank lender experience who rely in good faith on the recommendations of their banks' lenders and credit officers. In his Grant Interest Rate Observer dated July 1, 2011, under the heading "Chill is in the air", James Grant questioned whether bank directors will continue to approve loans in face of the potential personal liability they face if their bank fails or gets into trouble.

The banking regulators sometimes have exercised their enormous unfettered discretion in determining when to seize a viable community bank, resulting in catastrophic economic consequences for communities served by such community banks improperly seized and for their shareholders, and irreparable reputational and economic damage to the local business leaders who serve on local community bank boards of directors. There is a pressing need to protect against such regulatory abuse by requiring a higher level of accountability and transparency to ensure that the banking agencies act in accord with legal standards governing the extraordinary regulatory remedy of a bank seizure.

The Subcommittee's hearing on January 21, 2010 on the closing of Park National Bank, Chicago, a leading community bank lender to Chicago's inner city, raised significant questions about the propriety and wisdom of closing that bank.

In one especially troubling example of a plainly improper community bank seizure, a viable Denver bank with $400 million in available cash was seized by the OTS and FDIC without adequate statutory grounds. United Western Bank was on the verge of a $200 million private-sector recapitalization that would have further strengthened the bank's financial position and avoided a large and wholly unnecessary loss to the FDIC Deposit Insurance Fund. But in the face of a private-sector solution that would have led to expanded community banking activities in the Denver market, the OTS and FDIC precipitously and improperly closed the bank because, we believe, the regulators did not like the bank's business model.

Immediately following the seizure, all of the deposits and most of the assets of the bank were assumed by First-Citizens Bank and Trust Company, a North Carolina-based institution with over 400 branches that is owned by one of the 50 largest holding companies in the United States. Almost immediately following the January 2011 seizure and sale of the Bank by the OTS and FDIC, the acquiring bank closed four of United Western's eight branches, suspended United Western's large and successful SBA lending program, informed existing borrowers and new applicants that it would not make loans in the Denver market for at least 18 months, and fired approximately 50 local employees.

The regulators no doubt thought their drastic actions to impose the ultimate punishment on the bank for not embracing the business advice of the regulators would go unchallenged and their decision-making process remain secret, as they have in the almost 400 bank seizures since 2007. They were wrong in this instance. United Western Bank's owners sued the OTS and FDIC demanding the return of the bank to its rightful owners. At every turn in that proceeding, which is pending in U.S. District Court in the District of Columbia, the OTS and FDIC have attempted to evade judicial scrutiny and the exposure of their secretive internal processes. First, the OTS and FDIC sought to dismiss the case on technical grounds. Later, and only after being ordered to do so by the Court, the OTS produced a hand-picked, sanitized administrative record that excluded all of the many discussions between the agencies concerning the FDIC's distaste for the bank's business model and directive that the OTS force the bank to change that model and any internal communications discussing whether failing the bank was the right answer given its relatively strong financial position relative to other regulator-defined "troubled banks." Indeed, the regulators sought to persuade the Court that only a grand total of two internal email communications within or between the agencies were relevant to determination to seize the bank.

Notwithstanding these efforts to protect the secrecy of the regulatory proceedings leading to the seizure of this bank, in this case these proceedings may yet be exposed to public review. The OCC (who was substituted for the now-defunct OTS) was ordered by the court last week to certify the completeness of the censored administrative record or supplement the record as necessary after failing to convince the court that the administrative record, which will be made public, should consist of only those documents assembled by the OTS to support its position rather than everything, favorable or unfavorable, considered by the OTS. The court rejected soundly the longstanding position of the regulators that they are entitled by law to avoid judicial and public scrutiny of their actions and decision-making process related to seizing a community bank.[1]

While the United Western case and other subsequent cases involving other community bank seizures may ultimately cause the regulators to curtail the improper use of their extraordinary powers to seize community banks virtually at their whim, this subcommittee has the opportunity immediately to create transparency in the process and modify banking agency practice to conform to legal requirements.

[1]David Baris is a partner in the law firm of BuckleySandler LLP, which represents the former owners of United Western Bank.

This subcommittee has the authority to obtain agency materials and ask probing questions about the United Western Bank seizure and other comparably questionable recent seizures by the bank regulators. A strong community bank system is of critical importance throughout this nation to ensure availability of credit to small businesses and families. It should be the highest priority of the federal bank regulatory system to avoid wherever possible that which the FDIC and the OTS caused to occur in the case of United Western Bank, the seizure of a local bank and its resale to a large bank thousands of miles away that immediately stopped delivering certain basic banking products and services to the local community.

H.R. 2056, which passed the House of Representatives last month, is a step in the right direction. More can be done. The House Committee on Financial Services can direct the GAO to conduct a thorough study on the bank examination process to assure that the process is fair and consistent and properly gives banks reasonable discretion to classify loans, determine the accrual status of loans, adopt and apply a reasonable ALLL methodology, and make other reasonable determinations in operating their businesses.

Questions for Kevin M. Bertsch, Associate Director, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, from Representative Westmoreland:

How many examiners have been disciplined since 2008? How many were disciplined for not fully utilizing standard agency guidance for examination procedures?

How many examiners have had employment terminated since 2008 as a result of poor performance?

The Federal Reserve conducts its supervisory activities through its twelve Federal Reserve Banks across the country. Supervision is guided by policies and procedures established by the Board, but is conducted day-to-day by the Reserve Banks and their examiners. The performance of examiners is overseen and managed by officials of the Federal Reserve Banks.

In order to ensure consistent application of agency guidance, Federal Reserve examiners complete a comprehensive training program that includes course work, on-the-job training, and testing prior to becoming a commissioned examiner. This comprehensive training program takes approximately three years to complete and combines on-the-job training with the development of competencies through course work in primary areas of examination focus, including credit, operations, market, and management risk. Candidates must successfully complete two standardized and validated proficiency exams that test knowledge of concepts related to managing an institution and an overall understanding of other specialty areas. Typical classes include Banking and Supervision Elements, Credit Risk Analysis School, Financial Analysis and Risk Management, Principles of Asset Liability Management, Bank Management, and Examination Management.

In addition, Federal Reserve examiners receive continuing professional development to maintain and augment their skills. To provide examiners with training on content that is relevant to the current business environment, the Federal Reserve has developed an online Learning Center. The Learning Center provides examiners in the field with access to online training on the latest supervisory and regulatory guidance and emerging issues. Once delivered, the hour-long webcasts, called Rapid Response, are available to all Federal Reserve staff on demand. To date, more than 250 topics have been presented. In addition to Board guidance and policy, topics include Credit Analysis, Consumer Compliance, Operational Risk, Banking and Financial Environment, and Failed Bank Case Studies.

Based on the individual performance planning process, the Federal Reserve also supports other individual professional development needs. This may include the pursuit and maintenance of industry certifications, attendance at advanced skill training courses, peer forums, or participation in skill affinity groups.

In addition, Federal Reserve examiners are subject to a comprehensive performance management system. This includes annual performance planning that defines key objectives, deliverables, and development plans; regular performance feedback; and an annual appraisal. If a Federal Reserve examiner fails to meet the requirements of the position, the examiner is subject to a disciplinary process that could result in termination if the employee fails to correct performance problems. Depending on the severity of the issue, and whether it is a recurring one, a manager or supervisor may begin the disciplinary process at an advanced stage, up to and including termination. Further, management may deny or postpone merit increases for examiners on disciplinary status.

In regard to issues raised by bankers and other members of the public about examiner performance with the Federal Reserve Board's Ombudsman's office, the Ombudsman investigates the issues, and, if facts warrant, refers performance matters to the Reserve Banks for appropriate action within the existing performance management system.

Questions Submitted by Representative Westmoreland
Hearing: "H.R. 3461: the Financial Institutions Examination Fairness and Reform Act"
February 1, 2012

For all witnesses on Panel 1:

How many examiners have been disciplined since 2008? How many were disciplined for not fully utilizing standard agency guidance for examination procedures?

How many examiners have had employment terminated since 2008 as a result of poor performance?

The OCC process for ensuring consistent application of examination policy and procedures and sound performance by examiners is multi-faceted, and relies on formal training, regular communication with bankers, the performance review process, and a robust quality assurance review program to ensure the consistent application of examination policy. Support is provided by lead experts (credit, consumer compliance, capital markets, etc.) housed in each district office as a resource for field examiners and their managers to ensure correct and consistent application of policy and the arrival of accurate conclusions. Instances of examiner failure to accurately apply policy or arrive at accurate conclusions are typically dealt with as performance issues by field managers whose primary responsibility is to ensure effective bank supervision. Field managers review and sign-off on all Reports of Examination prior to issuance to ensure the accuracy and appropriate support for conclusions, citations for violations or policy exceptions, along with corrective action proposed. Field examiners are evaluated twice each year for, among other things, their technical and analytical skills, along with their ability to effectively communicate examination conclusions. Consistency is further assured through a quarterly quality assurance process. Bankers also have the opportunity to discuss and appeal examination conclusions via the local Assistant Deputy Comptroller, the District Deputy Comptroller, and/or the OCC's Ombudsman.

NCUA's Responses to Questions for the Record
House Financial Services Financial Institutions and Consumer Credit Subcommittee
Hearing on H.R. 3461, the Financial Institutions Examination Fairness and Reform Act
February 1, 2012

Questions Submitted by Congressman Lynn Westmoreland

- **How many examiners have been disciplined since 2008? How many were disciplined for not fully utilizing standard agency guidance for examination procedures?**

Since 2008, the National Credit Union Administration (NCUA) has disciplined 15 examiners. Of the 15 examiners disciplined, two of them were for not fully utilizing standard agency guidance.

- **How many examiners have had employment terminated since 2008 for performance?**

Since 2008, NCUA has terminated 29 examiners for performance. Of those 29 examiners, 26 were terminations of probationary employees within their first year of federal employment, and three had worked at NCUA for more than a year.

Managing Examinations in Challenging Times

Published September 2010

(Last Updated March 2011)

This document is designed to highlight how credit unions may challenge actions or findings made by NCUA examination staff. In addition, it will discuss issues that credit unions may wish to consider when "managing" the supervision and examination process. It is important to remember that each credit union's situation is unique. The decision regarding how to respond to an NCUA examination is, of course, the responsibility of each individual credit union and very much depends on the particular circumstances. For that reason, this document does not give legal advice. Rather, it highlights existing processes, guidance documents and ideas shared with us by both NCUA officials and NAFCU member credit unions. In providing this document, NAFCU does not necessarily infer inappropriate behavior on the part of NCUA examiners or inadequate internal controls on the part of credit union boards and management. Rather, NAFCU is highlighting resources and ideas that can lead to examinations that accurately rate the operation of a credit union against existing NCUA requirements. Finally, this document is intended to be preventive – to assist credit unions in avoiding a serious dispute when less confrontational means of resolution are available.

The current economic downturn has placed a great deal of stress upon the financial services industry, including NCUA and the credit union industry. In response to the pressures of increased NCUSIF assessments, increased delinquencies, foreclosures, charged off accounts and member unemployment, federal regulators have taken a more aggressive stance concerning enforcement and administrative actions. Agency officials have indicated that NCUA will take administrative actions more quickly than before in order to protect our insurance fund.

Our industry may take some solace in the fact that we are not alone. A recent article in the *American Banker* by David D. Gibbons, former Deputy Comptroller of the Currency for Special Supervision discussed supervisory actions. Gibbons, in "Responding to Regulatory Actions: 5 Steps to Get it Right," wrote that, "the surge in supervisory enforcement actions is a painful reality for bankers today ... (that) CEOs and board of directors cannot afford ... (to) ignore .... (as) enforcement actions ... are growing steadily...." Gibbons went on to state that examiner "tolerance for further risk is low, and their expectations for corrective action are high," and he listed "five essential" steps:

- Taking it seriously and mobilizing one's team – not denying the problems, ignoring their severity or "fighting city hall";
- Planning for contingencies and communications;
- Not waiting for the enforcement action to be executed to establish appropriate board and management governance and oversight;
- Getting a plan in place to comply with the action and its provisions; and
- Ensuring balance sheet risks are measured and reported accurately and in a timely fashion with accurate credit risk ratings and loan accounting.

From the credit union perspective, NCUA's new stance has created more disagreements between credit unions and examiners. NCUA acknowledges that their examiners are not infallible, and in spite of examiner training, disagreements and inconsistencies may occur in any given examination report. NCUA has a process in place for accommodating these situations. How to navigate this process, and even whether to challenge examiner findings, are things that credit unions should consider as an ongoing concern.

First, keep in mind that NCUA has a broad range of administrative tools at its disposal. Two good sources of information about these administrative powers are Chapters 20 and 30 of the NCUA Examiner's Guide. The following briefly describes some of the powers NCUA has at its disposal.

- **Document of Resolution.** Examiners use this administrative power, commonly referred to by its acronym of DOR, to formally document plans and agreements reached with credit union staff and officials to reduce areas of unacceptable risk. NCUA has indicated that this tool should not be used for minor issues.
- **Letter of Understanding and Agreement.** A Letter of Understanding and Agreement, commonly referred to by its acronym of LUA, is essentially a contract between NCUA and a credit union. In an LUA, the credit union agrees to take, or not take, actions outlined in the document. NCUA has indicated that it issues LUAs when credit unions have not adequately responded to less severe measures such as DORs.
- **Cease and Desist Order.** Akin to an injunction, the Federal Credit Union Act generally empowers NCUA to issue cease and desist orders when a credit union is or has engaged in an unsafe or unsound practice, or when the credit union has or is about to violate a law, regulation or a condition imposed in writing by NCUA's board. Credit unions that receive a cease and desist order have a right to a formal hearing before an administrative law judge. Once effective, violating the terms of a cease and desist order can trigger additional administrative actions, including civil money penalties.
- **Other Powers.** NCUA has numerous other administrative powers, including the following:
    - Issuing civil money penalties.

- Removing credit union officials.
- Issuing prohibition orders, which prohibit an individual from being involved in the affairs of any insured credit union.
- Conservatorship.

NCUA's more aggressive stance very likely has led to inconsistent examinations. NCUA, like any organization, acts through its employees and agents. No matter how much training is received, employees will react differently to the same situation. Some employees are more seasoned and will be better prepared than others. Mistakes will be made by examiners and credit unions; neither is immune from this phenomenon. It is no surprise that there are increasing occasions when a credit union and the NCUA examiner do not see eye-to-eye on a given issue.

What is a credit union to do when it disagrees with an examination finding? It is an easy question to ask, but a very difficult one to answer. NAFCU members have indicated that it is best to consider this issue in a step-by-step process that must be undertaken in a very careful, considered and deliberate manner.

Do nothing. If the issue is minor, a credit union may wish to concede. Challenging an examination takes time, effort and occasionally a good deal of money. Many credit union executives have indicated to NAFCU that they "pick their battles" carefully, avoiding a costly confrontation except in the most extreme and unusual circumstances. If a finding is minor and can be corrected quickly, many credit unions will make the suggested change even though they may disagree with the examiner's logic.

Discuss the issue. If the credit union disagrees and wishes the examiner to reconsider his or her position, the first step would be to discuss the disagreement informally with the examiner. NCUA officials have indicated to NAFCU that when they investigate credit union-examiner disagreements, a breakdown in communications is usually the cause. To maximize their chances of success at this level, NAFCU members have indicated to us that a credit union should communicate the rationale for its position clearly and without emotion. In addition, should attempts to resolve the matter with the examiner be to no avail, NAFCU-member credit unions have indicated that, depending on the weight of the matter, it can be advantageous to bring supervisory examiners into the conversation before resorting to a formal dispute.

Formal appeals. Should informal conversations fail to resolve a disagreement between a credit union and an examiner; credit unions have rights through which they can formally appeal exam findings. NCUA discussed these rights in the **March 2010 issue** of the NCUA report. Keep in mind that a credit union's board must authorize an appeal before it is filed. In short, the steps are as follows:

1. Request a review from the appropriate regional director in writing within 30 days of receiving a final report from an examiner. The regional director is to respond within 60 days.

2. Should a credit union not agree with the regional director's response or if the regional director does not respond within 60 days of receiving the request for

appeal, a credit union may submit an appeal to NCUA's Supervisory Review Committee. The Committee's structure and operation are outlined in **Interpretive Ruling and Policy Statement (IRPS) 11-1**. Credit unions should review the IRPS closely, as the Supervisory Review Committee only handles a limited number of "material issues." In addition, the following text from IRPS 11-1 is worth noting:

> *The determination or denial remains in effect pending appeal. The appeal does not prevent the NCUA from taking any action, either formal or informal, that it deems appropriate during the pendency of the appeal.*

The Committee's decision is appealable to the NCUA Board within 30 days of receipt.

3. There are other procedures in place for credit unions to use when contesting examiner findings. These can be found in the following Parts of NCUA's rules and regulations:

    - **Part 709** (creditor claim appeals);
    - **Part 745** (share insurance appeals);
    - **Part 792** (Freedom of Information Act appeals);
    - **Part 747** (appeals of various administrative and enforcement actions);
    - In addition, the NCUA Board serves as the final administrative decision maker for major disputes that are not otherwise covered by IRPS 95-1 (amended by IRPS 02-1) or the regulations noted above. These issues include disputes over chartering, insurance applications, field of membership expansion, merger, certain corporate credit union matters, charter changes and letters of understanding and agreement. NCUA has indicated that these issues should first be pursued through the appropriate Regional Office. After that, appeals concerning these matters should be addressed to the NCUA Board, but submitted through the appropriate Regional Office.

    Given the various avenues that credit unions can pursue, it is important to know which avenue is the proper one given the nature of the credit union's appeal.

In addition, there may be some other issues to keep in mind as you work through the exam process.

1. **Respect NCUA's position.** No matter how junior the examiner, he or she represents an independent agency of the United States government. That agency has a wide array of administrative powers at its disposal. Keep in mind that an examination report, email, or letter comes from NCUA, not the examiner. The examiner is an agent of the agency. For that reason, NAFCU members have indicated to NAFCU that they treat official communications that they receive from NCUA with gravitas. The same would go for communications they send to NCUA or other regulators.

2. **Due diligence.** Do not sign anything on behalf of your credit union unless you understand the nature of the document. NCUA officials have indicated that credit unions who sign a Document of Resolution or Letter of Understanding and Agreement will be held to the agreement. Be prepared to discuss the terms of these agreements with the examiner. Even issues such as timing are open to debate.
3. **Develop in-house capabilities.** In order to confidently appeal an examiner's finding, a credit union must understand NCUA's official position on a given issue. Credit unions should consider the development of staff with strong skills and expertise in the areas of accounting, finance, legal, loan underwriting, compliance, and statistics. Developing expertise in these areas will not only help you during a dispute, but having skilled staff will help you run your credit union in compliance with the laws, regulations and regulatory guidance documents that govern it. While the development of such skills may use considerable salary and training dollars, that development may pay off later in dealing with a dispute or preventing one from happening.
4. **Develop outside relationships.** Credit unions may wish to develop relationships with outside auditors and attorneys. Along those lines, many NAFCU members advise us that it is their routine practice to have legal counsel present when the agency requests to meet with the credit union's CEO and board. In addition, credit unions should consider consulting with these outside experts on a regular basis, rather than waiting for a formal dispute or other "emergency" to develop. Bringing an outside auditor or attorney up to speed on an issue is much easier to do when he or she is already knowledgeable about your credit union's operations. In addition, consulting with outside experts can also help you avoid problems, thereby minimizing the chance that a need for a formal appeal would be necessary. Such experts often can perform audits to identify problem areas before an examiner can locate them. Much like developing in-house capabilities, developing outside relationships will take up credit union resources.
5. **Be proactive.** Many credit unions have indicated to NAFCU that it pays to be proactive during an exam process. Examiners visit many credit unions, but no one examiner is an expert on *your* credit union. Credit unions that actively teach examiners about their skilled staff, dedicated board, credit union operations and the rationale behind practices, policies, and procedures may benefit.
6. **Document policies, procedures and training.** Board training, practices and the reasons why things are done must be translated into records, procedures and other documents that an examiner can review. In addition, research, statistics and information as to why a credit union created a certain practice or procedure may be helpful.
7. **Be readily acquainted with NCUA's examiner manual.** NCUA has an **Examiners Guide**. Thirty-two chapters in length, the Examiners Guide is the reference guide for credit union examiners. Chapters cover issues such as lending, asset liability management, exam report writing and administrative actions. The guide is a good way to understand NCUA expectations on a given issue. If the examiner is not following the guide's recommendations, it would be reasonable to ask why.
8. **Stay professional.** Creating an honest and cordial relationship with an examiner can go a long way. Many NAFCU CEOs have repeated a common theme – make

the examiner's job as easy as possible. If items have been requested ahead of the exam, gather them and have them ready when the examiner arrives. If the examiner asks for a document or policy, promptly provide it. Treating an examiner with respect and giving the examiner a comfortable and productive work environment can only help your case.

9. **Be specific.** When an examiner (or outside auditor) indicates that you must not do A or B, or that you must do C or D, ask them what law, regulation or guidance document is the basis for the recommendation. Many credit unions ask for the specific legal or regulatory citation.
10. **Stay connected.** While each credit union is unique, many of the situations we face have been seen by others. NAFCU-member credit unions have indicated to us that the more a credit union taps into networking, trade associations, training and conferences, the better prepared they are to deal with the uncertainties involved with NCUA supervision and examinations.

Given the unique nature of each credit union's operations, NAFCU understands that it is nearly impossible to generalize how a credit union should respond to NCUA. Each situation will be unique, and the credit union must make a business decision on how to choose to respond, or not to respond, to an examination finding. In the current environment, NAFCU wants credit unions to be able to access all the tools available to get the examinations that they feel are accurate and support the condition of their credit union.