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ENHANCING SAFETY AND SOUNDNESS: LESSONS LEARNED AND OPPORTUNITIES FOR CONTINUED IMPROVEMENT

HEARING

BEFORE THE

SUBCOMMITTEE ON
FINANCIAL INSTITUTIONS AND CONSUMER PROTECTION

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

ON

EXAMINING OPPORTUNITIES FOR CONTINUED IMPROVEMENT IN THE SAFETY AND SOUNDNESS OF OUR BANKING SYSTEM

JUNE 15, 2011

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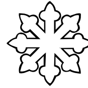

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C O N T E N T S

WEDNESDAY, JUNE 15, 2011

	Page
Opening statement of Chairman Brown	1
Opening statements, comments, or prepared statements of:	
Senator Corker	2

WITNESSES

Michael R. Foley, Senior Associate Director, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System	4
Prepared statement	31
Responses to written questions of:	
Senator Reed	59
Senator Merkley	59
Christopher J. Spoth, Senior Deputy Director, Division of Risk Management Supervision, Federal Deposit Insurance Corporation	6
Prepared statement	34
David K. Wilson, Deputy Comptroller, Credit and Market Risk, Office of the Comptroller of the Currency	8
Prepared statement	39
Responses to written questions of:	
Chairman Brown	61
Senator Reed	63
Senator Merkley	64
Salvatore Marranca, Director, President, and Chief Executive Officer, Cattraugus County Bank, Little Valley, New York	19
Prepared statement	52
Frank A. Suellentrop, Chairman and President, Legacy Bank, Colwich, Kansas	21
Prepared statement	56

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

Statement submitted by the American Bankers Association	68

ENHANCING SAFETY AND SOUNDNESS: LESSONS LEARNED AND OPPORTUNITIES FOR CONTINUED IMPROVEMENT

WEDNESDAY, JUNE 15, 2011

U.S. SENATE,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER PROTECTION,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Subcommittee met at 10:04 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Sherrod Brown, Chairman of the Subcommittee, presiding.

OPENING STATEMENT OF CHAIRMAN SHERROD BROWN

Chairman BROWN. The Subcommittee on Financial Institutions and Consumer Protection will come to order. I will do a brief opening statement, call on the Ranking Member, Senator Corker from Tennessee, and then I think Senator Reed and I believe Senator Moran will be here for opening statements, and Senator Moran wants to introduce somebody in the second panel.

From 1999 to 2007, Wall Street in many ways was a big party without adult supervision. Mortgage originators, investors, and investment banks all made money. Large megabanks made lots and lots of money. Citigroup's CEO, Chuck Prince, famously asked Treasury Secretary Hank Paulson, "Isn't there something you can do to order us not to take all of these risks?" The answer was, "Yes, but no one did." And so Prince concluded, "As long as the music is playing, you have got to get up and dance."

As a former Fed Chairman once said, "The Fed's job is to take away the punch bowl just as the party gets going." So where were the regulators? One Fed supervisor told the Financial Crisis Inquiry Commission, "Citigroup was earning $4 to $5 billion a quarter. When that kind of money is flowing out quarter after quarter, it is very hard to challenge."

While the securitization machine was in full swing, Wall Street basically wrote its own rules. Banking regulators relied on Wall Street's own internal risk models and allowed the banks to hold no capital buffer against their subprime securities while these securities were rubber-stamped as AAA by the rating agencies. The OCC's head of large bank supervision has acknowledged that they did not have enough information about market risk and failed to intervene before the crisis.

According to a 2009 evaluation, the New York Fed's supervision of Citigroup "lacked a disciplined and proactive approach in assessing and validating actions taken by the firm to address supervisory issues."

The former head of the Office of Thrift Supervision compared its ability to regulate AIG to that of a gnat on an elephant. With supervision like this, the party was sure to end in financial disaster.

Now there is a constant drumbeat on Wall Street and in Washington that focusing on safe and sound financial practices will hold back our economic recovery. Wall Street and my conservative colleagues in Washington have a bad case of amnesia. They have forgotten that poor safety and soundness oversight helped push us toward a fiscal crisis and a disaster in our economy. The Congressional Budget Office projects the financial crisis will increase Federal debt held by the private sector by 40 percent of GDP. Standard & Poor's estimates that another financial sector bailout could have up-front costs as high as $5 trillion.

These are not the only costs. We know home prices have fallen by more than they did during the Depression; 28 percent of homeowners are currently underwater, owing more on their house than their house is worth. Reports of foreclosure fraud and mortgage-backed security failures are all too commonplace.

Lax supervision also makes it harder to hold wrongdoers accountable because law enforcement agencies rely only on referrals too often only from bank regulators. As the *New York Times* noted in April, the Office of Thrift Supervision has not referred a single case to the Justice Department since 2000 and the OCC has referred only three. When laws can be ignored, then property can be taken from its rightful owners, homeowners and investors, and given to servicers and originators. A safe and sound banking system should attract capital from investors and provide it to borrowers to finance productive economic activity.

Guided by clear-cut, sensible rules, our banking system for over five decades has been a model of safety and security for the world, yet it is clear that we forgot the lessons learned in prior bank crises at home and abroad that an unsafe and unsound banking system destroys wealth and drains resources from the rest of the economy. I am afraid that American families and investors, simply put, have lost faith in our financial system.

So my question to the witnesses is: What are you doing—and those questions will be more specific from all of us after statements from us and you. What are you doing to restore Main Street's confidence? What have you learned about sound bank regulation? How has your approach changed? And what is being done right now before all the provisions of Dodd-Frank take effect to prevent another collapse of our banking system?

Senator Corker.

STATEMENT OF SENATOR BOB CORKER

Senator CORKER. Thank you, Mr. Chairman. That was quite a statement.

I want to thank each of you for coming and thank you for what you do. I will say that there is no question that I think people on both sides of the aisle would agree that we have to figure out a way

to keep regulation from being procyclical where, when things are really good, people loosen up, and when things are really bad, we create a self-fulfilling prophecy by overregulating. And I think probably everybody would agree that that is a problem that we have got to keep from happening.

But I have to tell you, I think I am amazed. Congress certainly was part of the party and was pouring some of the alcohol in the punch bowl, and, you know, I look at Dodd-Frank as an incredible exercise of laziness by Congress where basically Congress punted all the tough decisions to regulators, trying to act like it had done something great. And I think the *Financial Times* had the best summary of it about a week after they had an analysis, and it said, "So many pages, so little content." And I find it hilarious—it would be hilarious except for the damage that it is doing to our country right now.

You know, Dodd-Frank was basically put in place and rushed the way that it was to create clarity in the markets, and anything but that has happened. The fact is that, you know, Congress punted all tough decisions to regulators, did not give the clarity. Then I find it, again, hilarious except for the damage that is being done that we now have Senators on both sides of the aisle acting as supplicants to regulators, begging them not to do certain things because we have turned over all of the power as it relates to these financial institutions to regulators without really giving the type of direction that we should have given.

So I think over time historically, looking at Dodd-Frank, people are going to look at it as a minor disaster as it relates to our economy. I do wish we had taken more time to do the work we needed to do to understand the issues instead of just, as Congress typically does, acting like we did something great but basically have asked the regulators to make hundreds and hundreds of rules in a short amount of time. I mean, that alone we all know is going to lead to all kinds of unintended consequences.

So as we are pointing fingers, I certainly hope fingers will be pointed, as they should be, at the U.S. Senate and Congress for not doing the oversight that it should have done while the party was going on, for basically fueling it with much of the housing policies, and then now basically punting much of our responsibilities to regulators, creating a tremendous lack of clarity out there. And I do hope while the regulators, in my opinion, have made some bad decisions over the course of the last couple months, several months, this last year, the fact is that we are all in this together, and I think we all do want a sound financial system with appropriate reserves and all of those types of things.

So I think the pendulum has swung too far. I think Congress, just like regulators do, on a procyclical basis, the regulators overregulate during the bad times. We are seeing it throughout our country, especially with community banks. I think Congress has done the same thing, and instead of surgically looking at the problems and prescriptively trying to deal with those, we wrote this massive, massive, massive bill that has given the regulators tremendous powers, many of which the regulators do not want.

You know, we complain about regulatory overreach, and in the case of Dodd-Frank, I think the regulators are saying, "Please, do

not ask us to do all these things in the short amount of time that you have given us.”

So, with that, I look forward to your testimony, and I do that with a smile, and I thank you for being here.

Chairman BROWN. Senator Reed.

Senator REED. Thank you, Mr. Chairman, for convening this hearing.

Chairman BROWN. Good statement. Thank you.

Michael Foley is a Senior Associate Director of the Federal Reserve Board with responsibility for large bank supervision. In that role he cochairs a system-wide multidisciplinary committee that is responsible for implementing a coordinated, comprehensive supervisory program for large complex banking organizations overseeing horizontal examinations and evaluating the findings from key supervisory activities. He has served in that capacity since the formation of this group in mid-2010. Previously, he was senior adviser to the Director of Banking Supervision and Regulation beginning in late 2008.

Christopher Spoth is Senior Deputy Director of the FDIC’s Division of Risk Management Supervision. His responsibilities include oversight of the FDIC’s supervisory programs for safety and soundness and bank secrecy, antimoney laundering. Prior to his current appointment, Mr. Spoth was regional director of the FDIC’s New York Region. Welcome.

David Wilson was appointed Deputy Comptroller for Credit and Market Risk at the Office of the Comptroller of the Currency in June 2010. In this role Mr. Wilson is a key adviser to OCC’s senior management on evaluating credit risk. He also provides expertise on other major policy matters affecting national bank lending activities. Mr. Wilson cochairs OCC’s National Risk Committee and supplies executive direction in analyzing emerging risks to the financial banking system and establishing bank supervisory policy.

Mr. Foley, if you would begin.

STATEMENT OF MICHAEL R. FOLEY, SENIOR ASSOCIATE DIRECTOR, DIVISION OF BANKING SUPERVISION AND REGULATION, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. FOLEY. Thank you, Chairman Brown, Ranking Member Corker, and other Members of the Subcommittee. I appreciate the opportunity to testify today regarding the Federal Reserve Board’s supervision of financial institutions and, in particular, changes that we have made and are in the process of making to enhance our supervisory opportunities over these firms. As you mentioned, I am a Senior Associate Director at the Federal Reserve. I am responsible for the largest banking institutions.

The financial crisis revealed a number of vulnerabilities in the financial system and in the regulatory framework in the United States. Many of those have been addressed by the Dodd-Frank Act, but in addition, the Federal Reserve has taken a number of steps to strengthen our oversight of the largest, most complex financial institutions and to broaden our perspective to include a more macroprudential approach to supervision.

To that end, as you mentioned, we have established a new governance structure for large bank supervision. This was led by a number of senior officials from across the Federal Reserve System with expertise in a number of areas—macroeconomics, capital markets, payment systems—in addition to bank supervisors.

This committee is responsible for helping us to identify potential threats both to individual firms and to the system more broadly, to set supervisory priorities and strategies for the largest institutions, and to review the findings and the work of the examiners onsite at these institutions.

The Supervisory Capital Assessment Program, which was led by the Federal Reserve in early 2009, helped to stabilize the U.S. financial system, but also demonstrated the feasibility and the benefits of employing an across-firm macroprudential approach to the supervision of the largest firms. As a result, our examiners are making greater use of these horizontal assessments. The most recent example of this is the Comprehensive Capital Analysis and Review, or the CCAR, which we completed earlier this year in cooperation with our colleagues from the OCC and the FDIC.

The CCAR also, very importantly, represented a substantial strengthening of previous approaches by supervisors to ensure that large firms themselves have robust internal processes for managing their capital resources, that resulted in a forward-looking assessment of capital adequacy, both for individual firms and also for a majority of the assets of the U.S. banking system.

We also are strengthening our firm-specific supervisory techniques. We are using more detailed data, more frequent and more granular collection of data, and improved quantitative methods and models in analyzing that data.

I would like to add that while many of our recent actions have been focused on enhancing the supervision for the largest institutions, we also have been making adjustments to our oversight for community and regional banks. As liquidity strains developed during the course of the crisis, we adjusted our focus to place greater emphasis on evaluating liquidity contingency funding plans at those organizations. And as commercial real estate began to deteriorate and affected the performance of those firms, we conducted reviews of the implementation of the 2006 interagency guidance addressing commercial real estate concentrations. And as a result of those reviews, we identified a number of issues for which examiners and bankers needed clarification. That contributed to the 2009 interagency guidance aimed at facilitating prudent workouts of commercial real estate loans and prudent modifications of those loans.

So while the crisis made it clear that tightening of supervisory expectations and our processes was needed and appropriate, we are also mindful of the importance of maintaining banks' ability and willingness to lend to creditworthy small businesses and consumers. Consequently, we have worked hard to ensure that our examiners employ a balanced approach when they are reviewing banks' underwriting and when they are reviewing banks' risk management and mitigation practices. We expect our examiners to strive for consistency in the examination process throughout the business cycle.

I would add that credit markets have been recovering slowly since the financial crisis. Recent measures of aggregate credit outstanding that have shown some signs of improvement. But, clearly, the residential and commercial real estate lending sectors remain lagging. They are going to continue to present challenges for banks and supervisors for quite some time to come. With housing values flat or deteriorating in many markets, there are renewed concerns about the health of the mortgage market in general, and home equity loans and the activities of firms in that regard.

So with residential and commercial property values still under strain, heightened reserve levels at banks remain appropriate. We expect that banks will continue to incur higher-than-historical losses in these sectors for some time to come, certainly through the remainder of this year and beyond. In conclusion, the Federal Reserve has made significant enhancements to our supervisory process, and those enhancements, coupled with the Dodd-Frank Act, support enhanced regulation and supervision of large complex firms, but we have also enhanced our supervision of regional and community banks, placing greater emphasis on sound risk management practices. In so doing, we have been mindful of the need to ensure that bank supervision is scaled to the size and the complexity of the supervised firm, and that bank management and examiners take a balanced approach to ensuring the safety and soundness of the banking system and also serving the credit needs of their communities.

Thank you for inviting me to appear before the Committee today on these important issues. I would be pleased to take any questions that you may have.

Chairman BROWN. Thank you, Mr. Foley.

Mr. Spoth.

STATEMENT OF CHRISTOPHER J. SPOTH, SENIOR DEPUTY DIRECTOR, DIVISION OF RISK MANAGEMENT SUPERVISION, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. SPOTH. Chairman Brown, Ranking Member Corker, Members of the Committee, thank you for the opportunity to testify on behalf of the FDIC about our supervisory process. As Senior Deputy Director, Division of Risk Management, I oversee our nationwide safety and soundness examination program.

As the primary Federal supervisor of most community banks, the FDIC seeks to maintain a balanced approach to bank supervision, regardless of economic conditions. In our unique role as deposit insurer, we have a vital interest in assessing risks to the Deposit Insurance Fund posed by all FDIC-insured institutions.

Overall, we are cautiously optimistic regarding the current condition and trends in banking. The number of institutions on the FDIC Problem List is leveling off, and the number of failed insured financial institutions appear to have peaked in 2010. However, the number of problem institutions remains high at 12 percent of all insured institutions, indicating that a portion of the industry continues to struggle with lingering credit quality issues. These issues limit the ability of some institutions to grow their lending activity.

We identify four broad factors that led to the financial crisis: excessive leverage, misaligned incentives, regulatory gaps, and weak

market discipline. Much of the risk centered on poorly underwritten mortgage loans originated for securitization in the so called shadow banking system. Structured financial activities that generated the greatest losses were undertaken at the intersection of the lightly regulated shadow banking system and the more heavily regulated traditional banking system. This experience motivated legislative reforms and supervisory improvements.

The establishment of the Financial Stability Oversight Council, the designation of systemically important financial institutions, or SIFIs, and the heightened supervision of systemic institutions along with other regulatory changes will help restore market discipline to our financial system. At the FDIC we established the Office of Complex Financial Institutions to continuously monitor and, potentially, resolve SIFIs. Among other requirements the office will review SIFI resolution plans which must demonstrate that the firm is resolvable under the Bankruptcy Code.

With respect to community banks, they were generally not involved in the mortgage-related issues that were at the center of the financial crisis, but they were impacted in the fallout. Hit first was construction and development lending. Credit losses subsequently spread across all loan types. Further, home prices continued to fall because of several factors, including the foreclosure inventory.

Growth in well-underwritten loans is essential for bank revenue growth and for our economy to grow. However, recent independent surveys and some bankers indicate that borrower demand remains sluggish. Despite the challenges, community banks continue their vital role as lenders. In fact, they have increased their loan balances since the second quarter of 2008.

To address the significant challenges faced by banks and their borrowers, we continue our active engagement with banks. For example, 2 years ago the FDIC established its Advisory Committee on Community Banking. The committee provides the FDIC with advice on a broad range of policies. In addition, bank CEOs received a letter reiterating various channels, including confidential ones, for bankers to raise any concern about an examination.

The FDIC continues to work on eliminating unnecessary burdens on community banks whose structure and business lines are relatively noncomplex. As noted in my written testimony and appropriate for the causes of the crisis, much of the Dodd-Frank Act should not directly impact community banks, and certain provisions of the act provide some benefits.

We will continue to pursue methods to streamline our supervisory process using technology and other means to reduce disruption associated with examinations. We strive to be efficient in our work while also conducting effective examinations. Having our office locations in numerous communities across the country helps our examiners be knowledgeable about community banks in their areas and about local conditions.

The FDIC has been incorporating lessons learned into our examination program. We are encouraging banks to make loans to creditworthy borrowers, and we recognize their important role in the economy.

Thank you. I would be pleased to take your questions.

Chairman BROWN. Thank you, Mr. Spoth.

Mr. Wilson.

STATEMENT OF DAVID K. WILSON, DEPUTY COMPTROLLER, CREDIT AND MARKET RISK, OFFICE OF THE COMPTROLLER OF THE CURRENCY

Mr. WILSON. Chairman Brown, Ranking Member Corker, and Members of the Subcommittee, I appreciate the opportunity to discuss the OCC's perspectives on lessons learned from the financial crisis and our ensuing approach to bank supervision. While not covered in my remarks, pursuant to the Subcommittee's request, my written statement does provide an update on the current state of small business and real estate lending, mortgage servicing, and trading lines of business.

The financial crisis underscored the importance of prudent underwriting practices, adequate loan loss reserves, strong capital cushions, and it also highlighted the need for supervisors to develop better tools to evaluate and address emerging risks across the system. The OCC has taken action to strengthen our supervision and practices of the banks we supervise in each of these areas.

The primary driver of the financial crisis was the progressive slippage in underwriting practices that occurred as banks responded to competitive pressures from the shadow banking system. We closely monitor national bank underwriting and have directed our banks not to compromise their underwriting standards due to competitive or other pressures, and as well, we have strengthened our analytical tools to help monitor for slippage in loan quality so we can intervene at an earlier stage. This includes granular loan-level data on major credit portfolios that we are collecting from the largest national banks that allow us to conduct forward-looking analysis under varying economic scenarios.

The financial crisis also highlighted that risk management is and must be much more than simply a collection of policies, procedures, limits, and models. Effective risk management requires a strong corporate culture and corporate risk governance. This culture must be set, embraced, and enforced by the bank's board of directors and its senior management, and it must permeate through all the bank's activities. This is a point of emphasis in all of our meetings with senior management teams, directors, and senior management at large, midsized, and community banks.

We have also updated our risk assessment system that we use as a part of our examinations at each national bank to reflect and incorporate lessons learned from the financial crisis and have directed examiners to be more forward-looking when they assess and assign these risk assessments. Given the importance and role of large national banks and the importance they play in the financial stability of the U.S., we have made it clear that these firms should not operate without strong risk management and audit functions. Anything less would not be sufficient.

Further, we are directing large banks to incorporate robust, enterprise-wide stress testing as a part of their ongoing risk management. We are also working with smaller banks to improve their ability to assess potential concentrations in key portfolios, most no-

tably commercial real estate, so they can address potential problems before they occur.

To improve our ability to identify emerging systemic risks, we have established a financial markets group to monitor and gather market intelligence, and we developed a system of early indicators that signal a buildup of risk within the system. Under this system warning signals across a number of measures will trigger a more formal review and assessment of the risk and the need for a supervisory response.

The OCC has worked with supervisors across the globe to enhance and strengthen capital and liquidity standards. These efforts culminated in Basel III. These reforms tighten the definition of what counts as regulatory capital, expand the type of risk captured within the regulatory capital framework, increase overall capital requirements, establish an international leverage ratio, and introduce global minimum liquidity standards for large banks.

The OCC has also been a vocal advocate with the accounting standard setters to revise the current accounting model for loan loss reserves to make them more forward-looking.

In closing, the financial crisis exposed fundamental weaknesses in risk management and supervisory practices across the financial industry and the supervisory community. The OCC has taken numerous steps to enhance its supervision programs. As we implement these changes and those mandated by the Dodd-Frank Act, we are cognizant of the need to tailor our expectations to the scope and complexity of each bank's activities. We must also avoid wringing all risk out of the banking system. Banks' fundamental role is risk intermediation, and financial innovation and expansion of credit are important drivers of our economy. Banks must be able to respond to customer and investor demand for new and innovative products and services, and in this respect our overarching goal and mission remain the same: to assure banks conduct their activities with integrity and in a safe and sound manner, and that our supervision remains balanced and fair.

Thank you, and I would be happy to take questions.

Chairman BROWN. Thank you, Mr. Wilson. I do not think anybody wants, to your last comment, wring all the risk out of the financial system. I do not think that is where anybody is going in this.

Last week the Treasury Department—and this question will be for you, Mr. Wilson, but anybody can weigh in—announced it was withholding payments from three servicers due to poor performance in the HAMP program. We do not always in these hearings and in our deliberations think about human beings and the consequences of all of these actions.

I want to tell a quick story about Frank Vance from Medina County, an exurban county just south of Cleveland. He worked at the Arcelor Mittal Steel Plant as a railroad engineer. He and his wife bought their dream house in Chatham, Ohio, with a Countrywide mortgage. The financial crisis hit. The plant closed. The plant laid him off in 2009. He went to his lender, now Bank of America, entered into a trial modification that lowered his monthly payment by extending the loan 12 years. When a paper bill came in the mail showing the old payment amount, Frank called his bank. They told

him not to worry, to keep making his payments, that no negative reports were being made to the credit bureaus. The bank did not approve a permanent modification until August 2010 when his payments increased by $200 a month. He later discovered that all his payments for a period of 13 months were sitting in an escrow account, and his credit report made it appear as if he was not making any payments over that year. In addition to placing his home in jeopardy, it is now more expensive for him to make the second biggest purchase in his life—his car.

My question for the regulator is: What is the OCC doing to scrutinize these loans? What are you doing to help the Frank Vances of the world?

Mr. WILSON. Yes, Senator, HAMP is a Treasury program, but these problems are indicative of our findings of the reviews that we did late last year. They are the subject of the consent orders that we issued in April. Those consent orders get to the heart of, you know, where consumers were harmed because of foreclosure management practices. The consent orders specifically talk about dual-track processing and things like that. It is, unfortunately, not something that can be corrected overnight. But one of the reasons that the OCC and my colleague agencies moved forward with consent orders is to get them corrected as quickly as possible.

Chairman BROWN. Anyone else want to weigh in?

[No response.]

Chairman BROWN. Let me go somewhere else. National City Bank in Cleveland was a huge regional bank founded in Cleveland in 1845. As recently as 2007, it was the ninth largest U.S. commercial bank with $140 billion in assets. It was sold to PNC a year later during this terrible crisis. It is a case study in regulatory failure.

After buying subprime lender First Franklin in 1999, the bank's mortgage annual profits grew 20-fold in 4 years from $50 million to $1 billion. These volatile, unpredictable mortgages eventually did in National City. National City executives started talking about selling First Franklin in early 2005. It took until late 2006 for them to sell it. They were forced to retain $10 billion of the riskiest loans, half of the loans that ultimately brought National City down.

In the summer of 2006, their chief economist wrote a research report arguing that the housing market was headed for collapse. That report was ignored by the bank's own executives. A few months later, the bank spent 42 billion buying two Florida banks, a market that has been crushed by declining property values and foreclosures.

In early 2007 the bank bought back $3 billion of its own stock. A year later it was forced to raise a very expensive $7 billion from private investors. National City wound up losing $6 billion in 2008 and was bought by PNC for only $2.23 a share. The company and its regulators—the Fed and the OCC had known for almost a year the bank was in trouble.

What have we learned from this? What would you do differently? What are you doing now to prevent failures such as National City? And understanding that bank still exists as part of PNC, they still have a lot of employees in my State, but they have significantly

fewer employees, and a whole lot of stockholders in National City lost a lot of money.

Mr. WILSON. I will refer back to some of the comments about when do you take away the punch bowl. That is one of the most difficult things that regulators and supervisors have. And I referred to it in my testimony. We have developed a number of tools and indicators that really indicate when times are too good. For example, the best loans are often made during the worst of times and vice versa. So the worst loans are made during the best of times. Being able to identify that and flag it early and take early action I think is the key to preventing your description of National City.

Chairman BROWN. And you are capable of that, and the other regulators are now capable of that?

Mr. WILSON. We have a renewed emphasis, and we are going to do the best we can.

Chairman BROWN. Mr. Foley.

Mr. FOLEY. From our perspective the first step is to go back and consider the lessons learned in the crisis. The very situation you talked about really describes a collective failure of imagination by the banks and by the regulators themselves. Of course, this is in the context of very strong economic growth, a long benign economic environment, strong profitability from firms, and exceptionally low losses on mortgage lending.

But against that backdrop, bankers and supervisors did not consider the potential for a significant decline in house prices. We did not consider the potential that what were assumed to be stable sources of funding could go away in that type of environment. The result was that these firms were undercapitalized, and they were not prepared for the liquidity strains that they saw in the crisis.

One of the appropriate responses, we think, is that bankers themselves need to have stronger risk management in place and supervisors have to have better tools to assess the potential for low profitability, but high-impact stress events. Stress testing is one effective way to do that. That is required under the Dodd-Frank Act. That is reflective of the activities undertaken in the SCAP and the CCAR process. But one important element of this is the need for a forward-looking assessment of the potential risks of the firms. We need to consider more extreme economic events and idiosyncratic risks that can affect individual firms and relate that back to potential future losses, the ability to earn and supplement their capital base, and evaluate their need for capital and liquidity under those types of adverse circumstances.

Mr. SPOTH. Senator, I would only add, the one thing FDIC has done with the other regulators is reframe our back-up examination activities to protect the insurance fund wherein we adopted a new memorandum of understanding to engage in back-up activities where necessary.

Chairman BROWN. OK. Thank you. Senator Corker, before you begin, in light of your opening statement, I hope there are some statutory issues that maybe with Dodd-Frank we can work together on to help us with that. Thank you.

Senator CORKER. I appreciate that. As a matter of fact, I think there are, and I think that a lot of us are seeing a lot of unintended

consequences and I think a lot of folks wanted to see appropriate financial regulation, so I hope we can do that.

As I go through our State, people from all kinds of backgrounds and persuasions politically that are in community banking come up to me and say, "You know, Corker, I am beginning to think that the Federal Government just really does not want community banks in the number that they have today, that they really want to force consolidation, that they really are doing everything they can to keep us from being successful."

And I guess my question to each of you, without being too elaborate with your answers, is what is happening right now throughout community banks, the banking system? Is it a result of procyclicality, where, in essence, we are clamping down more than we should at a time when the economy is slow and creating a self-fulfilling prophecy? Is it that Dodd-Frank is forcing you to do things that you were not doing before? Or is it some other answer? But I really do believe that amongst community bankers in our country, there is a belief that the Federal Government really has stacked the deck in a way that makes it very difficult for them to compete.

Mr. SPOTH. I might touch on that first, Senator, as principally we are the regulator for most of the community banks. I think with respect to Dodd-Frank, the burden falls, as it should, on the largest financial institutions and we should work in that regard for implementation.

I hear the same things that you do when I am talking with bankers about burden. I am optimistic that the community bank franchise is a strong one and a valuable one and will continue to be so for our country. Looking at the numbers, I know that of all the 7,500 insured banks in this country, 90 percent of them are community banks serving their communities well. They have under a billion dollars in assets each, but they have a disproportionately large share of the commercial loans in their markets.

Mr. WILSON. At the OCC, we respect and support the role of community banks and have no intention of trying to reduce the number of community banks or anything like that. In addition to what Chris said, community banks are under a lot of pressure right now because they tended to be overly concentrated in commercial real estate, and commercial real estate, particularly income-producing commercial real estate, has lagged the recovery. A lot of banks are continuing to struggle with those concentrations and working through those concentrations. We are doing the best we can, and I know my colleagues are, as well, to make sure that we are fair and balanced in allowing the banks to work through those. But in some cases, it is just not possible.

Senator CORKER. Yes. We kind of forced them out of residential into commercial due to our policies here, and that is one of the problems that we, Congress, helped create.

The one thing I would say, Mr. Spoth, I know you mentioned that, somehow or other, this is tilted toward the large institutions. The fact is, that is not the case. I mean, the big just get bigger when we regulate the way that we have, and what has happened is with the community banks, their back offices now are much, much, much larger and are getting larger just to deal with all the

things that are in Dodd-Frank. So I would just say your statement is just categorically untrue, because larger institutions have the ability to absorb regulations in a much more efficient way. They can spread it over a larger mass than community banks do. So that is just categorically an incorrect statement. And you can go talk to any community bank in our country and they will tell you that the burden per asset base that they have is much larger on a community bank than it is on something that is much larger.

Let me ask another question. The risk retention piece, I thought, was ridiculous, and I think it is going to have tremendous effects on our securitization market. So, again, Congress punted and basically said, oh, well, we do not really want to get—we do not know how this works, really, so set up a Qualified Residential Mortgage. You guys have, in your wisdom, come up with a 20 percent downpayment and now Congress, being the supplicants that we now are in this process—everybody is writing letters to say, well, we really—oh, gosh, we wish you had not done that. Would you all like to respond to the Qualified Residential Mortgage and just the whole risk retention piece and how you guys, in your wisdom, have come up with a 20 percent downpayment that now Senators who punted their responsibilities are trying to keep you from doing.

Mr. WILSON. Of course, Senator. That rule is out for comment and we have invited comments on that very issue, especially the 20 percent downpayment. I think the policy makers looked at the rule as primarily a risk retention rule. The intent of the rule is that the securitizer would retain risk. It did allow, as you mentioned, the option of designing a very, very high quality asset that would be exempt from that risk retention rule. So the design of it was very conservative, not only in residential real estate, but in the other asset classes that are mentioned in the proposed rule. And, again, the intent of the law was risk retention, and so the exceptions to risk retention should be narrow.

Senator CORKER. So, basically, this is—for those out in the real estate world that are slightly upset, if you can imagine, about a 20 percent downpayment, what you would say is that is exactly what the U.S. Senate told you to do.

Mr. WILSON. We believe that there are many, many good mortgages, we would hope, that would still be made that are outside of QRM if you include——

Senator CORKER. But the institutions would have to hold risk against those.

Mr. WILSON. But they would have to hold——

Senator CORKER. And so that means that no community bank—let me just go back to the other statement—no community bank could possibly, possibly be in that world. It means that, now, home mortgages will be concentrated in the JPMorgans and the Citibanks and the Bank of Americas because nobody else has the ability to hold risk on their balance sheet, is that correct?

Mr. WILSON. We have tried to design the rule to not have that happen. The risk retention is the primary responsibility of the securitizer, not the originator. So under the current model where you have a community bank that will originate a handful of loans and then sell them to a securitizer, the community bank does not

have to retain the risk. It is the securitizer that has to retain that risk.

Senator CORKER. But will it not concentrate that market when you have to have a large balance sheet like that to hold the risk?

Mr. WILSON. To the extent that the community bank decides to sell that loan, that would be the model that existed before Dodd-Frank. So if the community bank decides to hold the loan on the books, then risk retention does not come into play. But we consciously tried to consider this factor when we debated whether we would make the originator retain the risk versus the securitizer themselves, and it was this consideration that went into that debate.

Senator CORKER. Listen, thank you. I know I have taken over my time. Thanks for having the hearing. I would just close by saying that I know you guys have 300 rulemakings to make, and I know in many cases you feel like you are making them too quickly, trying to meet deadlines. And I do know for a fact that it is creating tremendous lack of clarity out in the financial markets and people have no idea what the rules of the road are and I know that is hurting our economy. I know that. I do not know many things, but I know that.

I do hope that as you move along, if you see things that you feel like you are rushing, that you will not be cowered by those people who just want to see Dodd-Frank pushed through regardless, but that you will tell us that you need more time, and I thank you very much for what you do and appreciate the opportunity to be with you today.

Chairman BROWN. Thank you, Senator Corker.

Senator Reed.

Senator REED. Thank you very much, Mr. Chairman.

Just to follow, a point of clarification, Mr. Wilson. The 20 percent downpayment is not specified—I do not believe it is specified in Dodd-Frank in terms of qualifying. Is it specified?

Mr. WILSON. No, the 20 percent down is not specified.

Senator REED. Yes. In fact, the agencies have the flexibility to design a rule which would reflect an appropriate downpayment, but 20 percent is something you are proposing now.

Mr. WILSON. That is correct.

Senator REED. Thank you. Mr. Wilson, I am still, as you are probably aware, awaiting questions, or responses from the May 12 hearing from the OCC and I would appreciate very much if those responses would be forthcoming. I know my staff has talked to you. I appreciate that. But they are important questions and I would like answers. Any idea when we are going to get them?

Mr. WILSON. Senator Reed, we understand that. We are well along on answering those questions and I would hope it would be very soon.

Senator REED. Thank you.

Mr. WILSON. We take it very seriously.

Senator REED. Thank you. You have mentioned the OCC consent order. At the heart of it seems to be the requirement that the banks engage an independent consultant to look back at their servicing processes, which begs a couple of questions. First, why was the OCC looking at these processes? And then a related question

is at what point did the OCC become aware of what appears to be, and Senator Brown's example is just one of thousands, hundreds of thousands, serious deficiencies, in fact, deficiencies that appear to be violating law? So could you respond to those two issues?

Mr. WILSON. Yes, sir. We become aware, not really until it became public with the Allied Bank publicity, but we jumped in very quickly after that with horizontal examinations on an interagency basis.

As to why were we not looking at before, this is another lesson learned, but we do look at mortgage servicing operations. We do look at modification procedures, the basic transaction of the notary signing and affidavits, and things like that traditionally was a low-risk business. We did not have any indicators from internal audit or other risk management functions around the bank. We did not pick up any complaints in our consumer complaint process. So it was not something that we had a big focus on until we understood the nature of the problems.

Senator REED. Let me—just two points. One, I presume based on not only the response to this question but your previous responses that you have taken corrective action with respect to these issues in terms of your examination procedures, the training of examiners, and I would also sort of emphasize the consumer complaint process, because, frankly, our offices are deluged by consumer complaints. If you were getting a quarter of the complaints which were originating two or 3 years ago that I think some of them are also getting, then you have to look very carefully at your consumer relations and how you identify complaints and follow them up, because there was a lot of noise out there in terms of consumers, frustrated consumers literally banging down our doors, and I think I speak for everybody on this Committee and in every part of the country.

Let me shift gears briefly, and still in the context of this process of mortgage foreclosures. Yesterday, 11 of my colleagues, including the Chairman of the Committee, Chairman Brown, Chairman Leahy of the Judiciary Committee, sent a letter to the Comptroller asking the Comptroller to work very closely with the States' Attorneys General, with the Department of Justice, with the Department of Housing and Urban Development, to produce a comprehensive solution to this foreclosure crisis, not just rectifying the robosigns, *et cetera*. And I think at the heart of it is the notion that we have—until we stabilize the housing market, which we have not, we will not have any economic growth of consequence nor will the safety and soundness of banks begin to be self-sustaining and something that you have to worry about.

So let me just specifically ask, can you describe your proposed collaboration with the Attorneys General at all?

Mr. WILSON. I will try. I will say, number one, we agree with the letter. We agree that not only should we fix what is wrong with the foreclosure process, provide restitution to consumers that have been harmed, but then also address the broader issue of servicing and servicing standards and some of the things that got us to this place in the first place.

In terms of cooperation, we went forward with the consent orders to do that first piece of the two-piece puzzle, but we were very careful not to interfere with ongoing negotiations from the Department

of Justice and the State AGs, and, in fact, we are trying to coordinate. We just announced that we delayed the responses back from the banks by 30 days at the specific request of the Department of Justice, and so we do look forward to going forward. There are a number of groups working on national servicing standards and we all agree that we need to get to a commonplace at some point.

Senator REED. Let me, again, in the context of a comprehensive approach, I think—and the letter indicates this—there is also the possibility of modification, including principal reductions, in terms of terms, extensions of mortgages, so that we avoid foreclosures, basically. I think simply getting the foreclosure process correct, then go out and foreclosing more homes is not going to help anybody. And, in fact, in talking to the Attorneys General, this modification process is one of the things that was used in the Iowa farm crisis of the 1980s in terms of trying to correct similar situations. So I would presume that you would be working as best you can along with the Attorneys General in this regard, too, is that correct?

Mr. WILSON. That would be correct. I mean, the devil is in the details, but yes.

Senator REED. Thank you very much. Thank you, Mr. Chairman.

Chairman BROWN. Thank you.

Before turning to Senator Merkley and Senator Moran, we will also in a moment introduce one of the members of the next panel. A couple of questions before Senator Merkley.

For you, Mr. Wilson, brief questions. As Dodd-Frank in the Senate and the House worked together on sort of, obviously, reconfiguring the regulatory agencies with OCC and FDIC and the Fed and the new CFPB, I have two brief questions for you, Mr. Wilson, just so I understand, so we understand the structure better as we move forward. Does the OCC have a single head or a board? I understand they have a single head, correct?

Mr. WILSON. We have a single head, yes.

Chairman BROWN. OK. And the OCC is subject to the appropriations process or not?

Mr. WILSON. They are not, no.

Chairman BROWN. They are not. OK. It is important to make that clear.

Senator Merkley.

Senator MERKLEY. Thank you, Mr. Chair, and thank you all for your testimony.

I wanted to get a better sense of the contrast between the strategies used for overseeing or supervising or auditing the large, complex financial institutions as compared with community banks. Certainly in a smaller institution, the FDIC as it supervises community banks can go in and basically look at every loan file. In large, complex institutions, the strategy is more on the side of having, as I understand it, a staff member on-site working with the risk management staff of that institution.

I would like to get a sense of whether that embedded risk management approach is the best strategy. What have we learned from this financial crisis? Do we need to have kind of some more, if not loan level, but more deeper understanding or inspection of what is going on in the guts of complex institutions? And Mr. Wilson and

Mr. Foley, if you could share your thoughts on that, it would be helpful.

Mr. WILSON. I will start. We do have a significant difference between the way we supervise large institutions and community banks. Community banks tend to be more of a point in time examination where we go in periodically. In our large banks, we have core staffs—some of them can be quite large—that are resident in the bank at all times. And you are right. We try to work with risk management, audit, some of the risk functions. But to say that that is all we do is not correct. We do a lot of transaction testing, especially looking at individual loans, sampling individual loans. Every spring, we do a Shared National Credit Program, which is where we review all the big shared credits in the country that are significant. So that testing is there.

I think the question is, do we need to do more? I think in some cases we should. And in products that were homogeneous, we may have become a little more comfortable with the process and did not call a residential mortgage and say, how is this thing actually being underwritten. I think it is a lesson learned for the future.

Senator MERKLEY. Well, you are talking about transaction testing. Are you randomly selecting a few out of, of course, a very large volume of transactions to see kind of just what you find, whether, one, it was real, and two, presented to reflect the reality of the transaction and so forth?

Mr. WILSON. For things like credit, structural products, bonds, things like that, we would do a random selection. For example, in CMBS for commercial real estate, we will look at the quality of the loans that are going into those structures.

Senator MERKLEY. And before we shift over, is there anything that you feel has really been a modification of your strategy based on the lessons learned from the 2008–2009 crisis?

Mr. WILSON. Yes, as I said in my testimony, we are doing a lot more data collection from the banks, the large banks themselves. This is loan level data collection which started in 2008 and we have expanded it to additional asset classes to the point now where we are collecting on almost all major asset classes. We are doing a lot more modeling on that.

From our core staffs on our large banks, we have significantly ramped up our expectations for risk management in those institutions. I think before we were somewhat OK if we rated the risk management functions as satisfactory. We have communicated to our banks that that is no longer the grade. They have to be strong and we are working toward getting to strong risk management.

Senator MERKLEY. So are you designing any independent risk models or utilizing just simply kind of following what the bank itself is using?

Mr. WILSON. We do both, but on the loan level data collection that I was talking about, those are independent.

Senator MERKLEY. Mr. Foley.

Mr. FOLEY. Thank you, Senator. I think, again, part of this is looking at the structure in place before, and I think there were a number of limitations, many of which have been addressed by the Dodd-Frank Act. But the Federal Reserve, for example, by statute, was very narrowly focused to consider nonbank subsidiaries and

the impact they could have on depository institutions. Primary and functional regulators were very focused on the particular legal entities they were responsible for. But no Federal regulator had sufficient authority to consider those risks across the entire organization, and for very large, complex firms. For example, they may have a client in Asia that enters into a contract that is booked in the U.S., with the risk on that contract hedged in the U.K. Therefore the supervisory approaches that we take have to recognize the underlying business approaches that these firms use.

Transaction testing is a key element of that, but we are increasingly using techniques such as the SCAP, which involve a broader horizontal assessment. The nature of that exercise is to have the firms consider, for example, a particular stress situation. That could be an economic stress. That could be an idiosyncratic stress particular to the businesses that firm is engaged in. We collect extensive information from the firm to understand the impact of a stress on each of their loan portfolios, to understand the impact on their profitability going forward, to understand the impact on their liquidity.

It is important for the firm to be able to demonstrate they can collect data across the entire consolidated organization, that they can aggregate their risk exposures, that they can understand the potential impact on their profitability going forward and be able to translate that into what their capital and liquidity needs might be, not just as a point in time, but under a more stressful scenario going forward.

Those approaches are much more sophisticated. They allow us as supervisors to collect extensive, robust data on these firms that permits us to independently validate the firms' suggestions in their models. Additionally, we are able to run scenario analysis on any range of scenarios that we may have to consider beyond what the firms are focused on.

Senator MERKLEY. Thank you.

Chairman BROWN. Thank you, Senator Merkley.

Thank you very much for joining us. We very much appreciate it.

I call the second panel forward, Salvatore Marranca and Frank Suellentrop, and Senator Moran, as you get situated—he can wait a moment if he wants—but introduce Mr. Suellentrop.

Senator MORAN. Mr. Chairman, thank you very much. Thank you for accommodating our desire to have a Kansas community banker testify before this Subcommittee, and I appreciate your cooperation in that regard.

Frank Suellentrop is a fourth generation banker. The bank has been in his family for four generations and his bank is outside of Wichita, Kansas. He is an active member of the Kansas Bankers Association as well as the independent community bankers. Like community bankers across the country, he is so actively engaged in his community.

You have heard me say many times in this Subcommittee and more so in the full committee about my concern about the potential demise of community banking because of the regulatory environment. I do not know exactly what Mr. Suellentrop will testify to, but I am anxious to hear his and our other witness's testimony in

regard to the regulatory environment and the changes that have occurred since Dodd-Frank, and I thank you for allowing this Kansan to join us today.

Chairman BROWN. Thank you, Senator Moran, and welcome, Mr. Suellentrop.

Salvatore Marranca is Chairman of the Independent Community Bankers of America, the only national trade organization that exclusively represents community banks. He is Director, President, and CEO of Cattraugus County Bank in Little Valley, New York. He has served the community banking industry in many leadership positions.

Mr. Marranca served in the U.S. Army with a tour of duty during the Vietnam War. Thank you for your service to our country, Mr. Marranca. He is the past Board President of the New York State Banking Department, Director and Past President of the Independent Bankers Association of New York State.

Welcome to both of you. Mr. Marranca, if you would begin. Thank you.

STATEMENT OF SALVATORE MARRANCA, DIRECTOR, PRESIDENT, AND CHIEF EXECUTIVE OFFICER, CATTRAUGUS COUNTY BANK, LITTLE VALLEY, NEW YORK

Mr. MARRANCA. Thank you. Chairman Brown, Senator Moran, Senator Merkley, I am Sal Marranca, Director, President, and CEO of Cattraugus County Bank, a $174 million community bank founded in 1902 in Little Valley, New York. I am pleased to be here today as Chairman of the Independent Community Bankers of America, the ICBA.

The safety and soundness of our banking system is a significant concern to the nearly 5,000 community bank members of the ICBA. Early in my banking career, for more than a decade, I was a senior bank examiner with the FDIC. The commitment I made then to safety and soundness is still ingrained.

The recent financial crisis was fueled by high-risk lending and speculation by the megabanks and Wall Street firms. Significant harm was done to taxpayers and the economy. Community banks, too, were harmed. The economic decline retracted consumer spending and dramatically reduced the demand for credit. Residential and commercial real estate markets remain stressed in some areas. Still, the community banking industry remains well capitalized and, because we take a conservative, common sense approach to lending, has fewer problem assets than any other segment of the industry.

We must ensure this crisis never repeats itself and appropriate supervision of all financial services providers is a key component of that effort. However, the way safety and soundness is achieved is also very important. Misguided, though well intentioned, efforts could be very economically damaging. Frankly, many community bankers are deeply frustrated with the current exam environment.

I am fortunate to enjoy a cooperative and constructive working relationship with my regulator, the FDIC. Having been a bank examiner, I have been on both sides of the table and appreciate the concerns and the challenges examiners face. It is a difficult job

with a great deal at stake. The stakes were raised sharply after the financial crisis.

The pendulum has swung too far in the direction of overregulation. As a community banker, I have met with thousands of bankers from every part of the country in recent years and I can tell you there is an unmistakable trend toward arbitrary, micromanaged, unreasonable examinations that have the effect of suffocating lending. What is more, these exams—in fact, all regulatory compliance—are more costly and a burden to small banks because we have a smaller asset base and staff over which to spread the costs.

ICBA supports bringing consistency to the examination process. Arbitrary loan classifications are a particular source of frustration to community bankers. ICBA strongly supports legislation recently introduced in the House by Representative Bill Posey, the Common Sense Economic Recovery Act. This legislation would help establish conservative common sense criteria for determining when a loan is performing and provide more consistent classifications. We are hopeful a Senate companion bill will soon be introduced and considered by this Committee.

ICBA also supports House legislation introduced by Representative Blaine Luetkemeyer, the Communities First Act, the CFA. This bill contains many reforms that would improve the regulatory environment and community bank viability to the benefit of our customers and communities. To cite just a few examples, this bill would raise the threshold number of bank shareholders that triggers costly SEC registration, from 500 to 2,000. Another provision would extend the 5-year net operating loss carryback provision to free up community bank capital, when it is needed most. Again, ICBA hopes to see a companion bill introduced in the Senate.

The greatest threat to safety and soundness remains the too-big-to-fail institutions that dominate the financial services sector. The financial crisis has, in fact, accelerated industry concentration. Today, the ten largest banks hold 77 percent of all bank assets. A more diverse financial system would reduce risk and promote competition, innovation, and access to credit. This is why ICBA generally supports the too-big-to-fail measures in the Dodd-Frank Act.

Finally, I would note that some of the housing finance reforms being considered by the agencies and by Congress, if not done carefully, could have the unintended effect of driving further industry consolidation and jeopardizing safety and soundness. For example, the Dodd-Frank risk retention rule on securitized mortgages should include a fairly broad exemption for Qualified Residential Mortgages.

Thank you again for convening this hearing and giving ICBA the opportunity to testify. We share your commitment to enhancing the safety and soundness of our financial institution. I look forward to your questions. Thank you.

Chairman BROWN. Thank you, Mr. Marranca, and thanks to the Independent Community Bankers.

Mr. Suellentrop, welcome.

STATEMENT OF FRANK A. SUELLENTROP, CHAIRMAN AND PRESIDENT, LEGACY BANK, COLWICH, KANSAS

Mr. SUELLENTROP. Thank you, Mr. Chairman, Senator Brown, Ranking Member Corker, and Members of the Subcommittee. Thank you for the opportunity to testify before you today regarding lessons learned and opportunities for continued improvement.

My name is Frank Suellentrop. I am President and Chairman of Legacy Bank in Colwich, Kansas. We are a $250 million closely held community bank providing banking services to the area of Sedgwick County, Kansas. We have five branch locations, our charter bank location in Colwich, Kansas, population 1,400, and four branch locations in the Wichita, Kansas, community. Our bank was established in 1886, which means we are celebrating our 125th year in banking this year. I am fourth generation President of our bank since 1991. From that experience, I have seen the beginning of the consumer regulation in the early 1970s, the agriculture and real estate crisis of the 1980s, and now the Wall Street-induced real estate crisis of 2008.

Legacy Bank is significantly involved in residential development, residential construction, and commercial property lending, therefore, greatly impacted by the economic slowdown and depressed real estate market values. Fortunately, the economy in Wichita, Kansas, has fared reasonably well throughout the current crisis relative to other markets, primarily due to the fact that Kansas, specifically Wichita, had not experienced inflated real estate values of the past decade.

I would like to preference my comments regarding recent examination by saying that I understand examiners are charged with a difficult task. On one hand, they are expected to protect against bank failures, ensure consumer compliance and regulations are adhered to, to satisfy community groups and organizations' demand for fair banking practices, and heed Congressional demands for banking or financial oversight. On the other hand, regulators should be tasked with not interfering with the bank's corporate mission of creating value for its shareholders. Legacy Bank is a for-profit corporation.

Our most recent 2010 examination revealed stark differences from prior exams: Expectations of higher capital and liquidity standards, more demanding asset loan quality evaluations, expectations for higher allowance for loan and lease loss reserves, increased focus on management assessment and compensation practices. Comments made by regulators during our last exam include, "We do not like your risk profile," and "We are not going to bat for you in Washington."

To put the first comment in context, our bank has been a lender to residential real estate developers, home builders, and commercial property owners since the late 1980s. We feel our lending staff has the knowledge and experience to manage our loan portfolio composition. Examiners were significantly more aggressive compared to prior examination observations. Due to recent failures of problem banks in other areas of the country, our lending risk profile is now unacceptable.

In addition to the standard underwriting criteria of evaluating a borrower's capital, collateral, and capacity to repay, and market

conditions, our loan committee has added a new component to our loan approval discussion: Will the loan pass examiner review and approval? This component should not be a part of the loan approval process. A customer's loan request should be based on its viability and productive value. With respect to the latter comment, it illustrates the regulatory attitude that banks in real estate lending may be unsafe and unsound in their practices.

Banks are evaluated on a CAMELS component rating, which measures a bank's capital, asset quality, management, earnings, liquidity, and sensitivity to market risk. My comments on each of those follows.

Capital standards are being dictated above the levels for regulatory defined well capitalized banks and those standards that are required for our Nation's largest institutions. Regulators quite often use discretionary capital standards to demand higher capital levels for community banks—than those at large banks. Capital below the mandated Tier One risk-based levels are likely to receive a lower capital component rating in an examination, which may subject the bank to troubled bank status. The discretionary capital standards create a difficult moving target for community banks as we seek to achieve an acceptable capital component rating.

Asset quality loan evaluations have become more critical. Examiners are slow to recognize when a credit risk has been mitigated and classifications can be inconsistent.

Community banks' management compensation is being reviewed by examiners by suggesting potential negative impact to earnings and capital. Without a significant discussion, examiner comments dictated that we justify management compensation benefits by use of an outside source. Somehow, Wall Street excesses on executive pay have crept into the regulators' view of Main Street banking compensation practices when there is no valid comparison to Wall Street compensation abuses.

Earnings were reviewed and projected to be half by examiners of what actual 2010 actual earnings were for our bank, causing concerns for our earnings component.

In summary, micromanaging community banks is unproductive. Examiners should expect results, but if capital is solid and management is capable, then overregulation is unnecessary. Regulatory burden and examiner expectations are disproportionate in their impact on community banks versus the largest banks.

I appreciate the opportunity to comment and am open to your questions. Thank you.

Chairman BROWN. Thank you very much, Mr. Suellentrop and Mr. Marranca. Thank you very much.

I think that across the political spectrum and across both parties and everyone on this Committee is supportive of efforts to work with community banks, one, to help community banks deal with the difficulties of Dodd-Frank. I think that all of us want to see community banks succeed. I think all of us understand that the guilty parties on Wall Street caused—as Mr. Suellentrop said, the Wall Street-caused debacle to our financial system and to our economy had little to do with community bank practices, and all of us I think are disturbed—I can just talk for myself, but I think we all are. Mr. Marranca, your comments that the ten largest banks

today hold 77 percent of all U.S. bank assets, I am quoting you, compared with 55 percent of total assets in 2002. We know what that bank crisis, what the disaster on Wall Street, we know what it did to community banks as we have seen more concentration just in that 9-year period. We know what it has done to our economy. We also know how it has made regulation more difficult. When you put up the OCC or the Office of Thrift Supervision or any of these regulatory—the FDIC, any of these regulatory bodies dealing with the sophistication and the resources of the biggest banks, it obviously is too often a mismatch.

The former head of the OTS said an organization like OTS cannot supervise AIG, Merrill Lynch, or entities that have worldwide offices. There is no way. And that makes all of this more difficult.

But shifting, Mr. Marranca, to your comments and understanding that megabanks were rewarded so often for the regulatory failures with bailouts while community banks too often are being shut down and the concentration of the larger banks gets greater and greater, talk to me specifically—and I like the thoughts of—and your testimony was helpful in this way from both of you. Talk about the costs and burden and supervision for your bank as compared to a too-big-to-fail bank. Put that in context, if you would, with your bank personally or with some of your member banks, but obviously you know yours best.

Mr. MARRANCA. Yes, sir, Senator, and I would confidently say that my experience is the same as the vast majority of community banks across the country, and I will give you an example. I received an email 2 days ago that we would be—that soon an upcoming compliance examination by the FDIC would occur in my bank and that it would have a minimum of two people in my bank for a minimum of 4 weeks. That is just one compliance examination. I should add that at the current time I have the New York State Banking Department in my bank for a compliance examination.

The point is we have a small shop, approximately 30 people. There is an opportunity cost for all the time, attention, and energy let alone what I feel is there could be a better utilization of the resources of the examiners.

Again, this is just specialized compliance. In addition to compliance, we have a CRA examination, which is a separate examination. In my particular case, in New York State, I have a separate CRA examination by the State and by the FDIC.

In addition to that, I have a BSA examination. I have an IAT or ADP examination. I just completed an examination by the Federal Home Loan regarding our secondary mortgage market. We just completed—the IRS just left our bank.

There are very few times in my small, one-light town in Little Valley, New York, that I do not have examiners in my bank, and we are a 109-year-old institution, highly rated, low risk profile, and not a complex organization. It seems to me there is a better way to allocate the resources of examination. And this takes me away from lending and away from my consumers and away from my customers.

Chairman BROWN. You are a $174 million bank.

Mr. MARRANCA. Yes, sir.

Chairman BROWN. Your comments about that, if you would, Mr. Suellentrop.

Mr. SUELLENTROP. Thank you, Senator. Truth be known, we actually started an examination on Monday, so I should probably be there. We have, I believe, 17 examiners at our bank for probably a period of 2 to 3 weeks. We will review safety and soundness, information technology, BSA, and I am sure I am forgetting something, but it will take the time of the majority of our staff to accommodate getting their information and support, the bank's practices.

Our bank is fortunate in that we are of the size where we have a sufficient number of employees where those efforts can be delegated amongst a number of our staff, although it is still a tremendous burden. We have many banks in the State of Kansas and throughout the Nation, substantially smaller than we are, who those burdens fall on one or two individuals and can be tremendous in terms of their cost to the bank as well as the time that it takes away from serving their customers and their community.

So that is just the examination part. That does not take into account the daily routines of going through processes to ensure compliance and ensure safety and soundness and bank secrecy and the like. So it is a tremendous burden for community banks, and hopefully there are some alternative options to reducing that burden.

Chairman BROWN. You expressed, Mr. Suellentrop, you are reflecting, I think, what many community bankers, at least in my State and the conversations I have, and I think what you seemed to say of anger at what Wall Street did and the damage it caused to the economy, writ large, but obviously the damage it did to community banks, and the added scrutiny and pressure and costs to community banks.

Do you think regulators are doing enough to oversee the—understanding that you do not want it to spill on you in terms of more regulation, but do you think the regulators are doing enough to oversee these trillion-dollar banks? The last question for each of you.

Mr. MARRANCA. I would be happy to jump in there. The answer is no. I am held accountable for—my board and I are held accountable for what we do at our bank. We have skin in the game. We take care of our communities, we take care of our customers, and we take care of our employees. To bail out the largest banks because of their failures, and in some cases borderline criminal behavior, I think goes against the capitalistic ways of this country and I think has done great harm.

I have a tremendous competitive disadvantage when the 20 largest banks in this country are too big to fail, and my customers know that.

Are they held accountable? No. Are they scrutinized to the degree that we are? No. Should they be? Yes.

Chairman BROWN. Mr. Suellentrop, your comments on that?

Mr. SUELLENTROP. Thank you, Senator. Probably examiners' efforts with the largest banks is above my pay grade in making that determination, but I can tell you from sitting in our bank and the impact that we feel from recent economic problems and the conditions we have today, it certainly feels like we are receiving the brunt of the examination overload.

What additional regulation and examination is needed for the largest banks? I do not pretend to know that, but I know that for community banks the overload is significant, and they are certainly not slowing down. As the gentleman before us noted, there is a myriad of rules and regulations that are forthcoming.

Chairman BROWN. Thank you. And then a last comment. It seems that some in this town have been sort of lobbying the press and the media, and the agencies are using your situation to weaken the rules on some of the big banks, and I just do not want that ever conflated, that while virtually all of us I think here want to see the regulatory burden lifted from community banks and the banks in towns like where I grew up in Mansfield, Ohio, we do not want to see that as an excuse to weaken rules and further deregulation and weaken the Dodd-Frank implementation of the big banks that Mr. Marranca referred to.

Senator Moran.

Mr. MORAN. Mr. Chairman, thank you very much. I thank both witnesses for their testimony.

Let me ask in this case both of you, you heard—let me start with you, Mr. Suellentrop. You heard the previous panel in which we had representatives from the Federal Reserve, the Office of the Comptroller of the Currency, and the FDIC. Did you hear anything there that you would like to comment on as—at least it has been in my experience in every conversation I have had with regulators at the table that you are seated at, they all indicate to me they make special consideration for community banks, they understand the challenges they face, they have task forces that have been created to make sure that community banks are not overregulated. There is the whole list of disclaimers about all the things we are doing to address the concerns that we are talking about, overregulation of community banks. And yet it never seems to me in my conversations with my bankers that there is any consequence to that constant effort that is claimed by the regulators to avoid overregulation. And I wondered if you heard anything from the witnesses today that did or did not make sense to you.

Mr. SUELLENTROP. No, I cannot say that I did hear anything that would change my perspective on how community banks are going to be regulated or examined going forward. I would say that there is a significant persuasive attitude that an examiner in the field would be the same as the examiner in Washington, that they are not interested in having a problem bank or a failure on their watch. In other words, the comment was also made, "We are going to err on the side of caution," in the first part of our examination in 2010. And I do not think that is going to change. I think they have a significant interest in protecting their reputation, and one way to do that is to be aggressive and to be thorough in their examinations. We are not suggesting they should not be thorough. We just ask that they are equitable.

Mr. MARRANCA. Senator Moran, I would just ask—and the word that comes to my mind is—and it has been used often—is the "disconnect" between Washington and the examiner in the field. Again, the examiner in the field has a difficult job, but yet they are out there and, generally speaking, there is no compromise, there is no discussion, there is no "Let us get this fixed now, and we will take

care of this." The way it—ancient history now. The way it used to be in the examination field was a more cooperative basis and working together with the banker. Today's world—and I understand the world has changed. In the last 29 years that I have been CEO at Cattaraugus County Bank, every regulation that has landed on Wells Fargo or Bank of America has landed on my desk. There needs to be some type of tiered regulation. There needs to be a function where the examiners realize a difference between my risk profile and my business model and my relationship banking and the way that a $2 trillion bank does business. They do not have the flexibility to do that right now, so there is a real disconnect.

Senator MORAN. So the common conversation that we have that community banks, by regulators headquartered here in Washington, DC, their leadership tells us that community banks are treated differently. But your statement, your sentence stands out to me about what happens to Wells Fargo—every regulation that has been imposed upon them is imposed upon a community bank. Is that true?

Mr. MARRANCA. That is true. And I look around, and Wells Fargo, or whoever it may be, has X number of attorneys and X number of resources that they can allocate toward that new regulation. And, again, over 30 years they have built up and built up and built up. Every time I get that regulation, I look out of my office, and I am looking at Sue or Mary or Bob and trying to figure out how are we going to do this. In some cases, it does not relate to my market or my business model in a very rural part of New York State.

Senator MORAN. Any sense of the qualifications, the background, and experience of the examiners that are in your banks today as compared to what they were in the past? Is there a change in the personnel that are examining your banks and their qualifications or characteristics? You mentioned in a sense the good old days, but is there a change in who is in our banks today as far as ability?

Mr. MARRANCA. My perspective would be—and these are extremely sharp, smart, intelligent young people in many cases. In many cases—I do not know the average age of the examiner today, but the old corps, if you will, is gone, and the new youth is there. They are very smart. They are very intelligent. Do they have experience in banking? Not specifically.

Also, I do want to add, in today's world when you have an ADP specialist, a compliance specialist, a BSA specialist, a CRA specialist, none of those examiners have a holistic approach to the bank as a whole. They are not in any way concerned about my capital, my 100-year-old history, even my CAMELS rating or my profits. They are only concerned with their very narrow point of view of their expertise. So they are smart, they are intelligent, they are experts. But in my humble opinion, they need to broaden their holistic approach to the bank as a whole. We are not a risk to the FDIC fund, nor are we a risk to the economic system. So treat us in that way. Understand the role that we provide in the community. Because if they put us out of business, when we are gone we are gone, and it will be too late for my community.

Mr. MORAN. Mr. Suellentrop, Kansas has lost thirty banks in the last 5 years, as I understand the numbers. One of my concerns is

that community banking may become a thing of the past based upon increasing regulations and the cost associated with that. And by that I mean that community banks will need to have more branches, be acquired by a larger bank to spread those costs among, more assets, more loans, more customers.

Is there a consequence to the ability to keep community banking alive and well? Is there a consequence to this regulatory environment? And is there anything you see that is coming down the road? We still have the Consumer Protection Financial Bureau regulations to be put in place. Are there fears about what the next—my guess is you may tell me you may survive today, but are you worried about what is coming in the future and the uncertainty of that? How does it affect the operations of your bank?

Mr. SUELLENTROP. Senator, I would say that there is a concern in terms of the number of community banks continuing to decline. In conversations with bankers through meetings I attended, I would say that in the past year or 2 years there is a significant concern that bankers who are likely to sell their bank and to probably merge with another institution. And one of the things that I think is holding them back is that their market for that is not good right now. But there are many bankers frustrated by the rules and regulations and examinations and looking to possibly get out of the banking business in the next several years. I do not see anything immediate that is on the horizon that is going to change that. The Consumer Protection Bureau, as you suggested, has not yet begun to issue its regulations. That has certainly bankers concerned about the potential impact of additional regulatory burden.

Things that were discussed earlier, such as access to the secondary mortgage market, are very important to our bank and community banks because that is one of the significant ways we can increase our business exposure in our community.

Mr. MORAN. Thank you, Mr. Chairman.

Chairman BROWN. Thank you, Senator Moran.

Senator Merkley.

Senator MERKLEY. Thank you, Mr. Chairman, and thank you both for bringing your insights from the front line, if you will.

Mr. Marranca, you addressed in part the risk retention rule and noted that we should have a broad exemption for qualified mortgages. By broad exemption, I wanted to interpret that, but I wanted to make sure I had the correct interpretation. Currently there is discussion of a very sizable downpayment requirement, which has been of great concern to me. When you are speaking about a broad exemption, are you talking about a much smaller downpayment requirement, if you will?

Mr. MARRANCA. I think—and I will use the word "arbitrary"—20 percent is just unrealistic in the market, at least for a community bank, especially in my rural market. We have a very low per capita income and so forth. We have two family income earners struggling to either get into their first home or upgrade their home. We try very hard to make that dream come true and get a person in the right house. Mandatory 20 percent or a concentration of the secondary mortgage market out of my control, and I would hate to see it be with one of those 20 largest banks, I think would be—do a disservice to the housing market in our country and in my market.

Senator MERKLEY. Thank you. I think of what 20 percent is in the working community that I live in where houses are about $200,000, and the idea of families having $40,000 in savings to put down on a house seems one in a million. Thus, the folks would fall into a second category or a different mortgage market with yet to be understood interest penalties for that. My concern—and it sounds like you are echoing this—is that we essentially put home ownership out of reach of families.

Mr. MARRANCA. I do not think you can legislate or mandate, if you will, the underwriting process. Our job—and I have 30 years' experience, and I have a mortgage officer with many—our job is to underwrite our consumers when they walk in and they want that mortgage. We know how to do that, and it is not just downpayment. It is the ability to pay and certainly their credit and the debt-to-income. There are many, many factors involved.

We can make a business judgment if somebody can afford it and that is the right home for them at the right price. We certainly have never done any subprime and 110-percent loans, *et cetera, et cetera*. So leave the business of lending to us.

Senator MERKLEY. Mr. Suellentrop, do you share that concern over the potential 20-percent requirement?

Mr. SUELLENTROP. Absolutely, Senator. We have been in the business of making residential lending since I joined the bank 40 years ago almost as a key component of what we do for our customers in our community. Twenty percent down for the vast majority of homeowners is unreasonable. With the use of private mortgage insurance, there are many, many ways to satisfy safety and soundness in a mortgage transaction, and we originated over $30 million in mortgage lending last year. A very important part of our business and serving our customers and our community, and 20 percent would be a substantial impact to that process and that product for our customers.

Senator MERKLEY. Thank you both. I want to turn to a different topic, which is the ability to make additional loans. Mr. Marranca, in your testimony you note that banks have had to pass up sound loan opportunities, or at least your bank has, in order to preserve capital. This goes to the leverage ratio that the FDIC holds. And as I was talking to community banks in Oregon, they expressed the challenge of raising capital. We have gone from irrational exuberance to irrational fear, if you will, of investing in community banks.

So the result was developing the Small Business Lending Fund, which ICBA endorsed and assists with. We have had 600 to 700 applications so far to Treasury for Small Business Lending Fund equity so that banks could do additional lending but are constrained by the capital requirements, and not a single decision has been made yet by Treasury.

What is going wrong? Why isn't Treasury making decisions and using this program to increase access to capital, both important to the community banks and important to small Main Street businesses across America?

Mr. MARRANCA. Senator, I certainly cannot speak for the Treasury, but I would comment—I would love to participate in that, but I have looked at it very carefully, and there is just no way I can

do it. First of all, one capital ratio size does not fit all, just like one regulation does not fit all. We have plenty of capital at our bank, and, in fact, we need to grow our capital, but for a good reason: because our bank has grown 30 percent in the last 3 to 4 years. We acquired two branches in an adjoining county. That dropped our capital level down. But I am making a decision for my shareholders in the long run. What is in the best interests of the bank in the long run? So we dropped down, if you will, to a 7-percent capital level. Given our CAMELS ratings, our risk rating and so forth, 7 percent capital is more than adequate.

When an examiner comes in and says, “I do not know about that 7. It looks like you have dropped. I think you need to get up to 9, and we will see how you do, and we are going to be watching,” that gets my attention. It does not make me not make a loan, but yet it gets my attention. And I have had to slow down the growth of our bank from a depository standpoint because that affects the capital ratio, too.

On the Small Business Lending Fund, our bank has $100 million—we are a small bank—a $100 million loan portfolio. It takes $1 million a month in new loans just to maintain that level at $100 million, $1 million in new loans a month. I am in a very rural, nongrowth market. It is very difficult to do that. But we are doing it.

If it is very difficult to do that, it is going to be extremely difficult if not impossible for me to raise my lending 5 percent, 6 percent, 4 percent. Thus, I cannot participate in the Small Business Lending Fund. I cannot create loan demand. I have the products, I have the people, I have the money to lend. But I cannot create loan demand in a recessionary, very challenges economic market.

Senator MERKLEY. Yes. And you are in a different situation than some community banks in that access to capital was not your primary challenge, if you will, so that makes a lot of sense.

Any thoughts on this, Mr. Suellentrop?

Mr. SUELLENTROP. Well, Senator, I know there is a lot of interest in the Small Business Lending Fund, but I honestly do not have any insight into why the program is floundering.

Senator MERKLEY. Well, the main challenge is Treasury is not making any decisions.

Mr. SUELLENTROP. That is right.

Senator MERKLEY. So I am just trying to get a sense from the field. I know I am hearing from community banks that are very frustrated that have applied, feel like this would—these are banks that are constrained by their capital ratios, and so their ability to make additional loans is directly impacted by that.

I wanted to go back to—actually I am over my time, so thank you all.

Chairman BROWN. Thank you, Senator Merkley.

I wanted to follow up on one comment that Senator Merkley made or your response to the question about the 20 percent. I appreciate the flexibility and how you know your customers and know your communities, and a 20-percent downpayment might make sense for some, somebody else doing 15 percent, but having a strong financial credibility with you and all. So I certainly understand that flexibility.

Senator Corker mentioned that earlier. He had had an amendment, my recollection is, on the Senate floor during Dodd-Frank. He had an amendment for a requirement of a downpayment of 5 or 10 percent. I cannot remember. Understanding if we had had that, some standard across the country, some of our problems might not have—surely would not have happened. Would any requirement make sense? I understand 20 percent can be harsh when you know your customers well and need flexibility. If there were—and, again, this is not in the statute, to my understanding, but if there were a 5- or 10-percent requirement, would community banks object to that? Is that something that would make sense to you?

Mr. MARRANCA. It makes a lot of sense to me, Senator. I am a strong proponent of you have to have some skin in the game, whether it is buying a car, a house——

Chairman BROWN. And you do not mind a Federal rule perhaps saying 5 or 10? You would rather not have 20, but 5 or 10?

Mr. MARRANCA. If there were some flexibility there with some limited skin in the game, I do not see—I do not believe in 100-percent lending.

Chairman BROWN. OK. Any thoughts, Mr. Marranca?

Mr. MARRANCA. Well, I know that the recent past has proven that downpayments are important. However, I know that there are a number of first-time home buyer programs out there through various sources that are important to the housing industry and individuals and families getting into their own homes. So I think we would need to recognize that there are some programs that might be impacted if we demand a minimum amount of 5 or 10 percent.

Chairman BROWN. OK. Thank you very much, Mr. Suellentrop and Mr. Marranca. Thank you very, very much.

The record will remain open for 5 days, as we typically do. I appreciate your attendance, and thank you, Senator Merkley and Senator Moran.

The Subcommittee is adjourned.

[Whereupon, at 11:44 a.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF MICHAEL R. FOLEY

SENIOR ASSOCIATE DIRECTOR, DIVISION OF BANKING SUPERVISION AND REGULATION, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

JUNE 15, 2011

Introduction

Chairman Brown, Ranking Member Corker, and other Members of the Subcommittee, thank you for the opportunity to testify today regarding the Federal Reserve Board's supervision and examination of financial institutions and changes to our supervisory policies and procedures for these institutions in response to the recent financial crisis. I am a senior associate director in our Banking Supervision and Regulation division.

Background

The Federal Reserve has supervisory and regulatory authority for bank holding companies, including the consolidated supervision of large, complex financial firms, State-chartered banks that are members of the Federal Reserve System (State member banks), and certain other financial institutions and activities. We work with other Federal and State supervisory authorities to ensure the safety and soundness of the banking industry, foster the stability of the financial system, and provide for fair and equitable treatment of consumers in their financial transactions.

The Federal Reserve is involved in both regulation, that is, establishing the rules within which banking organizations must operate, and supervision, ensuring that banking organizations abide by those rules and remain, overall, in safe and sound condition. A key aspect of the supervisory process is evaluating risk-management practices. Because rules and regulations cannot always reasonably prescribe the exact practices each individual bank should use for risk management, supervisors design policies and guidance that expand upon requirements set in rules and regulations and establish expectations for the range of acceptable practices. Supervisors rely extensively on these policies and guidance as they conduct examinations and assign supervisory ratings.

Enhancing Supervision of Large Institutions

The recent financial crisis revealed critical vulnerabilities in the financial regulatory framework and the financial system. In the years before the crisis, nonbank financial entities proliferated by exploiting gaps in the regulatory framework. This occurred during a period of increasing asset prices and abundant capital and liquidity, which eventually led to a relaxing of underwriting standards, deterioration in risk-management practices, and rapid growth of complex and opaque financial products for both consumers and investors. The combination of these factors created the vulnerabilities that ultimately led to the financial crisis and, in response, the Congress and the Administration last year addressed many of these issues by enacting the Dodd-Frank Wall Street Reform and Consumer Protection Act.

However, even before passage of the Dodd-Frank Act, the Federal Reserve had been taking action to reorient its supervisory structure and strengthen its supervision of the largest, most complex financial firms in response to the crisis. In so doing, the Federal Reserve enhanced its large bank supervision program through the creation of the Large Institution Supervision Coordinating Committee, a centralized, multidisciplinary body made up of bank supervisors, economists, attorneys, and others. Relative to previous practices, this body makes greater use of horizontal, or cross-firm, evaluations of the practices and portfolios of the largest institutions. It relies more on additional and improved quantitative methods for evaluating the performance of firms, and it employs the broad range of skills of Federal Reserve staff more effectively. In addition, we have reorganized to more effectively coordinate and integrate policy development for, and supervision of, systemically important financial market utilities.

More recently, we have also created an Office of Financial Stability Policy and Research at the Federal Reserve Board. This office coordinates our efforts to identify and analyze potential risks to the broader financial system and the economy. It also helps evaluate policies to promote financial stability and serves as the Board's liaison to the Financial Stability Oversight Council.

The crisis demonstrated that a too narrow focus on the safety and soundness of individual firms can result in a failure to detect and thwart emerging threats to financial stability that cut across many firms. The Dodd-Frank Act requires supervisors to take more of a macroprudential approach; that is, to supervise financial institutions and critical infrastructures with an eye toward not only the safety and soundness of each individual firm, but also taking into account risks to overall financial stability. The Supervisory Capital Assessment Program (SCAP), led by the

Federal Reserve in early 2009 as a key element of the plan to stabilize the U.S. financial system, demonstrated the feasibility and benefits of employing such a perspective.

Building on SCAP and other supervisory work coming out of the crisis, the Federal Reserve initiated the Comprehensive Capital Analysis and Review (CCAR) in late 2010 to evaluate the internal capital planning processes of large, complex bank holding companies. The CCAR represented a substantial strengthening of previous approaches to ensuring that large firms have thorough and robust processes for managing and allocating their capital resources. We also focused on the risk measurement and management practices supporting firms' capital adequacy assessments, including their ability to deliver credible inputs to their loss estimation techniques.

While our revised internal organizational structure facilitates our implementation of a macroprudential approach to supervision, it does not diminish the need for careful microprudential oversight of individual institutions. This serves many purposes beyond the enhancement of systemic stability, including the protection of the deposit insurance fund, the detection of money laundering and other forms of financial crime, and the prevention of unlawful discrimination or abusive lending practices. Equally important, is that microprudential oversight also provides the knowledge base on which a more systemic approach must be built; we cannot understand what is going on in the system as a whole without a clear view of developments within key firms and markets. Without a strong microprudential framework, macroprudential policies would be ineffective.

Supervision of Community and Regional Banks

While many of our recent actions have focused on enhancing the supervision programs for the largest institutions, we have also been making adjustments to the supervision programs for community and regional banks in response to lessons learned. As liquidity strains developed at many banks during the crisis, we adjusted our focus to place greater emphasis on evaluating liquidity contingency funding plans at supervised community and regional banks. Liquidity pressures have eased considerably due to actions taken by the banking agencies during the crisis, recent legislative changes to increase the level of deposits insured by the Federal Deposit Insurance Corporation, and more stable market conditions. But given our experience during the crisis we are retaining a heightened focus on liquidity management and planning, particularly for institutions that rely on more volatile or nontraditional funding sources.

As commercial real estate (CRE) began to deteriorate and affect the performance of supervised institutions, we conducted reviews of our implementation of the 2006 interagency guidance addressing CRE concentrations. These reviews helped us to identify issues for which examiners and bankers needed clarification and to contribute to the 2009 interagency guidance aimed at facilitating prudent workouts of CRE loans. As real estate conditions have remained weak and adversely affected the performance of many banks, we have continued to refine our examination procedures to address emerging supervisory issues related to CRE lending.

To learn more from recent events, we have begun to analyze the characteristics of community banks that remained in sound condition throughout the crisis. Our preliminary work suggests that these institutions had many fundamental characteristics in common. For example, most of these banks had relatively well-diversified loan portfolios and because of that were able to report strong earnings and net interest margins throughout the crisis. They tended to have limited reliance on noncore funding and had strong capital levels as they entered the crisis. As we continue our study, we hope that what we learn will prove helpful in our efforts to evaluate and refine supervisory processes in the wake of the crisis.

In addition to these efforts, we have also increased our outreach efforts with community and regional banks. In October 2010, the Board formed a Community Depository Institutions Advisory Council that includes representatives from across the country and provides the Federal Reserve with direct insight and information from community bankers about the economy, lending conditions, supervisory matters, and other issues of interest. We expect these ongoing discussions will provide a particularly useful and relevant forum for improving our community bank supervision program, and a better understanding of how legislation, regulation, and evolving examination activities affect small banking organizations.

Additionally, the Board recently established a special supervision subcommittee that provides leadership and oversight on a variety of matters related specifically to community bank supervision. A primary role of this subcommittee, which includes Governors Elizabeth A. Duke and Sarah Bloom Raskin, two Board members with significant community banking experience, is to review policy proposals and

evaluate their potential effect on smaller institutions, both in terms of safety and soundness and potential regulatory burden.

While the crisis has made it clear that some tightening of supervisory expectations was needed, we are also mindful of the risks that excessive tightening could have on banks' willingness to lend to creditworthy small businesses and consumers. Consequently, we have worked hard to ensure that our examiners are well-trained and employ a balanced approach when reviewing banks' underwriting and risk-management practices. We expect examiners to strive for consistency in the examination process throughout the business cycle. Our Rapid Response program, which has been in effect since the crisis, is a widely attended weekly conference call for examiners that has been invaluable in delivering these messages, and others, to our field examiners.

Compliance and Examination Costs

Banks consistently tell us that they face a number of regulatory uncertainties, which makes it hard for them to calculate the potential cost of compliance and its potential effect on operations and profitability. Firms of all sizes have been communicating these concerns, despite the fact that the requirements of the Dodd-Frank Act are primarily directed at firms with consolidated assets of $50 billion or more. Smaller institutions voice concerns that supervisory expectations being set for the largest institutions could ultimately be imposed on them in a burdensome way, which will adversely affect community bank competitiveness and profitability, as these institutions have less ability to absorb increased compliance costs and have less staff available to manage new processes.

The Federal Reserve is cognizant of the challenges institutions, especially smaller institutions, face in the current environment. Banking supervision should be conducted in a way that is effective for all institutions, but it should also be scaled to the size and complexity of the supervised firm. The largest, most complex banks will incur costs to comply with the requirements of the Dodd-Frank Act. For example, stress testing provisions in the Dodd-Frank Act require these institutions to adequately identify the risks associated with their diverse business lines and to quantify this risk taking, which will require investments in data management technology and other risk identification systems. Smaller institutions, while still expected to adequately measure, monitor, and control risk in their organizations, will not necessarily need to incur additional costs, assuming existing risk management structures are sufficiently robust.

Continuing Credit Challenges

Credit markets have been recovering slowly since the financial crises, and recent measures of aggregate credit outstanding have shown signs of improvement after declining throughout 2009 and much of 2010. Nonrevolving consumer credit outstanding, which includes auto and student loans, has increased for the past 9 months. Issuance of corporate bonds and syndicated loans has been robust for the past few quarters, and new issuance of commercial mortgage-backed securities increased in the first quarter of 2011, albeit from very low levels. Outstanding balances of commercial and industrial loans have also resumed modest growth.

However, residential and commercial real estate remain lagging sectors. This continues to present challenges for banks and supervisors. With housing values flat or deteriorating in many markets, there are renewed concerns about the health of the mortgage market and home equity loans in particular. In addition, weak fundamentals in the CRE sector, including high vacancy rates and declining rents, continue to place pressure on all but the highest quality properties with strong tenants in healthier markets. With residential and commercial property values still under strain, heightened reserve levels at banks remain appropriate for these sectors, and we expect that banks will continue to incur losses due to ongoing weakness in real estate markets. It will take time to make progress on the overhang of distressed commercial and residential real estate, and banks will need to take strong steps to ensure that losses are recognized in a timely manner, and that reserves and capital levels remain adequate.

Conclusion

The crisis demonstrated the need to always be mindful of and diligent about addressing the possible implications of severely adverse outcomes for individual institutions and the financial system more broadly. Enhancements the Federal Reserve has made to its supervisory process, coupled with improvements required by the Dodd-Frank Act, support enhanced regulation and supervision of large, complex firms that have the potential to trigger systemic risks. But, improvements in the supervisory framework will lead to better outcomes only if day-to-day supervision is well executed, with risks identified early and promptly remediated. When we

have significant concerns about risk management at complex firms, we are raising those concerns forcefully with senior management at the firms, holding them accountable to respond, and tracking their progress.

The Federal Reserve is also enhancing supervision of regional and community banks, placing greater emphasis on the development of sound risk-management practices. In so doing, we are mindful of the need to ensure that bank supervision is scaled to the size and complexity of the supervised firm; and that bank management and examiners take a balanced approach to ensuring the safety and soundness of the banking system and serving the credit needs of the community.

PREPARED STATEMENT OF CHRISTOPHER J. SPOTH

SENIOR DEPUTY DIRECTOR, DIVISION OF RISK MANAGEMENT SUPERVISION, FEDERAL DEPOSIT INSURANCE CORPORATION

JUNE 15, 2011

Chairman Brown, Ranking Member Corker, and Members of the Subcommittee, thank you for the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) about our supervisory process, how it has changed based on lessons we learned from the crisis, and what we see as opportunities for continued improvement.

Congress created the FDIC in 1933 in response to the most serious financial crisis in U.S. history. Our mission is to promote financial stability and public confidence in individual banks and in our Nation's banking system through bank supervision, deposit insurance, consumer protection, and the orderly resolution of failed banking institutions. As the primary Federal supervisor for the majority of U.S. community banks, the FDIC seeks to maintain a balanced approach to bank supervision, regardless of financial and economic conditions. In our unique role as deposit insurer, we have a vital interest in assessing risks to the Deposit Insurance Fund (DIF) posed by all FDIC-insured institutions.

My testimony today first provides some background information on the condition of the industry and the problems that led to the recent financial crisis. I will discuss our approaches to supervising large institutions and smaller community banks. Finally, I will discuss some provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) that we are incorporating into our supervisory process.

Condition of the Industry

Leading up to the financial crisis, FDIC-insured institutions recorded 6 consecutive years of record earnings, culminating in $145.2 billion in 2006. However, this extended period of industry profitability masked the underlying weaknesses in credit quality that would emerge starting in 2007 as real estate markets weakened and the U.S. economy moved into recession. By 2008, annual industry earnings had fallen to just $4.5 billion and, in 2009, the industry recorded a net loss of $9.8 billion—the largest loss in its history. Quarterly provisions for loan losses taken by FDIC-insured institutions since the end of 2007 now total just under $645 billion, equal to over 8 percent of the book value of loans outstanding at the beginning of 2008.

During the first quarter of 2011, FDIC-insured institutions recorded annual net income of $29 billion, the highest level since before the recession, but still well below the all-time highs of the mid-2000s. The main driver of earnings improvement has been steadily reduced provisions for loan losses. This reflects general improvement in asset quality indicators, including declining levels of noncurrent loans and net charge-offs for all major loan types. However, the ratio of noncurrent loans [1] to total loans, at 4.7 percent, is still relatively high and remains above the levels seen in the late 1980s and early 1990s. While the reduced provisions for loan losses are encouraging, it is important to note that net operating revenue fell by $5.5 billion in the first quarter of 2011 compared to 1 year ago. Lower revenues, in part, reflect reduced loan balances, which have declined in 10 of the past 11 quarters. Growth in well-underwritten loans is essential not only for banks to build revenues but also to provide a stronger foundation for economic recovery. Recent surveys, such as the Federal Reserve Senior Loan Officers' Opinion Survey and the National Federation of Independent Businesses' Survey on Small Business Economic Trends, also indicate that borrower demand remains sluggish.

Despite the economic challenges, community banks, which comprise the vast majority of banks that we supervise, continue to play a vital role in credit creation

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[1] Noncurrent loans are those that are 90 or more days past due or are on nonaccrual.

across the country, especially for small businesses. This has been borne out by loan originations over the past several years. On a merger-adjusted basis, community bank loan balances have increased by about 1 percent since the second quarter of 2008.[2] However, over the same period, overall industry loan balances fell by about 9 percent.

While commercial property fundamentals point to stabilization, recent weakness in both residential and commercial property price trends highlight continued concerns. The S&P/Case-Shiller National Housing Index is down 5.1 percent year-over-year through first quarter 2011 and the Moody's/REAL Commercial Property Price Index has decreased by 8.5 percent in the year ending in March 2011. In both cases, distressed properties are weighing down prices.

Overall, we are cautiously optimistic regarding the current condition and trends in the banking industry. The number of institutions on the FDIC's "Problem List" is leveling off and the number of institution failures appears to have peaked in 2010. During the first quarter of 2011, the number of institutions on the FDIC's "Problem List" increased slightly from 884 to 888. Similarly, the current pace of failures is lower than the 157 failures in 2010. Nevertheless, the number of troubled institutions remains high at 12 percent of all insured institutions, indicating that a portion of the industry continues to struggle with lingering credit-quality issues. These issues adversely impact the ability of many institutions to grow their lending activity.

Factors That Led to the Recent Financial Crisis

Factors that led to the crisis of 2008 and motivated the legislative reforms were in four broad areas: excessive reliance on debt and financial leverage, misaligned incentives in financial markets, failures and gaps in financial regulation, and the erosion of market discipline due to regulatory arbitrage and "Too Big to Fail."

With regard to financial regulation, the regulatory reforms put in place for federally insured depository institutions following the banking crisis of the 1980s and early 1990s helped to constrain risk-taking on bank balance sheets. However, opportunities for regulatory arbitrage allowed risks to grow in the so-called shadow banking system—a network of large-bank affiliates, special-purpose vehicles, and nonbank financial companies that existed largely outside of the prudential supervision, capital requirements, and FDIC receivership powers that apply to federally insured depository institutions in the U.S. The migration of financial activities outside of regulated financial institutions to the shadow banking system ultimately lessened the effectiveness of regulation and made the financial markets more vulnerable to a breakdown.

Many of the structured finance activities that generated the largest losses were complex and opaque transactions undertaken at the intersection of the lightly regulated shadow banking system and the more heavily regulated traditional banking system. For instance, private-label mortgage backed securities (MBS) and associated derivatives were originated through mortgage companies and brokers and facilitated by banks that were securitizers. As became evident, many of the underlying mortgage loans were poorly underwritten and contained a host of layered risks.

The housing bubble ensued, fueled with poorly underwritten loans originated for sale into the securitization market. The MBS were subject to minimum securities disclosure rules that are not designed to evaluate loan underwriting quality. For banks, once these loans were securitized, they were off the balance sheet and no longer on the radar of many banks and bank regulators. The mortgage loans began to default in high numbers undermining the MBS market. Eventually, the housing bubble collapsed, construction and development slowed, unemployment rose, and the economy went into recession. In addition, home prices continue to be depressed due to several factors including flawed mortgage servicing practices, which are not yet fully corrected, the overhang of foreclosure inventory, and the potential for litigation exposure.

One of the most powerful inducements toward excess leverage and institutional risk-taking in the period leading up to the crisis was the lack of effective market discipline. Several large, complex U.S. financial companies at the center of the 2008 crisis could not be wound down in an orderly manner when they became nonviable. With the exception of any insured depository institutions that they owned, their operations were subject to the commercial bankruptcy code, as opposed to FDIC receivership laws. In addition, some major important segments of their operations were

[2] In merger-adjusted growth analysis, loan balances reported by banks with assets less than $1 billion in the current quarter are compared with these same institutions' loan balances in a prior period. Prior-period loan balances include those of any institutions merged or acquired in intervening periods.

located abroad and therefore outside of U.S. jurisdiction. In the heat of the crisis, policy makers in several instances resorted to bailouts instead of letting these firms collapse into bankruptcy because they feared that the losses generated in a failure would create a cascade of defaults through the financial system, freezing financial markets and seriously damaging our economic system.

Community banks were generally not involved in the mortgage-related issues at the first stages of the financial crisis, but were impacted as the recession took hold. Community banks tend to focus on local markets and loans for which local knowledge and personal service provide a competitive advantage, such as residential construction loans and other smaller commercial real estate projects. Construction and development (C&D) lending in areas that had experienced the steepest increase in home prices during the boom was hit first. Credit losses rose and subsequently spread across all loan types and rose as borrowers were caught in the recession and then slow recovery. At the same time, community banks' other sources of revenue used to offset credit losses from real estate portfolios was limited.

FDIC Supervisory Responsibilities

Despite the recent economic disruptions and subsequent stabilization, the FDIC's supervisory programs, while responsive to intensified problems in the industry, remain balanced. To accomplish this goal, the FDIC continuously enhances its examination and other supervisory approaches and maintains dialogue with institutions throughout the examination cycle.

The FDIC serves as the primary Federal regulator for State-chartered institutions that are not members of the Federal Reserve System. The FDIC currently supervises 4,664 institutions, 4,358 of which have total assets of less than $1 billion. Regardless of size, as deposit insurer, the FDIC has an important interest in the condition of all insured institutions and their individual and aggregate impact on the DIF. As a result, the FDIC also has back-up authority to participate in examinations, with the primary Federal regulator, at any insured institution.

The FDIC has, for a number of years, had different approaches to its supervision of larger, complex institutions from that of community banks. The larger, more complex institutions, and some mid-tier institutions, are subject to continuous on-site examination by teams of examiners and to extensive reporting. The smaller community banks have an annual or 18-month exam cycle and are also monitored off-site using quarterly Call Report information. The differences in the supervision of large and small banks are discussed in more detail below.

Supervision of Large Banks and Financial Firms

Supervisory programs, particularly for the larger institutions, have evolved to address the issues that led to the financial crisis, and to reflect the important protections and changes added by the Dodd-Frank Act. The Act requires that the FDIC and the Federal Reserve Board jointly issue regulations to implement new resolution planning and reporting requirements. These rules will apply to bank holding companies with total assets of $50 billion or more and nonbank financial companies designated by the Financial Stability Oversight Council (FSOC) as "Systemically Important Financial Institutions" (SIFIs).

In addition, covered companies would be required to submit a resolution plan. Resolution plans should identify and map covered companies' business lines to legal entities and provide integrated analyses of their corporate structure; credit and other exposures; funding, capital, and cash flows; domestic and foreign jurisdictions in which they operate; their supporting information systems and other essential services; and other key components of their business operations. The resolution plan requirement in the Dodd-Frank Act appropriately places the responsibility on financial companies to develop their own plans "for rapid and orderly resolution in the event of material financial distress or failure" with review by the FDIC and the Federal Reserve Board.

The agencies are also working to develop a substantive process for reviewing resolution plans to determine whether a plan is both credible and would facilitate an orderly resolution of the company under the Bankruptcy Code. If a resolution plan is found to be "not credible," then the FDIC and the Federal Reserve Board may impose more stringent standards and take other action. If, after 2 years, the company's plan is still "not credible," the FDIC and the Federal Reserve Board may, in consultation with the FSOC, direct a company to divest certain assets or operations.

To focus the FDIC's expanded responsibilities to monitor and, potentially, resolve SIFIs, we established an Office of Complex Financial Institutions (OCFI). The OCFI will be responsible for the FDIC's role in the oversight of large bank holding companies and their corresponding insured depository institutions as well as for nonbank

financial companies designated as systemically important by the FSOC. The OCFI will handle the FDIC's responsibilities, in concert with the Federal Reserve Board, for reviewing resolution plans and credit exposure reports developed by the SIFIs. Also, the OCFI will be responsible for implementing and administering the FDIC's SIFI resolution authority and for conducting special examinations of SIFIs under the FDIC's back-up examination and enforcement authority.

Supervision of Community Banks

Supervision of community banks consists of regular on-site examinations along with quarterly off-site monitoring of financial performance. Where conditions dictate closer supervision, we conduct on-site visits and collect supplemental information. As the supervisor of 4,358 community banks,[3] the FDIC has a keen appreciation for the important role community banks play in the national economy. Community banks have branches in nearly all towns and urban areas, and about two-thirds of all branches in rural areas belong to community banks.

The FDIC's supervisory activities are carried out by examiners working from field offices located in 85 communities across the country. These examiners know the community banks in their areas and are familiar with the local conditions facing those banks. Many have seen more than one previous economic down cycle and recognize the critical role that community banks play in credit availability.

As discussed earlier, community banks still face lingering problems in their real estate loan portfolios and spillover effects caused by the collapsed housing bubble and the slow economy. Asset quality is not deteriorating as before, but volumes of troubled assets and charge-offs remain high, especially in the most affected geographic areas. The FDIC supervisory responses are scaled according to the severity of the weaknesses that a bank may exhibit. Banks with significant loan problems require close supervisory attention.

Supervisory Action To Encourage Real Estate Recovery and Lending

Throughout the real estate and economic downturn, the FDIC has advocated for policies that will help community banks and their customers navigate this challenging period and mitigate unnecessary losses. We share community banks' desire to restore profitability, strengthen asset quality, and serve the credit needs of local markets. The FDIC has worked closely with banks as they have taken steps to raise capital, enhance their loan workout functions, and revise strategic plans to remain competitive in the financial services industry. Through our regional and field offices located throughout the country, the FDIC actively communicates with the community banks we supervise and provides recommendations for addressing operational and financial weaknesses as appropriate.

In addition, the FDIC has joined several interagency efforts that encourage banks to originate and restructure loans to creditworthy borrowers, and to clarify outstanding guidance. For example, the Federal bank regulatory agencies issued the *Interagency Statement on Meeting the Needs of Creditworthy Borrowers* on November 12, 2008, which encouraged banks to prudently make loans available in their markets. The agencies also issued the *Interagency Statement on Meeting the Credit Needs of Creditworthy Small Business Borrowers* on February 12, 2010, to encourage prudent small business lending and emphasize that examiners will apply a balanced approach in evaluating loans. This guidance was issued subsequent to the October 30, 2009, *Policy Statement on Prudent Commercial Real Estate Workouts* that encourages banks to restructure loans for commercial real estate mortgage customers experiencing difficulties making payments. The CRE Workouts Guidance reinforces long-standing supervisory principles in a manner that recognizes pragmatic actions by lenders and small business borrowers are necessary to weather this difficult economic period.

The FDIC also joined the other banking agencies in issuing the *Interagency Appraisal and Evaluation Guidelines* on December 2, 2010, to clarify expectations for real estate appraisals. Clarification of these guidelines was important for the industry given changes in property values over the past several years. We do not require banks to recognize losses on loans solely because of collateral depreciation or require appraisals on performing loans unless an advance of new funds is being contemplated. Moreover, the interagency guidance recognizes that borrowers' ability to repay real estate loans according to reasonable terms remains the primary consideration in a lending decision.

We also actively engage with community banks at the State level and nationally through various trade associations, which helps our agency articulate its super-

[3] Throughout this testimony, for purposes of data analysis, community banks are defined as banks and thrifts with total assets of less than $1 billion.

visory expectations on important issues through a variety of forums. For example, the FDIC established an Advisory Committee on Community Banking to provide us with advice and guidance on a broad range of policy issues impacting small community banks, as well as the local communities they serve, with a focus on rural areas. The Advisory Committee has provided valuable input on examination policies and procedures, credit and lending practices, deposit insurance assessments, insurance coverage issues, regulatory compliance matters, and obstacles to the continued growth and ability to extend financial services in their local markets. We also sponsor training events for community banks including regional and national teleconferences on risk management and consumer protection matters, as well as Directors Colleges to help bank directors better understand the supervisory process.

The FDIC conducts more than 2,500 on-site examinations annually, and we recognize that questions and even disagreements with individual examination findings may sometimes arise, especially in difficult economic times. The FDIC has a number of outlets for bankers to express their concerns when this occurs. On March 1, we issued guidance reiterating that FDIC-supervised institutions can voice their concerns about an examination or other supervisory determination through informal and formal channels. The FDIC takes pride in the professionalism of its examination force but also strongly encourages banks to provide feedback on FDIC examinations. The guidance highlights that often the most effective method for understanding why the FDIC reached a particular conclusion during its examination is for the bankers to discuss the issue with the examiner-in-charge, field office supervisor, or the appropriate official in the Regional Office.

Addressing Regulatory Burden

The FDIC is interested in finding ways to eliminate unnecessary regulatory burden on community banks, whose balance sheets are much less complicated than those of the larger banks. We continuously pursue methods to streamline our supervisory process through the use of technology and other means to reduce disruption associated with examination activity. While maintaining an effective examination process is paramount, we are sensitive to banks' business priorities and strive to be efficient in our work.

Certain supervisory programs are designed to be less burdensome on small banks compared to the larger, more complex institutions. For example, statutorily mandated examinations are less frequent for certain well-managed, well-capitalized institutions under $500 million in size. There are also fewer reporting requirements for smaller institutions, including Call Report line items and requirements for other reporting. In addition, to make it easier for smaller institutions to understand the impact of new regulatory changes or guidance, we specifically note up front in our Financial Institution Letters (the vehicle used to alert banks to any regulatory changes or guidance) whether the change applies to institutions under $1 billion. Finally, there are less burdensome requirements for smaller institutions in their implementation of the Community Reinvestment Act.

As we testified before this Subcommittee in April, much of the Dodd-Frank Act should have no direct impact on community banks, and certain changes in the Act provide benefits. For example, the Act permanently increased deposit insurance coverage to $250,000 and made changes in the assessment base that will result in significantly lower premiums for most banks under $10 billion in assets. Further, provisions of the Act that impose additional capital and other heightened prudential requirements on the largest financial institutions are aimed at reducing systemic risks. Those and other provisions of the Act should do much to return competitive balance to the marketplace by restoring market discipline and ensuring appropriate regulatory oversight of systemically important financial companies.

Finally, the Dodd-Frank Act should help level the playing field with nonbanks as they will now be required to meet the same standards as banking institutions, especially in the mortgage finance arena. However, it is clear that consumers have come to expect, and depend greatly on, insured institutions to design and offer fair and equitable financial products and services. We believe the public's significant trust in community banks has been fostered by their diligence in maintaining effective consumer protection programs.

Much of the regulatory cost of the Dodd-Frank Act will fall, as it should, directly on the large institutions that create systemic risk. The leveling of the competitive playing field will help preserve the essential diversity of our financial system, and prevent any institution from taking undue risks at the expense of the public.

Conclusion

The FDIC understands the significant challenges faced by banks and their borrowers as the real estate markets and the financial sector recover from the disloca-

tions that precipitated the crisis. The FDIC has made supervisory enhancements that address the lessons learned from the recent crisis and organizational changes to implement our new responsibilities from the Dodd-Frank Act. The FDIC has joined with other Federal financial regulators in encouraging lenders to continue making prudent loans and working with borrowers experiencing financial difficulties. As the primary Federal regulator for most community banks, the FDIC recognizes their critical role in helping local businesses fuel economic growth and we support their efforts to make good loans in this challenging environment.

Thank you and I would be pleased to answer any questions.

PREPARED STATEMENT OF DAVID K. WILSON

DEPUTY COMPTROLLER, CREDIT AND MARKET RISK, OFFICE OF THE COMPTROLLER OF THE CURRENCY

JUNE 15, 2011

I. Introduction*

Chairman Brown, Ranking Member Corker, and Members of the Subcommittee, my name is Dave Wilson, and I am currently the Deputy Comptroller for Credit and Market Risk at the Office of the Comptroller of the Currency. In July, I will assume the position of Senior Deputy Comptroller for Bank Supervision Policy and Chief National Bank Examiner at the OCC. I appreciate the opportunity to discuss the OCC's perspectives on lessons learned from the financial crisis and our ensuing approach to bank supervision.

My testimony addresses four key areas. First, I briefly summarize some of the major factors that contributed to the financial crisis. Next, I discuss lessons learned from the crisis and specific steps the OCC is taking to incorporate those lessons learned into our bank supervision activities and practices. With this background, I then describe the OCC's overall approach to bank supervision—our role as supervisors, and the efforts we are taking to ensure that as we implement needed supervisory enhancements and the reforms mandated by the Dodd-Frank Act, our supervision remains balanced, fair, and appropriately tailored to the size and risk of individual institutions. Finally, pursuant to the Subcommittee's request, I provide a brief update on small business and real estate lending, mortgage servicing, and trading.

II. Factors That Contributed to the Financial Crisis

Numerous studies and papers have been written that explore in depth the causes and factors that led to the recent crisis. Rather than catalog and summarize those findings, I want to offer my perspective, as a bank examiner and supervisor, on key precipitating factors that both supervisors and bankers failed to adequately recognize and mitigate.

In many respects, the seeds for the crisis were sown by the prolonged period of a relatively benign economy that fostered a market environment where investors, lenders, and supervisors became overly complacent about risk. This environment, characterized by low interest rates, strong economic growth, excess liquidity, and very low rates of borrower defaults spurred investors to chase yields, and U.S. mortgage-backed securities offered higher yields on historically safe investments. Hungry investors tolerated increased risk to obtain those higher yields, especially from securities backed by subprime markets, where yields were highest. This demand attracted new mortgage lenders and brokers many of whom had limited business experience or financial strength and operated outside of the commercial banking system and with little regulatory oversight. Increased risk layering—in the form of smaller downpayments, lower required credit scores, higher debt-to-income ratios, reduced documentation of income, and temporary reductions in monthly payments—became prevalent as lenders and borrowers became willing to finance and take on ever higher levels of debt, often on the belief that such debt could be easily refinanced or extinguished through the sale of underlying assets whose prices, it was assumed, would continue to escalate. The rapid increase in market share by unregulated brokers and originators put pressure on regulated banks to lower their underwriting standards, which they did, though not to the same extent as was true for unregulated mortgage lenders.

Investor demand for yield was also affecting the commercial leveraged loan market as many institutional investors were willing to accept increasingly liberal repay-

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*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.

ment terms, reduced financial covenants, and higher borrower leverage in return for marginally higher yields. The apparent risk to commercial banks' own loan portfolios was considered limited, because such banks and bank affiliates increasingly followed an "originate-to-distribute" model, syndicating most of these exposures for sale to institutional investors rather than holding them on their balance sheets for extended periods.

Compensation structures that rewarded loan production over loan quality placed added incentives for lenders to originate and produce loan products. Over time, product structures and funding mechanisms became more complex and opaque as underlying loans were repackaged, tranched, and further leveraged and financed in the form of various securitization and off-balance sheet funding conduits. Some of these structures, such as complex collateralized debt obligations, were poorly understood. Credit rating agencies and investors had a false sense of security that, no matter how poor the underwriting of the underlying asset, the risk could be adequately mitigated through geographic and product diversification, sufficient credit tranching, and other financial engineering. In many cases, the net result was poorly underwritten loans that financed longer-term assets and that were funded through short-term wholesale funds providers who, as it was later revealed, were extremely sensitive to real or perceived risks.

Smaller community banks were not immune from the build-up of risks occurring in the system. In particular, as the larger players increased their market shares in various retail credit products, such as residential mortgage loans and credit cards, community banks increasingly had to look elsewhere for profitable lending opportunities. For many community bankers, the housing and attendant real estate boom provided a natural area for growth—CRE (commercial real estate) lending for construction and development. This was especially true in areas with vibrant housing markets, where home building was a key part of the regional economy. Because this type of lending puts more of a premium on knowledge of individual borrowers and local market conditions, this type of lending is often well-suited for community banks. However, many smaller banks became overly concentrated in this sector and a smaller, but not insignificant, number fueled their rapid CRE growth—often in areas outside of their home market—with short-term volatile funding sources.

Lax underwriting, excessive leverage, rapid growth, and concentrations are all too familiar refrains from past credit cycles and were symptoms that, with the benefit of hindsight, supervisors and market participants should have better mitigated at a much earlier stage. What amplified these factors from past cycles was the manner in which these excesses were spread and disbursed throughout the global financial system. When the subprime mortgage market began to collapse, the opaqueness of the more complex product and funding structures made it difficult for bankers, investors, funds providers, and supervisors to readily assess the nature and scope of potential risk exposures. This uncertainty contributed to an abrupt shift in risk tolerance by many market participants across the globe and served to compound losses as investors attempted to unwind positions. Secondary market liquidity for mortgages and leveraged loan products largely evaporated, leaving many larger banks with an unfunded pipeline of loan commitments that would require on-balance sheet funding. Likewise, short-term funding vehicles, such as asset-backed commercial paper conduits, became strained as investors increasingly chose not to roll over maturing paper, placing further strains on the balance sheets of banks that served as sponsors to such conduits. Bankers and supervisors underestimated the resulting rapidity and depth of the global liquidity freeze.

As various external funding sources evaporated, concentrations and correlations that bank risk managers believed had been diversified away became more apparent. For example, direct exposures to subprime mortgages that had been avoided in a bank's lending operations nonetheless emerged through bank affiliate activities and affiliate-sponsored off-balance sheet vehicles. Products, markets, and geographic regions that previously were looked to as a source of risk diversification became more highly correlated as contagion effects spread across the globe and industry sectors.

The resulting strains of the financial crisis have been felt by both large and small banks. While the initial impact was largely confined to the largest institutions that were heavily reliant on wholesale funding, as the economy continued to deteriorate, banks of all sizes faced higher loan losses, lower margins, and reduced profitability, and are only now showing signs of recovery.

III. Lessons Learned and Areas for Continued Improvement for Bank Supervision

The financial crisis underscored that no amount of financial engineering can obviate the need for bankers and bank supervisors to adhere to and monitor the basic precepts of sound banking practice: prudent underwriting practices throughout the

credit cycle; strong risk-management systems that identify and control the build-up of risk concentrations across products and business lines; diversified funding sources, adequate loan loss reserves, and strong capital cushions that allow the bank to continue its normal operations during downturns or funding strains; and strong corporate governance, including compensation structures, that set the tone for balanced and prudent risk taking. While these fundamentals are clearly important, they primarily focus on the risks within an individual banking organization. As the financial crisis highlighted, bankers, and more importantly supervisors, must develop better tools to evaluate and address emerging risks across the system and how those risks may be interconnected. Similarly, regulators need to take steps to restore greater transparency and accountability by all market participants—lenders, borrowers, and investors—to facilitate market discipline on excessive risk taking and dispel reliance on potential or perceived Government backstops.

The sections that follow describe in some detail steps that the OCC has or is taking to address each of these areas. But let me begin by noting that while the OCC believes that these lessons are applicable for banks of all sizes, we are cognizant of the need to tailor our expectations to the scope and complexity of each bank's activities. As a result, our expectations for large banking organizations are generally more stringent and higher than for community banks whose scale of operations and complexity are considerably smaller. While we believe large banks must be held to higher standards, we do not subscribe to the view that big, in and of itself, is bad. Our country's economic well-being is inevitably linked to the global economy and if the U.S. financial system is to remain a predominant force in the global environment, we need to have banking organizations that can compete effectively with their global counterparts across product and business lines. Similarly, as we institute reforms to address some of the problems and abuses stemming from the last crisis, we need be careful that we do not attempt to wring all the risk or complexity out of the banking system. Banks' fundamental role is risk intermediation, and financial innovation and expansion of credit are important drivers of our economy. Banks must be able to respond to customer and investor demand for new and innovative products and services. As corporations become more risk management savvy, so do their demands for risk management products, such as various derivative instruments. Similarly, as technology advances, the methods and ways that consumers choose to interface with banks will become more complex and varied. We must allow banks to respond to this changing landscape provided that they do so in a manner that is safe and sound and conducted with integrity.

A. Prudent Underwriting Throughout the Cycle

The financial crisis underscored that underwriting standards matter, regardless of whether loans are being originated to hold on the bank's own balance sheet or sold to third party investors. Supervisors and banking organizations must be more diligent in ensuring that underwriting standards are not compromised by competitive pressures from unregulated firms, by investors who may be willing to take on more risk for incremental yield, or by desire for rapid growth or market share in products or geographic regions.

In the immediate aftermath of the subprime crisis, the OCC cautioned national banks that they should apply sound, consistent underwriting standards regardless of whether a loan is originated with the intent to hold or sell. Likewise, we have admonished national banks not to compromise their underwriting standards due to competitive pressures. Where we see signs of such slippage, we are intervening at an early stage. For example, last June in response to signs of slippage that examiners were seeing in some leveraged loan facilities, we issued guidance to our examiners that reinforced our supervisory expectations for this type of lending and directed them to criticize or classify credits that exhibit minimal repayment capacity, excessive leverage or weak/nonexistent covenants, even when the credits had been recently advanced.

Because of the adverse impact that competitive pressures can have on underwriting standards, the OCC has been a strong proponent for national, uniform standards for certain lending products, most notably residential mortgage loans.

As we take steps to promote more consistent and uniform underwriting practices and standards and to lean in more forcefully when we see slippage either in the system or at individual banks, we are mindful of the need to strike an appropriate balance. Ensuring that banks remain safe and sound, while at the same time meeting the credit needs of their communities and customers is one of the OCC's core missions, and knowing when to bear down is one of the most fundamental calls that examiners and policy makers must make. Waiting too long or supervising too lightly will result in some banks using federally insured deposits to make unsafe loans that can ultimately cause them to fail. On the other hand, supervising too strictly or in-

consistently can cause banks to become too conservative and deny loans to creditworthy borrowers.

Since the onset of the financial crisis, the OCC has taken a number of actions to improve our ability to objectively monitor trends in credit quality and underwriting standards to help us determine when stronger supervisory intervention is needed. These actions supplement our more traditional tools of on-site examinations, the annual interagency Shared National Credit review, and the OCC's annual underwriting survey. In 2009, we began collecting and analyzing detailed loan-level data on home equity, credit card, CRE, and large corporate syndicated credits at some of the largest national banks. This effort builds off of the highly valuable Mortgage Metrics data project that the OCC initiated in 2008 and provides us with much more granular level data than could be collected cost-effectively through the Call Report. This comprehensive loan-level credit data allows us to conduct comparative analysis of credit risk across large banks in a timelier manner and to identify potential systemic risk issues. In addition, these large comprehensive data sets provide us with the ability to conduct more forward-looking analyses to determine what could happen to credit quality under varying economic scenarios and assumptions. A key focus of our large bank examination and policy staff will be to identify and institutionalize critical underwriting metrics and related benchmarks so that we can objectively track the migration of practices over the course of future credit cycles. By limiting our data collection to the largest players, we are able to develop a system-wide view while minimizing undue reporting and compliance costs on smaller institutions.

For smaller institutions, our emphasis has been more tailored and focused on ensuring that these banks effectively recognize and manage the inherent concentrations that they may have in their lending portfolios. These efforts have included targeted examinations of key portfolios, most notably CRE portfolios, and providing examiners and bankers more analytical tools to assess how stresses in external market factors may affect those portfolios.

B. Strong Risk Management Systems That Identify and Control Risk Concentrations

The financial crisis exposed weaknesses in many banks' risk management systems and models. In many cases, risk concentrations accumulated undetected across products, business lines, and legal entities within an organization. Complex product structures and various off-balance sheet funding structures obfuscated certain exposures and risks. Credit risk models relied too heavily on historical correlations and did not adequately address their risk exposures to highly rated CDOs and other structured securities. Similarly, banks' internal stress tests failed to fully capture the risks that could be posed from various "tail" events and from off-balance sheet structures that were legally separate from the firm, but that the firm ultimately supported in order to maintain relationships with counterparties, funds providers, and investors. Many stress tests failed to fully estimate the potential severity and duration of stress events or focused on a single line of business.

Strengthening risk management practices and institutionalizing more robust and enterprise-wide stress testing has and continues to be a point of supervisory emphasis, particularly at the largest national banks. Given the need to implement such practices across the entire banking organization, we are working closely with our colleagues at the Federal Reserve on many of these efforts.

Given the importance and the role that these large institutions play in the overall financial stability of the U.S., we have instructed our examiners that these organizations should not operate with anything less than strong risk management and audit functions—anything less will no longer be sufficient. To build out this capability, examiners are directing these banks to improve their risk concentration aggregation and stress testing processes, requiring more robust model validations, and stepping up their challenges of quantitative models and the key assumptions supporting those models. These examiner directives have been supplemented with supervisory guidance, including the enhanced risk management requirements adopted by the Basel Committee for banks operating under the Basel II capital framework. Critics of Basel II have focused on the potential for an internal-models-based approach to produce lower capital charges for certain portfolios, a concern that has been addressed in the past year by substantial strengthening of the framework and the increased capital levels under Basel III. Meanwhile, the great benefit of the framework has been, and remains, its requirement for more stringent and robust risk management standards at applicable banks. The compliance costs associated with the Basel II advanced approaches rule is one reason why the OCC and other U.S. banking agencies limited its mandatory application to the largest U.S. banking organizations.

More recently, in April, the OCC and Federal Reserve issued guidance on model risk management that expands upon the OCC's previous guidance on model validation. The guidance articulates the elements of a sound program for effective management of risks that arise when using quantitative models in bank decision making. It also provides guidance to OCC examining personnel and national banks on prudent model risk management policies, procedures, practices, and standards. Last week, the OCC, Federal Reserve, and FDIC issued for comment *Proposed Guidance on Stress Testing for Banking Organizations With More Than $10 Billion in Total Consolidated Assets.* This joint interagency guidance outlines high-level principles for stress testing practices, applicable to all banking organizations with more than $10 billion in total consolidated assets. The proposed guidance highlights the importance of stress testing as an ongoing risk management practice that supports a banking organization's forward-looking assessment of its risks. It outlines broad principles for a satisfactory stress testing framework, and describes the manner in which stress testing should be employed as an integral component of risk management. While not intended to provide detailed instructions for conducting stress testing for any particular risk or business area, the proposed guidance describes several types of stress testing activities and how they may be most appropriately used by banking organizations. Although the guidance does not explicitly address the stress testing requirements imposed upon certain companies by section 165 (i) of the Dodd-Frank Act, the agencies anticipate those provisions, to be addressed in a future rulemaking, will be consistent with the principles in the proposed guidance.

As with other risk management practices, the OCC believes certain aspects of stress testing—such as scenario analysis of key portfolios—can also be a valuable tool for smaller banks. Thus, as previously noted, we have been working with community bankers to improve their ability to stress test CRE and other highly concentrated and volatile portfolios. For example, we have instructed banks that their stress testing of CRE transactions should consider the effect of multiple variables (*e.g.,* changes in interest rates, vacancy rates, and capitalization rates), and that such stress tests should be performed periodically throughout the life of the loan.

To assist community bankers in identifying and assessing potential CRE vulnerabilities, we developed, and have made available via our National BankNet Web site, loan level CRE stress testing tools that bankers can use. We also have developed a portfolio level model, which our examiners are now testing. Our intent is to also publish this on BankNet after proper validation. In addition to these tools, we provide examiners with access to various market databases that allow them to monitor and analyze CRE trends by major geographies and product types and are developing additional tools that they can use in their discussions with bank management about potential concentrations.

While more robust stress testing and improved risk management can help identify and mitigate the risks arising from concentrations, the financial crisis illustrated that there may be some types and levels of concentrations that, in a severe or protracted downturn, may simply be too large for a bank to absorb. Indeed, a common thread in the vast majority of bank failures in both this and previous credit cycles has been a concentration in certain types of CRE lending. Many of these banks had other risk management weaknesses that accentuated their CRE problems; however, some banks that had sound underwriting and internal controls for the CRE operations nonetheless failed due to their level of concentrations to this sector and the cascading effects that the downturn had on their borrowers and projects. This is the primary reason why we are directing smaller banks with these types of concentrations to shore up their capital base and to maintain capital levels above required regulatory minimums. Consistent with the GAO's recent report on CRE concentrations, we are continuing to assess and discuss with our supervisory colleagues whether additional clarification on supervisory expectations or other measures, such as more explicit limits, capital requirements, or triggers within the Prompt Corrective Action framework may be warranted to address the risks posed by excessive concentrations.

C. Diversified Funding, Strong Capital Cushions, and Adequate Loan Loss Reserves

In periods of severe financial stress, having sufficient liquidity, loan loss reserves, and capital become paramount in ensuring a bank's continued operations. Each of these components of a strong balance sheet had weakened in the years preceding the crisis.

As previously noted, many banks—both large and small—relied excessively on short-term and volatile funding sources to expand and fuel their growth. As banks competed for short-term profits and higher margins, traditional sources of asset-based liquidity, such as short-term, readily marketable securities were replaced with less liquid assets that offered higher yields. Many banks' liquidity plans assumed

that there would be a continuously ready market for highly rated assets that could provide liquidity and likewise failed to fully anticipate the liquidity demands resulting from their "originate to distribute" loan pipelines or off-balance sheet conduits. This combination of factors—undue reliance on short-term liabilities, little asset liquidity, and a growing accumulation of off-balance sheet assets that would require funding—proved disastrous for some firms when the short-term funding markets abruptly shut down in 2007.

Similarly, the crisis clearly demonstrated that common equity is superior to other capital instruments in its ability to absorb losses on a going-concern basis. Hybrid capital instruments that paid cumulative dividends and/or had a set maturity date had become an ever-larger proportion of the capital base for bank holding companies of all sizes, but were found lacking. While many banks hold innovative instruments that would have permitted them to defer or cancel dividends, during the financial crisis many banks did not exercise this option, which could have preserved liquidity and capital, for fear that such actions would reinforce market perceptions of the bank's weakened financial condition. Many non-U.S. banks even exercised call options to redeem hybrid instruments for fear that failure to do so would send strong market signals about the deteriorating condition of the bank.

Correcting these shortcomings has been the focus of considerable work by the OCC and other regulators and, as Acting Comptroller Walsh noted in his testimony before the full Committee in February, is the objective of various provisions of the Dodd-Frank Act.[1] The hallmark of this work internationally has been the enhanced and more stringent global capital and liquidity standards for large, internationally active banks adopted by the Basel Committee, known as Basel III. These reforms, when integrated with the various capital and liquidity provisions of Dodd-Frank will materially affect the level and composition of capital and liquidity for large banks. Together, these reforms tighten the definition of what counts as regulatory capital; expand the types of risk captured within the regulatory capital framework; increase overall capital requirements; establish an international leverage ratio applicable to global financial institutions that constrains leverage from both on- and off-balance sheet exposures; and provide for a more balanced consideration of financial stability in bank supervision practices and capital rules. The Basel reforms also introduce global minimum liquidity standards that set forth explicit ratios that banks must meet to ensure that they have adequate short-term liquidity to offset cash outflows under acute short-term stresses and maintain a sustainable maturity structure of assets and liabilities.

Since the Basel III enhancements can take effect in the U.S. only through formal rulemaking by the banking agencies, U.S. agencies have the opportunity to integrate certain Basel III implementation efforts with the heightened prudential standards required by the Dodd-Frank Act. Such coordination in rulemaking will ensure consistency in the establishment of capital and liquidity standards for similarly situated organizations, appropriately differentiate relevant standards for less complex organizations, and consider broader economic impact assessments in the development of these standards. Beyond the Basel III reforms, we have been directing banks of all sizes to improve their capital planning and liquidity risk management processes to ensure their ability to adequately fund and support anticipated growth and withstand unforeseen events. As part of this effort, we expect all banks to maintain a contingency funding plan that sets forth the bank's strategy for addressing unexpected liquidity shortfalls.

One of the most striking sidebars in the story of the financial crisis is the unprecedented speed with which once well-capitalized institutions succumbed to their credit losses. One reason for this is that banks held historically low levels of loan-loss reserves coming into the current recession. We agree with the findings and recommendations of the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) Financial Crisis Advisory Group on the need to amend accounting standards that contributed to the delayed recognition of losses on loans. Specifically, the accounting rules and the way they were applied made it difficult for bankers to reserve for losses that could be reasonably anticipated. The result was that when subsequent charge-offs on impaired loans did occur, the loan loss reserves were not there to support them, and higher provision levels reduced capital. This accelerated the spiral into insolvency for many financial institutions. As the FASB and IASB (collectively, the Boards) have recognized, this emphasizes the need for a revised accounting model for more adequate loan losses to supplement the strong capital cushions required by prudential regulators. The OCC has been a strong proponent of this need to make the loan loss allowances

[1] *See,* Testimony of John Walsh, Acting Comptroller of the Currency, before the Committee on Banking, Housing, and Urban Affairs of the United States Senate, February 17, 2011.

more forward looking so that banks can appropriately build their reserves when inherent credit risk is increasing, rather than waiting until loan problems are obvious. The OCC has been actively engaged in efforts by the Boards to revise the current impairment model for recognizing loan losses to provide for more forward-looking reserves. As part of this effort, OCC staff has served as the U.S. banking agencies' representative on the IASB's Expert Advisory Panel on Impairment and participated in various educational sessions as well as drafting interagency and Basel Committee comments to the Boards on this issue.

A challenge we and the industry face as implementation of these and other reforms mandated by the Dodd-Frank Act move forward is assessing their potential interaction and cumulative impact on banks' business models and strategic plans. While we support efforts to raise and strengthen capital and liquidity cushions, these standards must be reflective of the underlying risks and not become so excessive that they serve to promote rather than discourage risk-taking. In addition, we are concerned that some of the parameters underlying the Basel III liquidity standards are excessively conservative and, if implemented in their current form, could unnecessarily impede banks' balance sheet capacity for lending activities.

D. Strong Corporate Governance

The financial crisis highlighted that risk management is, and must be, more than simply a collection of policies, procedures, limits, and models. Effective risk management requires a strong corporate culture and corporate risk governance. This culture must be set, embraced, and enforced by the bank's board of directors and its senior management, and it must permeate all of the bank's activities. This is a point of emphasis in all of our meetings with senior management teams and directors. We are reminding bank directors that they should not be passive bystanders and should be willing and able to provide credible challenges to bank management on key issues and strategic plans. Informed directors are well positioned to engage in value-added discussions that provide knowledgeable approvals, guidance to clarify areas of uncertainty, and prudently question the propriety of strategic initiatives, human capital decisions (including compensation arrangements), and the balance between risk taking and reward.

Fulfilling these roles and responsibilities can be especially challenging for directors at smaller institutions who may have fewer resources or outside expertise to assist them. To assist them in this task, we offer a comprehensive series of director workshops, taught by some of our senior supervisory staff. These workshops, offered throughout the year in various locations across the country, cover four topics: a director's fundamental responsibilities, risk assessment, compliance risk, and credit risk. Participants receive an extensive package of resources, including a precourse reading packet, course materials, a CD containing selected OCC Web and telephone seminars, and other supporting materials.

A key component of prudent corporate governance is the establishment of well-defined and understood risk tolerances and limits. At larger banks, the science of defining and measuring risk tolerance levels has typically been confined to the business unit and more micro levels of the organization. While these lower level risk limits are generally effective in controlling individual areas of risk taking, they do not enable senior management or board members to monitor or evaluate concentrations and risks on a firm-wide basis. Consequently, we are directing larger banks to complement existing risk tolerance structures with more comprehensive measures and limits of risk addressing the amount of capital or earnings that may be at risk on a firm-wide basis, including the amount of risk that may be taken in each line of business, and the amount of risk that may be taken in each of the key risk categories monitored by the banks. For banks of all sizes, we are emphasizing the need for sound enterprise-wide asset-liability management systems that identify, monitor, and effectively limit the bank's liquidity and interest rate risks exposures. As part of our ongoing supervisory process, we are reviewing compliance with these directives.

As previously noted, flawed incentive compensation practices in the financial industry were among the factors contributing to the financial crisis. To address this issue, in June 2010, the OCC and other Federal banking agencies issued guidance on sound incentive compensation policies and practices. Key tenets of that guidance are that such practices should appropriately balance risk and reward; be compatible with effective controls and risk management; and be supported by strong corporate governance, including active and effective oversight by the organization's board of directors. In April, the OCC and other regulators issued proposed rules to implement the incentive-based compensation provisions of section 956 of the Dodd-Frank Act. This rule would build upon the agencies' June 2010 guidance by requiring the reporting of certain incentive-based compensation arrangements and prohibit incen-

tive-based compensation arrangements that provide excessive compensation or that could expose the institution to inappropriate risks that could lead to material financial loss. Consistent with the statute, institutions with less than $1 billion in assets would not be subject to this rule.

E. Identifying, Assessing, and Addressing Emerging Risks Across the Financial System

As I noted earlier, the financial crisis demonstrated the need for supervisors to improve their ability to identify, assess, and address emerging risks not only within a banking organization, but across the banking and broader financial system. Strengthening supervisors' ability to identify and respond to emerging systemic risks is clearly a key objective of the Dodd-Frank Act and a core mission of the FSOC. Beyond the measures provided for by the Dodd-Frank Act and the activities being conducted through the FSOC and its various staff committees, the OCC has taken a number of steps to enhance our ability to identify and respond to risks across the industry and financial system.

As previously noted, we are now obtaining granular, loan level information on key credit portfolios from the largest national banks to help identify underwriting and performance trends across the system. We have also developed a liquidity risk monitoring program to standardize liquidity monitoring information across 15 of the largest national banks and to provide more forward looking assessments of liquidity mismatches and capacity constraints that could signal future problems. We also have established network groups among our examiners at large national banks to facilitate information sharing and promote consistent supervisory actions for nine key risk areas.

In 2008, we established a Financial Markets Group within the agency and tasked it with the build-out of a market intelligence program. Their mission is to seek out early warning signs of emerging and systemic risk issues. This team is comprised of highly experienced bank examiners and subject matter specialists, and they spend considerable time meeting with bank investors, bank counterparties, bank analysts, and other relevant stakeholders to gain insights on emerging trends. To support the work of the OCC's National Risk Committee (NRC), this group has also developed a dashboard of metrics that provide early indicators of the build-up of risks within the system that may signal the need for firmer supervisory intervention at a juncture when such action can be modulated and most effective. These metrics are designed to provide warning signs before risks become manifested in market performance such as prolonged periods of low volatility that can promote complacency among investors and bankers and lead to excessive risk taking. While any one metric would be insufficient grounds for firmer intervention, warning signals across a number of measures will trigger a more formal review and assessment of the risks and the need for appropriate supervisory response by the OCC's NRC and Committee on Bank Supervision.

F. Restoring Transparency and Market Discipline

The problems that supervisors and market participants faced when trying to assess the nature and scope of exposures in complex structured products, off-balance sheet funding vehicles, derivatives, and trading strategies have been well documented. In many cases these challenges were further exacerbated by complex organizational structures of individual firms.

Providing greater transparency in financial statements has been a key objective of recent proposals by the FASB, and the OCC has provided its views and expertise on these proposals. One of the most significant revisions, as it pertains to various securitization and off-balance sheet funding vehicles that were prevalent before the crisis, has been the adoption and implementation of revisions to the Accounting Standards Codification (ASC) Topic 860, *Transfers and Servicing*, and ASC Topic 810, *Consolidation* (through Statements No. 166, *Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140*, No. 167, *Amendments to FASB Interpretation No. 46(R)*). As a result of these statements, many securitized assets must now be reflected on banks' balance sheets. The OCC and other Federal banking agencies have amended the agencies' risk-based capital rules to be consistent with these accounting changes. Many of the derivatives-related provisions of the Dodd-Frank Act will likewise provide greater transparency through increased disclosures and more extensive use of central counterparties or clearinghouses.

The combined provisions of Titles I and II of the Dodd-Frank Act that provide the authority to extend the Federal Reserve's supervisory oversight of certain nonbank financial companies and for the orderly liquidation of failing financial companies that pose significant risk to the financial stability of the U.S., are critical tools in

restoring market discipline and accountability for large financial firms. Through FSOC, the OCC is actively engaged in efforts to implement these provisions.

As problems in the mortgage market have vividly demonstrated, improved transparency and disclosures about the terms, costs, and risks of retail banking products are critical to promote informed consumer choice and responsibility. We have long supported that goal and applaud the Consumer Financial Protection Bureau's initiative to start this process through the testing of revised residential mortgage disclosure forms.

IV. OCC's Supervisory Approach—Balanced Supervision, Tailored to Risks

The OCC's core mission is to assure the safety and soundness of the institutions subject to our jurisdiction and to ensure that those institutions support fair access to financial services and fair treatment of their customers. We carry out this mission through our ongoing supervisory activities. Through these activities we evaluate banks' compliance with applicable laws, regulations, and supervisory requirements, and we assess whether they have adequate risk management systems, controls, and capital to support the size, scope, and complexity of their activities. Where we find weaknesses or violations, we direct management to take appropriate and timely corrective action. Provided that the bank has the requisite corporate governance, risk management, and capital infrastructure to support risk taking, it is not the job or role of an examiner to determine whether or what lines of business, products, or strategic focus is appropriate—these are decisions that the bank's board must make. Likewise, examiners do not tell bankers which loans to make or deny. However, they will assess whether such loans have been prudently underwritten, properly risk-rated, and, if any show signs of trouble, are appropriately classified and reserved for.

As I previously noted, one of the most difficult jobs we have in carrying our this mission is knowing when and how hard to tap on the brakes to rein in excessive risk taking without causing bankers to become so conservative or uncertain about regulatory actions that they unduly restrict credit. We are acutely aware that our actions—both on the policy side at the 50,000 foot level, and on the ground, through our on-site examinations—can and do influence banks' behavior and their appetite for taking risk. We also recognize that in past downturns, many believed that overzealous regulators and examiners exacerbated the contraction in credit.

One of the lessons we learned is the detrimental effect of waiting too long to warn the industry about excesses building up in the system, resulting in bankers and examiners slamming on the brakes too hard when the economy experienced problems. This is one reason why we are working to develop better tools that will enable us to identify signs of accelerating risk taking at an earlier stage when our actions can be more modulated. We know that it is critical that our expectations for bankers be clear and consistent, that the "rules of the game" under which banks operate not be changed abruptly, and that changes in regulatory policies are made in an open and transparent manner that provides bankers with reasonable time frames to make necessary adjustments. This will be especially true as bankers try to absorb and comply with the myriad of rules and regulations that will result from the implementation of the Dodd-Frank Act.

We are particularly mindful that new or changing regulatory requirements can often have a disproportionate cost and burden on community banks due to their limited size and resources. For this reason, as we develop regulations, supervisory policies, and examination standards, we strive to provide sufficient flexibility in the application of those standards to reflect the size and complexity of the institution. As the complexity and scope of a bank's activities and its potential impact on the financial system increases, so do our expectations for their internal controls and risk management systems.

To provide consistency and continuity in our supervision, we organize our supervision programs around a common framework and national perspective that is then supplemented by the hands-on knowledge of our examiners. Our supervision by risk framework establishes a common examination philosophy and structure that is used at all national banks. This structure includes a common risk assessment system (RAS) that evaluates each bank's risk profile across eight risk areas—compliance, credit, interest rate, liquidity, operational, price, reputation, and strategic—and assigns each bank an overall composite rating and component ratings on the bank's capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risks using the interagency Uniform Financial Ratings System (informally known as CAMELS). Specific examination activities and supervisory strategies are tailored to each bank's risk profile. These strategies are updated and approved annually. While tailored to each individual bank's risk profile, they also incorporate key agency supervisory priorities for the coming year.

To reflect the different expectations for controls and risk management between large and small banks, our bank supervision programs and core examination procedures to determine a bank's RAS and CAMELS ratings are aligned across two primary lines of business: Midsize and Community Bank Supervision, and Large Bank Supervision. Upon full integration of OTS, we will align Federal thrifts into these lines of business.

Our community bank supervision program is built around our local field offices located in over 60 cities throughout the U.S. Every national community bank is assigned to an examiner who monitors the bank's condition on an ongoing basis and who serves as the focal point for communications with the bank. The primary responsibility for the supervision of individual community banks is delegated to the local Assistant Deputy Comptroller, who is under the oversight of a district Deputy Comptroller, who in turn, reports to our Senior Deputy Comptroller, Jennifer Kelly. The frequency of our on-site examinations for community banks follows the statutory provisions set forth in 12 USC 1820(d), with on-site exams occurring every 12 to 18 months. The scope of these examinations is set forth in the OCC's Community Bank Supervision handbook and requires sufficient examination work and transaction testing to complete the core assessment activities in that handbook, and to determine the bank's RAS and CAMELS ratings. On-site activities are supplemented by off-site monitoring and quarterly analyses to determine if significant changes have occurred in the bank's condition or activities.

Our Large Bank program is organized with a national perspective. It is centralized and headquartered in Washington, and structured to promote consistent uniform coordination across institutions. As part of our Large Bank Supervision program, we maintain on-site resident examination staff that conducts ongoing supervisory activities and targeted examinations of specific areas of focus. This process allows the OCC to maintain an ongoing program of risk assessment, monitoring, and communication with bank management and directors. Given the volume and complexity of the literally hundreds of thousands of transactions that flow through large banking organizations, it is not feasible to review every transaction in each bank, or for that matter, every single product line or bank activity in each supervisory cycle. Nonetheless, as in our community bank examinations, examiners must complete sufficient work and transaction testing throughout the year to complete the core assessment activities set forth in the OCC's Large Bank Supervision handbook, and to determine the bank's RAS and CAMELS ratings. The on-site teams at each bank are led by an Examiner-in-Charge, who reports directly to the Deputy Comptrollers in our Large Bank Supervision Office, and in turn, to our Senior Deputy Comptroller, Mike Brosnan.

In January 2010, we updated and revised our RAS system as it applies to both community and large banks to reflect and incorporate lessons learned from the financial crisis. We also have directed examiners to be more forward looking when they are assessing and assigning RAS ratings. Specifically, when assessing direction of risk for all risk categories, examiners should consider current practices in the bank and how those practices, combined with other quantitative and qualitative factors, affect direction of risk over the next 12 months. For example, the direction of credit risk may be increasing if a bank has relaxed its underwriting standards during a strong economic cycle, even though the volume of troubled credits and credit losses remain low. Similarly, the direction of liquidity risk may be increasing if a bank has not implemented a well-developed contingency funding plan during a strong economic cycle, even though existing liquidity sources are sufficient for current conditions. We will be reinforcing this message with our examination staffs at our upcoming staff conferences in July that will bring together all of our examination staffs across our lines of business and those examiners who are joining the OCC from the Office of Thrift Supervision.

In both our Midsize and Community Bank Supervision and Large Bank Supervision programs, we have mechanisms in place to ensure that our supervisory policies and procedures are applied in a consistent and balanced manner. Every report of examination is reviewed and approved by the responsible ADC or Deputy Comptroller before it is finalized. Both units have formal quality assurance processes that assess the effectiveness of our supervision and compliance with OCC policies. Our examination force is kept abreast of emerging issues and supervisory policies through weekly email updates and periodic nationwide conference calls, team meetings, and staff conferences.

A key element of the OCC's supervisory philosophy is open and frequent communication with the banks we supervise. In this regard, our senior management teams encourage any banker that has 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. Should a banker not want to pursue those

chains of communication, our Ombudsman's office provides a venue for bankers to discuss their concerns informally or to formally request an appeal of examination findings. The OCC's Ombudsman is fully independent of the supervisory process, and he reports directly to the Comptroller. In addition to hearing formal appeals, the Ombudsman's office provides bankers with an impartial ear to hear complaints and a mechanism to facilitate the resolution of disputes with our supervisory staff.

The OCC also recognizes the importance of communicating regularly with the industry outside of the supervision process to clarify our expectations, discuss emerging issues of interest to the industry, and respond to bankers' concerns. We participate in numerous industry-sponsored events, as well as conduct a variety of outreach activities, including Meet the Comptroller events, chief executive officer roundtables, and teleconferences on topical issues.

V. Current State of Small Business and Real Estate Lending, Mortgage Servicing, and Trading Lines of Business

The Subcommittee's letter of invitation noted the uncertainty that remains in small business and real estate lending, mortgage servicing, and trading, and requested the OCC's views on the state of those business lines. Let me conclude with a brief overview of each.

A. Small Business Lending

National banks are significant providers of small business credit, but discerning trends in small business lending is difficult due to the variety of lending facilities that small business owners use for financing. One proxy for a portion of small business lending is the data collected in the quarterly Call Reports on commercial and industrial loans in amounts less than $1 million and agricultural loans less than $500,000. In the last few years, the outstanding balance of these loans has declined, reflecting both demand and supply factors. Mirroring trends in the broader economy, demand for credit by many businesses has weakened as both businesses and their consumers have scaled back spending and investments. It is also true that some bankers, in response to deteriorating credit and economic conditions, have become more risk averse and selective in their lending.

The OCC recognizes the important role of small businesses in the economy, their dependence on banks for credit, and the difficulty that some small business owners have reported in obtaining new credit or renewing existing credit. In response to these concerns, in February 2010, the OCC and other Federal banking agencies issued a statement on creditworthy small businesses. The statement is intended to facilitate small business lending and provide bankers with more regulatory certainty by outlining our expectations for prudent underwriting practices. In this statement and in our ongoing discussions with examiners and bankers, we reiterate our policies that we encourage bankers to lend to creditworthy borrowers and to work constructively with borrowers who may be facing difficulties, and that examiners should take a balanced approach and not criticize banks that follow sound lending practices.

We actively encourage national banks to participate in various Government programs that are designed to support small business lending. These include the Small Business Administration loan guarantee programs and the $30 billion Small Business Lending Fund program established as part of the Small Business Jobs Act of 2010. To-date approximately 106 national banks have applied for this program, and we are in the process of providing Treasury with information to assist them in evaluating those requests.

There is some evidence that credit conditions for small business lending are improving. In our recent annual credit underwriting survey, a few respondents have eased small business underwriting standards in anticipation of market growth and an opportunity to compete. Just over half of the banks in the survey are planning to grow their small business lending portfolio greater than 10 percent over the next year. Many of the largest national banks have revamped and built up their small business lending operations.

Despite these positive signs, the ongoing lack of sales revenue and widespread uncertainty about the economy continue to hamper small business owners' sentiments and bankers' ability to develop loan growth in this market segment. In its May 2011 report on small business economic trends, the National Federation of Independent Business (NFIB) stated credit supply was not the problem for the overwhelming majority of small business owners and that weak sales and uncertainty continue to be major factors for the lack of credit demand.[2] This uncertainty is reflected in the

[2] *See,* NFIB Small Business Economic Trends, May 2011, p. 2.

NFIB's small business optimism index: while this index has bounced back from the 2009 lows, its level has declined in March and April. [3]

B. Real Estate Lending

Commercial real estate lending is a prominent business line for many national banks and is a sector that the OCC monitors very closely. While there are signs that the commercial real estate markets are beginning to stabilize, we are a long way away from a full recovery. Vacancy rates across all major property types are starting to recover, but remain high by historical standards. We expect vacancy rates to remain elevated and recovery to be slow.

Capitalization rates—the rate of return demanded by investors—have also shown recent signs of stabilization. Cap rates fell substantially from 2002 through 2007 to a point where they often did not fully reflect the risks associated with the properties being financed. Then they increased markedly in 2008 and 2009 as investors became more risk averse. Recently, cap rates appear to have stabilized, particularly for high quality assets, but the spreads being demanded by investors, relative to Treasuries, for lower quality assets remain wide.

A key driver for property values and CRE loan performance is the net operating income (NOI)—or cash flows—generated by the underlying commercial properties. Overall, NOI has continued to decline due to soft rental rates. While we expect the rate of decline to lessen, only apartments are expected to show meaningful NOI growth this year, with other major market segments expected to turn positive in 2012.

Property prices have also shown some signs of stabilization. Although the Moody's All Property Index recorded a decline of 4.2 percent in March 2011, transaction volumes have increased. We expect volatile prices until underlying market fundamentals improve consistently.

The trends and performance of CRE loans within the national banking system mirror those in the broader CRE market. While there are signs of stabilization in charge-off rates and a decline in nonperforming loans, levels remain elevated and continue to require significant attention by bank management and supervisors. The effect of the distressed CRE market on individual national banks varies by the size, location, and type of CRE exposure. Because charge-off rates for construction loans led performance problems in the sector, banks with heavier concentrations in this segment tended to experience losses at an earlier stage. Performance in this segment is expected to improve more rapidly as the pool of potentially distressed construction loans has diminished. In contrast, performance of income-producing commercial mortgages continues to be more stressed and one that we continue to monitor closely.

C. Mortgage Servicing

As the Subcommittee's letter of invitation references, the mortgage servicing business is also under severe stress. Its business model was already challenged by the mortgage crisis, and that challenge is now compounded by widespread deficiencies in foreclosure processing. Through our recent consent orders, the OCC is focused on fixing the very serious problems we found in foreclosure processing; ensuring that any borrowers harmed by shoddy practices receive appropriate remedies; and getting mortgage markets operating again. Yet as Acting Comptroller Walsh recently noted in his remarks before the Housing Policy Council of the Financial Services Roundtable, additional challenges and uncertainties loom ahead for this line of business. [4] The new Basel III framework will require that servicing rights beyond relatively modest levels be deducted from capital for regulatory capital calculations, effectively increasing the capital requirements for mortgage servicers. The Dodd-Frank Act will impose a myriad of new requirements that mortgage lenders will need to address. As the Acting Comptroller noted, while each of these requirements individually have merit, it is hard to predict how all of these requirements will work together.

In addition to the requirements of Dodd-Frank, an important area for reform in the mortgage servicing business is the need for uniform mortgage servicing standards that apply to all facets of servicing the loan, from loan closing to payoff. A number of months ago, to further this effort and interagency discussions, the OCC developed a framework for comprehensive mortgage servicing standards that we shared with other agencies, and other agencies put forward their recommendations

[3] *Ibid.*, p. 4.

[4] *See,* Remarks by John Walsh, Acting Comptroller of the Currency, Before the Housing Policy Council of The Financial Services Roundtable, May 19, 2011, available at: *http://www.occ.gov/news-issuances/speeches/2011/pubspeech-2011-60.pdf.*

as well. We now have underway an active interagency effort to develop a set of comprehensive, nationally applicable mortgage servicing standards. As an example, these standards would address:

- Handling borrower payments, including applying payments to principal and interest and taxes and insurance before they are applied to fees, and avoiding payment allocation processes designed primarily to increase fee income;
- Providing adequate borrower notices about their accounts and payment records, including a schedule of fees, periodic and annual statements, and notices of payment history, payoff amount, late payment, delinquency, and loss mitigation;
- Providing an easily accessible single point of contact for borrower inquiries about loss mitigation and loan modifications;
- Ensuring appropriate levels of trained staff to meet current and projected workloads;
- Responding promptly to borrower inquiries and complaints, and promptly resolving disputes;
- Providing an avenue for escalation and appeal of unresolved disputes;
- Effective incentives to work with troubled borrowers, including early outreach and counseling;
- Making good faith efforts to engage in loss mitigation and foreclosure prevention for delinquent loans, including modifying loans to provide affordable and sustainable payments for eligible troubled borrowers;
- Implementing procedures to ensure that documents provided by borrowers and third parties are maintained and tracked so that borrowers generally will not be required to resubmit the same documented information;
- Eliminating "dual track" processes where legal steps to foreclose on a property or conduct a foreclosure sale go forward even when a borrower has completed an application for a loan modification or is in a trial or permanent modification and is not in default on the modification agreement;
- Notifying borrowers of the reasons for denial of a loan modification, including information on the NPV calculation; and
- Implementing strong foreclosure governance processes that ensure compliance with all applicable legal standards and documentation requirements, and oversight and audit of third party vendors.

While we are at an early stage in this interagency process, the OCC is optimistic that the agencies can achieve significant reforms in mortgage servicing practices across the board for all types of mortgage servicing firms. These types of standards should help put the mortgage servicing business on sound footing for the future.

D. Trading Activities

Trading revenues in the banking system have been quite strong, as the industry reported record trading revenues in both 2009 and 2010. After a loss of $836 million in 2008, insured commercial banks reported trading revenues of $22.6 billion and $22.5 billion in 2009 and 2010 respectively despite reductions in trading assets and risk. A key driver of the strong results has been predominately one-way bull markets as bonds, equities, commodities, and foreign currencies rallied. In the first quarter of 2011, insured commercial banks added another $7.4 billion in trading revenues. Notwithstanding the current strength of trading revenues, however, there are a number of issues that create uncertainty, and will likely limit, trading revenues prospectively. Section 619 of the Dodd-Frank Act restricts many forms of proprietary trading, but for banks, stand alone proprietary trading has generally accounted for a relatively small portion of trading activity, so the impact of this change should be limited. There are, however, other provisions of the Act that could affect trading activities at national banks. Legislative mandates to increase central clearing may reduce trading activity generally and narrow profit margins. Recently proposed swap margin rules require, for the first time, initial margin for inter-dealer and dealer/financial end-user trading activity, raising costs and potentially reducing the transaction volumes that create revenue. Revenues from securitization activities remain weak due to continued weakness in loan volumes and underlying asset prices for housing. In addition, securitization markets may be affected by uncertainty associated with implementation of the Dodd-Frank Act risk retention requirements and proposed changes in the regulatory capital treatment of mortgage servicing rights. Finally, bull markets for the past 2 years have stimulated client demand for risk management products, reduced market-making risk, and increased interest income spread on market-making inventory resulting from the steep yield

curve. The potential for markets to be less bullish and to become more volatile may put further pressure on bank trading revenues.

VI. Conclusion

The financial crisis exposed fundamental weaknesses in risk management and supervisory practices across the financial industry and supervisory community. Numerous initiatives, including those mandated by the Dodd-Frank Act, are underway to address these failures. The OCC has and is continuing to take steps to enhance its supervision programs and to implement its responsibilities under the Dodd-Frank Act. As we implement these changes, we will strive to do so in a manner that, to the greatest extent possible, continues to allow all U.S. financial firms to compete fairly both within our own financial system and the broader global economy. We are also mindful of the special role that community banks play in our financial system and the disproportionate burden that changing regulatory requirements can pose to these entities. In this respect, our overarching goal and mission remains the same—to assure the safety and soundness of the institutions under our jurisdiction, to ensure that they treat their customers fairly, and in carrying out this mission, to conduct our supervision in a balanced and fair manner that reflects and is tailored to the risks posed by each institution.

PREPARED STATEMENT OF SALVATORE MARRANCA

DIRECTOR, PRESIDENT, AND CHIEF EXECUTIVE OFFICER, CATTRAUGUS COUNTY BANK, LITTLE VALLEY, NEW YORK

JUNE 15, 2011

Chairman Brown, Ranking Member Corker, and Members of the Subcommittee, I am Sal Marranca, Director, President, and CEO of Cattaraugus County Bank, a $174 million asset bank in Little Valley, New York. I am pleased to be here today to represent the nearly 5,000 members of the Independent Community Bankers of America. Thank you for convening this hearing on "Enhancing Safety and Soundness: Lessons Learned and Opportunities for Continued Improvement."

The safety and soundness of our banking system is a significant concern to community banks. Early in my career, I was a Senior Bank Examiner with the FDIC for over a decade, and the commitment I made then to safety and soundness I still carry with me today as President of Cattaraugus County Bank and as Chairman of ICBA.

The recent financial crisis was caused by high risk lending and speculation by the megabanks and Wall Street firms. Significant harm was done to taxpayers and the economy. Community banks too were harmed. The economic decline retracted consumer spending and dramatically reduced the demand for credit. Residential and commercial real estate markets remain stressed in some areas. Still, the community banking industry remains well capitalized and—because we take a conservative, commonsense approach to lending—we have fewer problem assets than other segments of the industry.

We must ensure the crisis never repeats itself, and appropriate supervision of all financial services providers is an important part of that. But how safety and soundness is achieved is very important. Misguided, though well intentioned, efforts could be very economically damaging. Frankly, many community bankers are deeply frustrated with the current exam environment, which has consistently registered as a top concern among ICBA members.

Difficult Exam Environment

As we consider the topic of safety and soundness, we must remember that community banks did not cause the financial crisis, nor are they a source of ongoing systemic risk. Community banks have a starkly different risk profile from other financial services providers because of their smaller scale, which precludes systemic risk, and more importantly, because they practice conservative, common sense lending to customers they often know personally. This different risk profile must be taken into consideration as policy makers consider how community banks should be examined. Community banks are eager to make prudent loans in their communities, and as we consider ways to enhance safety and soundness, we must not tip the scale into actions that will suffocate economic activity. Safety and soundness is a very real concern, but so is the seemingly intractable unemployment that has plagued our economy for nearly 3 years. Smart examination and compliance practices will allow for more lending without creating undue risk to the financial system.

Specifically, exams could be greatly improved by being more consistent and rational. This would encourage prudent lending without loosening standards. Arbi-

trary exams chill lending indiscriminately—sound loans as well as risky loans. There are more thoughtful, systematic ways to reduce risk without discouraging sound lending.

I'm fortunate to enjoy a cooperative and constructive working relationship with my regulator, the FDIC. I value this relationship very highly. It is an important part of the success of my bank and has allowed me to weather the financial crisis. Having worked as a bank examiner, I've been on both sides of the table and can appreciate the concerns and challenges examiners face. It's a difficult job with a great deal at stake. The stakes were raised sharply after the financial crisis, but I believe many examiners overreacted and the pendulum has swung too far in the direction of overregulation. I've met with thousands of community bankers from every part of the country in recent years, and I can tell you there is an unmistakable trend toward arbitrary, micromanaged, unreasonably harsh examinations that have the effect of suffocating lending.

This has not always been the case. Before the crisis, examiners frequently worked in partnership with the banks they examined. They were a resource, a help in interpreting often ambiguous guidance. Where corrections were needed, opportunity was given to make them, and compliance was a mutual goal. This was the model of examination I followed when I was an examiner. I believed then and still believe today it is the best means of achieving safety and soundness without interfering with the business of lending. Currently, the relationships are too often adversarial. Understandably, an examiner does not want to be blamed for the next crisis. Examiners are not evaluated on banks' contributions to the economy. At all costs, they want to avoid a bank failure that would put a black mark on their record. The examiner's incentive is to err on the side of writing down too many loans, demanding too much capital.

The crisis was not caused by a failure to adequately examine community banks, but examiners have reacted to the crisis with overreaching exams that have harmed the economy and made it harder to emerge from the recession.

A particularly frustrating aspect of the exam environment is the disconnect between the examiners in the field and the directives from Washington. A November 2008, Interagency Statement on Meeting the Needs of Creditworthy Borrowers established a national policy for banks to extend credit to creditworthy borrowers in order to help initiate and sustain an economic recovery. It stated, "The agencies expect all banking organizations to fulfill their fundamental role in the economy as intermediaries of credit to businesses, consumers, and other creditworthy borrowers." Unfortunately, this policy is often neglected by examiners in the field, especially in the regions most severely affected by the recession. Field examiners are second guessing bankers and independent professional appraisers. They are demanding unreasonably aggressive write-downs and reclassifications of viable commercial real estate loans and other assets. The misplaced zeal of these examiners is having a chilling effect on lending. Good loan opportunities are passed over for fear of examiner write-down and the resulting loss of income and capital. The contraction in credit is having a direct, adverse impact on the recovery.

Furthermore, examiners are demanding capital levels higher than those required by regulation. To bankers, the process feels arbitrary and punitive. Many community banks complain that the required capital level goalpost is unpredictable. Regulators simply keep moving it further, making it nearly impossible to satisfy capital demands in a difficult economy and capital marketplace. So bankers are forced to pull in their horns and pass up sound loan opportunities in order to preserve capital. This is not helpful for their communities and economic growth. Bankers used to expect prompt feedback that they could act on immediately as part of the exam process. Quick, useful feedback has been replaced by examination reports that follow months after the examiner's visit, with no opportunity for the banker to sit down with the examiner, go over the results, and respond to the examiner's concerns on the spot.

Legislative Help Is Needed

ICBA supports legislation to bring more consistency to the examination process. With regard to loan classifications, for example, one of community bankers' greatest concerns, a bill recently introduced in the House would establish criteria for determining when a loan is performing and thereby provide for more consistent classifications. When loans become troubled often the best course for the borrower, lender, and the community is a modification that will keep the loan out of foreclosure. But in recent years, many examiners have penalized loan modifications by aggressively placing loans on nonaccrual 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. Representative Bill Posey's Common Sense Economic Recovery Act of 2011 (H.R. 1723) would establish conservative, commonsense criteria for loan classifications.

Community bankers enthusiastically support this bill because it resonates with their experience in examination. It would give bankers flexibility to work with struggling but viable borrowers and help them maintain the capital they need to support their communities. We hope a counterpart bill will soon be introduced in the Senate and considered by this Committee.

Consumer Financial Protection Bureau

The new Consumer Financial Protection Bureau (CFPB) presents another potential challenge to the safety and soundness of community banks, which will be subject to its rules though institutions with less than $10 billion in assets are exempt from primary examination. Because the CFPB is not charged with protecting safety and soundness, and does not have experience or expertise in this area, there is a real risk CFPB rules could promote consumer protection at the expense of safety and soundness. For example, any rule that interferes with a bank's ability to price for risk in a given product, or that disrupts an important revenue stream, could compromise safety and soundness. Prudential regulators, on the other hand, have long experience with regulating consumer protection in the context of safety and soundness. This is why ICBA supports legislation that would give prudential regulators a stronger voice in CFPB rulemaking.

There are different ways of accomplishing this. One example is a bill recently passed by the House Financial Services Committee. The Consumer Financial Protection Safety and Soundness Improvement Act, sponsored by Representative Sean Duffy, would strengthen prudential regulatory review of CFPB rules, which is extremely limited under the Dodd-Frank Act. Prudential regulators have the ability to comment on CFPB proposals before they are released for comment and an extremely limited ability to veto regulations before they become final. This veto can only be exercised if, by a ⅔ vote, the Financial Stability Oversight Council (FSOC) determines that a rule "puts at risk the safety and soundness of the banking system or the stability of the financial system," a standard that is nearly impossible to meet. A rule that doesn't meet this high standard could nevertheless do extraordinary harm to banks and consumers. H.R. 1315 would change the voting requirement for an FSOC veto to a simple majority, excluding the CFPB Director, and change the standard to allow for a veto of a rule that "is inconsistent with the safe and sound operations of United States financial institutions." While this change would improve CFPB rulemaking, ICBA has proposed language that would further broaden the standard to allow FSOC to veto a rule that could adversely impact a subset of the industry in a disproportionate way. We believe that this standard would give prudential regulators a more meaningful role in CFPB rule writing.

Communities First Act

The ICBA-backed Communities First Act (CFA, H.R. 1697) captures many reforms the community banking sector deems necessary to alleviate the difficult regulatory burden they face, including a change to the FSOC veto standard for CFPB rules very similar to H.R. 1315 discussed above. This legislation was recently introduced in the House and cosponsored by members from both sides of the aisle. ICBA is working to introduce a similar bill 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.
- Reduce the paperwork burden that acts as a dead-weight cost for community banks, consuming scarce resources that could support lending.
- Defer taxation of interest on long-term certificates of deposits and tax the interest at capital gains rates so more consumers are rewarded for saving and investing.
- 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.

These and other provisions would improve the regulatory environment and community bank viability, to the benefit of their customers and communities.

Moral Hazard and Too-Big-To-Fail Institutions

The greatest threat to safety and soundness remains the too-big-to-fail institutions that dominate the financial services sector. Today, the four largest banking companies control more than 40 percent of the Nation's deposits and more than 50

percent of the assets held by U.S. banks. The largest banks have grown larger since the financial crisis. The ten largest hold 77 percent of all U.S. bank assets compared with 55 percent of total assets in 2002, according to a recent Bloomberg study. ICBA does not believe it is in the public interest to have 10 institutions controlling a significant majority of the assets of the banking industry. A more diverse financial system would reduce risk and promote competition, innovation, and the availability of credit to consumers of various means and businesses of all sizes.

As a result of the financial crisis, our Nation went through an agonizing series of forced buy-outs or mergers of some of the Nation's largest banking and investment houses, costing American taxpayers hundreds of billions of dollars. Some mega-institutions—too-big-to-fail and also too big-to-be-sold to another firm—were directly propped up by the Government. One large institution, Lehman Brothers, was allowed to go bankrupt, with disastrous consequences that only confirmed the policy of too-big-to-fail. The doctrine of too-big—or too-interconnected—to-fail finally came home to roost, to the detriment of the American taxpayer and our economy. Our Nation cannot afford to go through that again. Systemic risk institutions that are too big or interconnected to manage, regulate or fail should either be broken up or required to divest assets until they no longer pose systemic risk.

In a speech made as the country was emerging from the crisis, Federal Reserve Chairman Ben S. Bernanke outlined the risks of the too-big-to-fail system:

> The belief of market participants that a particular firm is considered too big to fail has many undesirable effects. For instance, it reduces market discipline and encourages excessive risk-taking by the firm. It also provides an artificial incentive for firms to grow in order to be perceived as too big to fail. And it creates an unlevel playing field with smaller firms, which may not be regarded as having implicit Government support. Moreover, Government rescues of too-big-to-fail firms can be costly to taxpayers, as we have seen recently. Indeed, in the present crisis, the too-big-to-fail issue has emerged as an enormous problem.

Unfortunately, Government interventions necessitated by the too-big-to-fail policy have exacerbated rather than abated the long-term problems in our financial structure. Through Federal Reserve and Treasury orchestrated mergers, acquisitions and closures, the big have become bigger. A recent Bloomberg Government study concluded that the number of too-big-to-fail banks will increase by 40 percent over the next 15 years.

Government efforts to stabilize the financial system, though necessary to stave off a full scale financial collapse and even deeper recession, were deeply unfair to community banks. The Government bailed out too-big-to-fail institutions, while the FDIC summarily closed too-small-to-save institutions, victims of a crisis created on Wall Street. Community bankers across the country were deeply angered by the results of too big to fail.

This is why ICBA generally supports the too-big-to-fail measures in the Dodd-Frank Act. These include measures to prevent firms from getting too big; offset the advantages of being too big; more diligent monitoring for systemic risk; subject large, interconnected firms to enhanced capital and prudential standards; and create a resolution authority for large firms so the Government is never again forced to choose between propping up a failing firm and allowing it to fail and wreak havoc on the financial system. However, whether the Dodd-Frank Act will succeed in ending the market perception that large, interconnected firms are too big to fail will largely depend on the implementing rules and how diligently they are enforced in the coming months and years.

Housing Finance Reform, If Not Done Properly, Could Lead to Industry Concentration

Key aspects of the housing finance system—the rules governing underwriting, risk retention, servicing, foreclosure, securitization, and the structure of secondary market entities—are facing review and revision. This is an expected and appropriate response to the housing-driven financial and economic crisis we've just experienced. But we must recognize that ill-considered changes—singly and cumulatively across a number of areas—could unintentionally reduce competition, amplify moral hazard, and jeopardize safety and soundness. Specifically:

- The agencies "qualified residential mortgage" (QRM) exemption from the Dodd-Frank risk retention requirement on mortgages sold and securitized should be sufficiently broad to encompass the majority of the residential mortgage market, consistent with stronger underwriting standards. Because risk retention will require increased capital, which will pose a challenge for community banks, a narrow definition of QRM will drive thousands of community banks and other lend-

ers from the residential mortgage market, leaving it to the largest lenders whose actions brought about the financial crisis. In our view, the QRM definition currently proposed by the banking agencies, which includes a 20 percent downpayment requirement, is too narrow.

- While policy makers are rightly alarmed by the sloppy and abusive servicing standards of some large lenders, they must recognize that community banks have fundamentally different standards, practices, and risks. With smaller servicing portfolios, better control of mortgage documents, and close ties to their customers and communities, community banks have generally been able to identify repayment problems at the first signs of distress and work out mutually agreeable solutions with struggling borrowers. Overly prescriptive servicing requirements—a burden for community banks which do not have the staffing and financial resources to implement extensive new programs—could cause many community banks to exit the mortgage servicing business and accelerate consolidation of the servicing industry with only the largest too-big-to-fail lenders surviving.
- As proposals for replacing Fannie Mae and Freddie Mac are considered, policy makers should be extremely careful not to recreate the moral hazard they represented. Some of the proposals put forward would, by allowing just a small number of large banks to dominate the secondary mortgage market, create a new variety of moral hazard, just as pernicious as the old variety. Any solution that fuels consolidation is only setting up the financial system for an even bigger collapse than the one we've just been through.

Policy makers must proceed with caution in housing finance reform. The mortgage market is critical to the broader economy, as we learned during the recent crisis, and the potential for unintended consequences is significant.

Conclusion

Thank you again for convening this hearing and giving ICBA the opportunity to testify. We share your commitment to enhancing the safety and soundness of our financial system and hope that the community bank perspective has been valuable.

PREPARED STATEMENT OF FRANK A. SUELLENTROP

CHAIRMAN AND PRESIDENT, LEGACY BANK, COLWICH, KANSAS

JUNE 15, 2011

Chairman Brown, Ranking Member Corker, and Members of the Subcommittee, thank you for the opportunity to testify before you today regarding the topic of "Enhancing Safety and Soundness: Lessons Learned and Opportunities for Continued Improvement."

My name is Frank Suellentrop and I am President and Chairman of Legacy Bank in Colwich, Kansas. We are a $250 million closely held community bank providing banking services to the area of Sedgwick County, Kansas. We have five branch locations: our charter bank location in Colwich, Kansas, population 1,400, and four branch locations in the Wichita, Kansas, community.

Our bank was established in February 1886, which means that we are celebrating 125 years in 2011. I am fourth generation President of our bank with over 38 years of employment at Legacy Bank. I have been President of our bank since 1991. From that experience, I have seen the beginnings of consumer regulation in the early 1970s, the agriculture crisis, the savings and loan and real estate crisis of the 1980s and early 1990s, and now, the Wall Street-induced real estate crisis of 2008.

Legacy Bank is significantly involved in residential development, residential construction, and commercial property lending and therefore, has been impacted greatly by the economic slowdown and depressed real estate market values. Fortunately, the economy in the Wichita, Kansas, area has fared reasonably well throughout the current crisis relative to other markets, primarily due to the fact that Kansas, specifically Wichita, had not experienced inflated real estate values of the past decade.

I would like to preface my comments regarding a recent examination by saying that I understand examiners are charged with a difficult task. On one hand, they are expected to protect against bank failures, insure consumer compliance and regulation are adhered to, satisfy community groups and organizations demand for fair banking practices, and Congressional demands for banking/financial oversight. On the other hand, regulators are/should be tasked with not interfering with a bank's corporate mission of creating value for its shareholders. Legacy Bank is a "for-profit" corporation. Our most recent 2010 examination revealed stark differences from prior exams: higher capital and liquidity standards, more demanding asset quality eval-

uations, expectations for higher allowance for loan and lease loss reserves (ALLL), and increased focus on management assessment and compensation practices.

Comments made by regulators during our last exam include, "We don't like your risk profile" and "We're not going 'to bat' for you in Washington." To put the first comment in context, our bank has been a lender to residential real estate developers, homebuilders, and commercial property owners since the late 1980s. We feel our lending staff has the experience and knowledge to manage our loan portfolio composition. These comments were significantly more aggressive compared to prior examination observations. Due to recent failures or problem banks in other areas of the country, our lending "risk profile" is now unacceptable. In addition to standard loan underwriting criteria of evaluating a borrower's capital, collateral, capacity to repay, and market conditions, we have added a new component to our loan approval discussion process—"Will the loan pass examiners' review and approval?" This component should not be a loan approval consideration. A customer's loan request should be based on its viability and productive value. With respect to the latter comment, it illustrates a regulatory attitude that all banks in real estate lending are unsafe and unsound in their practices.

Banks are evaluated based on their CAMELS component ratings, which measures a bank's capital, asset quality, management, earnings, liquidity, and sensitivity to interest rates. My comments on each of these bank evaluation components under the current regulatory environment are provided below.

Capital

Capital standards for most banks are being dictated above levels for regulatory defined "well-capitalized' banks and standards required for our Nation's largest financial institutions. Regulators are using their discretionary capital standards caveat to demand capital levels above those banks defined as "well-capitalized." Capital below the mandated Tier-One and risk-based levels are likely to receive a lower "capital component," which may subject banks to a "troubled bank" status. Discretionary capital standards create a difficult moving target for banks as we seek to achieve an acceptable capital component rating.

Asset Quality

Examiners are slow to recognize when credit risk has been mitigated. Classifications are inconsistent. No credit given for past performance of the borrower. Some classifications are backdated after the borrower begins to show improvement.

Management

Management compensation is now being reviewed by examiners, suggesting potential negative impact to earnings and capital. Without significant discussion during our last examination, examiner comments dictated a requirement that we justify management compensation and benefits. Somehow "Wall Street" excesses on executive pay have crept into regulators view of "Main Street" banking compensation practices when there is no valid comparison to their abuses.

Earnings

Earnings evaluations are focused on budget expectations and provide a source of capital growth. Budgets are a fluid document where changes occur relative to changing market conditions. Variances occur throughout the year and are detailed in monthly review of performance *vs.* a rebudgeting process as suggested by an examiner.

Liquidity

Current examination expectations dictate a higher level of liquidity to protect against the "what ifs" for funding assets. Examiners are reluctant to recognize the value of purchased funding costs *vs.* core deposit funding. Levels of purchased funding should be variable to the institution and not an industry standard.

At each examination, an Examiner in Charge (EIC) is designated. My experience with this practice is that often an EIC does not want to overrule another examiner's findings regarding loan quality issues or other components of an examination. On completion of an examination, EIC comments are submitted to a Review Examiner. The Review Examiner then does not want to overrule an EIC's submitted comments; therefore, the process can be problematic for bankers where an inexperienced or unqualified examiner's findings become a part of the "report of examination." These results then become a part of the final report for bank examination ratings and mandated actions to address findings. Only experienced examiners capable of managing others' activities should be designated as an "Examiner in Charge" to insure quality in a final report of examination. Recourse for bankers disputes regarding examination findings are often treated as we agree to disagree by examiners.

In summary, micromanaging is unproductive. Part of the regulator's role is to offer insight into latest industry trends and issues. Instead, exam outcomes now seem predetermined with enforcement actions imposed for minor issues that do not enhance a bank's viability. To move forward in a productive, mutually beneficial manner, there should be more focus on the root cause of examination findings. Examiners should expect results, but if capital is solid and management is capable, then overregulation is unnecessary. Regulatory burden and examiner expectations are disproportionate in their impact on community banks *vs.* the largest banks. Many community banks have a limited staff to respond to examiner expectations *vs.* the largest banks full-time staff devoted to regulatory compliance.

Thank you again for the opportunity to comment. I hope that this testimony provides productive insight into the current regulatory environment for community banks.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR REED FROM MICHAEL R. FOLEY

Q.1. What is the purpose of the Commercial Bank Examination Manual? While certain sections were updated in April (which was identified as "Supplement 35"), it appears that there has been no comprehensive review and update of the entire manual. Does the Federal Reserve intend to conduct a comprehensive rewrite of this manual? Why or why not?

A.1. Response not provided.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR MERKLEY FROM MICHAEL R. FOLEY

Q.1. *Examination Staffing*—Recent reports indicate the Federal banking agencies are increasing their on-site examination teams at the largest banks. For each of the six largest banking organizations that your agency respectively supervises today, please detail: (a) how many examiners you have had dedicated to supervising each such organization for each year beginning in 2005 through the present; (b) whether those examiners resided on-site at the firm's headquarters permanently, whether those examiners resided on-site occasionally for examination periods, or whether those examiners remained at the agency (and if so, which office/Reserve Bank); and (c) what the principal responsibilities of those examiners were (for example, data analysis of risk models, supervising management compliance with policies and procedures, *etc.*).

For those 6 largest banking organizations, please also quantify the number of personnel at each banking organization working in the risk management group, or the internal audit department.

A.1. Response not provided.

Q.2. *Examination Staffing*—Please provide specific detail regarding the methodology you used/use for determining how many examiners you dedicate to firms you supervise. Please provide other information relevant to staffing levels and practices for your examinations, such as the FTE examination hours applicable per $10 billion of assets at the 10 largest banking organizations and the FTE examination hours applicable for $10 billion of assets at all other banking organizations.

A.2. Response not provided.

Q.3. *Examination Staffing*—During the 2005 through 2010 period, please detail the dates on which peer reviews or other internal reviews were conducted within your organizations that evaluated the sufficiency of examination staffing for the six largest institutions under your supervision. Please state the staffing conclusions for each such peer review.

A.3. Response not provided.

Q.4. *Interagency Cooperation*—Senior examiners have indicated that the largest banking organizations run their businesses without respect to the legal entity involved, and that specific business operations can straddle entities with different regulatory jurisdictions. In light of Dodd-Frank, how has the communication among agencies changed? When multiple regulators oversee a banking or-

ganization, what procedures do you have in place to review and follow-up on concerns raised by one regulator when such concerns may touch upon oversight conducted by other regulators or the entire firm?

A.4. Response not provided.

Q.5. *Investigations*—The HUD Inspector General has recently issued findings that at least one major financial institution has obstructed a State attorneys general investigation and a HUD investigation into foreclosure and servicing abuses. What specific steps have you taken to ensure that all institutions under your supervision are complying with both your supervision and with relevant investigations by other regulatory agencies and law enforcement officials?

A.5. Response not provided.

Q.6. *Documentation Oversight*—Following the robosigning scandal and the difficulty some banks have had documenting the claim of ownership on mortgages on which they are pursuing foreclosure, what steps have you taken to increase oversight of documentation requirements at large complex financial institutions?

A.6. Response not provided.

Q.7. *International*—What systems do you have in place or do you envision needing to ensure the proper supervision of large complex foreign financial institutions which either operate in the U.S. or which materially affect U.S. financial markets?

A.7. Response not provided.

Q.8. *Trading Book*—For the firms that now make up the six largest bank holding companies, what percentage of losses by those firms on a consolidated basis during the 2008 financial crisis were due to losses in their respective trading books as opposed to their banking books? Please include within that analysis assets which would have been losses had those assets not been transferred from the trading book to the banking book and therefore not subject to fair value accounting. Also include in those losses assets or positions that were placed on the books of that national bank, after the outbreak of the crisis, such as the liquidity puts that were used to bring back CDQs onto a bank's balance sheet.

Please provide relevant data/analysis as appropriate.

A.8. Response not provided.

Q.9. *Review of Trading Operations Under FRB Manuals*—Section 2030.3 of the Federal Reserve's Commercial Bank Examination Manual, in effect since March 1994, lists certain specific procedures that examiners are expected to conduct in their supervision of commercial banks' trading operations. For example it asks examiners to "test for compliance with policies, practices, procedures, and internal controls . . . " (#3); requests a series of schedules, including "an aged schedule of securities," "an aged schedule of trading account securities . . . held for trading or arbitrage purposes," "a schedule of loaned securities," *etc.* (#4); requests the examiner to "review customer ledgers, securities position ledgers, *etc.*, and analyze the soundness of the bank's trading practices by . . . reviewing a representative sample of agency and contemporaneous prin-

cipal trades . . . and reviewing significant inventory positions taken since the prior examination" (#9).

Today, some of the largest bank holding companies conduct their derivatives trading operations directly through Federal Reserve-regulated member banks. How frequently do examiners conduct the reviews directed by section 2030.3? Under what circumstances will you discipline an examination team for failing to follow policies and procedures set out in agency manuals—please describe up to three examples?

A.9. Response not provided.

Q.10. *Safety and Soundness Review of Trading Operations*—The Federal Reserve Trading and Capital Markets manual sets out a wide range of approaches to monitoring firms' trading activities, in particular focusing on whether firms have in place policies and procedures to monitor risks. As part of this monitoring of risks, on what occasions might you make an independent evaluation of the trading positions themselves on a safety and soundness basis, rather than simply the policies and procedures regarding risk management?

For example, the former CEO of one large banking group said he couldn't be bothered with his firm's $43 billion dollar exposure on subprime CDOs because he had a $2 trillion balance sheet to manage. However, that $43 billion dollar exposure represented ⅓ of the group's capital. Meanwhile, community bank examiners regularly examine the substance of large loans for conformance with safety and soundness. Under what circumstances would a trading position such as the one outlined above be reviewed for the underlying risk by your examiners? Please detail at least three examples in the last 5 years.

How has oversight of trading activities changed between prefinancial crisis and now?

A.10. Response not provided.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN BROWN FROM DAVID K. WILSON

Q.1. In a speech in London yesterday, Acting Comptroller Walsh cited a 2007 study which stated that "there is widespread agreement in the theoretical academic literature that the immediate effects of constraining capital standards are likely to be a reduction in total lending and accompanying increases in market loan rates and substitution away from lending to holding alternative assets." If this was true prior to the financial crisis, when this study was conducted, it is no longer the case today. There now appears to be widespread agreement that equity is not expensive and that increased capital buffers are a good thing.

In August of 2010, Professor Anat Admati and several of her colleagues published a paper explaining that requiring banks to increase their funding through equity will not contract lending.

David Scharfstein and Jeremy Stein of Harvard University argued last September in the *Financial Times* that increased capital will make institutions safer, and actually reduce the risk of a credit crunch.

A study by the Bank for International Settlements suggests an optimal capital ratio of about 13 percent.

A Government-sponsored panel in Switzerland has said that massive banks UBS and Credit Suisse should hold a 19 percent capital buffer.

The Bank of England is reportedly considering capital ratios as high as 20 percent.

In his recent testimony before the Congressional Oversight Panel of TARP (COP), Professor Allan Meltzer noted that large banks in the 1920s held capital equal to 15 to 20 percent of their assets.

In response to written questions pursuant to a February hearing in the Senate Banking Committee, FDIC Chairman Sheila Bair stated, "we do not agree that the new [capital] requirements will reduce the availability of credit or significantly raise borrowing costs."

a. Do you believe that equity is expensive despite the work of respected academics showing that it is not?

b. What are the costs of increasing banks funding through equity?

c. What other evidence, aside from the study cited by Mr. Walsh, supports your conclusion that banks increasing their equity funding would be expensive and contract lending?

d. Does the OCC have any evidence suggesting that the alleged costs of additional equity funding outweigh the costs associated with undercapitalization at rates below those required by Basel III combined with an additional SIFI capital buffer?

e. What does the OCC believe to be the optimum capital buffer?

A.1. Response not provided.

Q.2. According to a June 12th report in the *Financial Times,* OCC data shows that nearly 20 percent of private label mortgage-backed securities held by banks are at least 30 days late or in some stage of foreclosure. Amherst Securities estimates that 30 percent of mortgages contained in PLS held by outside investors are at least 60 days delinquent.

The COP estimates that, at the end of the third quarter 2010, the four largest banks reported $420.0 billion in second lien mortgages. The OCC sent a letter to Representative Brad Miller in December in which you estimated that banks' total losses on second liens would not exceed $18 billion.

COP estimates that banks are subject to $52 billion in mortgage-backed security put-back claims. Institutional Risk Analytics estimates that JPMorgan Chase alone is subject to $50 billion in investor claims under the Securities Act.

a. What losses does the OCCproject the banks to incur on their private label MBS holdings? Please provide a specific number, and please explain the assumptions and rationale behind your calculation.

b. What losses does the OCC project banks to incur on their second lien portfolios? Please provide a specific number, and please explain the assumptions and rationale behind your calculation.

c. What losses does the OCC project banks to incur through investors' securities claims? Please provide a specific number, and

please explain the assumptions and rationale behind your calculation.

A.2. Response not provided.

Q.3. In February, Acting Comptroller Walsh testified that "[mortgage servicing] deficiencies have resulted in violations of State and local foreclosure laws, regulations, or rules."

a. In written questions for that hearing I asked Mr. Walsh what specific laws, regulations, or rules were violated. The only specific laws cited were State attestation and notarization laws. In a subsequent answer, he noted violations of the Servicemembers Civil Relief Act, bankruptcy law, and mortgage modification programs.

i. Please list all of the violations of specific laws, regulations, or rules—either local, State, or Federal—that your reviews uncovered.

ii. How many violations of each law, regulation, or rule did you uncover?

b. The Treasury Department was unable to determine in 18.8 percent of Bank of America's HAMP files whether a second look had been conducted, and there were income miscalculations in 22 percent of cases. The numbers for JPMorgan Chase were 11.3 percent and 31 percent, respectively.

Mr. Walsh noted in his written responses that "Documents in the foreclosure files may not have disclosed certain facts that might have led examiners to conclude that a foreclosure should not have proceeded however, such as misapplication of payments that could have precipitated a foreclosure action or oral communications between the borrower and servicer staff that were not documented in the foreclosure file."

i. What other errors did you uncover in your reviews that might have led examiners to conclude that a foreclosure should not have proceeded? Please describe every error that you uncovered.

ii. How many files reviewed by the OCC contained such errors?

A.3. Response not provided.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR REED FROM DAVID K. WILSON

Q.1. Please provide a response to May 12, 2011, questions that were submitted to the Office of the Comptroller of the Currency (OCC). No response has been received to date.

A.1. Response not provided.

Q.2. What is the purpose of the Comptroller's Handbook? What revisions have been made to the Comptroller's Handbook to address observations from the financial crisis? When will there be a comprehensive rewrite?

A.2. Response not provided.

Q.3. Please describe the specific changes you have made to the training programs for examiners in response to matters observed during the financial crisis.

A.3. Response not provided.

Q.4. What reliance do you place on a bank's internal control system? What basis do you have for that reliance? Describe what work

the OCC has done to be assured that there are no significant weaknesses the agency is inherently relying on.

Please describe any meetings that the OCC has had with the Public Company Accounting Oversight Board (PCAOB) to discuss any weaknesses the OCC identified in the internal control? Please indicate the date of such meetings and the substance of the matters discussed.

Please describe any meetings that the OCC has had with the Securities and Exchange Commission (SEC) about such weaknesses. Please indicate the date of such meetings and the substance of the matters discussed.

A.4. Response not provided.

Q.5. Describe the facts and circumstances, if any, that may prevent principal reduction, whether structured as forbearance or forgiveness, from being considered as a viable option in mortgage modifications. Please indicate whether the agency has taken any position with respect to mortgage servicer accounting for all forms of mortgage modifications. Please include any guidance provided to servicers or other regulators, including the date and substance of the guidance provided.

A.5. Response not provided.

Q.6. Describe the facts, circumstances, and relevant accounting guidance that applies to accounting for mortgage modifications by mortgage servicers. Please provide internal or external guidance.

A.6. Response not provided.

Q.7. Describe the facts, circumstances, and relevant accounting guidance that concerns servicers consolidation of securitization trusts. Please describe the total mix of information considered, including all quantitative and qualitative factors, with respect to defining "significance." Please indicate the reasons that servicers have or have not consolidated securitization trusts as a result of recently implemented generally accepted accounting principles (including SFAS Nos. 166 and 167). Please include specific discussion of anticipated losses as a result of servicer conduct that is the subject of the OCC Consent Orders and other reviews.

A.7. Response not provided.

Q.8. Provide the data that serves as the basis for the statement made by Mr. Walsh on June 21, 2011, "Capital levels are now extraordinarily high by historical standards." Please include the period of time considered and the relevant quantitative measure at each interval.

A.8. Response not provided.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR MERKLEY FROM DAVID K. WILSON

Q.1. *Examination Staffing*—Recent reports indicate the Federal banking agencies are increasing their on-site examination teams at the largest banks. For each of the six largest banking organizations that your agency respectively supervises today, please detail: (a) how many examiners you have had dedicated to supervising each such organization for each year beginning in 2005 through the

present; (b) whether those examiners resided on-site at the firm's headquarters permanently, whether those examiners resided on-site occasionally for examination periods, or whether those examiners remained at the agency (and if so, which office/Reserve Bank); and (c) what the principal responsibilities of those examiners were (for example, data analysis of risk models, supervising management compliance with policies and procedures, *etc.*).

For those 6 largest banking organizations, please also quantify the number of personnel at each banking organization working in the risk management group, or the internal audit department.

A.1. Response not provided.

Q.2. *Examination Staffing*—Please provide specific detail regarding the methodology you used/use for determining how many examiners you dedicate to firms you supervise. Please provide other information relevant to staffing levels and practices for your examinations, such as the FTE examination hours applicable per $10 billion of assets at the 10 largest banking organizations and the FTE examination hours applicable for $10 billion of assets at all other banking organizations.

A.2. Response not provided.

Q.3. *Examination Staffing*—During the 2005 through 2010 period, please detail the dates on which peer reviews or other internal reviews were conducted within your organizations that evaluated the sufficiency of examination staffing for the six largest institutions under your supervision. Please state the staffing conclusions for each such peer review.

A.3. Response not provided.

Q.4. *Interagency Cooperation*—Senior examiners have indicated that the largest banking organizations run their businesses without respect to the legal entity involved, and that specific business operations can straddle entities with different regulatory jurisdictions. In light of Dodd-Frank, how has the communication among agencies changed? When multiple regulators oversee a banking organization, what procedures do you have in place to review and follow-up on concerns raised by one regulator when such concerns may touch upon oversight conducted by other regulators or the entire firm?

A.4. Response not provided.

Q.5. *Investigations*—The HUD Inspector General has recently issued findings that at least one major financial institution has obstructed a State attorneys general investigation and a HUD investigation into foreclosure and servicing abuses. What specific steps have you taken to ensure that all institutions under your supervision are complying with both your supervision and with relevant investigations by other regulatory agencies and law enforcement officials?

A.5. Response not provided.

Q.6. *Documentation Oversight*—Following the robosigning scandal and the difficulty some banks have had documenting the claim of ownership on mortgages on which they are pursuing foreclosure,

what steps have you taken to increase oversight of documentation requirements at large complex financial institutions?

A.6. Response not provided.

Q.7. *International*—What systems do you have in place or do you envision needing to ensure the proper supervision of large complex foreign financial institutions which either operate in the U.S. or which materially affect U.S. financial markets?

A.7. Response not provided.

Q.8. *Trading Book*—For the firms that now make up the six largest bank holding companies, what percentage of losses by those firms on a consolidated basis during the 2008 financial crisis were due to losses in their respective trading books as opposed to their banking books? Please include within that analysis assets which would have been losses had those assets not been transferred from the trading book to the banking book and therefore not subject to fair value accounting. Also include in those losses assets or positions that were placed on the books of that national bank, after the outbreak of the crisis, such as the liquidity puts that were used to bring back CDQs onto a bank's balance sheet.

Please provide relevant data/analysis as appropriate.

A.8. Response not provided.

Q.9. *Review of Trading Operations Under FRB Manuals*—Section 2030.3 of the Federal Reserve's Commercial Bank Examination Manual, in effect since March 1994, lists certain specific procedures that examiners are expected to conduct in their supervision of commercial banks' trading operations. For example it asks examiners to "test for compliance with policies, practices, procedures, and internal controls . . . " (#3); requests a series of schedules, including "an aged schedule of securities," "an aged schedule of trading account securities . . . held for trading or arbitrage purposes," "a schedule of loaned securities," *etc.* (#4); requests the examiner to "review customer ledgers, securities position ledgers, *etc.*, and analyze the soundness of the bank's trading practices by . . . reviewing a representative sample of agency and contemporaneous principal trades . . . and reviewing significant inventory positions taken since the prior examination" (#9).

Today, some of the largest bank holding companies conduct their derivatives trading operations directly through Federal Reserve-regulated member banks. How frequently do examiners conduct the reviews directed by section 2030.3? Under what circumstances will you discipline an examination team for failing to follow policies and procedures set out in agency manuals—please describe up to three examples?

A.9. Response not provided.

Q.10. *Safety and Soundness Review of Trading Operations*—The Federal Reserve Trading and Capital Markets manual sets out a wide range of approaches to monitoring firms' trading activities, in particular focusing on whether firms have in place policies and procedures to monitor risks. As part of this monitoring of risks, on what occasions might you make an independent evaluation of the trading positions themselves on a safety and soundness basis, rath-

er than simply the policies and procedures regarding risk management?

For example, the former CEO of one large banking group said he couldn't be bothered with his firm's $43 billion dollar exposure on subprime CDOs because he had a $2 trillion balance sheet to manage. However, that $43 billion dollar exposure represented ⅓ of the group's capital. Meanwhile, community bank examiners regularly examine the substance of large loans for conformance with safety and soundness. Under what circumstances would a trading position such as the one outlined above be reviewed for the underlying risk by your examiners? Please detail at least three examples in the last 5 years.

How has oversight of trading activities changed between prefinancial crisis and now?

A.10. Response not provided.

Q.11. Your testimony on page 24 [*Editor*: See, Page 51, Part D, of this hearing] regarding section 619 suggests a narrow view of proprietary trading that seems to envision a world wherein all proprietary trading occurs on distinct, separate stand-alone proprietary trading desks.

Please provide details on what, if any, analysis the OCC has made on the conflicts of interest and risks to institutions from proprietary trading wherever it may occur, and particularly that which occurs on market-making desks and in other business units of a firm, such as securitization-structured product underwriting and merchant banking.

For example, the U.S. Permanent Subcommittee on Investigations found that large, conflicted proprietary trading activities of one firm occurred on its mortgage desks, which were non- stand-alone proprietary trading desks. How does the OCC identify those conflicts and risks now and what new forms of oversight are you contemplating putting in place to ensure the statutory intent of section 619 is implemented?

A.11. Response not provided.

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

STATEMENT SUBMITTED BY THE AMERICAN BANKERS ASSOCIATION

Chairman Brown, Ranking Member Corker, and Members of the Subcommittee, the American Bankers Association appreciates the opportunity to submit this statement for the record on ways to enhance safety and soundness in the aftermath of the financial crisis. 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.

The topic of this hearing is very important. In an effort to deal with the aftermath of the financial crisis, the response by Congress and the regulators has been to drive out all the risk from the system in the name of safety and soundness. This has meant that good loans that could and should be made are left unfunded. The pendulum has swung too far in favor of tighter regulation, micromanagement, and second-guessing. This has made the daily efforts of banks to make credit and financial services available much more difficult. Combined with hundreds of new regulations expected from the Dodd-Frank Act, these pressures are slowly but surely strangling traditional community banks, handicapping their ability to meet the credit needs of communities across the country.

Congress must be vigilant in overseeing regulatory actions that unnecessarily restrict loans to creditworthy borrowers. Holding oversight hearings like this one is critical to ensure that banks are allowed to do what they do best—namely, meet the credit needs of their communities.

For banks to be successful and meet the needs of their customers, they need to be profitable. *There is no better assurance of safety and soundness than a healthy, profitable industry.* Once again, Congress and the regulators have acted to reduce sources of income, made it much harder to raise capital, and threaten to drive some banks completely out of business lines, such as acting as municipal advisors or making residential mortgage loans.

One of those very important sources of income that will be significantly diminished is a direct result of the Durbin Amendment in the Dodd-Frank Act that imposes severe restrictions on interchange prices. The ABA and the thousands of banks we represent were deeply disappointed with the outcome of Senate vote last week. Failure to approve the bipartisan amendment sponsored by Senators Tester (D–Mont.), Corker (R–Tenn.), and others to address the serious concerns over the interchange amendment marks a dark day for every bank that issues debit cards and for consumers that have come to rely on them.

American consumers will now have to pay more for basic banking services, while big-box retailers go off and count their unjustified profits. Community banks—the backbone of local communities—will suffer the most. They will see a reduction in a key source of revenue that allows them to offer low-cost banking services to everyday consumers and supports lending and fraud protection measures. Key banking regulators—including Federal Reserve Board Chairman Ben Bernanke and FDIC Chairwoman Sheila Bair—have unequivocally stated that small banks will be harmed by the implementation of the Durbin Amendment. While a majority of Senators supported the Tester/Corker amendment, it is simply unconscionable that the Senate will not complete the work and protect community banks from this destructive effect.

It is within the Federal Reserve's power to mitigate the disastrous consequences that are sure to come from this policy initiative, and we urge the Fed to take all necessary action to do so.

The entire banking industry thanks Senators Tester and Corker—and the other 52 senators that stood up for debit card customers—for their extraordinary effort to address this serious problem in a constructive and deliberate way.

The remainder of this statement focuses on several key issues:

- Driving all the risk out of the system means slower economic and job growth;
- Access to New Capital for Community Banks is Problematic; and
- Restrictions may drive banks out of some lines of business altogether.

I. Driving All the Risk out of the System Means Slower Economic and Job Growth

ABA believes that it is a mistake for policy makers to apply the most restrictive approach to every bank. By swinging the pendulum too far in the direction of minimizing risk, the Dodd-Frank Act risks choking off important banking activity that can and should be done by banks—particularly by banks that had no hand in creating the financial crisis. It is important to keep that pendulum close to the center in order to encourage diversity and innovation.

The health of the banking industry and the economic strength of the Nation's communities are closely interwoven. ABA strongly believes that our communities cannot reach their full potential without the local presence of a bank—a bank that understands the financial and credit needs of its citizens, businesses, and Government. This model will collapse under the massive weight of new rules and regulations. The vast majority of banks never made an exotic mortgage loan or took on excessive risks. They had nothing to do with the events that led to the financial crisis and are as much victims of the devastation as the rest of the economy. These banks are the survivors of the problems, yet they are the ones that pay the price for the mess that others created.

Managing this mountain of regulation will be a significant challenge for a bank of any size. For the median-sized bank with only 37 employees this burden will be overwhelming. The new rules create more pressure to hire additional compliance staff, not customer-facing staff. They mean more money spent on outside lawyers to manage the risk of compliance errors and litigation. They mean more money to hire consulting firms to assist with the implementation of all of the changes, and more money to hire outside auditors to verify there are no compliance errors. They mean more risk of regulatory scrutiny, which can include penalties and fines. All of these expenditures take away precious resources that could be better used serving the bank's community.

The consequences are real. Costs are rising, access to capital is limited, and revenue sources have been severely cut. It means that fewer loans get made. It means a weaker economy. It means slower job growth. With the regulatory overreaction, piles of new laws, and uncertainty about Government's role in the day-to-day business of banking, meeting local community needs is difficult at best. Without quick and bold action to relieve regulatory burden we will witness an appalling contraction of the banking industry.

II. Access to New Capital for Community Banks Is Problematic

Banks have to be profitable and provide a reasonable return to investors. If they do not, capital quickly flows to other industries that have higher returns. Capital is critical as it is the foundation upon which all lending is built. Having sufficient capital is critical to support lending and to absorb losses when loans are not repaid. In fact, $1 worth of capital supports up to $10 in loans. Most banks entered this economic downturn with a great deal of capital, but the downward spiral of the economy has created losses and stressed capital levels. Not surprisingly, when the economy is weak, new sources of capital are scarce.

The timing of the Dodd-Frank limitations on sources of capital could not have been worse, as banks struggle to replace capital used to absorb losses brought on by the recession. While the market for trust preferred securities (which had been an important source of capital for many community banks) is moribund at the moment, the industry needs the flexibility to raise capital through various means in order to meet increasing demands for capital. Moreover, the lack of readily available capital comes at a time when restrictions on interchange and higher operating expenses from Dodd-Frank have already made building capital through retained earnings more difficult.

These limitations are bad enough on their own, but the consequences are exacerbated by bank regulators piling on new requests for even greater levels of capital. Many community banks have told us that regulators are pressing banks to increase capital-to-assets ratios by as much as 4 to 6 percentage points—50 to 75 percent—above minimum standards. For many banks, it seems like whatever level of capital they have, it is not enough to satisfy the regulators. This is excess capital not able to be redeployed into the market for economic growth.

Thus, to maintain or increase capital-to-assets levels demanded by the regulators, these *banks have been forced to limit, or even reduce, their lending.* The result: the banking industry becomes smaller while loans become more expensive and harder to get.

While more capital certainly can improve safety and soundness, it ignores the fundamental fact that banks are in the business of taking risk—every loan made runs the risk of not being repaid. Ever-increasing demands for more capital are dragging down credit availability at the worst possible time for our Nation's recovery. Moreover, it works at cross purposes with banks' need for the strong and sustainable earnings that will be the key to addressing asset quality challenges. *Therefore, anything that relieves the increasing regulatory demands for more capital will help banks make the loans that are needed for our Nation's recovery.*

III. Regulatory Risk and Uncertainty Are Rising, Reducing Incentive To Lend

Businesses—including banks—cannot operate in an environment of uncertainty. Unfortunately, Dodd-Frank increases uncertainty for banks, and as a consequence, raises credit risks, raises litigation risks and costs (for even minor compliance issues), leads to less hiring or even a reduction in staff, makes hedging risks more difficult and costly, and restricts new business outreach. All of this translates into less willingness to make loans. In fact, banks' biggest risk has become regulatory risk. Four examples help to illustrate this increase in regulatory risk and uncertainty:

First, the nature and extent of rules from the Consumer Financial Protection Bureau are unknown, but uncertainty about the potential actions creates potential litigation risk as actions taken today may conflict with the changes in rules devised by the Bureau. The expectation of significant new disclosures, for example, translates into less willingness to lend (and therefore less credit extended overall), and higher costs to borrowers that still have access to credit to cover the added risks and expenses assumed by banks.

A second important example of uncertainty and unease created by Dodd-Frank arises from the provisions regarding preemption. Congress explicitly preserved in the Dodd-Frank Act the test for preemption articulated by the United States Supreme Court for deciding when a State law is preempted by the Federal laws that govern national banks' activities. Nevertheless, any mention of the preemption standard in a statute is likely to generate lawsuits from those who argue that the standard somehow has changed. The Dodd-Frank Act preemption provisions will affect all banks, including State-chartered banks and thrifts that benefit from wildcard statutes. State attorneys general will have greater authority to enforce rules and regulations, specifically including those promulgated by the Consumer Financial Protection Bureau. The potential changes and risk of litigation necessarily reduce the willingness of banks to lend to any business or individual with less than a stellar credit history.

Third, Government involvement in price controls—such as the Durbin Amendment on interchange fees—sets a dangerous precedent, suggesting that financial institutions may be subject to future, unknowable price controls on other financial products and services, undermining important free-market principles. Banks have always accepted the operational, reputational, and financial risk associated with developing new products and services and making them available to millions of consumers. Now financial institutions risk losing their investments of billions of dollars into improvements of existing products and services, and the creation of new ones, through Government price controls. Why would any business invest in an innovative product knowing the Government *ex post facto* will interfere by imposing price controls? The Durbin Amendment serves as a strong disincentive for innovation and investment by financial institutions in other emerging payment systems and financial products and services. In the end, it is the American public who suffers.

The fourth uncertainty relates to the implementation of the swap rules. Banks do not know yet how the swaps exchanges will operate, what impact the clearing requirements will have on banks' ability to customize swaps, or even which banks and transactions will be subject to each of the new rules. For example, while other end users will be exempt from complex and costly clearing requirements, we are waiting to find out if our community banks will receive the same treatment. If not, then these banks might not be able to use swaps and the end result would be reduced lending, increased risk for banks, and higher costs for customers if banks cannot hedge the risk.

We urge Congress to actively oversee the Commodity Futures Trading Commission (CFTC) and SEC as they implement the new swaps requirements to be sure there are no adverse affects on lending or competition for U.S. banks. *We also encourage Congress to enact legislation explicitly granting small banks the same exemption from swaps clearing requirements that is available to other end users.*

IV. Restrictions May Drive Banks Out of Some Lines of Business Altogether

Safety and soundness is best protected when banks are able to meet the credit needs of their customers. This is what is so disturbing about the implementation of some rules under Dodd-Frank that would effectively drive banks out of lines of businesses altogether. This not only hurts the customers, but also means less income—and less diversified sources of income—that forms the base of financial health for any bank. New rules on registration as municipal advisors and on mortgage lending are two particularly problematic provisions.

Proposed SEC municipal advisor rules could limit banking options for State and local governments.

ABA believes that Dodd-Frank intended to establish a regulatory scheme for unregulated persons providing advice to municipalities with respect to municipal derivatives, guaranteed investment contracts, investment strategies or the issuance of municipal securities. Most community banks do not deal in bonds or securities. But banks do offer public sector customers banking services and are regulated closely by several Government agencies.

The Securities and Exchange Commission has proposed a very broad definition of "investment strategies" that would cover traditional bank products and services such as deposit accounts, cash management products and loans to municipalities. This means that community banks would have to register as municipal advisors and be subject to a whole new layer of regulation on bank products for no meaningful public purpose. The result of this duplicative and costly regulation is that banks may decide not to provide banking services to their local municipalities—forcing these local and State entities to look outside of their community for the services they need. This proposal flies in the face of the President's initiative to streamline Federal oversight and avoid new regulations that impede innovation, diminish U.S. competitiveness, and restrain job creation and economic expansion.

We urge Congress to oversee this implementation and ensure that the rule addresses *unregulated* parties and that *neither* Section 975 of Dodd-Frank nor its implementing regulation reaches through to traditional bank products and services.

New proposed mortgage rules likely to drive many community banks out of mortgage lending.

ABA has grave concerns that the risk retention proposal issued by the regulators will drive many banks from mortgage lending and shut many borrowers out of the credit market entirely. Responding to widespread objections from consumer groups, banks, and Senators and Congressman, the regulators extended the comment period from June 10th to August 1st. While more time for commenting on such a far reaching regulatory proposal is welcome, what is really necessary is for the rule to be withdrawn in its current form and substantially reconsidered.

It is true that the proposal's immediate impact is muted by the fact that loans sold to Fannie Mae and Freddie Mac while they are in conservatorship escape risk retention. However, once the rule's requirements are imposed broadly on the market (should they be adopted) they would likely shut out many borrowers entirely and act to destabilize the housing market once again. Since it is also the stated goal of both the Congress and the Administration to end the conservatorship of Fannie and Freddie, it is important that risk retention requirements be rational and nondisruptive when they are applied broadly to the market. The rule as proposed does not meet those tests.

Therefore, ABA urges Congress to ensure that the regulators revise the risk retention regulation before it is imposed on the mortgage market broadly. Specifically we recommend:

Exemption from risk retention provisions must reflect changes in the market already imposed through other legislative and regulatory change.

In the Dodd-Frank Act, Congress determined that some form of risk retention was desirable to ensure that participants in a mortgage securitization transaction had so-called "skin in the game." The goal was to create incentives for originators to assure proper underwriting (*e.g.,* ability to repay) and incentives to control default risk for participants beyond the origination stage. There have already been dramatic changes to the regulations governing mortgages. The result is that mortgage loans with lower risk characteristics—which include most mortgage loans being made by community banks today—should be exempted from the risk retention requirements—regardless of whether sold to Fannie Mae and Freddie Mac or to private securitizers.

Exempting such "qualified residential mortgage" loans (QRM) is important to ensure the stability and recovery of the mortgage market and also to avoid capital requirements not necessary to address systemic issues. However, the QRM as proposed is very narrow and many high-quality loans posing little risk will end up being excluded. This will inevitably mean that fewer borrowers will qualify for loans to purchase or refinance a home. Instead, the QRM definition should more closely align with the proposed QM definition promulgated by the Federal Reserve Board. The QM definition (as proposed) focuses on a borrower's ability to repay and allows originators to measure that ability with traditional underwriting tools. The proposed QRM rule, in contrast, takes most underwriting decisions away from originators in favor of rigid loan to value and other targets.

For example, for the loan to qualify for QRM status, borrowers must make at least a 20 percent downpayment—and at least 25 percent if the mortgage is a refinancing (and 30 percent if it is a cash-out refinance).

Certainly loans with lower loan-to-value (LTV) ratios are likely to have lower default rates, and we agree that this is one of a number of characteristics to be considered. However, the LTV should not be the only characteristic for eligibility as a "Qualified Residential Mortgage," and it should not be considered in isolation. Setting the QRM cutoff at a specific LTV without regard to other loan characteristics or features, including credit enhancements such as private mortgage insurance, will lead to an unnecessary restriction of credit. To illustrate the severity of the proposal, even with private mortgage insurance, loans with less than 20 percent down will not qualify for the QRM.

ABA strongly believes that creating a narrow definition of QRM is an inappropriate method for achieving the desired underwriting reforms intended by Dodd-Frank.

The Risk Retention Requirements as proposed will inhibit the return of private capital to the marketplace and will make ending the conservatorship of Fannie Mae and Freddie Mac more difficult.

The proposal presented by the regulators will make it vastly more difficult to end the conservatorship of Fannie and Freddie and to shrink FHA back to a more rational portion of the mortgage market. As noted above, under the proposed rule, loans with a Federal guarantee are exempt from risk retention—which includes loans sold to Fannie Mae and Freddie Mac while they are in conservatorship and backed by the Federal Government. FHA loans (as well as other federally insured and guaranteed loan programs) are also exempt. Since almost 100 percent of new loans today being sold are bought by Fannie and Freddie or insured by FHA—and as long as these GSEs can buy loans without risk retention—it will be dramatically more difficult for private securitizers to compete. In fact, the economic incentives of the proposed risk retention strongly favor sales of mortgages to the GSEs in conservatorship and not to private securitizers. Thus, this proposal does not foster the growth of private label securitizations that would reduce the role of Government in backing loans.

Equally important is the fact that the conservatorship situation is unsustainable over the long term. That means that eventually, these highly narrow and restrictive rules would apply to a much, much larger segment of the mortgage market. That means that fewer borrowers will qualify for these QRM mortgage loans and the risk retention rules make it less likely that community banks will underwrite non-QRM—but prudent and safe—loans. Some community banks may stop providing mortgages altogether as the requirements and compliance costs make such a service unreasonable without considerable volume. Driving community banks from the mortgage marketplace would be counterproductive as they have proven to be responsible underwriters that have served their borrowers and communities well. Instead of exempting the GSEs from risk retention, the QRM should also factor in the underwriting requirements of the GSEs. If a loan meets those requirements (which we anticipate will evolve to conform with any new QM definition) and is thus eligible for purchase by the GSEs, it should also be exempt from risk retention requirements. More closely conforming the QM, QRM, and GSE standards will set the foundation for a coherent and sustainable secondary mortgage market.

The imposition of risk retention requirements to improve underwriting of mortgage loans is a significant change to the operation of the mortgage markets and must not be undertaken lightly. ABA urges Congress to exercise its oversight authority to assure that rules adopted are consistent with the intent of the statute and will not have adverse consequences for the housing market and mortgage credit availability.

Conclusion

Safety and soundness is best protected by created an environment where banks can make good business decisions and take prudent risks. Unfortunately, the pendulum has shifted too far in favor of driving out risk entirely and constant second-guessing of banks' decisions.

Ultimately, it is consumers that bear the consequences of Government imposed restrictions. The loss of interchange income will certainly mean higher costs of using debit cards for consumers. Greater mortgage restrictions and the lack of certainty on safe harbors for qualified mortgages means that community banks may no longer make mortgage loans or certainly not as many. Higher compliance costs mean more time and effort devoted to Government regulations and less time for our communities. Increased expenses often translate into layoffs within the bank.

This all makes it harder to meet the needs of our communities. Jobs and local economic growth will slow as these impediments inevitably reduce the credit that can be provided and the cost of credit that is supplied. Fewer loans mean fewer jobs. Access to credit will be limited, leaving many promising ideas from entrepreneurs without funding. Capital moves to other industries, further limiting the ability of banks to grow. Since banks and communities grow together, the restrictions that limit one necessarily limit the other.

Lack of earning potential, regulatory fatigue, lack of access to capital, limited resources to compete, inability to enhance shareholder value, and return on investment, all push community banks to sell. The Dodd-Frank Act drives all of these in the wrong direction and is leading to consolidations. The consequences for local communities are real.

The regulatory burden from Dodd-Frank and the excessive regulatory second-guessing must be addressed in order to give all banks a fighting chance to maintain long-term viability and meet the needs of local communities everywhere.