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WASHINGTON — The battle between community banks and their examiners is about to heat up again on Capitol Hill. The banking industry is strongly supporting a new bipartisan bill that would allow banks to appeal examination findings to an outside arbiter as well as provide new guidelines for examiners regarding commercial loans.

Although regulators are staying quiet in public, they seem likely to strongly oppose the bill unless significant changes are made. A regulatory source said the current draft may have a negative impact on banks' safety and soundness.

But lawmakers say the legislation is necessary because of ongoing banker complaints that examiners are being too tough- effectively preventing many institutions from lending. Rep. Shelley Moore Capito, a co-sponsor of the bill and chairman of the House financial institutions subcommittee, said in an interview that regulators are applying their exam standards inconsistently, effectively curbing economic growth. "Are we putting our small institutions in a position where they're really in a position to lend to small businesses?" she asked. She is supported by Rep. Carolyn Maloney, the subcommittee's lead Democrat, who made a similar argument during a recent hearing on the issue. "All of us have heard from financial institutions in our districts that examiners — especially in this difficult economic time — have been unrealistic in their demands for them to build capital reserves in very short periods of time," said Maloney.

Earlier this month, Capito and Maloney teamed up to defeat a separate bill sponsored by Rep. Bill Posey, R-Fla. That legislation drew opposition from both the Federal Deposit Insurance Corp. and the Office of the Comptroller of the Currency, which argued that it would have weakened regulatory accounting standards. But there remains concern among both Republicans and some Democrats that overzealous and inconsistent examiners are hindering bank lending. "I think it's the inconsistencies across the regulatory area," Capito said. "I think it crosses party lines, it crosses regional concerns." Capito and Maloney said their bill does not go as far as the earlier measure, which prevented examiners from classifying a loan as nonaccrual if it met certain standards. The new bill instead would provide regulators with guidelines on how and when to classify commercial loans. "We're trying to really work with the guidance that's already out there," Capito said. Regulators are unlikely to buy that argument. Spokesmen for the OCC and FDIC would not comment for this article, saying they are still reviewing the text of the legislation.

The bill has two main parts. First, it would establish a series of examination standards that would give banks more time to try to deal with commercial loans that are presenting problems. For example, the bill would bar an examiner from placing a commercial loan into non-accrual status solely because the loan's collateral has deteriorated in value. Regulators view this kind of measure as forbearance, allowing problems to multiply instead of forcing a bank to take earlier action. While not taking a public position on the new bill, past testimony from the regulators makes it clear they would oppose it. At a hearing on Posey's bill in July, George French, deputy director of the FDIC's division of risk management supervision, testified that changing regulatory capital standards to allow banks to treat certain loans as non-accrual loans would result in those banks reporting higher regulatory capital than Generally Accepted Accounting Principles would allow. "Such regulatory capital forbearance would detract from investors' confidence in the reliability of all banks' financial statements," French testified. "Moreover, historical experience has been that policies to systematically delay the recognition of bank losses can ultimately increase losses to the FDIC Deposit Insurance Fund, and thus the cost that healthy banks pay for their deposit insurance premiums." The second part of the bill would set up a new ombudsman's office at the Federal Financial Institutions Examination Council, the interagency group that establishes uniform standards for bank exams. Banks could appeal examination findings to the new ombudsman's office, with the hope of getting a more sympathetic hearing outside of the agency that conducted the exam. An additional appeal to an administrative law judge would also be possible. This process would be in addition to an existing appeals process, under which banks can appeal findings to an ombudsman within the agency that conducted the exam. Under the proposal, banks would have a choice about which appeals process to pursue. Regulators are likely to oppose this provision, too, because it effectively allows FFIEC staff to override an examiner's ruling.

Industry representatives, however, argue it's needed because the existing appeal process is flawed. Jason Kratovil, vice president of congressional relations at the Independent Community Bankers of America, said an appeal only invites later retribution from the bank's regulator. "It's a process that's simply not worth a community banker's time," Kratovil said. "Their eyes start to roll. You hear little snorts and chuckles." Floyd Stoner, executive vice president for congressional relations and public policy at the American Bankers Association, said that he does not believe the new appeals process would be used frequently. "In fact, we would hope that it wouldn't be," he said. "We believe that its existence would help ensure that the actual appeals would not be needed."

The bill, known as the Financial Institutions Examination Fairness and Reform Act, currently has 17 co-sponsors, 15 of whom are Republicans. A congressional hearing on the bill is expected early next year.