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TESTIMONY OF
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Before the

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT
COMMITTEE ON FINANCIAL SERVICES
U. S. HOUSE OF REPRESENTATIVES

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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.

Introduction

Chairman Capito and members of the Subcommittee, my name is Gil Barker and I am the Deputy Comptroller for the Southern District of the Office of the Comptroller of the Currency (OCC). In this position, I oversee the supervision of more than 550 national community banks – including 29 of the 244 banks chartered in Georgia. I am also responsible for supervising 109 federal savings associations, including 16 in Georgia. I appreciate the opportunity to appear today to discuss the OCC’s supervision of national banks and federal savings associations (herein after referred to as “banks”), including the steps we take to ensure that our supervision is balanced, fair, and consistent with OCC policies and guidance.

I have been a commissioned national bank examiner for 29 years. For almost my entire career, I have been involved in the direct supervision of community banks, so I have a deep appreciation for the challenges that those bankers face.

Community banks play a crucial role in providing consumers and small businesses in communities across the nation with essential financial services as well as the credit that is critical to economic growth and job creation. A primary goal of our supervision is to ensure that community banks have the strength and capacity to meet the credit needs of their customers and communities. Fundamentally, the best way to ensure that banks are making credit available in their communities is to assure that they are safe and sound and have sufficient capital available to support lending to creditworthy borrowers. Thus, a key part of our job is to work with bankers to ensure that they recognize and address problems at the earliest possible stage when remedial action is

likely to be most effective. The simple truth is that seriously troubled banks cannot effectively meet the needs of their local communities.

I understand that some bankers believe they are receiving mixed messages from regulators about the need to make loans to creditworthy customers while at the same time being subject to what some have termed as “overzealous” regulatory examinations. In particular, some bankers have stated that their ability to meet the needs of their communities is being constrained by what they regard as overly aggressive regulatory loan classifications and the substitution of examiner judgment for that of bank management. I appreciate this opportunity to address these concerns and to explain the OCC’s policies, and how examiners apply those policies, when assessing a bank’s loan portfolio. These assessments are a core component of our examinations, and we strive to make sure that they are fair, balanced, and consistent over time and across institutions. I believe that the OCC examiners I supervise are striking the right balance in encouraging bankers to make loans to creditworthy borrowers, but to also identify and address problem credits.

My testimony discusses the OCC’s examination policies and procedures and our recent supervisory guidance to encourage bankers to make prudent loans and to work constructively with troubled borrowers. I then discuss how we structure and carry out our examinations at the local level to ensure consistency and balance in examiners’ assessments. With this background, I then describe our supervisory approach to assessing loan quality and performance, and address some of the common issues we hear from bankers about examiners’ actions. I close with a short discussion of the process we use when a bank’s condition becomes so impaired that we must work with the FDIC to

find a least cost resolution of the bank, consistent with the Prompt Corrective Action (PCA) provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991, or “FDICIA.”

Let me begin, however, by acknowledging the challenging environment that community bankers are facing. Although community bank profitability, as measured by return on equity, has improved in recent quarters after precipitous declines in 2008 and 2009, returns remain sharply below historical averages. For example, only 52 percent of the national community banks and 50 percent of the federally chartered savings associations in Georgia were profitable in 2010. A major factor contributing to the decline in profitability is the continued pressure on community banks’ net interest margins. Tepid loan demand and the low interest rate environment are contributing to the decline in these margins: as loans and investments mature, banks are forced to replace them with lower yielding assets. While the rates banks pay for certificates of deposit and other funding sources have also declined, many core deposits are already at extremely low rates, leaving little room for further declines. Lending activity – the primary revenue source for community banks – has been hampered by the overall economic climate. Although it is true that many bankers have adjusted and tightened some of their credit underwriting standards, most of the community bankers I talk to reiterate that lending is the backbone of their business and that they are seeking to make loans to creditworthy borrowers. We continue to encourage bankers to lend to such borrowers, but in many areas and sectors, loan demand remains weak. For example, the NFIB Research Foundation’s recent report, “*Financing Small Business – Small Business and Credit Access*,” noted that while small business financing conditions have deteriorated over the

last two to three years, the small business problem has been, and remains, weak sales, followed by continued problems in the housing and real estate sectors.¹

The strains in the economy and most notably in the real estate sector resulted in a substantial increase in the number of problem institutions and bank failures in recent years. For example, since the current down cycle began at the end of 2007, 67 insured-depository institutions have failed in Georgia. Of these, 10 were federally chartered by the OCC or OTS, and 57 were chartered by the state of Georgia. While there are signs that the number and severity of new problem institutions is abating, there remain banks whose condition has been severely affected by the combination of high levels of problem loans and impaired capital. Some of these institutions will be able to find strong buyers – in some instances with our assistance – that will enable them to avoid failure and resolution by the FDIC. But that will not always be possible. In that circumstance, our goal, consistent with the provisions of FDICIA, is to facilitate the FDIC’s early and least cost resolution of the bank with a minimum disruption to its customers and community.

In this environment, some have talked about the need for regulatory “forbearance,” where supervisors allow troubled banks to ignore credit problems in the hope they will go away over time. This is not permissible under generally accepted accounting principles. Nor would it be advisable. As the savings and loan crisis of the 1980s demonstrated, regulatory forbearance, by delaying the recognition of problems, can ultimately make those problems and their cost of resolution far worse.² The savings

¹ See: NFIB Research Foundation, “Financing Small Business – Small Business and Access to Credit,” January 2011, page 5.

² The Congressional Budget Office staff memorandum, “The Cost of Forbearance During the Thrift Crisis,” 1991, estimated that regulatory forbearance increased the cost of resolving the thrift crisis by \$66 billion.

and loan experience caused Congress to enact the PCA regulatory regime in FDICIA that expressly rejects regulatory forbearance.

OCC's Examination Policies, Procedures, and Supervisory Guidance

The OCC has a consistent examination philosophy and structure that is used at all banks. We will be applying this same philosophy at the thrifts that we supervise. This approach includes a uniform risk assessment system that evaluates each bank's risk profile across eight risk areas – compliance, credit, interest rate, liquidity, operational, price, reputation, and strategic – and assigns an overall composite and component ratings on a bank's capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risks using the interagency Uniform Financial Institution Rating System (CAMELS).

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. In other words, while the OCC generally holds all of the banks it regulates to the same set of standards and regulations, the methods and controls banks use to implement those standards may vary, based on their size and complexity. As the complexity and scope of a bank's activities increase, so do our expectations for their internal controls and risk management systems. To reflect these differences in expectations, we have two sets of core examination procedures – one for community banks and one for larger, more complex banks.

The OCC has worked with the other federal banking agencies to encourage bankers to work with and extend credit to creditworthy borrowers. In November 2008, we and the other federal banking agencies issued the *Interagency Statement on Meeting*

*the Needs of Creditworthy Borrowers*³ that underscored the crucial role that prudent bank lending practices play in promoting our nation's economic welfare and the importance of bankers and regulators working together to meet the needs of creditworthy borrowers.

Given the concerns expressed about how examiners were assessing troubled commercial real estate loans, we and the other banking regulators issued guidance in October 2009 to provide greater clarity and certainty to the industry and examiners on our policies and expectations for commercial real estate (CRE) loan workouts.⁴ The guidance provided real world examples that our examiners were confronting to help promote consistency in how examiners apply key supervisory principles. We followed that guidance with interagency conference calls with the industry and discussed its implementation in a nationwide call with our examiners. To help assess the effectiveness of this guidance, the federal banking agencies and the Conference of State Bank Supervisors conducted a survey in 2010 to gain a better understanding of how institutions were working with creditworthy CRE borrowers affected by economic and market difficulties. Approximately 97 percent of the survey respondents indicated that the CRE policy statement had been helpful, and nearly 88 percent indicated there were not any specific regulatory policies that were impeding their ability to work constructively with troubled CRE borrowers.

In February 2010, the OCC and other agencies issued the *Interagency Statement on Meeting the Credit Needs of Creditworthy Small Business Borrowers*,⁵ which

³ See: OCC News Release 2008-131 at: <http://occ.gov/news-issuances/news-releases/2008/nr-ia-2008-131.html>.

⁴ See: "Policy Statement on Commercial Real Estate Loan Workouts," at: <http://www.occ.treas.gov/ftp/release/2009-128a.pdf>.

⁵ See: OCC Bulletin 2010-6, "*Small Business Lending: Meeting the Credit Needs of Creditworthy Small Business Borrowers*," available at: <http://www.occ.gov/news-issuances/bulletins/2010/bulletin-2010-6.html>.

encourages prudent small business lending and emphasizes that examiners apply a balanced approach in evaluating loans.

OCC's Supervisory Structure to Ensure Consistency and Balance

The OCC's community bank supervision program is built around our local field offices located throughout the United States. In the Southern District, we have 21 offices in nine states. The primary responsibility for the supervision of individual community banks is delegated to the local Assistant Deputy Comptrollers (ADCs) who manage those field offices. We have two ADCs in Atlanta who oversee the supervision of national banks and federal savings associations operating in Georgia. These ADCs report to an Associate Deputy Comptroller, who reports directly to me. Each individual bank is assigned to an examiner who monitors the bank's condition on an on-going basis and who serves as the focal point for communications with the bank.

Our structure ensures that community banks receive the benefits of highly-trained bank examiners with local knowledge and experience, along with the resources and specialized expertise that a nationwide organization can provide. While our bank supervision policies and procedures establish a common framework and set of expectations, our examiners are taught to tailor their supervision of each community bank to its individual risk profile, business model, and management strategies. As a result, our ADCs are given considerable decision-making authority, reflecting their experience, expertise, and their "on-the-ground" knowledge of the institutions they supervise.

To support our local examiners, we have district analysts who monitor and provide information on local markets and conditions within each district. This information, along with various databases and other analytical tools we use, allows us to

tailor our supervisory activities to unique challenges being faced within local economies and business sectors. For example, as the housing market began to deteriorate in Georgia, we adjusted our examination schedules to focus more attention on the banks that our analysis indicated had the greatest potential exposure to the downturn. We also redeployed our most experienced examiners to those institutions. Our goal in taking these actions was to identify potential problems at an early stage so that bank management would have time to take appropriate remedial actions.

The OCC has mechanisms in place to help ensure that our supervisory policies are applied to community banks in a consistent and balanced manner. Our examiners are alerted to new policy issuances via weekly updates. When warranted, we supplement these issuances with targeted supervisory memos that provide additional direction on how examiners should implement those policies or guidelines on a consistent basis across the country. These messages are reinforced and clarified through periodic national teleconferences with our field staff. Every report of examination is reviewed and signed off by an appropriate OCC manager before it is finalized. In those cases where significant issues are identified and an enforcement action is already in place, or is being contemplated, additional levels of review occur prior to finalizing the examination conclusions. We apply these same additional levels of review to a sample of institutions that are not subject to enforcement action in order to ensure our ADCs apply our standards consistently. We also have formal quality assurance processes that assess the effectiveness of our supervision and compliance with OCC policies through quarterly, randomly selected reviews of the supervisory record. The Enterprise Governance unit that reports directly to the Comptroller oversees this process. Finally, we have an active

outreach program in place that includes regular interaction with state banking associations and periodic interagency meetings with state and federal regulators. These sessions provide the opportunity for industry feedback on our supervision efforts and a chance to discuss common issues with other regulators.

OCC's Approach to Assessing Loan Quality and Performance

Given the central role that asset quality plays in a bank's overall safety and soundness, we expend considerable time and resources in providing training and guidance to our examiners on evaluating credit. Loan review and analysis, and the application of appropriate accounting principles, are focal points of every new examiner's classroom and on-the-job training. Topical booklets in *The Comptroller's Handbook* provide detailed examination procedures on various aspects of credit review and lending practices and are available on the OCC's Web site. Twice a year the Southern District conducts commercial credit roundtable meetings. These sessions include senior credit examiners from each of our field offices and focus on topical commercial credit issues throughout the district. After each meeting, the information and materials from these roundtables are shared and discussed with our examiners at each of our local field offices. We also offer a variety of continuing educational opportunities for more experienced examiners to ensure that their skills remain current and to keep them abreast of current supervisory policies and expectations and accounting standards. These include various interagency classroom and on-line training opportunities offered through the Federal Financial Institutions Examination Council and topical seminars and conferences.

OCC examiners review and assess a bank's loan portfolio during each examination cycle. The primary objectives of these reviews are threefold. First,

examiners assess whether the bank has adequate systems to identify, measure, monitor, and control the amount of credit risk in its loan portfolios. A key component of such systems is the process that the bank uses to monitor and rate the relative risk of its loans. Second, examiners assess whether the bank's financial statements accurately reflect the condition of its loan portfolios and conform to generally accepted accounting principles (GAAP) with regard to loan loss reserves, the accrual of interest income, and the reporting of troubled debt restructurings. Third, examiners assess whether the bank has adequate capital cushions to support the bank's lending activities and credit risk exposures.

When making these assessments, examiners first consider the adequacy of the bank's policies, procedures, and practices to ascertain the degree of reliance that we can place on the bank's own evaluations and assessments. Our goal is to review and confirm bank management's assessments, not to "second guess" or supplant their judgments with ours. Examiners confirm management's assessment through transaction testing of specific loans or loan portfolios. Where weaknesses or deviations from sound practices are found, examiners will direct bank management to take corrective action to ensure that the bank's lending practices are conducted in a safe and sound manner.

The OCC expects banks to have credit risk management systems that produce accurate and timely risk ratings. Well-managed credit risk rating systems promote bank safety and soundness by facilitating informed decision making on matters such as loan selection and underwriting standards, loan pricing, and maintaining adequate loan loss reserves and capital levels. Such systems also serve as important "early warning" indicators for bank management of when a borrower's or loan facility's performance may

be deteriorating and warrant additional action to improve the likelihood of continued performance. Such action may include a variety of measures, including modification of loan terms and obtaining additional collateral or other forms of support.

Bankers use a variety of systems to “grade” and risk-rate their loan portfolios. To provide consistency in the examination process, the OCC and other banking agencies use a common, uniform risk rating scale to identify problem credits. This regulatory classification system, which has been in use in some form since it was first established in 1938, consists of four levels of designations that identify different degrees of credit weakness, ranging from a potential problem to a more serious actual one.

Credit risk rating and loan classification are focused on ensuring that the credit risk of a bank’s loan portfolios is properly identified. Ensuring that those risks are properly reflected in the bank’s financial statements and asset valuations is the function of the bank’s loan accounting policies and procedures. Accurate and transparent financial statements are essential to allow investors, creditors, and regulators to evaluate a bank’s overall financial condition. Congress recognized and underscored the importance of ensuring that banks’ regulatory reports are accurate when it passed FDICIA in 1991. Section 121 of FDICIA requires that the accounting principles used for regulatory reporting should be no less stringent than GAAP.

When a loan or borrower shows signs of trouble, there are generally three key accounting concepts that bankers and examiners must consider: 1) whether the loan, for financial reporting statements, should continue to accrue interest or, conversely, be put on nonaccrual status; 2) whether, if the loan is subsequently modified, it should be reported as a “troubled debt restructuring” (TDR); and 3) whether the bank has properly and

adequately set aside loan loss reserves for any loan impairment.⁶ The OCC and other banking agencies' standards for applying these concepts are governed by GAAP and are contained in the instructions that banks must follow when filing their quarterly Consolidated Reports of Income and Condition (Call Reports).⁷

First, consistent with GAAP, Call Report instructions require that a loan be put on nonaccrual status when: 1) payment in full of principal or interest is not expected; or 2) principal or interest has been in default for a period of 90 days or more unless the asset is both well secured and in the process of collection. As a general rule, a nonaccrual loan may be restored to accrual status when: 1) none of its principal and interest is due and unpaid, and the bank can reasonably expect repayment of the remaining contractual principal and interest; or 2) when it otherwise becomes well secured and in the process of collection.

Second, under GAAP, a modification of a loan's terms constitutes a TDR if the bank, for economic or legal reasons related to the borrower's financial difficulties, grants a concession to the borrower that the bank would not otherwise consider.⁸ Likewise, designating a loan as a TDR does not, by itself, mean that the loan must be placed on nonaccrual. If the borrower has demonstrated performance under the previous terms and shows the capacity to continue to perform under the restructured terms, the loan will likely remain on accrual. If the borrower was materially delinquent on payments prior to the restructure, but shows potential capacity to meet the restructured terms, the loan

⁶ This discussion assumes that a bank's loan portfolio is accounted for on amortized or historical cost basis. There are some loans or portfolios that are reported at fair value, but the vast majority of loans, especially for community banks, are held at amortized cost.

⁷ The Thrift Financial Reports (TFRs) that savings associations currently file are also governed by GAAP. Beginning in the first quarter of 2012, savings associations will begin filing their financial reports using the same reports and instructions as commercial banks.

⁸ See: Accounting Standards Codification (ASC) 310-40, Receivables – Troubled Debt Restructurings by Creditors.

would likely remain on nonaccrual until the borrower has demonstrated a reasonable period of performance – generally at least six months.

Third, consistent with GAAP, the OCC expects banks to maintain an appropriate allowance for loan and lease losses (ALLL). An appropriate ALLL covers estimated credit losses on individually evaluated loans that are determined to be impaired as well as estimated credit losses inherent in the remainder of the loan and lease portfolio. Estimated credit losses mean an estimate of the current amount of loans that it is probable the bank will be unable to collect given facts and circumstances as of the evaluation date. When available information confirms that specific loans, or portions thereof, are uncollectable, those amounts should be promptly charged off against the ALLL.

Decisions about the proper classification, accrual, and TDR treatment of a loan is fact specific. The examples provided in the 2009 CRE policy statement were designed to provide greater transparency to bankers in how changes in underlying facts or assumptions may affect examiners' assessments. The OCC's Bank Accounting Advisory Series, available on our Web site, provides similar guidance to bankers and examiners by illustrating how various fact patterns will affect accrual, TDR, and ALLL determinations. These examples and fact patterns draw upon frequent issues that examiners encounter and are updated on a regular basis to reflect current situations and accounting standards.

Banker Concerns About Examiner Classification and Accrual Decisions

As we work through the current problems in the industry, our messages to examiners continue to be these: Take a balanced approach; communicate concerns and expectations clearly and consistently; and encourage bankers to work with troubled borrowers in a prudent manner and to extend new credit to creditworthy borrowers. This

does not mean that bankers can ignore or delay recognition of their credit problems. If a banker is unwilling or unable to take appropriate action to identify and manage the risks in the bank's credit portfolio as required by GAAP and established supervisory standards, examiners will then direct bank management to take corrective action. At institutions where bank management has not sufficiently identified or addressed their loan problems, our reviews may result in a bank needing to make additional loan loss provisions; to charge off loans that are deemed loss; or to place loans on nonaccrual where full collection of principal and interest is in doubt. Depending on the specific circumstances, the bank may also be directed to strengthen its credit underwriting or risk identification and management practices.

With this background, let me address some of the specific concerns we are hearing about examiners' actions.

- *Examiners are barring loans to certain borrowers or industries, or are criticizing loans simply because they are located in a state with a high mortgage foreclosure rate or to an industry experiencing problems.*

We expect banks to have robust credit underwriting and risk management processes which, among other things, monitor and control the bank's overall exposure to a particular borrower and industry segment. We also expect bankers to assess how borrowers, and their industries, may perform in stressed economic environments to ensure they will continue to have the capacity to perform under the terms of their loan obligations. However, examiners should not criticize loans simply because a borrower is located in a certain geographic region or operates in a certain industry. Each loan must be evaluated based on its own structure, terms, and the borrower's willingness and ability

to repay the loan under reasonable terms. Market conditions, however, can influence a borrower's repayment prospects and the cash flow potential of the business operations or underlying collateral, and these are factors that we expect bank management to consider when evaluating a loan.

- *The bank can no longer work with a borrower because the examiner has classified the borrower's loan.*

When a borrower's ability to repay its loan deteriorates or becomes impaired, we expect the bank to "classify" the loan to recognize the increased risk. This means that they move the borrower from a "pass" designation into one of three categories set forth in the agencies' uniform credit classification system based on the weaknesses in the credit and likelihood of the bank incurring some degree of loss. Although some bankers may infer that they are no longer allowed to extend credit to borrowers whose loans have been classified, this is simply not the OCC's position. We expect and, in fact, encourage bankers to continue working with "classified" borrowers who are viable. An increase in classified loans does not automatically trigger supervisory action – we expect banks to have higher classified loan ratios during economic downturns – provided that bank management is being realistic in its assessments, has reasonable workout plans, and is maintaining adequate loan loss reserves and capital ratios.

- *Examiners are classifying loans to borrowers who are current and can meet their debt obligation – what has sometimes been referred to as "performing non-performing" loans.*

The OCC does not direct banks to classify borrowers that have the demonstrated ability to service both interest and principal under reasonable payment schedules. There

are instances, however, where liberal underwriting structures can mask credit weaknesses that jeopardize repayment of the loan. The agencies' October 2009 policy statement on CRE loan workouts addresses these situations and provides examples of when classification would and would not be appropriate. One common example is bank-funded interest reserves on CRE projects, where the interest reserves are being used to keep the loan current, and expected leases or sales have not occurred as projected and property values have declined. In these cases, examiners will not just accept that the loan is good quality because it is current; instead, they will also evaluate the borrower's ability to make future payments required by the terms of the loan. While interest reserves on CRE loans are one common issue, there may be other examples, such as terms that require interest-only payments for extended periods, or the use of proceeds from other credit facilities to keep troubled loans current. Again, in these cases, examiners will consider the totality of the borrower's credit exposure and debt service obligations.

- *Examiners are criticizing loans or borrowers simply because the current market value of their collateral has declined and are forcing bankers to write down loans to current distressed market values.*

Examiners will not classify or write down loans solely because the value of the underlying collateral has declined to an amount that is less than the loan balance – a point that we reiterated in the October 2009 CRE policy statement and the 2010 interagency statement on small business lending. For many CRE projects, however, the value of the collateral and the repayment of the loan are both dependent on the cash flows that the underlying project is expected to generate. Because of this linkage, current collateral

values can be an important indicator of the project's viability and can signal changes that will adversely affect the cash flow available to service or repay the loan.

In making loan classification or write-down decisions, examiners first focus on the adequacy of cash flow available to service the debt, including cash flow from the operation of the collateral, support from financially responsible guarantors, or other bona fide repayment sources. However, if these sources do not exist, and the only likely repayment source is sale of the collateral, then examiners will direct the bank to write down the loan balances to the value of the collateral, less estimated costs to sell.

- *Examiners are unduly overreaching and are second guessing bankers and professional independent appraisers.*

One of the areas of greatest controversy during the last significant real estate downturn in the late 80's and early 90's was the practice of examiners making adjustments to real estate appraisals. We have taken steps to minimize the need for such adjustments during the current cycle. In 2008, in a nationwide teleconference and supervisory memo, we reiterated to examiners that it is management's responsibility to have updated borrower information and current real estate appraisals. We also noted that a new appraisal may not be necessary in instances where an internal evaluation by the bank appropriately updates the original appraisal assumptions to reflect current market conditions and provides an estimate of the collateral's fair value for impairment analysis. As noted in the October 2009 CRE policy statement, appropriately supported assumptions are to be given a reasonable degree of deference by examiners. The policy statement also provides guidance on the factors that examiners are to consider when assessing the reasonableness of those assumptions used for an appraisal or evaluation

Provided that the appraisal is reasonable, our examiners will not make adjustments or apply an additional haircut to the collateral.

- *Examiners are penalizing 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.*

As previously noted, determinations about a loan's accrual status are based on interest income recognition criteria in GAAP. For a loan that has been modified, if the borrower has demonstrated performance under the previous terms and shows the capacity to continue to perform under the restructured terms, the loan will likely remain on accrual. If the borrower was materially delinquent on payments prior to the restructure, but shows potential capacity to meet the restructured terms, the loan would likely remain on nonaccrual until the borrower has demonstrated a reasonable period of performance.

- *Examiners are arbitrarily applying de facto higher regulatory capital requirements, constraining banks' ability to lend.*

The recent financial crisis has underscored the importance of strong capital buffers in protecting a bank from unforeseen losses and stress events. It is the OCC's long-standing policy that regulatory capital requirements represent minimum capital levels, and that most banks will need to maintain capital levels above these minimums to support their banking activities. When assessing a bank's capital adequacy, examiners consider the bank's internal capital planning and allocation process and risk factors that are not explicitly captured by the agencies' risk-based capital regime. One critical factor is the degree and nature of concentrations that may exist in the bank's loan portfolio.

Concentrations of credit exposures that have a high degree of correlation with cyclical changes or economic events can accentuate a bank's risk exposure and therefore generally will require additional capital buffers.

In anticipation of rising credit losses, over the last two years the OCC has urged banks to build loan loss reserves and strengthen capital. Indeed, if a bank simply maintained its capital at the minimum level defined by regulation and then incurred unexpected losses, the resulting decline in its capital ratios could immediately trigger the provisions of PCA that would constrain the bank's activities. Thus, there are instances where we have directed, and will direct, bank management to maintain higher capital buffers if they choose to have significant risk concentrations. Such decisions, however, are not made unilaterally by a field examiner. Any such directive is reviewed and approved by our district supervision management teams.

OCC's Resolution of Problem Banks

At the OCC, the supervision of problem banks – those banks with a composite CAMELS⁹ rating of 3, 4, or 5 – is divided between experienced examiners in our districts and our Special Supervision Division located in Washington, D.C. Banks supervised from Washington include all 5-rated banks, 4-rated banks with total assets over \$1 billion, and any bank that our management team believes should be supervised by Special Supervision. All other problem banks are supervised by the district in which they are geographically located. The Special Supervision Division works to resolve critical problem banks, first through rehabilitation, or if that is not successful, through orderly

⁹ The CAMELS rating system is an interagency bank-rating system for bank supervisors to rate an institution's Capital adequacy, Asset quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk. Insured depository institutions are assigned a rating from 1 to 5 on each of these elements (with "1" being the highest or best rating), as well as an overall composite rating.

failure management. The Special Supervision Division monitors and consults with our district offices on the supervision of problem banks, and supports OCC supervisory objectives as an advisor and liaison to OCC management and field staff on emerging problem bank issues.

As a bank's condition becomes more troubled, or when we find weaknesses in its management processes, we use a variety of enforcement tools to achieve the corrective action needed to restore the bank's condition. The intent of enforcement action is to address problems or weaknesses at an early stage, before they develop into more serious supervisory issues or adversely affect the bank's performance and viability. This may mean taking action well before problems or weaknesses are reflected in a bank's financial condition. With respect to problem banks, our Enforcement Action Policy¹⁰ describes factors to be considered when assessing the situation and what action to take. The policy also describes formal and informal enforcement action options and the typical use of those actions based upon indicated factors. Formal enforcement action is often used if a bank has less than satisfactory management, or if there is uncertainty surrounding management and the board's ability or willingness to take corrective measures.

Each enforcement action is specifically tailored to the institution, and is designed to correct deficiencies and return the bank to a safe and sound condition as soon as possible. Once an enforcement action is taken, it is our policy to incorporate into the supervisory strategy an early assessment of the bank's efforts to comply with the action. This monitoring is critical to helping management and the board address the requirements of the action and achieve timely compliance. Where rehabilitation is unsuccessful,

¹⁰ OCC's Enforcement Action Policy describes the OCC's policy for taking appropriate enforcement action in response to violations of laws, rules, regulations, final agency orders, and/or unsafe and unsound practices or conditions and was publicly released as OCC Bulletin 2002-38.

consistent with the FDICIA, our goal is to effect early and “least cost” resolution of the institution.

The OCC has the authority to place a bank into receivership on the basis of capital inadequacy, specified unsafe and unsound practices, illiquidity, and other grounds specified in the Federal Deposit Insurance Act. The decision to place a bank into receivership is made with great care and must be approved by senior management at the OCC. We consider the overall viability of the bank including the status of efforts to recapitalize; earnings and liquidity trends; competence of the board and management; and the existence of other factors such as fraud or insider abuse, where delay in closing the bank would increase the cost to the FDIC Deposit Insurance Fund. Our decision to place a bank in receivership is supported by a fully developed administrative record that includes a supervisory analysis of the bank’s condition, history, and the applicable grounds for closing, along with a legal analysis of the sufficiency of the supervisory record to support the grounds for closing.

While we work closely with other regulators during all phases of problem bank resolution, our interaction is virtually continuous when a bank’s condition is deteriorating. When we have determined that a problem bank has exhausted all options, has no reasonable prospect for raising capital, is facing insurmountable liquidity problems, or for other reasons is no longer viable, the FDIC’s Division of Resolution and Receivership (DRR) joins our examiners on-site in the bank to begin preparing for receivership. The OCC’s goal is to provide DRR with the maximum amount of time possible to prepare for the closing in order to minimize both the disruption to the depositors and customers of the failed bank and the FDIC’s cost to resolve the bank.

Conclusion

The OCC's supervisory philosophy is to have open and frequent communication with the banks we supervise. My management team and I encourage any banker that has concerns about a particular examination finding to raise those concerns with his or her examination team. 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.

The OCC agrees that access to credit plays a vital role in restoring economic growth and jobs to our communities, and that banks should not be unduly constrained from meeting these credit needs. We are committed to supporting these goals with supervision that is balanced and fair and that does not cause bankers to become too conservative in their lending decisions. At the same time, however, we must avoid forbearance strategies that defer recognition of loss. History has demonstrated that forbearance is not a viable solution during times of economic stress because it leads to larger future losses and more severely troubled banks.