TESTIMONY OF

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BEFORE THE

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SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

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Good morning Chairwoman Capito, Ranking Member Maloney and members of the Subcommittee. Thank you for the opportunity to submit this statement for the hearing record. H.R. 3461 is important and valuable legislation that will help create checks and balances that have been largely lacking in the bank examination process. My focus today will be on the Ombudsman provisions.

The American Association of Bank Directors provides advocacy, informational and educational support for bank and savings institution directors.

Your hearing today and previous hearings on the bank examination process on August 16, July 8 and May 26, 2011 are extraordinarily important. They help to shed light on a process that often is shrouded in secrecy. Bank examiners can make life and death discretionary examination decisions. Public pronouncements by federal banking agency heads, while made in good faith to make the process more transparent, may not always be consistent with what may happen during and after an examination of an individual bank.

The federal banking agencies have had virtually unbridled and unchallenged discretion in how they examine banks.

Until recently, Congressional oversight of the bank examination process has been limited and lacked depth.

Banks may appeal examination results to the Ombudsman (or equivalent) of the agency that examines them, but many banks are reluctant to appeal for fear of retribution and others decide not to because they do not believe that the Ombudsman is truly independent of the agency.

Banks have no statutory right to appeal adverse results of an examination to a federal or state court.

The examiners in the field as well as some of their supervisors realize that if they err on the side of stringency, they will not be criticized. But they know that the Inspectors General of

the respective federal banking agencies will criticize them for not having identified problems earlier in banks that ultimately failed. The reports of the Inspectors General frequently criticize the primary federal banking regulator of the failed bank for not having identified and acted on deficiencies earlier, but never criticize the regulator for being too stringent.

Bank examiners have discretion on a wide array of matters, including whether to classify a loan, whether to place a loan in nonaccrual even though it is performing, and to substitute their own ALLL methodology for that of the bank. This is so even though a bank might have had reasonable systems and controls in the bank to make reasoned determinations of their own, or may have relied on qualified third party auditors or loan review advisors for their determinations.

Many of these decisions are judgment calls based on the facts and circumstances of the individual bank. It matters a great deal as to the extent to which examiners allow banks to exercise reasonable discretion in exercising their good faith judgment.

During good times, examiners and supervisors tend to give bankers some leeway in applying reasonable judgment as to these matters; but when the economy weakens, there is a greater tendency to substitute the examiners' judgment for that of the bankers. This is unfortunate since examiner judgments, in the aggregate, can make a recession deeper and longer than it needs to be. That is because a bank's financial condition will often dictate whether it can make loans to those who reside and do business in their community and because the uncertainty and unpredictability of examiner judgments make banks less willing to lend except in limited circumstances involving extraordinarily strong borrowers.

There are instances, rare I believe, where there is animosity between the examiners/supervisors and bank representatives that might have an impact on the subjective judgments that examiners and supervisors exercise during and after an examination. In those rare circumstances where emotions affect judgments, it is essential to have access to a fair and impartial arbiter.

We also know of circumstances where examiners from different federal banking agencies will treat contemporaneously the same participation loan differently. For example, a state nonmember bank's interest in the loan might be considered accruing, whereas a national bank's interest might be considered non-accruing, as determined by the examiners.

H.R. 3461 corrects some of the weaknesses in the current Ombudsman system.

It sets up a separate, central Ombudsman office at the FFIEC. This facilitates the uniform treatment of all banks and provides encouragement to banks that the appeal of the examination findings will be conducted by an office and individual who is not directly reporting to the agency head of the agency that conducted the examination.

The legislation establishes a right for a bank to seek an independent determination of the underlying facts through an administrative hearing before an independent administrative law judge. There is no such right currently. It is not clear in the current system to what extent the Ombudsmen of the federal banking agencies will delve into the underlying facts asserted by the examiners and supervisors in supporting their examination determinations.

H.R. 3461 also directs that the administrative law judge not defer to the opinions of the examiner or agency, but must independently determine the appropriateness of the agency's decision. Under the current Ombudsman system, it is not clear whether and to what extent the Ombudsmen defer to the opinions of the examiner or agency. The OCC's Ombudsman prepares annual reports of summaries of his decisions which shed light on the process, but we are not aware that the FDIC and Federal Reserve prepare such public reports.

Finally, the legislation will create a counterforce to the pressures that examiners and bank supervisors are under when the economy is in a downturn and the banks suffer losses. These pressures can result in the examiners and supervisors ignoring or devaluing the judgments of competent bankers whose banks happen to be suffering the consequences of a bad economy.