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TESTIMONY OF

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FOR MIDSIZE AND COMMUNITY BANK SUPERVISION

OFFICE OF THE COMPTROLLER OF THE CURRENCY

Before the

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

September 16, 2014

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.

I. Introduction

Chairman Johnson, Ranking Member Crapo, and members of the Committee, thank you for the opportunity to discuss the challenges facing community banks and actions that the Office of the Comptroller of the Currency (OCC) is taking to help them meet those challenges and remain a vibrant part of our nation's financial system. Consistent with the Committee's invitation letter, my testimony provides an overview of the OCC's supervisory program for small national banks and federal savings associations (hereafter referred to as community banks) and describes initiatives we have implemented to address their specific needs and concerns. These initiatives include offering a broader array of practical resources and tools that are tailored to community banks as well as refinements to our supervisory processes to improve, for example, the clarity and timeliness of supervisory reports and expectations. I also describe actions we have taken to tailor supervisory policies and regulations to recognize the business models of community banks while remaining faithful to safe and sound banking practices, statutory requirements, and legislative intent. These efforts include our ongoing Dodd-Frank Act related rulemakings, our decennial review of regulations to identify where they could be streamlined or eliminated, and our exploration of ways to provide more flexibility for federal savings associations to respond to the changing economic and business environment as well as to meet the needs of their communities.

Before describing these initiatives and actions, I would like to provide my perspective on community banks. Last month I assumed the role of Senior Deputy Comptroller for Midsize and Community Banks. In this role, I am responsible for the OCC's community bank supervision program that oversees approximately 1,400 institutions with assets under $1 billion. Previously, I served as the OCC's Deputy Comptroller of the Northeastern District where I was responsible for the oversight of more than 300 community banks.

Community banks play a crucial role in providing consumers and small businesses in communities across the nation with essential financial services and a source of credit that is critical to economic growth and job expansion. Throughout the country, community bankers help small businesses grow and thrive by offering "hands-on" counseling and credit products that are tailored to their specific needs. Community banks and their employees strengthen our communities by helping meet municipal finance needs and through their active participation in the civic life of their towns.

Community banks are important to the OCC. Approximately two-thirds of our examination staff is dedicated to the supervision of these institutions. In my previous role as deputy comptroller, and now as senior deputy comptroller, I regularly meet with community bankers to hear first-hand their successes, their challenges, and their frustrations. I have seen how well-managed community banks were able to weather the financial crisis and provide a steady source of credit to their local communities and businesses. But I've also heard the concerns expressed by many community bankers about the long-term viability of their business models and their frustration that too much of their time and resources are spent on trying to track and comply with an ever-expanding array of regulatory requirements rather than meeting with and responding to the needs of their customers and communities.

In my meetings with community bankers, I underscore the advantages they have over larger competitors because of their deep understanding of the unique needs of their local markets and customers and their ability to tailor their products to meet these needs. The willingness and ability of community bankers to work with their customers through good times and bad is one reason why local businesses rely on community banks. Following the recent financial crisis, we took a look at what factors enabled strong community banks to weather that storm, and summarized those findings in our booklet, *"A Common Sense Approach to Community Banking,"* published last year. This booklet shares best practices that have proven useful to boards of directors and management in successfully guiding their community banks through economic cycles and other changes and challenges they might experience.

I am pleased to report that the overall financial condition of community banks has improved considerably since the crisis: the number of troubled institutions has declined significantly, capital has increased, asset quality indicators are improving, and there are signs that lending opportunities are rebounding. Indeed, community banks have experienced growth in most major loan categories and at a higher pace than that of the federal banking system as a whole. Despite this progress, challenges remain. For example, economic recovery and job creation continues to lag in many regions and communities, and many community bankers face the challenge of finding profitable lending and investment opportunities without taking on undue credit or interest rate risks. Strategic risk is a concern for many community bankers as they search for sustainable ways to generate earnings in the current environment of prolonged low interest rates and increased competition and compliance costs. Moreover, the volume and sophistication of cyber threats continue to challenge banks of all sizes.

The remainder of my testimony describes steps that the OCC is taking to help community bankers meet these challenges, to help them navigate the changing regulatory landscape, and to ensure that the OCC's supervisory policies and regulations are appropriately tailored to community banks. It also provides the OCC's perspectives on factors the Committee may wish to consider as it explores legislative proposals aimed at reducing regulatory burden on community banks.

II. OCC's Approach to Community Bank Supervision

The OCC is committed to supervisory practices that are fair and balanced, and to fostering a regulatory climate that allows well-managed community banks to grow and thrive. The OCC's community bank supervision program is built around our local field offices, and a portfolio management approach. Our community bank examiners are based in over 60 locations throughout the United States in close proximity to the banks they supervise. They understand the local conditions that affect community banks. The local assistant deputy comptroller (ADC) has delegated responsibility for the supervision of a portfolio of community banks. Each ADC reports up to a district deputy comptroller who reports to me.

Our program 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. Our bank supervision policies and procedures establish a common framework and set of expectations. Each bank's portfolio manager tailors the supervision of each community bank to its individual risk profile, business model, and management strategies. Our ADCs are given considerable decision-making authority, reflecting their experience, expertise, and their "on-the-ground" knowledge of the institutions they supervise.

We have mechanisms in place to ensure that our supervisory policies, procedures, and expectations are applied in a consistent and balanced manner. For example, every report of examination prepared by an examiner is reviewed and approved by the responsible ADC before it is finalized. In cases where significant issues are identified and an enforcement action is in place, or is being contemplated, we undertake additional levels of review prior to finalizing the examination conclusions. We also have formal quality assurance processes that assess the effectiveness of our supervision and compliance with OCC policies. These policies include periodic, randomly selected reviews of the supervisory record, with oversight by our Enterprise Governance unit that reports directly to the Comptroller.

A key element of the OCC's supervisory philosophy is open and frequent communication with the banks we supervise. In this regard, my management team and I encourage any banker who 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. Our ADCs and deputy comptrollers expect and encourage such inquiries. Should a banker not want to pursue those chains of communication, our Ombudsman 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 examination staff.

III. Enhancements to the OCC's Community Bank Supervision Program

At the OCC we continuously seek ways to improve our supervisory processes and how we interact with the banks we supervise. A frequent comment I hear from community bankers and their directors is the need for more practical information and tools that can help them identify and respond to emerging risks. I also hear about the challenges community bankers face in trying to absorb and keep track of new or changing regulatory and supervisory requirements, and their desire to have a "one-stop" source where they can go for information. In response to these requests, we have taken a variety of steps to improve and expand upon our suite of tools and resources for community bankers and their directors.

A. Information and Resources

OCC BankNet: Over the last several years, we have enhanced OCC BankNet, our dedicated Web site for national banks and federal savings associations. The site is designed to provide a "one-stop" source that bankers and their directors can use to obtain up-to-date information on OCC policies and regulations, various educational programs, workshops and web conferences, as well as resources and analytical tools designed for community banks. We also are expanding its use as a safe and secure means that bankers can use to transmit supervisory data or various forms and applications to the OCC.

To provide community bankers with more practical tools and research, we have expanded the portfolio of stress testing tools available on BankNet to include tools and worksheets for individual and portfolio commercial real estate, acquisition and development and agricultural loans – the types of loan products that are commonly offered by many community banks. To help community bankers keep abreast of emerging economic trends and accounting policies, we have started providing quarterly "snapshots" – brief summaries on topical issues of interest to bankers. The snapshots include recent and pending accounting proposals that may affect banks, and information on national and regional economic and real estate trends, which are especially useful for community bankers.

Quarterly Letters: We have taken a number of initiatives to help community bankers manage the flow of information. A number of years ago, we instituted a quarterly letter that each of our ADCs send to the banks in his or her portfolio. These quarterly letters summarize all of the bulletins and rules that the OCC issued during the previous quarter and highlight any particular supervisory issue or concern that the ADC may be seeing. During the past year, we refined the format and content of our quarterly letters in response to feedback from bankers. In addition, the portfolio manager has a quarterly discussion with the institution's CEO about recent regulatory issuances, significant changes in the bank's strategic plan, and market changes affecting the bank.

Banking Bulletins: We have redesigned our bulletins. Each bulletin includes a "highlights" section that summarizes the key points of the guidance and a box that informs community banks whether and how the guidance may apply to them.

Semiannual Risk Perspective Report: Community bankers also have asked us to be more transparent about the issues and risks that are receiving heightened supervisory attention and our rationale for that attention. To provide this transparency, the OCC publishes a *Semiannual Risk Perspective* report. This report, compiled by our

National Risk Committee, summarizes the current operating environment, condition and performance of banks, and key risks across the OCC's lines of businesses. Because the issues and challenges facing community banks can differ from those that larger banks confront, the report provides data and commentary for both large and small banks. Beginning with the most recent report, published in June, the report also outlines our key supervisory priorities for the next twelve months for large, midsize, and community banks.

Outreach: We provide timely information via alerts and joint interagency statements about a range of issues including cyberattacks and vulnerabilities. We also are expanding our use of Web and telephone conferences with bankers to explain our expectations when we issue significant new policies or rules or when we see emerging risks that may be of special interest to community bankers. Recent examples include seminars on cybersecurity, interest rate risk, and compliance issues such as community bank implementation of the Consumer Financial Protection Bureau's (CFPB) ability-to-repay and qualified mortgage standards, and the OCC's guidance on managing third-party relationships. We also have expanded our offerings of director workshops. These hands-on workshops, targeted for community bank directors, are taught by some of our most experienced ADCs and community bank examiners and provide directors with practical tools to help carry out their responsibilities.

B. Improved Internal Supervisory Processes

The above initiatives underscore our commitment to continually look for ways to improve the information and resources we provide to community banks. We are equally committed to improving our internal supervisory processes to ensure that our supervision of individual banks is balanced, timely, and consistent. Specific actions we have taken to respond to concerns raised by community bankers are described below.

<u>Communication on Matters Requiring Attention (MRAs):</u> One of the lessons we learned from the crisis is that when we find deficient practices, we and bank management must have a common understanding of the deficiencies and the actions required by bank management to correct them. To improve the clarity and consistency of our communications, we developed internal guidance used by all of our community bank examiners that establishes clear criteria and a format for the information to be conveyed when citing MRAs. The guidance directs examiners to document and share with bank management: 1) the specific concern that has been identified; 2) the root cause of the concern; 3) the likely consequence or effects on the bank from inaction; 4) the supervisory expectations for corrective actions; and 5) bank management's commitment to corrective action, including applicable timeframes. As part of our transparency efforts, we provide summary data about MRAs in our *Semiannual Risk Perspectives* and on our BankNet Web site.

<u>Timeliness of Examination Reports:</u> We have responded to banker concerns about the timeliness of reports of examination (ROEs) by establishing clear timeframes and benchmarks for completing and sending ROEs to a bank's board of directors. We have incorporated these benchmarks into the performance standards for all the managers within our community bank line of business. I am pleased to report that over 90 percent of the ROEs issued to 1- and 2-rated community banks are mailed within 90 days of the exam start date and within 120 days for 3, 4, or 5-rated banks.

Consistent Application of Policy: Finally, to ensure that our examiners are aware of and applying supervisory policies consistently, we periodically conduct nationwide calls with all of our community bank examiners and managers. We use these calls to explain our expectations for new policies or regulations, and to communicate common issues and areas of emerging risks.

IV. Tiered Regulation

Given the broad array of institutions we oversee, the OCC understands a one-size-fits-all-approach to regulation does not work, especially for community banks. We recognize that community banks have different business models and more limited resources than larger banks, and, to the extent underlying statutory requirements allow it, we factor these differences into the rules we write and the guidance we issue.

The OCC seeks to minimize burden on community banks through various means. Explaining and organizing our rulemakings so these institutions can better understand the scope and application of our rules, providing alternatives to satisfy prescriptive requirements, and using exemptions or transition periods are examples of ways in which we tailor our regulations to accommodate community banks, while remaining faithful to statutory requirements and legislative intent.

For example, our final interagency rule to implement the domestic capital requirements illustrates how we seek to tailor our regulatory requirements to reflect the activities of individual banks. The financial crisis made it clear that all banks need a strong capital base, composed of high quality capital that will serve as a buffer in both good times and bad. Consequently, the new capital rule not only raises the minimum capital ratios, but it also emphasizes the need for common equity, the form of capital that has proven to be best at absorbing losses. However, the crisis also showed that there are very important differences between the largest banks and the rest of the industry. It is clear that the largest banks, which were taking on the biggest risks, can have an outsized impact on the entire system. That is why we have differentiated our capital requirements and are imposing higher capital requirements through the supplementary leverage ratio and the countercyclical capital buffers to the largest banks. We also adjusted our final capital rule to address significant concerns raised by community bankers. The final risk-based rules retain the current capital treatment for residential mortgage exposures and allow community banks to elect to treat certain accumulated other comprehensive income (AOCI) components consistently with the current general risk-based capital rules. Treating AOCI in this manner helps community banks avoid introducing substantial volatility into their regulatory capital calculations.

Other recent rulemakings do not apply to community banks. For example, our heightened standards rule recognizes that large banks should be held to higher standards for risk management and corporate governance and require more formal structures in these areas than community banks. That is why the rule generally applies only to those banks with average total consolidated assets of $50 billion or more. Similarly, our recent rule that establishes quantitative standards for short-term liquidity funding does not apply to community banks.

The OCC responded to community bank concerns when finalizing our revised lending limits rule in accordance with section 610 of the Dodd-Frank Act to include counterparty credit exposures arising from derivatives and securities financing transactions. Specifically, the rule now exempts from the lending limits calculations certain securities financing transactions most commonly used by community banks. In addition, the rule permits small institutions to adopt compliance alternatives commensurate with their size and risk profile by providing flexible options for measuring counterparty credit exposures covered by section 610, including an easy-to-use lookup table.

Similarly, our final rule removing references regarding credit ratings from our investment securities regulation, pursuant to section 939A of the Dodd-Frank Act, allowed an extended transition period of almost six months for banks to comply with the rule. In response to concerns raised by community bankers about the amount of due diligence the banks would have to conduct, we also published guidance to assist banks in interpreting the new standard and to clarify the steps banks can take to demonstrate that they meet their diligence requirements when purchasing investment securities and conducting ongoing reviews of their investment portfolios.

Our final rule implementing the Volcker Rule provisions of the Dodd-Frank Act is another example of how we seek to adapt statutory requirements, where possible, to reflect the nature of activities at different sized institutions. The statute applies to all banking entities, regardless of size; however, not all banking entities engage in activities covered by the prohibitions in the statute. One of the OCC's priorities in the interagency Volcker rulemaking was to make sure that the final regulations imposed compliance obligations on banking entities in proportion to their involvement in covered activities and investments.[1]

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[1] Shortly after the agencies issued the final rule, we learned that certain collateralized debt obligations backed primarily by trust preferred securities (TruPS CDOs), which were originally issued as a means to facilitate capital-raising efforts of small banks and mutual holding companies, would have been subject to eventual divestiture and immediate write-downs under the applicable accounting treatment and that the rule

The OCC also is providing more manageable ways for community banks to digest new regulatory and supervisory information and to assist them in quickly and easily understanding whether and how this information applies to them. As I noted previously, each bulletin announcing the issuance of a new regulation or supervisory guidance now includes a box that allows community banks to assess quickly whether the issuance applies to them and a "highlights" section that identifies the key components of the rule or regulation. We have also identified other means to convey plain language descriptions of complex requirements and to assist community bankers in understanding newly issued rules. For example, the OCC produced a streamlined, two-page summary of the final domestic capital rule highlighting aspects of the rule applicable to community banks and key transition dates. We supplemented this summary with an online regulatory capital estimator tool that we developed with the other federal banking agencies. Likewise, we provided to community banks a quick reference guide to the mortgage rules the CFPB issued in January.

V. Additional Opportunities to Reduce Burden and Improve Competitiveness

The OCC is committed to exploring additional ways to reduce unnecessary regulatory burden on, and promote the competitiveness of, community banks. For example, in response to concerns raised by community banks and our ongoing research, the OCC would be supportive of exempting community banks from the Volcker Rule. We also would suggest a change to current law that would increase the $500 million asset size threshold for community banks so more of them can qualify for an exam every 18

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was inconsistent with another provision of the Dodd-Frank Act — the Collins Amendment. Given the importance of this issue to affected community banks and to mitigate the unintended consequences, the agencies responded promptly by adopting an interim final rule to address this concern. See 79 Fed. Reg. 5223 (Jan. 31, 2014), available at http://el.occ/news-issuances/federal-register/79fr5223.pdf.

months, rather than every year. As well, we support pending legislative proposals to exempt banks from issuing a mandatory annual privacy notice requirement in certain circumstances.

We believe the foremost factor when evaluating our consideration of proposals to reduce burden on community banks is to ensure that fundamental safety and soundness and consumer protection safeguards are not compromised. We would be concerned, for example, about proposals that would adversely impact or unduly complicate the exam process, mask weaknesses on a bank's balance sheet, or impede our ability to require timely corrective action to address weaknesses.

In addition to these overarching principles, there are other factors that we consider when evaluating proposals. For example, a number of the tools that we make available to bankers to assist them in risk identification and that we use to tailor and streamline our examinations, rely on the detailed data we collect in certain Call Report schedules. We recognize that the decision to include detailed data requires both an analysis of the costs that community banks face in preparing their Call Reports, and an evaluation of the benefits to the agency of being able to do more examination work and monitoring off-site.

Pursuant to the requirements of the Paperwork Reduction Act, the OCC and other federal banking agencies, under the auspices of the Federal Financial Institutions Examination Council (FFIEC) seek comment on Call Report changes and on the agencies' estimates of the burden hours of those proposed changes. In analyzing potential changes to the Call Report, we consider ways that we can tailor reporting requirements to the size of a bank's activities. At the OCC, we have an internal review process for any material changes to the Call Report that OCC staff may want to propose to the FFIEC for consideration. Our internal standard is that Call Report data should directly support long-term supervisory needs to ensure the safety and soundness of banks, and that any additions must be supported by a strong business case that discusses the relative benefits, costs, and alternatives.

Recently, we have received proposals to reduce the burden associated with the preparation of the Call Reports including the feasibility of allowing certain banks to file a short-form Call Report for two quarters of a year. I have discussed the Call Report issue in numerous meetings with bankers, and we are committed to giving careful consideration to their concerns.

Finally, we have heard countless examples of the need for increased resources to operate in today's environment as well as the difficulties in attracting and retaining needed expertise. We are supportive of community banks exploring avenues to collaborate, for example, by sharing resources for compliance or back office processes. We believe opportunities exist for community banks to work together to face today's challenges, and we are prepared to be a resource to assist in these efforts.

Regulatory Review Efforts: Notwithstanding our efforts to ensure that our regulations are appropriately calibrated, we recognize the need to periodically step back and review our regulations to determine if there are ways that we could streamline, simplify, or in some cases, remove, regulations to ease unnecessary burden on banks. The OCC has two concurrent efforts underway that could help identify ways to reduce regulatory burden.

OCC/OTS Rule Integration: The Dodd-Frank Act transferred to the OCC all the functions of the Office of Thrift Supervision (OTS) relating to the examination, supervision, and regulation of federal savings associations. As part of our integration effort, we are undertaking a comprehensive, multi-phase review of our regulations and those of the former OTS to reduce regulatory burden and duplication, promote fairness in supervision, and create efficiencies for national banks and federal savings associations. We have already begun this process and, in June of this year, we issued a proposal to integrate national bank and federal saving association rules relating to corporate activities and transactions. The comment period on this proposal closed a few weeks ago, and we are currently reviewing the comments received.

Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA): The OCC and the other federal banking agencies are currently engaged in a review of the burden imposed on insured depository institutions by existing regulations as part of the decennial review required by the EGRPRA. EGRPRA requires that, at least once every ten years, the FFIEC, OCC, FDIC, and Federal Reserve review their regulations to identify outdated or otherwise unnecessary regulations for all insured depository institutions. The EGRPRA review provides the FFIEC, the agencies, and the public with an opportunity to consider how to reduce burden and target regulatory changes to reduce burden on all institutions. The OCC, as chair of the FFIEC, is coordinating this joint regulatory review.

In connection with the EGRPRA process, the agencies published a *Federal Register* notice this past June asking for comment on three categories of rules. The comment period on this first notice ended earlier this month, and the agencies are reviewing the comments received. Over the next two years, the agencies will issue three more *Federal Register* notices that will invite public comment on the remaining rules. In each notice, we will specifically ask the public to identify ways to reduce unnecessary burden association with our regulations, with a particular focus on community banks.

Charter Flexibility: One of the strengths of the community bank model is the diversity it provides in the types of charters and missions of institutions that can serve a local community. We see this most prominently in the important roles that minority-owned and mutual savings institutions play in their communities. We have established advisory committees with leading representatives of these banks to help us address the unique challenges facing these institutions. One issue that we hear from federal savings associations is about their desire to offer a broader range of services to their communities without having to change their charter type. More specifically, any federal savings association that wants to expand its mortgage lending business model to one that emphasizes a mix of business loans and consumer credit would need to change charters. I believe that the federal savings association charter should be flexible enough to accommodate either strategy. When the Comptroller was a regulator in Massachusetts, that state made powers and investment authorities, as well as supervisory requirements, the same or comparable regardless of charters, and allowed state thrifts and banks to exercise those powers while retaining their own corporate structure. Congress may wish to consider authorizing a similar system at the federal level. This flexibility will improve the ability of federal savings associations to meet the financial needs of their communities.

VI. Conclusion

Community banks are an essential part of our nation's communities and small businesses. The OCC is committed to providing effective supervision of these banks while minimizing unnecessary regulatory burden. We will continue to carefully consider the potential effect that current and future policies and regulations may have on community banks and will be happy to work with the Committee on any proposed legislative initiatives.