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TESTIMONY OF

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Before the

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

UNITED STATES 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.

I. Introduction

Chairman Gutierrez, Ranking Member Hensarling, and members of the Subcommittee, my name is Jennifer Kelly. I have been a commissioned national bank examiner for 26 years, and I am currently the Senior Deputy Comptroller for Midsize and Community Bank Supervision for the Office of the Comptroller of the Currency ("OCC"). I appreciate the opportunity to describe the OCC's roles and responsibilities in the supervision of national banks and the process for resolution of severely troubled banks.

My testimony begins with an overview of the OCC's role in the supervision of national banks, followed by a description of the process for dealing with troubled banks and, when necessary, the appointment of a receiver for those institutions. I will conclude with a discussion of the circumstances surrounding the failure of the FBOP national banks.

II. OCC's Role in the Supervision of National Banks

The OCC supervises 1,564 national banks and 51 federally licensed branches of foreign banks. As of September 30, 2009, this constituted approximately 18 percent by number of all federally insured banks and thrifts, holding 61 percent of all bank and thrift assets. These nationally chartered institutions include 15 of the very largest U.S. banks, with assets generally exceeding $100 billion; 23 mid-sized banks, with assets generally ranging between $10 billion and $100 billion; and over 1,400 community banks and trust banks, with assets between $1.5 million and $10 billion. In recognition of the varying challenges presented by these three different types of national banks, the OCC has distinct and dedicated supervisory programs for each group that are tailored to the unique challenges that each faces.

OCC Oversight of National Banks

The primary mission of the OCC is to ensure that the national banking system remains safe and sound and fully able to support the needs of its customers. Our goal in supervising banks of all sizes is to ensure that they operate in a safe and sound manner and in compliance with laws requiring fair treatment of their customers and fair access to credit and financial products. In addition, Congress has charged the banking agencies with responsibility for protecting the FDIC Deposit Insurance Fund.

All of us – supervisors, bankers, and members of this Committee – recognize the important role that credit availability and prudent lending plays in our nation's economy, and we all share the goal of ensuring that banks can continue to meet the credit needs of their customers. Community banks play a vital role in that regard, and we recognize and address the particular challenges they face through our dedicated program of supervision of national community banks.

Fundamentally, we believe that the best way to ensure that national banks are making credit available in their communities is to assure that they are safe and sound and have capital available to lend to creditworthy borrowers. Conversely, it also must be recognized that seriously troubled banks cannot effectively serve the needs of their communities.

We actively encourage national banks to work constructively with borrowers who may be facing difficulties and to make new loans to creditworthy borrowers. It is our responsibility, however, to ensure that they do so in a safe and sound manner and that they recognize and address their problems on a timely basis. And just as it must be recognized that the difficult economic times are impacting existing borrowers and causing deterioration in the banks' loan portfolios, it is also the case that more borrowers are having difficulty qualifying for credit under appropriate credit underwriting standards. With that in mind, during this stressful period we are cognizant of the need to take a balanced approach in our supervision of national banks, and we have repeatedly conveyed that message to our examiners in the field. However, balanced supervision does not mean turning a blind eye to credit and market conditions, or simply allowing banks to forestall recognizing problems in the hope that markets or borrowers may turn around.

It is the OCC's long-standing policy that regulatory capital levels established by Prompt Corrective Action ("PCA") are minimum capital requirements. In fact, most well-run, healthy banks maintain capital significantly in excess of the PCA "well capitalized" level. Regulators expect banks with significant credit concentrations or deteriorating asset quality to hold higher capital levels to compensate for their risk profile. A bank's ability to lend diminishes as its capital is impaired by losses and poor asset quality. In other words, depletion of capital by losses and elevated risk are key drivers causing a constriction in the ability of some individual banks to lend. Conversely, an increase in capital increases a bank's ability to lend.

The combination of deteriorating credit quality, lower yields on earning assets, and reduced loan demand from creditworthy borrowers is currently affecting the earnings of many banks. Nonetheless, the vast majority of national banks today are in sound condition and have the financial capacity and management skills to weather the current economic environment. Moreover, it is important to understand that most banks that develop problems are restored to a safe and sound condition. Some cannot be however, and as discussed below, when necessary, the Federal Deposit Insurance Corporation Improvement Act charges the OCC with taking timely action that will enable a severely troubled bank to be resolved at the "least cost" to the Deposit Insurance Fund.[1]

The Problem Bank Resolution Process

In problem situations, the OCC's goal is to intervene at an early stage and take actions that will lead to a national bank's rehabilitation. Where rehabilitation is not achievable, it is the OCC's goal to effect early and least cost resolution of the institution in an orderly manner that minimizes the impact on depositors and customers.

Under the PCA framework that Congress established, the OCC is authorized, and in some cases required, to place a national bank into receivership on the basis of capital inadequacy, certain unsafe and unsound practices, illiquidity, and other grounds specified in the Federal Deposit Insurance Act. The decision to place a national bank into receivership is made only following scrupulous deliberation. We consider the overall viability of the bank including the

[1] The Federal Deposit Insurance Corporation Improvement Act of 1991 requires that all possible resolution alternatives be considered and evaluated, and that the FDIC choose the option that has the lowest cost for the Deposit Insurance Fund.

status of recapitalization efforts, 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 Deposit Insurance Fund.

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. In particular, we have a very good working relationship with the FDIC on problem banks. Our communication and work with the FDIC increases as a bank's condition deteriorates, but the FDIC essentially has an open invitation to participate in our supervisory activities of our problem banks. When a national bank reaches a stage where its viability is doubtful, our contact with the FDIC is often daily and ongoing.

When we have determined that a problem bank has exhausted all reasonable options, including the 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 the DRR with early access to the bank and the maximum amount of time possible to prepare for the closing in order to minimize disruption to the depositors and customers of the bank and the FDIC's cost to resolve the bank.

III. The FBOP Situation

Let me now turn to the Subcommittee's questions regarding the failure of the FBOP banks. The background described above provides the framework for how the OCC supervised the national bank subsidiaries of FBOP and ultimately made the decision to appoint the FDIC as receiver of those banks.

FBOP was a financial holding company that owned six national banks and three state banks.[2] Total assets of all nine banks were approximately $19 billion. Through these banks, FBOP operated in California, Illinois, Arizona, and Texas. The FBOP banks were an interrelated enterprise. In large part, business strategies were determined on a corporate-wide basis. Because of FBOP's size, geographic scope, and complexity, the OCC supervised the national bank subsidiaries of FBOP centrally as an enterprise within the OCC's Midsize Supervision Department, which reports to me. An Examiner-in-Charge supervised these banks on a full-time basis.

FBOP's business model was successful for many years, but a combination of circumstances exposed vulnerabilities that the banks were not able to overcome. Previously, during periods of stress, FBOP focused on acquiring troubled financial institutions at attractive prices. Since 1990, FBOP completed over 30 acquisitions. The company successfully resolved

[2] California National Bank, Los Angeles, CA; Park National Bank, Chicago, IL; San Diego National Bank, San Diego, CA; Pacific National Bank, San Francisco, CA; North Houston Bank, Houston, TX; Madisonville State Bank, Madisonville, TX; Bank USA, National Association, Phoenix, AZ; Citizens National Bank, Teague, TX; and Community Bank of Lemont, Lemont, IL.

the acquired institutions' problems and integrated them into the organization. This business model proved successful from 1990 into 2008, and yielded a consistently profitable organization that became a sizable company.

However, from the fourth quarter of 2007 through the first half of 2008, FBOP implemented strategic decisions that, in retrospect, diminished the company's financial flexibility and exposed the banks in the company to ultimate failure. Two decisions proved to be particularly critical. First, various bank subsidiaries of FBOP purchased nearly $900 million of FNMA ("Fannie Mae") and FHLMC ("Freddie Mac") preferred stock. FBOP perceived the purchase of this Government Sponsored Enterprise ("GSE") stock as a safe way to deploy its liquidity sources given its perception of implicit government backing. While these investments were generally viewed as having little credit risk at the time they were made, the extent of the investment made by FBOP was high relative to the combined capital of the FBOP banks. In addition, the FBOP banks purchased securities and corporate bonds – then rated investment grade – of certain companies in the financial sector, including Washington Mutual Bank ("WAMU").

Second, consistent with its historical approach, FBOP initiated a loan portfolio growth strategy in late 2007, as the credit and real estate markets deteriorated. From September 30, 2007 to September 30, 2008, consolidated banking subsidiary loans grew approximately 35 percent, from approximately $10 billion to almost $14 billion. In taking this approach, FBOP took advantage of others' unwillingness to finance commercial real estate ("CRE") given the market turmoil.

Despite the growth of the FBOP banks through the second quarter of 2008, overall the company remained in satisfactory financial condition. However, the growth limited FBOP's financial flexibility and ability to absorb losses due to unforeseen adverse events. In the third quarter of 2008, two devastating financial events occurred from which FBOP ultimately was not able to recover. First, and most significantly, Fannie Mae and Freddie Mac were placed into conservatorship, rendering the nearly $900 million in preferred stock investments by the FBOP banks almost worthless. On the heels of this event, WAMU failed, causing approximately $100 million in additional losses. These two events caused losses (on a pre-tax basis) of approximately $989 million or 63% of the consolidated banking subsidiaries' Tier 1 capital. As a consequence, the four largest national banks, representing more than 90% of FBOP's banking assets, became less than well-capitalized for PCA purposes.

At this point, the company was in a significantly distressed condition and its ability to withstand further adversity was eroding. Unfortunately, late 2008 marked the beginning of an unprecedented series of severe credit and market events. The combination of FBOP's business strategies and these market events pushed FBOP into a "perfect storm."

It is important to emphasize that as soon the GSE conservatorships occurred, FBOP (and the OCC) appreciated the critical need to bring in new capital. Initially, FBOP committed to increasing the capital in each of the banks to well-capitalized status by September 30, 2008. This was the first in a series of commitments to raise capital that FBOP was unable to meet. In the period immediately following the GSE write-downs, FBOP had serious investor interest.

However, the initiation of the Treasury Department's Capital Purchase Program ("CPP") as part of the Troubled Asset Recovery Program ("TARP") created uncertainty for investors as to what their ultimate stake in the company would be, which had the practical effect of sidetracking the private capital option. CPP did not have an option available to non-public companies when it began in mid-October, 2008, and so obtaining TARP capital initially was foreclosed as an option for FBOP.

When the private company TARP option became available in mid-November, FBOP formally applied for funds. After consideration of the application, and in recognition of the significant impact that the GSE write-downs had on the FBOP banks, the OCC submitted a recommendation for approval of FBOP's application to the interagency council that evaluated certain applications prior to their review and decision by the Treasury Department.[3] As a result of the Council's deliberations, FBOP was requested to provide additional information before a recommendation could be made to Treasury. During this period, the condition of many of the FBOP banks began to decline precipitously, and the OCC determined that FBOP was no longer able to meet the approval standards established by the Treasury Department.

Deterioration of the loan portfolio, especially the commercial real estate loan portfolio, accelerated. To address the need for additional capital and the safety and soundness deficiencies at the banks, the OCC placed informal and formal actions on all of the national banks, except Citizens National Bank, Teague, Texas ("Citizens"). California National Bank and San Diego National Bank, due to their tangible equity ratios, became critically undercapitalized for PCA

[3] The Initial Report to the Congress of the Office of the Special Inspector General for the Troubled Asset Relief Program (February 6, 2009) includes a description of the process used by the federal banking agencies in evaluating applications and forwarding recommendations for approval to the Treasury Department.

purposes on July 30, 2009. Under PCA, the OCC is required to place a critically undercapitalized bank into receivership within 90 days of it reaching that status. So, by the third quarter of 2009, time was running short for a number of the FBOP banks.

As described above, the OCC worked closely with FBOP for almost 14 months in its efforts to raise capital and to address the multitude of issues that confronted the FBOP national bank subsidiaries. FBOP presented numerous proposals for capital throughout this period. In addition, informally and then later as required by Individual Minimum Capital Ratios established by the OCC, and eventually by formal OCC Consent Orders, FBOP committed to timeframes to raise sufficient capital. Notwithstanding the OCC's decision to extend these deadlines several times, FBOP was never able to raise the needed capital. As 2009 progressed, the continuing increase in adversely classified loans impaired the FBOP banks' ability to attract external capital. Although numerous proposals were put forth, FBOP was never able to reach a definitive agreement with investors that would provide sufficient capital to make the enterprise viable.

The FDIC was promptly informed of the impact of the GSE losses on FBOP. Subsequently, we provided regular updates to the FDIC on the condition of the banks as well as the status of efforts to recapitalize the company. As FBOP's condition deteriorated, the frequency of our interactions with the FDIC increased.

In October 2009, the OCC concluded that after 14 months of effort by FBOP, the banks' problems and the stressed environment made it unrealistic to expect that a viable private capital solution could be achieved. Moreover, as noted above, the condition of two of the national banks had so deteriorated that they were on the statutorily mandated clock for closure. At that point, the OCC and the FDIC began focusing on an orderly resolution. The OCC determined that it could support the closure of California National Bank, San Diego National Bank, Pacific National Bank, and Bank USA, National Association, based on safety and soundness and capital grounds. In addition, the state banking departments of Texas and Illinois came to similar conclusions with respect to North Houston Bank, Houston, TX, Madisonville State Bank, Madisonville, TX, and Community Bank of Lemont, Lemont, IL.

However, Park National Bank ("Park") and Citizens were in a somewhat different status. While both the OCC and the FDIC recognized that Park had serious troubles, as evidenced by the bank's financial condition and the Consent Order entered into with the OCC to address the safety and soundness deficiencies at the bank, the OCC concluded that statutory grounds did not yet exist to support the appointment of a receiver. However, absent a dramatic – and unforeseen – reversal of its trends and current condition, it was evident that grounds would soon exist for the resolution of Park as well.

In early October 2009, the FDIC notified the OCC that it was considering whether immediate assessment of "cross guaranty liability" against Park and Citizens would result in the least cost to the Deposit Insurance Fund. In situations in which banks are commonly controlled, generally through bank holding company structures such as FBOP's, the FDIC is authorized to assess banks that have not failed for the anticipated losses to the Deposit Insurance Fund caused by the failure of affiliated banks. This is generally known as "cross guaranty liability." The

FDIC has up to two years to make the assessment, but when it determines that it is in the best interest of the Deposit Insurance Fund, it may make the assessment immediately payable.

As required by the statute, the FDIC consulted with the OCC regarding its determination to immediately assess Park and Citizens for the anticipated losses of the other FBOP banks. We responded that we did not object to the FDIC's plan to immediately invoke the cross-guaranty claim if the FDIC determined it would result in least cost to the Deposit Insurance Fund.

On October 30, 2009, the OCC appointed the FDIC as receiver of California National Bank, San Diego National Bank, Pacific National Bank, and Bank USA, National Association, based on safety and soundness and capital grounds. On the same day, the states of Illinois and Texas placed the three state chartered FBOP banks into receivership. The FDIC determined to immediately assess Park and Citizens for the anticipated losses for the seven failed banks and presented Park and Citizens with an order to immediately pay such assessment. As a result of the assessment, Park and Citizens immediately became insolvent, and the OCC appointed the FDIC as receiver.

In this chronology of the FBOP banks' demise several points stand out. First, FBOP's business strategy—which had previously been successful—left the bank vulnerable to the perfect storm of events that the FBOP banks could not survive, including unforeseen and devastating GSE losses. Second, and most importantly, the determinations to place the FBOP banks into receivership were consistent with, or required by, the statutory scheme Congress put in place in 1991 to resolve banks, or groups of banks, at least cost to the Deposit Insurance Fund.

IV. Conclusion

I appreciate the opportunity to appear before the Subcommittee today to describe the OCC's oversight of national banks and its role, when necessary, in the appointment of a receiver for those banks.

I would be happy to answer any questions from the members of the Subcommittee.