

**Statement of
Jennifer Kelly
Senior Deputy Comptroller, Midsize and Community Bank Supervision
Office of the Comptroller of the Currency**

**before the
Financial Institutions and Consumer Credit Subcommittee
of the
Committee on Financial Services
U.S. House of Representatives**

July 8, 2011

Chairman Capito, Ranking Member Maloney and members of the Subcommittee, I appreciate this opportunity to explain the OCC's approach in assessing the condition of banks' loan portfolios, including determining whether individual loans should be classified or placed on non-accrual, and to offer the OCC's views on H.R. 1723 and H.R. 2056.

Access to credit plays a vital role in restoring economic growth and supporting jobs in our communities, and we share the Subcommittee's view that banks should not be unduly constrained from meeting the needs of creditworthy borrowers. We are committed to balanced and fair supervision of the financial institutions we regulate, and I believe our examiners are striking that balance.

OCC examiners assess the quality of a bank's loan portfolio during each examination cycle. The goal of our reviews is to confirm the accuracy of bank management's own assessments of credit quality, not to "second guess" or supplant their judgments with ours. When a borrower's ability to repay a loan becomes impaired, we expect the bank to classify the loan to recognize the increased risk. Examiners confirm

management's assessment through transaction testing of specific loans or loan portfolios. Where weaknesses are found, examiners direct bank management to take corrective action.

To provide consistency in the examination process, the OCC and other banking agencies use a uniform risk rating scale to identify problem credits. This regulatory classification system consists of four levels of designations that identify different degrees of credit weakness.

We have a variety of mechanisms in place to help ensure that OCC examiners apply our policies in a consistent and balanced manner across institutions, and we spend considerable time and resources providing training and guidance to our examiners on evaluating credit risk. Loan analysis and accounting principles are focal points of every new examiner's classroom and on-the-job training.

One of our primary regulatory objectives is to ensure that the Call Report a bank is required to publish each quarter accurately reflects the condition of the institution at that point in time. Accurate and transparent financial statements are essential to allow investors, creditors, and regulators to evaluate a bank's financial condition. Congress recognized the importance of this 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 generally accepted accounting principles, or GAAP, in order to facilitate prompt resolution of troubled institutions.

When a borrower shows signs of trouble, bankers and examiners must consider whether the loan warrants criticism or classification, then, whether the loan should continue to accrue interest, and further, if the loan is subsequently modified, if it should

be reported as a “troubled debt restructuring.” The banking agencies’ policies for these and other loan accounting issues are detailed in the instructions that banks follow when preparing their quarterly Call Reports. Consistent with GAAP, the Call Report Instructions require that a loan be put on nonaccrual status when payment in full of principal or interest is not expected, or when 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 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 when it otherwise becomes well secured and in the process of collection.

With this background, let me briefly offer the OCC’s perspectives on H.R. 1723 and H.R. 2056. H.R. 1723 would permit certain loans that would otherwise be treated as nonaccrual loans to be treated as accrual loans for the purposes of calculating regulatory capital. We are concerned that legislation prescribing specific regulatory accounting that is less stringent than GAAP could mask troubled assets and overstate a bank’s capital ratios. This type of forbearance could diminish investor confidence in banks and undermine a primary objective of the Prompt Corrective Action regime.

H.R. 1723 also requires the Financial Stability Oversight Council to study how to prevent contradictory guidance on loan classifications and capital requirements from being issued by the federal banking agencies. The OCC shares Congress’s interest in assuring that assessments are fair, balanced, and consistent over time and across institutions. For this reason, we generally coordinate with our regulatory counterparts on the issuance of regulations and supervisory guidance on matters such as capital

requirements and loan classifications. As previously noted, the criteria for loan classifications and loan accruals are set forth in interagency guidance and the Call Report Instructions.

H.R. 2056 would require the FDIC's Inspector General to study the effects of certain policies that may also pertain to institutions directly supervised by the OCC. As such, we believe it would be appropriate for the OCC to be given an opportunity to provide comment before the study is finalized

Thank you, and I'll be happy to respond to your questions.