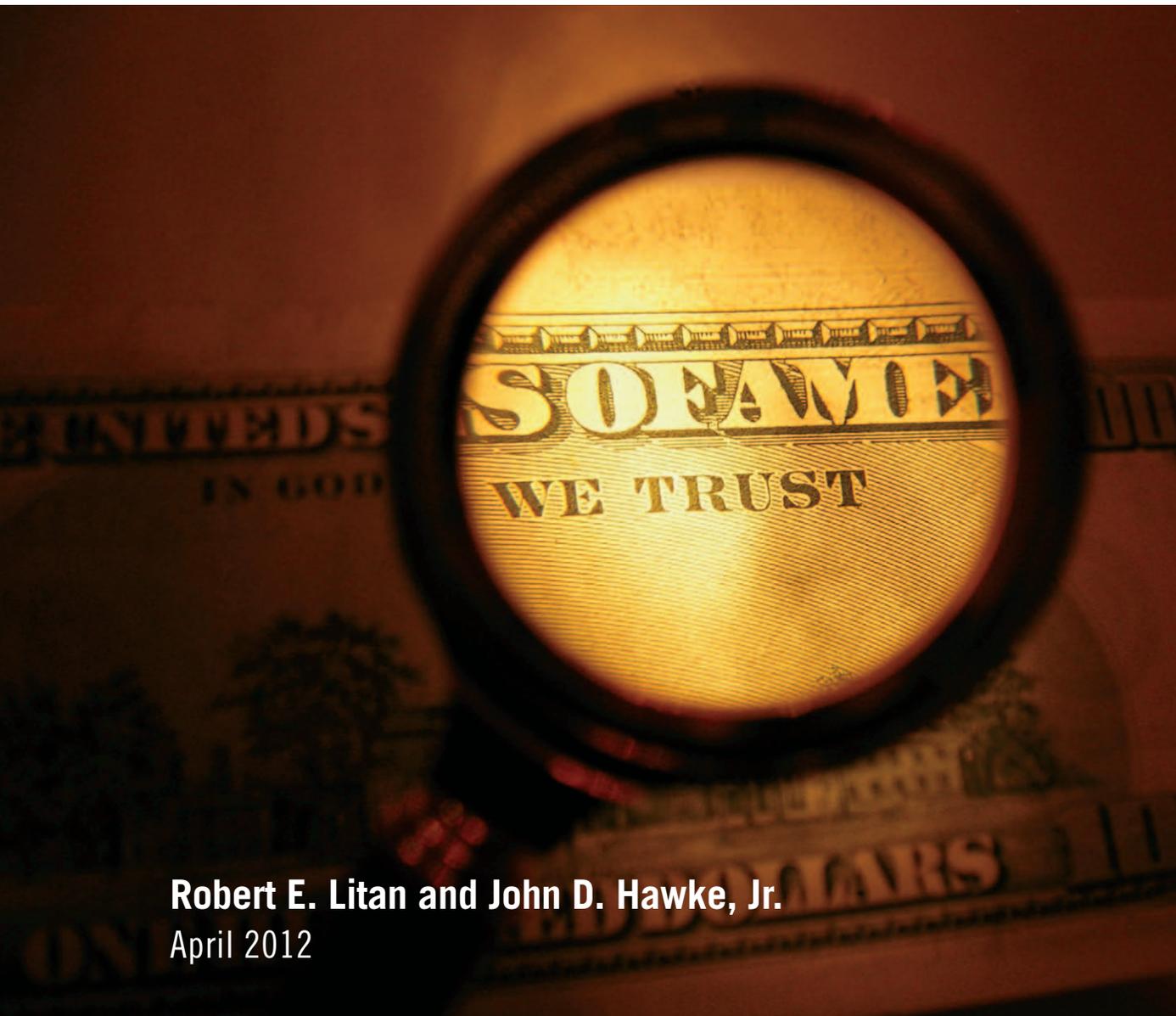


Value-Added Bank Supervision:

A Framework for Safely Fostering Economic Growth



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The American Bankers Association represents banks of all sizes and charters and is the voice for the nation's \$13 trillion banking industry and its two million employees. The majority of ABA's members are banks with less than \$165 million in assets. ABA's extensive resources enhance the success of the nation's banks and strengthen America's economy and communities.

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The U.S. economy has been struggling to recover from the deepest recession since the Great Depression, one that had among its origins excessive, poorly underwritten subprime mortgage lending by non-bank and bank lenders, coupled with excessive leverage among many financial participants. Many factors contributed to bringing on and aggravating the crisis, but among them were supervisory shortcomings by state and federal banking regulators. Since the crisis, minimum bank capital standards have been significantly increased, loan underwriting standards have been improved, and the regulatory agencies have since changed their bank examination procedures to ensure that new capital standards are more effectively enforced. The American system of bank supervision has been put through the most demanding of tests. What have we learned?

The Concept of Value-Added Supervision

When it works well, bank examination and supervision not only help ensure the safety and soundness of the overall banking system, but can help individual banks to operate successfully and better serve their customers and their communities. That examiners will be checking on their activities can induce bank management and directors to be more effective risk managers and to operate their banks more efficiently. Examinations themselves can pinpoint both successes and weaknesses in a bank's activities that can lead the way toward improvements, while helping banks make the right decisions when lending money or serving other customer needs. In short, when it is done right, bank supervision can be value-enhancing for banks and their employees, executives, directors and shareholders.

Conversely, inappropriate examinations can be ineffective at best and counter-productive at worst. Overly rigid, one-type-fits-all examinations that do not take account of the individual characteristics of banks, their customers and the geographic and product markets in which they compete can either lead examiners to miss troubles in the making, or discourage lending to creditworthy borrowers, impairing not only the profitability of the affected banks but, given the importance of bank credit to many firms and individuals, slowing the growth of the economy. Similar results can occur if bank examiners fail to provide clear and consistent guidance to banks as to how they should operate or how much capital they should maintain to support their loans and investments. Regulatory uncertainty can be just as damaging to banks and the overall economy as excessive rigidity.

Bank regulators, therefore, have a very difficult but highly important job, one that has only become more difficult and important in the aftermath of the crisis. Regulators quite rightly and appropriately do not want to repeat errors of the past, but at the same time they do not want to contribute to the sluggishness of the economy, weakening the very banks whose financial health they are charged with overseeing. Indeed, while regulators cannot and should not show favoritism for any particular bank, the different federal regulatory authorities each were given a critical mission relating to the *banking industry as a whole*: the Comptroller of the Currency (OCC) to promote a national banking system; the Federal Reserve to promote, among other things, a stable and reliable banking system in light of the Fed's original function to assure sufficient liquidity at all times within that system; and the FDIC to discourage bank runs and to promote a stable banking industry by insuring deposits. All of this is to say that bank supervision and examination should contribute to the overall health and strength of the banking industry because of the industry's importance in sustaining the broader health of the economy. That supervisory role embraces weeding out as quickly as possible individual banks that are on the brink of insolvency or have become insolvent while providing guidance to assure and improve the safe and sound performance of all other banks.

Method of Analysis

We were asked by the American Bankers Association (“ABA”) to evaluate the condition of the bank supervisory program today, particularly with regard to meeting its historic role of promoting the health and strength of the industry. A major part of that effort involved a careful inquiry into how a broad group of banks of different sizes, charters, and business models, operating in many different places throughout the country, viewed the bank examination process as it stood as of October and November 2011. We concentrated on the impact of bank supervision on commercial lending, in particular—because much of the focus of policy makers and the media on the banking system since the crisis has been on the willingness of banks to make such loans—and the impact, if any, of bank supervision and examination on these decisions.

To carry out our mandate, we prepared a survey that was distributed by the ABA to 90 bank members of the ABA, inquiring broadly into the examination process and its impacts. The survey and responses to it are attached in the Appendix. The survey questions were informed by more detailed interviews that we conducted with the CEOs of 15 members of this group. We report here the findings of both of these endeavors, which were carried out during October-November 2011, or a period in which the U.S. economy was modestly recovering and amidst the financial and economic turmoil in Europe. This was also when the fresh memories of the recent financial crisis were tempered by some opportunity for reflection. We then draw on our experiences in advising and regulating banks and studying the banking industry to take what we learned from this exercise to formulate some suggestions for banking examiners going forward.

The bottom line from both the surveys and the interviews is that while there is some concern that bank examinations are holding banks back from lending today, there is much greater worry among bankers that various aspects of the post-crisis regime of examination will *permanently* chill lending *in the future*—either by making it more expensive for borrowers, largely in the form of additional paperwork accompanying any loans, and higher required equity cushions—or denying loans to borrowers that many bankers believe would be sound but run substantial risk of regulatory criticism. The potential negative impact on future

lending is of special concern because it can slow the recovery in the intermediate term, and if sustained, could lower potential national economic growth over the longer run by raising the cost and reducing the availability of business lending. These impacts will be magnified to the extent they curtail bank lending to small and newer businesses, which historically have been a main driver of both job growth and cutting-edge innovation. In other words, we find that in dangerous ways distance has developed between the bank supervisory program and its value-added mission.

Proposed Adjustments to the Program of Supervision

The American concept of bank examination and supervision is fundamentally sound, but we believe it could be improved through several adjustments in the bank examination process outlined in this report. These adjustments would continue to maintain the integrity of the supervisory process and indeed would reinforce its historic purpose and role as adding value to banks and to the banking industry. Some of these suggestions are more in the nature of principles on which further implementation details should be based. Others are more specific.

Customized Supervision. The American banking industry is as varied as its customers in the world's largest economy. In order to reinforce the value that this variety offers to the economy and to bank customers, bank examiners should make greater efforts to customize their examinations, by taking account of the nature of the bank's business model, its management's record with borrowers, and borrower characteristics, including prior repayment history and strength of personal guarantees. Distinctions such as these are more important than the categories of bank asset size that regulators have historically used to differentiate their examination practices. More customization in bank examination is certainly as achievable as it is desirable, as demonstrated by the fact that it is the way that auditors function with respect to their clients. Exams more customized and more fitted to the bank would better enable banks to conduct their core business function: to make *judgments* about the creditworthiness of borrowers.

Focus on the "Big Picture." A value-added supervisory program that is flexible enough to recognize and accommodate the wide variety of institutions in the banking industry needs to be careful that exams avoid getting lost in the weeds. The overall approach should be risk-based, looking for evidence of significant patterns or practices that, if unaddressed, could affect the safety and soundness of the bank, and thus its survivability. Too often both safety and soundness and compliance exams can appear as "gotcha" exercises, focusing on technicalities and minor issues that have little bearing on the genuine safety or conduct of the institution. Examination practices should be informed and improved by continuing research by the regulatory agencies, a process that can be facilitated by ensuring continued interactions between examiners and research staff (who should be encouraged to attend some exams).

Clarity in Capital Requirements. Examiners and their agencies should provide greater clarity about effective minimum capital standards. If the objective in these uncertain and difficult times is to raise capital standards, then banks should be made aware of this objective with clarity and some precision. In any event, regulators should weigh the costs of even higher capital standards, which reduce banks' ability to lend, particularly in light of the benefits of a more effective supervisory and examination system of the type outlined here that can more cost effectively substitute for more capital in promoting safe and sound

operations. However this balance is struck, banks should know the capital targets they are expected to achieve, rather than having to speculate or simply wait for examiners to raise the capital bar at every exam. Uncertainty and unexpected changes in capital standards, even more than higher standards themselves, can discourage banks from lending while discouraging investors from committing more capital to individual banks and the banking system.

Stress Testing. For larger banks, examiners should rely to a greater extent on well designed stress tests as examination tools and rely less on “anticipatory” classifications of business loans to recognize losses and build up loan loss reserves in advance. Indeed, regulators should consider giving all or a wide range of banks the option of going through some form of a stress test rather than using the traditional approach that relies heavily on loan classifications.

Risk Management of Loan Losses. For all other banks, while “anticipatory” loan classifications may be appropriate in particular cases, because of legitimate concerns about future revenues to support loan repayment, examiners should consider other mitigating circumstances, such as the existence of reliable personal guarantees or other appropriate risk management practices in deciding whether to classify a loan. A value-added examination program should recognize and reward the value-added risk management efforts of the banks themselves.

Experienced Examiners. While it is important for the national offices of the federal bank regulatory agencies to provide broad guidance for regional and local examiners to assure national consistency in basic examination practices, regional and national offices of these agencies should give significant and appropriate deference to local examiners with good track records and therefore substantial useful experience with the banks in their regions to make on-site judgment calls. One step that would give regional and national offices greater comfort in extending this deference is to assure that examiner teams are balanced overall in their level of experience and are led by adequately experienced senior examiners. In this regard, it is important that the agencies continue to have the resources to train and retain good junior and mid-level examiners so that they remain to become sound senior examiners and to ensure that judgment is exercised in keeping with general supervisory principles set by agency leadership.

Cooperation with State Bank Examiners. In the case of state-chartered banks, which are supervised by both federal and state supervisors, examiners at both levels should redouble efforts to cooperate. Where either regulator has substantial experience with a particular banking practice that the other does not, efforts should be made to share knowledge or give deference to the regulator with that experience. This is especially the case with respect to state regulators and examiners of state-chartered banks who tend to have the most local knowledge about these banks and the economic conditions of the areas in which the banks compete. Sound supervision of state-chartered banks reinforces the strength of our dual-banking system.

Self-Review by Regulators. Finally, each of the federal banking regulatory agencies may want to conduct a parallel study of its own examiners, covering those with a broad range of and length of experience, sufficient to assess whether they believe the examination process has changed over time, if so how, and what changes they believe would enhance the value-added mission of bank supervision.

We do not offer these recommendations to weaken bank supervision or to encourage in any way a return to the inadequacies and indeed dangers of the pre-crisis era. We outline them instead out of a sincere effort to better enable examiners to strike the right balance, to employ the flexibility of approach that embraces the great variety in the American banking industry and its customers, and to ensure that the supervisory and examination program continues providing the value added to the banking system and to the economy that it is charged with providing. We have learned during the course of this project that most banks have a healthy and constructive relationship with their examiners. If our recommendations are to have any impact on the examination process, these constructive relationships will not only have to be maintained, but broadened, in the interest of both the examiners and the banks they supervise, and ultimately for the communities and customers that they serve.

Importance of Bank Lending to the Economy

Banks remain vital providers of credit to businesses. Large businesses to some degree in recent decades have moved away from borrowing from banks, preferring at times to issue their own commercial paper, but even then these securities typically require a back-up bank line of credit. Banks lend directly, however, to the over 90 percent of U.S. businesses that are not so large and well-established that they can access the commercial paper market.

The commercial lending market for banks thus ranges from startups that have sufficient collateral or can offer personal guarantees of their founders, to seasoned middle-market companies with hundreds, even thousands of employees. Indeed, until the crisis, banks were far more important sources of credit for startups than is commonly believed. Using a data base of 5,000 firms launched in 2004, a year that coincidentally turned out to be a mid-point of the last economic expansion, economists Alicia Robb and David Robinson found that banks collectively supplied 40 percent of startup firms' funds, well above founders' equity and funds supplied from such third parties as friends, family, and angel or venture capital investors.¹ This finding debunks the conventional wisdom that banks haven't loaned funds to startups or young companies because they typically have no collateral. Until the financial crisis and subsequent recession induced banks to cut back on these sources of credit, company founders often tapped their personal credit cards or home equity lines of credit. They even located some banks willing to provide standard commercial credit as well, if the founders guaranteed those loans or provided some personal assets as collateral.

A focus on startups, in particular, is important because recent research has documented their crucial role in generating new jobs. From 1980 until the recession, firms less than five years old accounted for virtually all net new jobs created in the U.S. economy.² Beginning in 2005, however, the number of startups launched each year, and the jobs they generated, have fallen, taking their steepest nosedive in the recession itself.³ Although technology—the Internet, cloud computing and dramatic decline in cost of personal computers and software—has significantly reduced the cost of launching many new businesses, growing companies all need

1 Alicia M. Robb and David T. Robinson, "The Capital Structure of New Firms," NBER Working Paper 16272, August, 2010, and forthcoming in *The Review of Financial Studies*

2 Dane Stangler and Robert E. Litan, "Where Will the Jobs Come From?" Kauffman Foundation, November 2009, http://www.kauffman.org/uploadedFiles/where_will_the_jobs_come_from.pdf

3 E.J. Reedy and Robert E. Litan, "Starting Smaller, Staying Smaller: America's Slow Leak in Jobs Creation," Kauffman Foundation, July 2011, http://www.kauffman.org/uploadedFiles/job_leaks_starting_smaller_study.pdf

funding in order to innovate, meet expanded demand, and bring on new employees. That is why it is essential for these companies and for the economy as a whole for banks to be both financially able and willing to make commercial loans not only as demand for goods and services picks up, but on a sustained basis thereafter to support a stronger rate of economic growth over the longer run.

So far, commercial lending by banks overall has been recovering. Small business loans, however, which would include loans to startups—though these are not separately broken out in the official statistics—have not done as well. Defining a small business loan as one under \$1 million, researchers at the Federal Reserve Bank of San Francisco reported in October 2011 that such loans as of mid-2011 were down by \$47 billion compared with their pre-recession peak in 2007. After rising at the beginning of the crisis by 3.1 percent, from mid-2007 to mid-2008, small business loans defined this way dropped every year thereafter, most rapidly by 6.4 percent from mid-2009 to mid-2010, but slowing to a decline of 5.5 percent from mid-2010 to mid-2011.⁴ The trends in small business lending by banks contrasts starkly with the more sustained increase in overall commercial and industrial (“C&I”) bank lending. Given the importance of small business lending, especially to new businesses, this disparity in lending between C&I borrowers in general and smaller business borrowers in particular is not a pattern that bodes well for the future and one that should be of concern to bank examiners in particular and economic policy makers more broadly.

The Fed researchers cite surveys by the National Federation of Independent Businesses indicating that poor demand for goods and services is reported to be a significantly more important reason for low loan demand by small business than the inability to gain financing. This finding is broadly consistent with the October 2011 Senior Loan Officer Survey by the Federal Reserve and our own survey and interviews (reported next). The various survey data relating to current lending practices, however, give no clue as to how willing or able banks will be to extend commercial loans to credit-worthy small and new business borrowers as consumer demand strengthens in a sustained way and as growth continues. That critical question is one of the main subjects we tackle in the results section of this report.

The Importance of Value-Added Bank Examination and Supervision

Ever since governments began chartering banks, they have had an interest in conducting at least some examinations, albeit with a checkered history, to monitor their financial soundness, and in recent decades, to ensure compliance with various other statutory mandates, such as those relating to disclosure, money laundering, consumer protection, community reinvestment and non-discrimination. This report focuses on safety and soundness examination, although we also received feedback during the course of our interviews about excessively costly compliance examinations.

It is useful to think of bank examiners as the financial equivalent of physicians. Doctors conduct annual physical exams to assess a patient’s health and to spot potential problems, and they frequently provide advice about how to sustain or improve health in the coming year. Few people look forward to their annual physicals: they are frequently uncomfortable, sometimes painful, and clearly intrusive. But we go through them because we know they can prolong and

4 Liz Laderman and James Gillan, “Recent Trends in Small Business Lending,” *FRBSF Economic Letter*, October 17, 2011, www.frbsf.org/publications/economics/letter/2011/el2011-32.html. The authors note that some loans under \$1 million go to large businesses, but suggest that these are likely to be exceptions rather than the rule

improve the quality of our lives. Using an economic metaphor, annual physicals *add value*. Bank examinations, likewise, should add value to the banks they supervise. Bank examiners are more than just another set of auditors who check over the numbers—the revenues and expenses that make up a bank’s income statement or the assets, liabilities, and net worth recorded on its balance sheet. Examiners are experts who are specially trained to look beyond the numbers, seeking to determine whether the *processes* that banks use to gather deposits, extend loans, manage risk, and keep track of all this information and to ensure its security, are appropriate. To carry out their jobs, examiners thus ask questions—of bank employees, executives and directors—all with an eye to ensuring that the bank is well managed and appropriately managing risks. Banks must take risks in order to make money and to remain competitive and in the end to serve their customers. After all, lending thousands or millions of dollars to businesses and people is a risky exercise, one on which our nation relies every day. The key is that risks be undertaken and managed prudently, that bank officials and directors are fully aware of the risks and understand them, and that banks have sufficient loan loss reserves and capital to absorb losses when some risks do not turn out well.⁵

When conducted with the foregoing objectives in mind, bank examinations add value to banks just as annual physicals add value to patients. Banks that are doing well and have no major need for change, which is typically the case, are better off for having gone through their examinations. Banks that are told to improve in one or more ways also are better off for knowing the areas that require improvement. And banks that have significant weaknesses, including capital shortfalls or insufficient liquidity, must be told to shape up, in their own interest, and in the interest of other banks, which bear the cost of insuring their deposits in the event troubled banks fail. Moreover, the identification of bank shortcomings benefits the broader economy, which suffers when too many banks are too weak to lend responsibly, or at all.

By regulators’ own admissions, bank examination fell short in the run-up to the financial crisis, allowing too many banks of all sizes to weaken credit underwriting, to take excessive risks in packaging and selling securities backed by subprime mortgages and in extending loans for commercial real estate acquisition and development. In addition, had regulators acted earlier to induce banks with significant losses on their loans and securities to raise additional capital and set aside higher loan-loss reserves, those institutions and the broader economy would have been better cushioned against those losses, thereby mitigating the consequences of the crisis itself.

Given these events, some adjustments in bank examination and supervision after the crisis clearly were in order. Improved attention to upgrading the quality of capital, a stronger focus on concentrations of loss exposures, a better review of counterparty risks, but above all, the recognition by both regulators and banks of the risks inherent in mortgage lending and need for improved underwriting all have contributed to a healthier banking system since the crisis. In addition, the forward-looking stress tests adopted for the nation’s largest banks in 2009 helped to regain the trust of depositors and investors in those institutions.

Beyond the stress tests, to what extent has bank examination and supervision actually changed since the crisis? Is it better? Is it worse? In short, what value does it add? One useful way to find out is to ask how the subjects of the examination process—banks themselves—answer these questions.

5 The examination process is formalized under numeric grades given to the components of the “CAMELS” system: capital, asset quality, managerial competence, earnings, liquidity, and sensitivity to market risk.

Bank Examination and Supervision Since the Crisis: Survey and Interview Findings

That is precisely what the ABA asked us to do. At our request, the ABA gave us a list of more than 90 banks whose CEOs have been active on bank examination issues and would be willing to speak to us candidly about the current characteristics of examinations. The banks were chosen to include a broad range of charter types, business models, geographic locations and sizes. We also instructed the ABA to steer away from banks that currently had major examination issues with their regulators, reflected in the fact that all but two had no capital adequacy issues. Above all, the key defining feature of the banks surveyed is that they are led by seasoned executives who have thought extensively about the supervisory process and were willing to share their views on this subject. We had no reason to believe that ABA cherry-picked these banks or went about the selection with any bias. Indeed, that will be clear shortly when we discuss the varied responses to many of the questions we posed. If there had been a particular bias, much greater uniformity in the answers would have been reported.

We initially chose 15 of the 90 banks as subjects for detailed, confidential interviews with their CEOs or chief financial officers. Our choices were essentially random, though we made an effort to select banks from different parts of the country and of different sizes. We underscore the confidential nature of the interviews: we told the interviewees that they individually or their banks would not be identified in any follow-up report or document such as this, in order to solicit their candid responses. However, we did indicate that we could make use of the aggregate responses of all of the interviewees, and that is what we have done here.

Based on these conversations, we then formulated the attached survey, which the ABA distributed at the beginning of November 2011 on our behalf to all 90+ of the banks initially selected. We gained responses from 67 of the 90 banks by mid-November, an excellent response rate by any standard.

In what follows, we report both the responses to the survey questions and our broad impressions of our more detailed initial interviews. These responses form the basis for the recommendations we advance.

Characteristics of the Survey/Interview Sample. Roughly two-thirds of the banks responding to the survey have assets below \$1 billion, roughly similar to the population of banks generally (Question #1). Virtually all of the reporting banks are in compliance with minimum bank capital standards (Question #2).

Has Bank Supervision Changed Since the Crisis? Almost all of the banks surveyed believe that bank supervision has changed since the crisis; a majority believes significantly so (Question #3). Some banks indicated in the interviews that changes in supervision began even before the crisis. *Further, some of the banks, though clearly in the minority, expressed no complaints about supervision and praised their supervisors, even though they recognized the legitimacy of concerns and complaints about changes in supervision affecting other banks.*

Nature of Supervision Since the Crisis. We explored with the banks in both the survey and the interviews some specifics of how supervision has changed since the crisis.

As to the survey, 37 percent of the respondents reported that their bank examiners take adequate account to a significant degree of the particular profile of their bank—its charter, areas of business, business model and size. But a plurality, 42 percent, only believe this to be mildly so, and 21 percent do not agree that supervisors customize their examinations. *In other words, fully 63 percent of the respondents believe there are some problems in the way bank examinations are being carried out, and at least implicitly are expressing concern about a one-size-fits-all approach taken by bank examiners.*

More specifically, many of the banks interviewed during our in-depth interviews believe that since the crisis examiners have put much greater emphasis on “the numbers”—income-to-debt ratios and formulaic rules of thumb—rather than on less quantifiable factors such as a borrower’s character, reliable personal guarantees or personal assets of borrowers or on the quantifiable but apparently now less relevant pattern of a borrower’s prior loan payments. Indeed, some bankers expressed frustration with their local examiners’ lack of knowledge of the strong financial health of some of the banks’ borrowers and the examiners’ unwillingness to trust the bankers’ judgments about these individuals and their credit-worthiness. Examiners can get off track, and have counter-productive impacts on bank lending, when they second guess too much the individual judgment calls on individual loans, unless they detect problem loans as part of a *pattern* of activity and lack of judgment material enough to endanger the bank.

Several of the banks in our interviews also expressed concern that examiners were vague about the minimum capital requirement their banks were really expected to meet, implying that however much capital their banks had at the time never appeared to be enough. This was generally supported by our broader survey in which 51 percent of the respondents reported that “the amount of the effective minimum capital required is unclear or seems to be a moving target,” with only 21 percent saying that examiners have been clear on this point (Question #8).

We heard other concerns in our interviews. For example, many of the bankers we talked with noted how decisions of their local examiners have been much more frequently second-guessed by regional or national supervisors. This second-guessing may be expected where local examiners have erred or departed materially from national standards. To be sure, nationwide consistency in the application of supervisory standards is highly desirable. But local examiners who have had good examination records and possess extensive local knowledge about both the banks and the economies in which they do business should be listened to. Narrowing the discretion afforded local examiners can encourage a numbers-driven process in the exams and by banks in their lending decisions as well. There is no clear evidence that numbers-driven banking is superior to more judgment-based lending decisions. Indeed, the tendency of too many lenders to rely solely on numbers, such as credit scores, or unsound loan-to-value ratios, contributed to the excessively risky lending that led to the crisis. When only numbers drive the lending process, then potentially creditworthy borrowers whose good character and prior payment history are known to the bank will be denied credit or be forced to borrow on more onerous terms than would otherwise be the case.

In addition, a number of bank CEOs voiced concerns about increased examiner rotation, with the result that their current local examiners may have little or no local knowledge of the banks’ operating area or its customers. This tends to reinforce examiners’ reliance on numbers and documentation, without adequate account being taken, in these bankers’ views, of the specific characteristics of loans or the borrowers.

In their defense, federal bank regulators have limited examiner staffs, and with the increase in the numbers of problem banks and deteriorating real estate markets around the country during and after the crisis the bank regulatory agencies have had to redeploy examiners at “healthy” banks to those not quite as healthy or in more precarious condition. A few of those healthy banks reported good, cooperative relations with their supervisors, even to the point of checking with them on “close call” loans before extending credit. To be sure, there is a danger in failing to rotate long-serving examiners at particular banks who can “go native” and adopt the mores and thinking of the bank itself, which can lead examiners to overlook problems in the making. But excessive rotation also probably has contributed to a less customized approach to examination of some banks. Going forward, the regulatory agencies have to balance these effects of rotation, which perhaps can best be accomplished by having examiner teams that have a mix of experience with the specific institution so that the examinations benefit from at least some bank-specific examiner experience while gaining the benefit of some fresh eyes of the examiners with shorter tenure at the bank.

Some state-chartered bank CEOs voiced concerns about a lack of coordination between state and federal examiners, and more precisely about federal examiners overriding many views of state examiners. There were also complaints of state examiners treating certain banking practices harshly because of a lack of understanding of the practice as opposed to voicing specific safety and soundness concerns.

The most specific critique of recent and current supervisory practices was provided by Harris Simmons, CEO of Zions Bancorporation, headquartered in Salt Lake City. We identify him by name because he gave a speech precisely on this topic before an American Banker Regulatory Symposium on September 20, 2011. Simmons publicly advanced two concerns about the loan classification process that we would like to emphasize.

First, by the regulators’ own admission in 2005, the classification of loans as “substandard,” which can trigger additions to loan loss reserves or loan charge-offs, does not adequately take into account the severity of loss if a particular loan defaults, and especially how such factors as collateral and guarantees can mitigate that loss, a problem that regulators proposed to correct in 2005, but which they have not yet done.

Second, Simmons argues that examiners have taken a more restrictive position on the classification of *commercial* loans as “substandard” than they have for *consumer* loans. In particular, commercial loans can be classified substandard *regardless of their current delinquency status*—that is even if the borrower is current on its loan payments—if the examiners believe that deteriorating economic or borrower-specific conditions *in the future* will lead to delinquency. Because bankers understandably seek to minimize any classified loan commitments, the difference in regulatory treatment may already be chilling commercial lending now, but more importantly, could act as a significant headwind on banks’ willingness to provide such credits as commercial loan demand strengthens, a point we elaborate further below.

Do Bank Exams Add Value?

Given our own view that examination, when properly carried out, can add value to a bank’s operations (including improved performance by its employees and executives), as well as the belief by regulators in the benefits of the examination process, we wanted to know whether banks agreed with this “value proposition.” Specifically, we asked this “value” question as it applied in the two to three years prior to the crisis (Question #5) and then since the crisis

(Question #6). The survey responses indicate a sharp difference between the two time periods, supporting the earlier finding that bank supervision has changed significantly since the crisis, and not for the better.

In particular, fully 73 percent of survey respondents answered that before the crisis bank exams added value, either significantly (27 percent) or mildly (46 percent). In contrast, only 45 percent of banks believed this to be true since the crisis (12 percent significantly, 33 percent mildly). Even more startling is the increase in bankers who see the examination *as being counter-productive*, jumping from just 3 percent before the crisis to 34 percent after it. The change in attitude evidenced in the survey is consistent with the various concerns expressed in the in-depth interviews. That is to say, that at least as perceived by the industry, the gap between the purpose and the performance of bank examination has widened dangerously.

Impact of Changed Supervision on Future Bank Lending

What is the prospect for bank lending to business in the future? The survey indicates that as of November 2011, the month in which the survey was taken, 40 percent of the respondents expected that their bank would increase not only the volume of total commercial loans, but the ratio of those loans to total assets (Question #9). A larger share, 46 percent, expected the ratio to remain the same, and 13 percent thought the ratio would decline.

The expected prospects for commercial *real estate lending* are poorer, however (Question #10). Only 27 percent expected the ratio of such loans to their total assets to increase, while 58 percent expected it to remain the same, and 15 percent to decline.

Based on the foregoing survey and interview responses, one would expect that changes in bank examination since the crisis would discourage commercial lending, or at least make it more expensive, as we were told that explicitly by most of the banks in our interviews. The survey responses confirmed this result on a broader scale:

- **49 percent** said that changes in examination practices would “toughen underwriting standards *permanently*” as applied by the bank.
- **48 percent** agreed that the changes would require borrowers to have more equity in their deals.
- **48 percent** reported that the changes would reduce their willingness to lend to customers that in the past they would have considered creditworthy.

On their face, these responses may not seem necessarily worrisome, since any tightening of underwriting standards that may have been excessively loose before the crisis is clearly appropriate. On closer examination, however, the survey results raise some warnings. Only 21 percent of the survey respondents believe that the changes in examination post-crisis “will improve the safety” of their bank. This statistic is consistent with the criticisms in our in-depth interviews of examinations “by the numbers” that give little or no credit to banks’ judgments of borrowers’ character, past creditworthiness and repayment behavior. Moreover, remember that this is the opinion of bankers who might be termed the “survivors” of the financial crisis, not the firms that failed.

Indeed, our broad impression from the in-depth interviews is that the banks we talked with generally believed since the crisis, that unless a bank is “perfect” along every key dimension—it has high and consistently high capital ratios, well above the regulatory minimum, has not received TARP monies, has very low loan losses/delinquencies, is doing business in an area where the local economy is relatively better off than the national average, and has had stable and sound management—the bank’s loans have been scrutinized much more rigidly than before the crisis. Many bankers believe that much of the heightened supervision has focused excessively on underlying documentation or bank governance of little direct relevance to the likelihood of continued loan payment. A few bankers we interviewed even believed the regulators were actively discouraging them from *any* new lending, especially if collateralized by real estate, although virtually all of the bankers also acknowledged that loan volume was below what it otherwise might be primarily because of weak demand.

These views are consistent with a concern expressed by most of the interviewees that changes in bank examination practices will reduce the willingness of at least some banks to lend to qualified commercial borrowers for fear of later being second-guessed by examiners, either locally, or by their regional or national supervisors. To the extent this is true, bank supervision is likely to slow the pace of the recovery in the short run and possibly impair the rate of long-term growth.

More broadly, we believe these findings are important, because despite the recent uptick in bank C&I lending overall in recent months, concerns remain among many bankers about the *long-term impact* of the new supervisory practices and attitudes. Will the new practices cause business lending growth to be below trend because of the deficiencies highlighted in this survey? Will examination problems deepen future recessions and/or make recoveries from them more difficult? The concerns expressed by bankers about the direction of supervision since the crisis point to worrisome answers to both of these fundamental questions.

Accordingly, we offer the recommendations below in an effort to reinforce the fundamental concept of value-added examinations and supervision, which we believe will have both short and long run positive effects for banks individually, for the banking system collectively, and the broader economy.

Recommendations

We recommend several ways that the bank supervision/examination program can strengthen rather than impede economic recovery and help sustain long-run growth, enhancing the quality and integrity of the bank examination process at the same time. These recommendations are offered to stimulate an ongoing discussion between regulators and industry to re-enthroned value-added supervision as a prominent and defining element of the American banking system that makes it superior to alternative regulatory approaches, both with regard to safety and soundness of the industry and the value that banking provides to the economy and to bank customers. Some of these recommendations offer strategic principles to guide specific applications, while others are more tactical and detailed.

First, examiners should make every effort to better customize their examinations taking account of the nature of a bank’s business model, charter type and perhaps most important, bank management’s record with borrowers and borrower characteristics, prior repayment history and strength of personal guarantees. Regulators’ traditional focus on size as proxy for

all these and possibly other characteristics of a bank is of less importance in a more complex banking environment, where these other factors have a lot more to say about a bank's ability to serve its customers—as well as its likelihood to get into trouble—than size does.

In this regard, examiners should give credit to well-run banks that know their customers and local regions, and often have as much if not more experience in knowing which borrowers are creditworthy and which are not, than examiners themselves, especially if examiners are new to a region. One-size-fits-all judgments about such standards as to whether and how much to reserve against loans, especially when driven solely by numerical analysis, effectively take away bankers' autonomy and the value of their judgment in contributing to the best allocation of capital to enhance growth. Well-run banks should not be treated as if every activity must be micro-managed. Banks, like every other private enterprise, should be free to make mistakes and to learn, provided they have sufficient capital and reserves to absorb losses that occur and that these operations take place within the context of an overall well-managed institution. Auditors take into account the multiple differences between their clients. There is no reason why bank examination should be any different.

Second, a truly value-added safety and soundness exam should focus on the big picture and avoid getting lost in the weeds. The overall approach should be risk-based, looking for evidence of significant patterns or practices that, if unaddressed, could affect the safety and soundness of the bank, and thus its survivability. Too often exams can appear as “gotcha” exercises, focusing on technicalities and minor issues that have little bearing on the genuine safety and soundness of the institution. Examination practices should be informed and improved by continuing research by the regulatory agencies, a process that can be facilitated by ensuring continued interactions between examiners and research staff (who should be encouraged to attend some exams), together with improved interaction with industry outside of the examination environment. The thrust of this recommendation applies with equal force to compliance exams, which according to many of the banks we interviewed have displayed the same check-the-box characteristics as safety and soundness examinations.

Third, regulators and examiners should provide clearer guidance on exactly how much capital banks are expected to maintain. There are capital rules on the books, and then there are the real rules in the field, which many bankers believe are a constantly upward-shifting target. There is nothing inherently wrong with somewhat higher standards in specific cases directly related to risk issues, but it is important that bankers know more clearly what the true targets are. Otherwise, bankers face undue uncertainty, which can lead to excessive caution and shedding of assets, which is a much easier way to meet higher capital standards than raising new capital. The shrinkage of bank assets is not what a growing and vital economy needs, however. Accordingly, the more clarity and predictability examiners and their supervisors can bring to capital standards, the better positioned banks will be to finance the recovery and to sustain growth over the longer run. That includes the ability to attract investors, who perhaps even more than the bankers themselves want to know what regulatory capital demands will be.

If the broader policy objective in these uncertain times nonetheless is to raise broad capital standards even higher, then banks should be made aware of this objective with greater specificity and clarity. But before doing this, regulators should take into account the high costs of higher capital standards (which reduce banks' ability to lend and reduce return to investors) in light of the benefits of a strengthened supervisory and examination system of the kind outlined here which may more cost effectively serve the same purposes intended by heightened capital ratios.

Fourth, we agree with Harris Simmons' recommendation that at least with respect to banks where stress testing is feasible and cost-effective and can be designed appropriately for the institution, regulators should substitute well-designed stress tests when assessing asset quality and capital requirements—instead of giving excessive weight to classified asset ratios and using measures of non-current loans to level the comparisons of credit risks in consumer and commercial loan portfolios. Indeed, regulators should consider giving banks not already subject to stress tests (or soon to be subjected to this procedure under the Fed's proposed rules) the option of going through some variation of a stress test rather than using the traditional approach that relies heavily on loan classifications.

Consider this example: regulators may well be justified in anticipating the renewal of rents in this year and subsequent years, as leases expire, at levels considerably below where they are now. If this is the case, then many commercial real estate loans that may be performing now may not be performing in future years, hence the anticipatory classification. While there is merit in this counter-view, we believe, like Simmons, that if a bank passes a stress test that accounts for the possibility that rent or other revenues of borrowers will fall, then regulators should acknowledge the stress test result and not require the bank to raise additional capital or subject it to other regulatory limits.

Fifth, for all other banks that are not likely to be subjected to stress tests or do not choose them, we suggest that examiners take greater account of various effective techniques banks use to mitigate lending risks and to mitigate potential losses, such as through borrowers' personal guarantees, where borrowers have the assets or income to back them up. That is to say, it may well be appropriate for examiners to take a more forward-looking approach to loan classifications, especially in difficult economic circumstances, but they should also be willing to accept other legitimate means of addressing these concerns. Failure to do so is likely to discourage the use of risk mitigation techniques, ironically weakening incentives banks have for adopting these constructive measures or developing and employing new and more effective techniques.

Moreover, this is an important means of differentiating between those banks that are well run and those that are less so. Once again, our point is that value-added supervision takes each institution on its own, recognizing the quality of its differences, employing a less regimented or one-size fits all approach, as various banks with various business models will employ risk management strategies appropriate for those banks that may be less effective in a rather different bank.

Sixth, just as we believe it is appropriate for examiners to give greater deference to well-managed banks with respect to their lending judgments, it is also appropriate for the bank regulatory agencies to restore some deference to local examiners who have performed well in the past. Such judgment and experience should not be simply ignored (though we recognize that national and regional offices have legitimate reasons for questioning the judgment of inexperienced examiners or those who have not performed well, rotating or even removing the latter for cause). The variety in the industry requires that examiners be allowed to exercise their judgment in adapting fundamental safety and soundness standards to the variety that they find in institutions. As we have noted, local examiners know both the banks and the economic environments in which they operate, and regional and national authorities should take advantage of that local knowledge. One step that would give regional and national offices greater comfort in extending this deference is to assure that examiner teams are led by senior examiners and are balanced overall in terms of examiner experience. In this regard, it is

important that the agencies continue to have the resources to train and retain good junior and mid-level examiners so that they remain to become sound senior examiners.

Seventh, with respect to the supervision of state-chartered banks, both federal and state supervisors should redouble their efforts to cooperate. Where either regulator has substantial experience with a particular banking practice that the other does not, efforts should be made to share knowledge and/or give deference to the regulator with that experience. This is especially apt, we believe, for state examiners of state-chartered banks. These individuals and the agencies they work for tend to have the most knowledge of the local bank and the areas in which they compete. Enhanced joint training of state and federal examiners also can contribute to tangible cooperation in the field, but the initiative here will have to come from federal authorities.

Eighth and finally, each of the federal banking regulatory agencies may want to conduct a parallel study of its own examiners, being sure to cover those with a broad range and length of experience, to assess whether *they* believe the examination process has changed over time, if so how, and what changes in examination they would recommend. In particular, it would be worthwhile knowing whether examiners have some of the same beliefs and attitudes reflected in this bankers' survey, or whether there is a marked difference. At the very least, the findings in this survey suggest a need for reexamination and improvement of the supervisory process so that it enhances the value of bank examinations for the banks involved and for the broader economy. Undoubtedly, experienced examiners have practical ideas as to how to improve the value of exams, and surely new examiners entered the profession with the goal in mind of adding value to the banks in the industry that they examine.

This important objective can be better achieved, we believe, if bank regulatory agencies adopted the foregoing recommendations.

Appendix

Survey Questions and Responses

1. Total assets of your bank (or all of your banks if a multi-bank holding company):

<i>Answer</i>	<i>#</i>	<i>%</i>
Below \$1 billion	43	64%
\$1 billion to \$10 billion	20	30%
\$10 billion to \$50 billion	2	3%
Over \$50 billion	2	3%
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TOTAL	67	100%

2. Is your bank (or are all of your banks if a multi-bank holding company) currently in compliance with minimum bank capital standards to be deemed well capitalized?

<i>Answer</i>	<i>#</i>	<i>%</i>
Yes	65	97%
No	2	3%
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TOTAL	67	100%

3. Since the financial crisis of 2007–08, have your bank examiners changed the way they carry out their supervision?

<i>Answer</i>	<i>#</i>	<i>%</i>
Yes, to a significant degree	38	56%
Yes, but only mildly so	27	40%
No change	3	4%
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TOTAL	68	100%

4. Do your bank examiner(s) adequately take into account the particular profile and characteristics (size, charter, geography, business model) of your bank during the supervision process?

<i>Answer</i>	<i>#</i>	<i>%</i>
Yes, to a significant degree	25	37%
Yes, but only mildly so	28	41%
No change	15	22%
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TOTAL	68	100%

5. In the experience of your bank in the two to three years prior to the financial crisis of 2007–08, did bank supervision and examination add value to your bank, either through the reassurance that the bank is operating in a safe and sound manner and/or by identifying legitimate problems that need to be addressed and overseeing the development of a plan to resolve these issues?

<i>Answer</i>	<i>#</i>	<i>%</i>
Yes, to a significant degree	18	26%
Yes, but only mildly so	32	47%
Did not add value	16	24%
Was counterproductive or excessively costly in relation to benefits	2	3%
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TOTAL	68	100%

6. In the experience of your bank since the financial crisis of 2007–08, has bank supervision and examination added value to your bank, either through the reassurance that the bank is operating in a safe and sound manner and/or by identifying legitimate problems that need to be addressed and overseeing the development of a plan to resolve these issues?

<i>Answer</i>	<i>#</i>	<i>%</i>
Yes, to a significant degree	8	12%
Yes, but only mildly so	22	32%
Did not add value	15	22%
Was counterproductive or excessively costly in relation to benefits	23	34%
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TOTAL	68	100%

7. Please estimate the value that your bank obtains from bank exams with regard to your ability to serve your customers and communities:

<i>Answer</i>	<i>#</i>	<i>%</i>
Exams generally improve significantly our ability to serve our customers and communities	8	12%
Exams generally provide some moderate value to our ability to serve our customers and communities	4	6%
Exams generally have little impact on our ability to serve our customers and communities	24	35%
Exams generally make it somewhat more difficult to serve our customers and communities	31	46%
Exams create significant impediments to serving our customers and communities	9	13%
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TOTAL	68	100%

8. How do you feel about examiners' guidance of how much capital your bank should have?

<i>Answer</i>	<i>#</i>	<i>%</i>
Examiners have been clear about the bank's effective minimal capital requirement	21	31%
The amount of effective minimum capital required is unclear or seems to be a moving target	35	51%
Neither of the above	12	18%
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TOTAL	68	100%

9. Looking ahead, do you think your bank will increase or decrease its commercial and industrial lending (relative to total assets) in the next 12 months?

<i>Answer</i>	<i>#</i>	<i>%</i>
Increase	28	41%
Decrease	9	13%
About the same	31	46%
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TOTAL	68	100%

10. Looking ahead, do you think your bank will increase or decrease its commercial real estate lending (relative to total assets) in the next 12 months?

<i>Answer</i>	<i>#</i>	<i>%</i>
Increase	19	28%
Decrease	10	15%
About the same	39	57%
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TOTAL	68	100%

11. How will the way your bank has recently been examined affect your bank's commercial lending going forward? (check all that apply)

<i>Answer</i>	<i>#</i>	<i>%</i>
It is likely to toughen our underwriting standards permanently	34	50%
It will require our bank to insist that borrowers have more equity in their deals than would have been the case before the financial crisis	33	49%
It is likely to mean that we will be less able to lend to customers whom in the past we would have considered creditworthy	33	49%
It will improve the safety of our bank	14	21%
It will have no material effect on our underwriting standards and/or capital required	16	24%
It will have no material effect on our total loan volume	14	21%

