

“Permanent chills” and how to avoid them

How exam process can move beyond the crisis

By Steve Cocheo, executive editor and digital content manager

Does bank commercial lending run the risk of a longstanding slowdown? Specialists studying the current relationship between banks and their federal examiners for ABA warned of that likelihood in the course of their research.

“While there is some concern that bank examinations are holding banks back from lending today, there is a 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.”

Former Comptroller of the Currency John D. “Jerry” Hawke, Jr., now a partner at Arnold & Porter LLP, and Robert Litan, vice-president for research and policy at the Kauffman Foundation and a senior fellow at the Brookings Institution, wrote the recently released Value-Added Bank Supervision: A Framework for Safely Fostering Economic Growth. The quote above, taken from it, continues with this warning from the two authors:

“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.”

The ABA-sponsored survey found that, post crisis:

- 49% of bankers surveyed said exam practices would “toughen underwriting standards permanently, as applied by the bank.”
- 48% agree that examination shifts “would require borrowers to have more equity in their deals.
- 48% reported that changing standards “would reduce their willingness to lend to customers that in the past they would have considered creditworthy.”

What's "valued added"?

To some bank bashers, the thought that the nation's economic health and the shape of its banks bear a relationship to each other may seem novel. But Litan and Hawke's broader point is that regulatory supervision of banks means more than looking over banks' shoulder every year or so.

The authors explain their concept that bank examinations should have a "value added" element by drawing an analogy, the annual medical checkup.

"It is useful to think of bank examiners as the financial equivalent of physicians," they write. "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 like going to the doctor, they continue, but they do in the belief that doing so will improve life, even prolong it. Patients rely on doctors to point out ways to make themselves feel better, and live healthier lives.

Examiners, they say, are more than auditors, and should be seen, and should act, that way.

"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 of this information, and to ensure its security, are appropriate," they write. "... When conducted with the foregoing objectives in mind, bank examinations add value to banks just as annual physicals add value to patients."

The point, they write, is that if the bank is doing well and no significant changes are necessary, then the bank is better off for the exam. And an exam conducted as a value-added exercise should identify issues that a bank requiring something more needs to deal with.

"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," they state.

Where's the value?

The study found that since the crisis, bankers have not felt that examinations have been adding value. Many bankers surveyed feel that examiners don't tailor their examinations to the profile of the bank being examined. The survey found 37% felt examiners adapted their work to the institution, while 42% only felt this was somewhat the case, and 21% felt that supervisors don't customize their examinations at all.

"In other words," Litan and Hawke state, "fully 63% 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."

Many other concerns about the exam process came out of the surveys and in-depth personal interviews that were conducted. Vagueness on capital standards came up frequently, for instance, while the second guessing of field examiners often seems of concern.

“To be sure, nationwide consistency in the application of supervisory standards is highly desirable,” Litan and Hawke write. “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.”

Indeed, the study found that many bankers found exams were “value added” prior to the crisis. “Fully 73% of survey respondents answered that before the crisis bank exams added value, either significantly (27%) or mildly (46%),” they write. By contrast, post-crisis, 45% felt exams added value, 12% significantly so, and 33% mildly.

Notably, while 3% felt pre-crisis exam were counterproductive, 34% felt that way post-crisis.

Eight steps toward improvement

Litan and Hawke suggest eight steps that can help restore some equilibrium. In brief:

1. Customized supervision. Regulators should move away from “one size fits all” examination and supervision. Business models, rather than solely bank size, should be driving more of the customization.
2. Focus on the “big picture.” Examiners have to put aside “gotcha” approaches, and “getting lost in the weeds,” and focus on the overall state of the institution much more.
3. Produce clarity in capital requirements. “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,” the authors state.
4. Look more closely at stress testing. Stress tests helped stabilize confidence in the large banks a few years back, the authors note, and this indicates that they can be used more heavily by examiners, in place of “anticipatory” loan classifications. They also suggest that smaller banks could adopt more stress testing as an option that would free them from traditional exam approaches that rely heavily on loan classification. In some ways, this is similar to the “self-evaluation” option under the Community Reinvestment Act.

5. Consider how banks manage risk when reviewing loan losses. "A value-added examination program should recognize and reward the value-added risk management efforts of the banks themselves," they write.

6. Respect experienced examiners. More respect, and latitude, should be given to experienced, competent examiners in the field, recognizing the value of their real-world savvy.

7. Foster cooperation with state bank examiners. The strengths of the dual-banking system should be exploited, by sharing knowledge and by giving deference to the exam team with the most local insight.

8. Review the federal examination troops. Federal banking agencies should study their field staff to see if the skills and skill levels they have match what the examination process should be today.

"In particular," the authors write, "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."

To obtain the ABA's full report, go to <http://tinyurl.com/valueaddedstudy>

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