The Meeting of the Advisory Committee on Community Banking

of the

Federal Deposit Insurance Corporation

Held in the Board Room

Federal Deposit Insurance Corporation Building

Washington, D.C.

Open to Public Observation

April 9, 2014 - 8:45A.M.

The meeting of the FDIC Advisory Committee on Community Banking ("Committee") was called to order by Martin J. Gruenberg, Chairman, Federal Deposit Insurance Corporation ("FDIC") Board of Directors.

The members of the Committee present at the meeting were: Robert F. Baronner, Jr., President and Chief Executive Officer ("CEO"), Bank of Charles Town, Charles Town, West Virginia; Cynthia L. Blankenship, Vice Chairman and Chief Operating Officer, Bank of the West, Grapevine, Texas; Leonel Castillo, President and CEO, American Bank of Commerce, Provo, Utah; Jane Haskin, President and CEO, First Bethany Bank & Trust, Bethany, Oklahoma; Mark Hesser, President, Pinnacle Bank, Lincoln, Nebraska; James Lundy, Chief Executive Officer, Western Alliance Bank, Phoenix, Arizona; Joseph G. Pierce, President and CEO, Farmers State Bank, Lagrange, Indiana; Kim D. Saunders, President, CEO and Director, Mechanics & Farmers Bank, Durham, North Carolina; Dorothy A. Savarese, President and CEO, Cape Cod Five Cents Savings Bank, Orleans, Massachusetts; David Seleski, President, CEO and Director, Stonegate Bank, Fort Lauderdale, Florida; Mark Stevenson, President & CEO Capital Pacific Bank; Alan Thian, President and CEO, Royal Business Bank, Los Angeles, California; and Derek Williams, President and CEO, First Peoples Bank, Pine Mountain, Georgia.

Carolyn "Betsy" Flynn, President and CEO, Community Financial Services Bank, Benton, Kentucky and Joseph G. Pierce, President and CEO, Farmers State Bank, Lagrange, Indiana were absent from the meeting.

Members of the FDIC Board of Directors present at the meeting were: Martin J. Gruenberg, Chairman, Thomas M. Hoenig, Vice Chairman and Jeremiah O. Norton, Director (Appointive).

Corporation staff who attended the meeting included: Willa M. Allen, Ruth R. Amberg, Steven O. App, Lisa D. Arquette, Heather L. Basnett, Bobby R. Bean, Michael W. Briggs,

Richard A. Brown, Kitty Chaney, Navid K. Choudhury, Patricia A. Colohan, Carolyn D. Curran, Patricia B. Devoti, Doreen R. Eberley, Bret D. Edwards, Diane Ellis, Patricia W. Farrell, Robert E. Feldman, George E. French, Shannon N. Greco, William H. Henley, Jr., Martin D. Henning, Shamara L. Humbles, Kathy Kalser, Sally J. Kearney, Yan Y. Lee, Alan W. Levy, Linda Lorch, Christopher Lucas, Peter A. Martino, Roberta K. McInerney, Jonathan N. Miller, Rae-Ann Miller, Robert W. Mooney, Sumaya A. Muraywid, Thomas A. Murray, Christopher J. Newbury, Thomas E. Nixon, Richard Osterman, Bimal V. Patel, Mark E. Pearce, Sylvia H. Plunkett, Stephen A. Quick, Jack Reidhill, Marlene M. Roberts, Claude A. Rollin, Barbara A. Ryan, Martha Solt, Marc Steckel, Robert Storch, James C. Watkins, Cottrell L. Webster, Mindy West, Lauren A. Whitaker and Smith T. Williams.

William A. Rowe, III, Deputy to the Chief of Staff and Liaison to the FDIC, Office of the Comptroller of the Currency ("OCC") and Elizabeth Ellis, Senior Advisor to the Director, Consumer Financial Protection Bureau ("CFPB"), were also present at the meeting.

Chairman Gruenberg welcomed the Committee and gave an overview of the topics that would be discussed during the day. The topics he reviewed were: technical assistance resources that the FDIC is producing for community banks' use; current FDIC research projects and a recent study on the impact of consolidation on community banking; current cyber security issues; the role of the FDIC Ombudsman and the supervisory appeals process; customer due diligence issues; a discussion of the qualified mortgage rules issued by the CFPB; and finally, a supervisory policy update focused on a final rulemaking concerning the "Volcker Rule" and recent actions by the Financial Accounting Standards Board ("FASB"). Chairman Gruenberg also welcomed Mark Stevenson as a new member of the Committee.

Chairman Gruenberg introduced Chief of Staff Barbara Ryan, who moderated the day's proceedings. Ms. Ryan in turn introduced Doreen Eberley, Director, Division of Risk Management Supervision ("RMS") and Mark Pearce, Director, Division of Depositor and Consumer Protection ("DCP") who led the panel titled, "Community Bank Initiative – Supervisory Update." Ms. Eberley noted that there had been 75,000 views of FDIC-produced technical assistance videos, including the Director's College videos. She said the Interest Rate Risk ("IRR") video had been the most viewed one so far. Ms. Eberley gave an overview of four of the safety and soundness technical assistance products released since the last Committee meeting and discussed their contents. The four subjects she discussed were: appraisals and evaluations; evaluation of municipal securities; Allowance for Loan and Lease Losses ("ALLL"); and Troubled Debt Restructuring ("TDR"). Ms. Eberley noted the FDIC's initiative to provide technical assistance for rulemakings and said that guidance for complying with the Volcker Rule had been issued. She then described the information packages the FDIC will be sending to all FDIC-supervised institutions that describe the resources provided under the Community Bank Initiative; the FDIC Ombudsman program; and the Supervisory Appeals Review program. Ms. Eberley said the package also included a cover letter that encouraged community banks to provide feedback to the FDIC and the ways they may do that.

Mr. Pearce then described the two technical assistance videos released since the last Committee meeting that assist community banks in complying with consumer compliance responsibilities. He described both a flood insurance video series and another related to fair

lending and fair lending risk. Mr. Pearce said that, at the beginning of every compliance exam, the FDIC provides the bank with an information packet that describes the exam process and the variety of ways the bank may communicate with FDIC personnel. Last, he noted that the FDIC also uses teleconferences to provide technical assistance and that DCP conducted a teleconference on mortgage rules which had more than 45,000 participants in 2013.

There was consensus that the technical assistance videos were very useful to community banks. Member Seleski said the videos prompted more discussion than just reading materials might; he said that his board watched videos as a group and then engaged bank management in a discussion of the bank's decision-making in relation to the video's recommendations. Member Saunders said that her bank made videos part of the directors' meetings; she suggested that a video on the Home Mortgage Disclosure Act ("HMDA") would be helpful as a refresher for banks that do not generate many residential mortgages. She said that directors also requested assistance concerning their roles concerning credit. Member Saunders suggested that, from an examination perspective, technical assistance would be useful on custom bench marking and that the guidance could be shared with both examiners and bankers to encourage consistent application.

Member Castillo said that his directors found the videos very beneficial and were particularly curious about their roles concerning risk management. He said they were also interested in guidance about their roles regarding the bank's audit committee and would prefer to hear guidance from the FDIC than from other sources. Member Stevenson said he had not previously known about the FDIC technical assistance available and was pleased to learn about it. Member Blankenship applauded the FDIC's efforts and said she especially liked the videos' "frequently asked questions" and "what if?" sections because they help viewers consider real-world situations. She suggested that a second FDIC notification to banks about the availability of the technical assistance would be helpful, particularly if it was directed to the bank's trainer or compliance officer. Member Savarese commended the FDIC on the videos; she said that they enable directors to understand their roles and responsibility much more quickly, and that they encourage a consistency of expectations among bankers and examiners. She suggested that guidance on the new mortgage rules would be useful. Mr. Pearce said that, as DCP had trained its examiners concerning the new mortgage rules, DCP had considered how the examiner training could be repurposed to be helpful to bankers.

Ms. Eberley said the FDIC was interested in learning how banks felt about the videos' utility and what new or different subjects would be helpful. She said that RMS considered adding questions at the end of the banker surveys that occur at the end of exams, but noted that only about 33 percent of banks respond and that the information would be somewhat lagging. Ms. Eberley said RMS had also considered conducting an industry survey that might also help create awareness of the technical assistance available. Member Blankenship suggested that the FDIC could promote awareness by including information about the technical assistance in trade group newsletters, in publications from professional groups and universities, or by Tweeting about it. Member Williams said that he thought the examination survey would be the best approach since it had a relatively high response rate compared to other surveys. Member Savarese suggested the FDIC consider using a micro-survey, a short one or two topic survey that could occur every week or two; she noted that a periodic survey would allow the FDIC to be

aware and respond to emerging issues. Member Savarese also suggested that a pop-up survey that occurred at the end of a YouTube video might work. For example, it might ask the viewer to rate the video on a 1 to 5 scale. Member Savarese and Ms. Eberley also noted the possibility of a Supervisory Insights Journal article on how bankers use the videos. Member Saunders suggested that a paper survey could be included in the information packets that had been described earlier.

Ms. Ryan then introduced Diane Ellis, Director of the Division of Insurance and Research ("DIR") and Richard Brown, Chief Economist, DIR, who spoke about community banking research. Ms. Ellis said the FDIC was committed to developing a better understanding of the structure and performance of community banks, their environment and the issues they face, and that the research was a priority of Chairman Gruenberg. She said the FDIC released a study on long-term trends in consolidation earlier that day and had updated a study describing community bank performance and structural changes in late 2013. Ms. Ellis described two current studies that were well underway: the first concerns minority depository institutions and their structural changes and performance between 2001 and 2012; the second study updates an earlier FDIC study about trends in rural depopulation and the challenges for community banks in those areas. Ms. Ellis said that three other studies were in early development. The first study concerns *de novo* institutions, their early performance and viability. The second study, she said, considers branch office trends, including what drove branch expansion before the financial crisis and branch contraction after it. The third study in development looks at commercial real estate ("CRE") and construction and development lending by community banks.

Richard Brown discussed the study, "Community Banks Remain Resilient Amid Industry Consolidation." Noting that the Committee had discussed industry consolidation before, he said that a focus on the reduction in the number of bank charters told only an incomplete and unduly pessimistic story. Referring to a packet of charts with the same title, Mr. Brown observed that consolidation in banking was not a new phenomenon, and that it had various components, each of which has its own driving forces. He said there were two main forms of voluntary attrition in banking charters: the first type was based on the voluntary merger of charters between different banking companies; the second type occurred when there was consolidation within banking companies. Mr. Brown said that a substantial amount of voluntary attrition occurred in the late 1980's and through the 1990's, due to the relaxation of geographic restrictions on banking, and that the pace of voluntary attrition had slowed after 2001. He said that 2,500 charters had left the industry involuntarily since 1985 through failure, but that the FDIC did not expect failures to contribute substantially to consolidation in the next five years. Mr. Brown said that new chartering activity is another driver that has been highly cyclical over time; new chartering has declined sharply during and after the last three recessions and has always recovered after conditions normalized. He said the period since 2008 had been a very slow period of charter formation, but that it had probably reached the bottom for this economic cycle.

Mr. Brown discussed the effects of the trends on the size distribution of charters. He noted that consolidation had a big effect on the smallest institutions, those with assets under $100 million, which had declined in number by 85 percent since 1985. Consolidation also affected the distribution of the share of industry assets; institutions with over $10 billion in assets held 81 percent of assets at the end of 2013 compared to 28 percent in 1985. Mr. Brown said it was

important to not overlook middle-sized institutions, those with assets between $100 million and $10 billion. He said, after 28 years of consolidation, those middle-sized institutions had grown in number and in the share of assets they held, thus indicating a sense of stability in center of the size distribution of community banks. After discussing trends among small institutions, Mr. Brown said it appeared that they evolved into somewhat larger institutions over time, not that they were headed toward extinction.

Mr. Brown observed that the FDIC's definition of "community bank" was not solely based on size, but also placed importance on a bank's traditional lending and deposit gathering as well as limited geographic scope of operations. With that definition, he said that community banks had remained stable amid a larger trend of industry consolidation. Community banks made up 93 percent of insured institutions at the end of 2013, compared to 87 percent in 1985. Mr. Brown said that when community banks are acquired, they are usually acquired by other community banks and the succeeding institutions usually remain community banks. Referring to what he called a 'resilience chart,' he said that of community banks in operation at year-end 2003 with assets less than $100 million, some 94 percent still operated as community banks in 2013 or had been acquired by another community bank. Mr. Brown said that larger community banks (those with assets over $1 billion) showed a higher rate of attrition and a lower propensity to be acquired by other community banks. Mr. Brown said that, in summary, consolidation was not a new trend and that it had not brought about the demise of the community banking model, which has shown resilience amid larger changes in industry structure.

Member Stevenson said he appreciated the information concerning past trends but that his primary concern was profitability going forward. He said that in the northwest U.S., there was (at least) a positive correlation between size and profitability and that community banks with a 6-7 percent return on equity may not be viable in the long run if shareholders demanded higher returns. Mr. Brown noted that larger banks tended to be the first in and the first out of the financial crisis while community banks were taking a longer time to work out of their real estate exposures. He also said that the community bank operating environment, including interest rates, had not been favorable, but that the operating environment seemed poised to improve as the economy normalizes. Member Savarese said that two new factors in the community bank operating environment might reduce the benefit of a retrospective analysis; one is the increased cost of compliance burden; the second is the cost of technological changes. She queried if there was any way those two factors could be factored into a retrospective analysis in order to predict future performance. Mr. Brown noted earlier Committee discussions about the difficulty of separating regulatory and non-regulatory expenses in the data the FDIC has available to it. He suggested that it may be productive to think of regulatory costs in the broader context of total expenses and how they are affected by economies of scale. Mr. Brown said the FDIC's 2012 economies of scale research could be updated to assist with both the regulatory cost and technology cost issues. Member Williams observed that many community banks are closely and locally held and may not demand as much return as other investors so that talk about the cost of regulatory compliance may not translate into actual consolidation. He added that the market for selling a community bank is weaker now than in the early 2000's and some community bankers may believe that their franchises are worth more than the current market would pay; thus, fewer consolidations may occur.

Member Blankenship asked if the FDIC had done any analysis on how truly voluntary some voluntary consolidations were; she indicated that the decision of a bank to merge with a CAMELS "3" rating might be considered less voluntary than a merger decision by a higher-rated bank. Mr. Brown said it is difficult for an economist to make judgments about the strategic considerations concerning mergers and consolidations and the FDIC had not pursued that inquiry. He contrasted the situation with those of failed banks where the FDIC has more data available. Member Lundy suggested a methodology that the FDIC might use to address the previous questions. He indicated that an important question was whether, in the future, the community banking model was a viable way of deploying capital. He observed that regulators make it difficult for capital to exit a bank such that a consolidation may be the only way to do it.

Member Thian asked about research on Minority Depository Institutions ("MDIs"), including if they are smaller than other bank types, and if they are more vulnerable to increased regulatory and technology costs. He said there are underserved and not-served communities that may be better served by an MDI and inquired if the FDIC saw any trends regarding them. Mr. Brown noted that an FDIC MDI study was underway. He added that the MDI structure has been more volatile than community banks with institutions entering and leaving the MDI category. Mr. Brown said that there had been some consolidation among MDIs since the financial crisis, but he noted that the MDI program had proven to be robust and MDIs had grown in a lot of metro areas. Regarding performance, he said that some MDIs underperform and have high expense ratios but that, when their social impact is considered, they are phenomenally successful. Ms. Ellis said that MDI successes are demonstrated in Call Report and HMDA data. She noted, for example, that MDIs engage in more lending to low and moderate income borrowers, and minority borrowers, than do traditional community banks generally.

Member Baronner said he thought that the larger banks that formerly acquired community banks had left the market in the last six years and there has been a resulting drop in consolidation. Member Castillo asked about the average size of community banks over thirty years, if FDIC research provided insights about market share issues of the smallest community banks, and if the research distinguished between urban and rural community banks, and what business models they used. He said that the smallest community banks seemed to be losing the market share battle and that shareholder expectations had changed substantially from what they had been eight years ago. Mr. Brown said that community bank median asset size had grown from about $40 million in 1985 to about $167 million in 2013, approximately the same as the fourfold increase in the nominal size of the U.S. economy. He noted that the largest non-community banks had grown disproportionately in the same period, experiencing about a tenfold increase. Mr. Brown said that community banks continued to have the largest market share in rural and micropolitan counties, but they have lost market share in metropolitan areas, especially those experiencing growth.

Member Savarese said she viewed the continued existence of smaller institutions to be critical to the U.S. economy and recommended that a research goal be to help develop actionable strategies to support their survival. She said that some small institutions saw the increasing costs of technology and regulatory compliance and chose to merge or sell before their earnings dropped too much. Such mergers of small institutions, she indicated, may not be good for the semi-rural communities they serve or for minority or small-business lending. Member Savarese

suggested possible ways to support small institutions would be to allow them to share services or mitigating the compliance expense for them. Member Seleski said his bank had made some acquisitions where the sellers were motivated by board and management fatigue and/or a lack of a management successor. He said that these subjective reasons for consolidation would be difficult to capture absent individual interviews. Member Saunders suggested a useful research subject would be to explore how much market share was going to non-bank competitors instead of regulated banks. Another subject she suggested was to explore trends in the number of banking offices and how the activities that occur in them are changing. Member Stevenson suggested that any quantitative research done not be limited to a single point in time but be done on an ongoing basis.

Ms. Eberley indicated that the FDIC could try to look deeper into voluntary mergers and possible relationships between the merger decisions and the acquired institutions' pre-merger CAMELS ratings and returns on earnings and assets. Mr. Brown said that the FDIC has data on banking offices and would incorporate that information into a report coming out later in the year. Member Castillo said he perceived community banks were moving away from consumer-related loans, in part because of compliance costs, and asked if the Call Report data showed such a migration. Mr. Brown said the 2012 community bank report did indicate community banks did much less retail lending and migrated toward commercial lending, while non-community banks began to dominate consumer lending and mortgage lending (although some community banks maintained a successful niche in mortgage lending). He said the FDIC intended to continue monitoring those trends. In response to a question from Member Lundy, Mr. Brown confirmed that community banks make about one-half of small business loans, defined as commercial loans below $1 million and agricultural loans below one-half million.

Member Hesser said that the current low interest rate environment impacts consolidation rates because, although bank owners are ready to sell, there is no alternative place to invest the proceeds. He also said that he expected many community banks would have marginal profitability in 2014 because of the continuing decline in the net interest margin, the increased regulatory burden and the loss of non-interest income. Mr. Brown agreed that non-interest income may decline because there was less mortgage refinancing occurring. Member Thian said one reason smaller community banks were engaging in less retail banking is because regulators respond to any mistake in compliance with an enforcement action against the bank. Member Williams later said he believed that compliance regulators held banks to a perfection standard that could not be reasonably met and was inconsistent with community bankers' work of mitigating risk. He also expressed concern that that a perfection standard would migrate to commercial lending.

Chairman Gruenberg said he thought the discussion had been very helpful and that further work was needed to develop a better understanding of the dynamics of the consolidation process. He said that the broad center of community banks, those from $100 million to $1 billion in assets, had remained stable in number, had retained their niche and remained competitive over time, even as there was more consolidation among the smallest institutions. Chairman Gruenberg indicated that closer review of the information did not confirm the notion that community banks are disappearing in the U.S. Instead, it showed that they remain viable -- especially in terms of small business finance and servicing lower population areas, functions that

large institutions are not in a position to fill. Chairman Gruenberg said he did not think that the FDIC held banks to a perfection standard, and should not, but that the subject was worthy of later discussion.

The Committee stood in recess at 10:07 a.m. and reconvened at 10:21 a.m. that same day.

Ms. Ryan then introduced the FDIC staff for the "Cyber Security Update," Ms. Eberley, Marlene Roberts, Senior Examination Specialist, RMS, and William Henley, Associate Director, Technology, RMS. Ms. Eberley began by summarizing a variety of recent and ongoing Information Technology ("IT") initiatives by the FDIC and the Federal Financial Institutions Examination Council ("FFIEC"). She said that IT is a significant focus of the FDIC's bank supervision program and that the FDIC's concerns range from banks' adoption and implementation of new delivery channels to their readiness for cyber threats. She said that IT guidance is developed through the FFIEC and the FDIC actively participates in the FFIEC's Task Force on Supervision ("TFOS"), its IT subcommittee, and the Cyber Security and Critical Structure Working Group. Ms. Eberley said these groups assess existing examination programs and develop strategies to enhance IT oversight with the goals of ensuring the resilience of the financial services sector, protecting customers, and promoting confidence in the financial system.

Ms. Eberley described four categories of FFIEC activities, the first being examination methodology for technology service providers ("TSPs"). She said that a key goal regarding TSPs was to share examination reports quickly and directly to TSP client institutions, a recommendation that the Committee had previously made to the FDIC. The second focus area was to identify and address gaps in examination policies on cybersecurity and critical infrastructure resilience. The third area was communications. Ms. Eberley said one goal was to ensure that TSP examination reports clearly articulate their findings (and responses) to client institutions as well as the TSPs. The fourth category was cybersecurity. She said that the FFIEC's Cybersecurity and Critical Infrastructure Working Group was working to promote industry awareness about cyber threats, how banks can protect their systems and their customers, and to enhance information sharing and coordination through public-private partnerships. Ms. Eberley described guidance that the FFIEC groups had recently issued and said that the FFIEC was developing a cybersecurity webinar designed for CEOs to help focus their management of cybersecurity risk. She observed that cyber threats were different from natural disasters and said the FDIC was encouraging focus on business continuity and recovery planning for cyber threats, and described some of the issues that banks should consider.

Member Savarese thanked the FDIC for its fast response to the Committee's earlier recommendation that TSP examination results be shared with all TSP client banks automatically and quickly. She also thought that the CEO cyber threat video was a good idea for focusing busy CEOs attention. Member Blankenship later said that the CEO focused video "hit the nail on the head" because too many CEOs were not sufficiently aware of the threats to their institutions. She said that a communication from the FDIC would help CEOs understand the seriousness of the issue, and suggested that communications include some examples of how cyber issues can threaten an institution.

Member Savarese asked for additional information about how community banks can get timely notification of impending cyber threats. Ms. Roberts began by describing the Financial Services Information Sharing and Analysis Center ("FS-ISAC"), a membership organization created by Presidential directive in 1999 to encourage critical infrastructure sectors to set up information sharing and analysis centers to facilitate the flow of information to members in a particular critical center. She said that the FS-ISAC's funding comes from member dues (graduated from $850 to $50,000 depending on the amount of information made available). Ms. Roberts explained that, whenever a member of the FS-ISAC detects cyber threat activity (such as a distributed denial of service, or "DDoS,"attack), the FS-ISAC allows members to quickly exchange information about how the attacks are being made and how to mitigate them. Ms. Roberts said the FFIEC working group was exploring ways that community banks could get similar levels of information and that one idea was to rely on TSPs to provide such information to their clients. Member Savarese responded that she did not think it would be effective to rely on TSPs to be intermediaries concerning cyber threats to community banks. She observed that speed was of the essence concerning a cyber threat, so that the bank could take steps to harden their systems. Member Savarese described various factors that would impede the fast flow of information to potentially affected community banks, including: some TSPs are very large corporations which are slow to communicate; community banks are not the largest clients of the large TSPs; in addition, many community banks use vendors that are not TSPs to host their websites that are subject to DDoS attacks; and, that some community banks maintain their own systems rather than rely on TSPs, or rely on smaller TSP resellers. Member Savarese suggested creating a network of Chief Information Officers to quickly distribute information.

Chairman Gruenberg inquired whether the FS-ISAC membership model was a potential vehicle for community banks and the extent to which its membership costs were an obstacle. He observed that bank regulators were making progress on dissemination of information among larger institutions, but had not reached the same point for community banks, although the issue was also highly relevant to them. Member Savarese said that the cyber threat issues were not on the top of the minds of all community banks and that it would require some education efforts to help them understand the issues. Member Haskin said many community banks do not realize there is a preferred, single source of information. She observed that her bank uses a third party (separate from its core processor) for firewall maintenance, and that the provider was a member of the information sharing organizations, but that it was difficult to know if the correct players actually get the key information.

Ms. Roberts said there were a variety of sources of information available concerning various cyber threats and described them. One, she said, is U. S. Computer Emergency Readiness Team ("US-CERT"), a portal through which the FBI distributes alert bulletins that include, for example, in DDoS attacks, information about attacking IT address. Another FBI project that is based in about 50 cities is called InfraGard, she said. Ms. Roberts said that the FFIEC is working with internet service providers ("ISPs") to get classified internet protocol ("IP") addresses to the ISPs so that they can block the pipeline before it gets to the pipeline. She said the FFIEC was also working with the Federal Communications Commission on a Communications Security and Reliability Council to explore ways that ISPs can block attacking IP addresses.

Ms. Eberley said that it was clear the FFIEC agencies needed to organize and publish the information in a Financial Institution Letter ("FIL"). She referred to information sessions that the agencies sponsored between 2002-2005 that encouraged public-private partnerships in local communities that were focused on natural disasters and terrorist attacks. Ms. Eberley noted that cyber-attacks were much faster, and that education was needed about them and the resources available to respond to them, including their costs. Ms. Roberts said about 23 regional coalitions had been created through the mid-2000s effort just mentioned and that they had successfully brought the financial services sector together in those areas to respond to physical events. She said it was important now for the regional coalitions to expand their scope to cyber issues and that institutions know who to call and be able to exchange information quickly. Later, Ms. Roberts also described the Department of Homeland Security's Private Sector Clearance Program which would allow certain individuals to receive up to a "secret" level security clearance so that they could receive cybersecurity briefings that included classified information.

Member Savarese observed that the ability for two-way communications was critical; that the system needed to allow community banks to communicate that they were under attack (as well as receive information from a central source). But, she noted, banks were sometimes reluctant to share information about themselves that would create a competitive disadvantage for them. Member Savarese also inquired about ways that the costs of receiving information could be reduced for community banks, for example, through leveraging their mass buying power. Ms. Eberley said that the FS-ISAC is meant to be a place where institutions could share information on themselves and that the system contained confidentiality barriers so that the information that is distributed to other members does not indicate who was attacked.

Member Savarese referred to the information security standards published by the National Institute of Standards and Technology ("NIST") and said that she hoped those standards would not become an additional layer of regulatory burden with which banks would have to comply. Ms. Eberley said that the FDIC was reviewing the NIST standards to ensure that its examination program does not have any gaps, but that there was no intention to examine banks for compliance with the NIST framework. Member Lundy referred to a recent compliance examination his bank had and said that the pre-examination conference call with DCP had been very helpful in letting the bank understand the examiners' expectations and be prepared. He suggested that a similar, collaborative pre-examination conference call, perhaps several months before the IT exam, would be helpful. Member Saunders later suggested that anytime the FDIC disseminates new examination training it would be a good time to distribute a webinar for banks on the same subject so that banks could consider whether they are prepared for threats as well as examinations. Members Hesser, Savarese, Ms. Roberts and Ms. Eberley also discussed certain recent IT and cyber threat issues and the industry and agency responses to them.

Chairman Gruenberg said the panel had been very helpful. He noted that the issue of how community banks could receive and respond to information about cyber threats was an issue that deserved attention. Member Savarese said that community banks were excited that it was a matter of regulator focus.

Ms. Ryan then introduced Cottrell Webster, FDIC Ombudsman, and Roberta McInerney, Deputy General Counsel, Legal Division, who led the panel, "FDIC Ombudsman and

Supervisory Appeals Process." Mr. Webster gave the Committee an overview of the Ombudsman's operations which are guided by three basic tenets: independence, neutrality and confidentiality. Mr. Webster observed that the Ombudsman's office is independent of the FDIC supervisory process; it advocates for a fair process and does not advocate for the FDIC or for banks; and that all conversations with banks are strictly confidential unless the bank requests the Ombudsman to identify the bank to help resolve an issue. Mr. Webster said the Ombudsman is an informal resource and its role is determined in large part by what banks request. He said that bankers usually prefer direct discussion of issues with examiners, and the Ombudsman encourages direct communications between banks and examiners, but occasionally banks prefer a confidential sounding board. Mr. Webster said that a question or issue can often be sufficiently clarified by a conversation with the Ombudsman staff only; occasionally, Ombudsman staff pursues an inquiry with FDIC staff. He said that his office receives questions by calls, letters, faxes and through the FDIC website; he said that, if a banker wanted anonymity from the Ombudsman's office itself, the Ombudsman's website provided that capability.

Mr. Webster described the roles of the regional Ombudsmen, including outreach to bankers and to state banking departments. He also described reports the Ombudsman's office makes to FDIC leadership so they can stay in tune with bankers' concerns, and reports it makes to industry, which were developed at the request of bankers (and have about 14,000 subscribers). Regarding the Supervisory Appeals Review Committee ("SARC") process, Mr. Webster said that the Ombudsman's office has a strictly observer role, that it does not act as an advocate or mediator. After the SARC issues a decision, he said that the Ombudsman's office follows-up with the bank about its view of the process and reports to the SARC Chairman.

Ms. McInerney provided the Committee with an overview of the SARC history and process. She noted that the SARC had been created, along with the Ombudsman's office, by the Riegle Community Development and Regulatory Improvement Act of 1994, which required the banking regulatory agencies to establish independent intra-agency appellate processes to review material supervisory determinations ("MSDs"). Ms. McInerney observed that "independence" in this context means that SARC members are independent of the persons who made the MSDs under review. The FDIC SARC membership, she said, consists of FDIC Vice Chairman Hoenig as SARC Chairman, and the deputies to FDIC Chairman Gruenberg and FDIC Director Norton. The FDIC's (acting) General Counsel also serves as a non-voting member. Ms. McInerney described the MSDs that could be subject to SARC review and noted they included various examination ratings (such as CAMELS, consumer compliance, IT, and Community Reinvestment Act (("CRA")) ratings). She also described various determinations that are not subject to SARC review, including decisions to: initiate informal enforcement actions such as memoranda of understanding, initiate formal enforcement actions, require prompt corrective action under Section 38 of the FDI Act, or to appoint a conservator or receiver for a bank.

Ms. McInerney summarized the process of SARC review. She noted that it began with a written request for review, including a detailed description of the issues in dispute, to the appropriate division director within 60 days of the MSD. In turn, the division director would provide a written determination within 45 days. If the bank disagreed with the division director's determination, it could appeal the decision to the SARC within 30 days. Ms. McInerney noted that the SARC could review only matters that had first been presented to the division director

and that the SARC review was generally limited to the facts and circumstances as they existed at the time of the MSD (thus, a bank's subsequent corrective actions could not be considered by the SARC). Ms. McInerney said the SARC meets within 90 days of a bank's appeal and issues its decision within 45 days after its meeting. She said that the SARC generally granted a bank's request for oral presentation and found the presentations helpful in clarifying issues. The SARC's review of an appeal is to determine if the MSD is consistent with the FDIC's policies, procedures, and is reasonable overall, she said, and the SARC's decisions are made public (but are redacted to avoid disclosing confidential information). Ms. McInerney noted that, in order to promote independence, the Legal Division staff that advises the SARC is separated from the Legal staff that advises the division whose determination is being appealed. She emphasized that the FDIC took SARC matters seriously and any retaliation against a bank for exercising its SARC rights was prohibited.

Member Stevenson said that his bank had a longstanding, positive and transparent relationship with their supervisory office and thus had not needed to turn to the Ombudsman's office. He said that he understood that part of the Ombudsman process was to gain mutual understanding through informal conversations, but asked if there was a quantitative measure of the Ombudsman process. Mr. Webster expressed his view that the Ombudsman process was effective, and that, in many cases, the Ombudsman's sharing their knowledge of the exam process with banks had significantly reduced the number of formal appeals to the SARC (although the Ombudsman does not specifically track numbers of SARC cases). Ms. McInerney agreed that many issues were resolved informally before they got to the level of the division director or the SARC. She said the SARC had handled over 60 appeals since 1995 and that the decisions were published, but not tracked as to the result. Member Stevenson said the growth or contraction in the number of appeals might suggest whether bankers thought that the process was worth pursuing. Member Williams said the volume of matters presented to the Ombudsman and the SARC could be related to the regulatory environment. He said that the Atlanta regional Ombudsman met with bankers during the most difficult days after the financial crisis, and assisted their understanding of the FDIC's processes. Member Baronner agreed that such visits were appreciated even if the bankers did not like what they were told. He encouraged the Ombudsman's office to continue visits to the field.

Member Savarese said that there were such robust conversations with examiners in the northeast region that many bankers did not feel a need to consult with the Ombudsman. Noting that part of the Ombudsman's work was to help the FDIC engage in continuous improvement, a hallmark of Chairman Gruenberg's tenure, she suggested that it would be helpful for the FDIC to gather feedback on bankers' "grumbles" and not just moments of more intense disagreement. In response to a question from Member Savarese about the Ombudsman's reporting structure, Mr. Webster said that he reports to Chief of Staff and Chief Operating Officer Barbara Ryan regularly and that Chairman Gruenberg also meets with regional Ombudsman staff regularly. Ms. Ryan said that the FDIC greatly values the direct line of communication with the Ombudsman's office for its view of issues and trends among bankers, but that the FDIC was careful to respect the needs for confidentiality and independence of the Ombudsman function. Member Savarese said that she thought that the Ombudsman's outreach was positive but that, given the natural reluctance of people to provide negative feedback, it might be useful to harden up the Ombudsman's independence and to communicate that hardening to bankers.

Member Castillo said that it would not occur to him to use the Ombudsman resources. He indicated that the Ombudsman appeared to be an informal resource, something akin to a therapy session for the banker. Member Castillo said that the process might be more effective if it became a more formal resource that injected some accountability into the system, maybe not to the point of being able to change an exam rating, but more formal than at present. He said that the number of SARC cases, 60 in 20 years, struck him as a low number and that it might be related to the perception of bankers and banking attorneys that the SARC process would be unsatisfying to the banker. Member Castillo shared an experience that occurred in about the last six years in which an examiner said that his bank should not be in business because it was too small. He said that he would not want to report the examiner's statement just to feel better about it, but in order to get an actual positive result from the FDIC, such as focused examiner training. Mr. Webster said that he had heard of such comments, but that the ability to respond was limited if bankers would not release the Ombudsman's confidentiality promise. He said that he was certain that senior management at the divisions and at the FDIC as a whole would not want an examiner making such a comment. Member Castillo said that he would be more willing to put his name on a complaint if the process was more formal. Mr. Webster clarified his use of the terms formal and informal. He said that the Ombudsman process is described as informal so that bankers are not confused that the Ombudsman can change or interrupt the examination process, but that, as a resource for a banker, the Ombudsman can be formal.

Member Stevenson inquired how the FDIC can control against retribution against a banker who makes a complaint; he noted that retribution can be hidden and insidious. Mr. Webster agreed that it could be hard to pinpoint, but said that a bank identifying itself with its complaint did something in itself. Ms. McInerney noted that the SARC guidelines specifically prohibited retaliation and that it was not something division directors, or the FDIC, would sanction. Member Saunders said she thought the Ombudsman's office was a great resource. She said that she had heard stories of retaliation occurring and said that confidentiality was important. Member Saunders suggested that the Ombudsman's office could gather feedback more broadly so that any systemic issues of inappropriate comments or conduct could be identified for appropriate FDIC response. Mr. Webster said the Ombudsman did do that and that the divisions had provided focused training when a systemic issue was identified. Addressing the issue of obtaining regulatory feedback, Member Savarese observed that banking trade organizations gathered information about the exam process in an anonymized manner and shared it with regulators. She noted that the FDIC post-examination surveys were conducted by the examination divisions themselves and suggested that by making the surveys more confidential and anonymous, bankers might feel freer to provide negative feedback. Member Savarese also noted that the OCC had structured its Ombudsman to allow direct reporting to the Comptroller and authority to intervene in some actions.

Chairman Gruenberg said that the Ombudsman reported directly to Chief of Staff and Chief Operating Officer Ryan and that the three of them met regularly. He noted that Mr. Webster, a former regional director, was a senior agency official who had access to senior officials and so had the ability to intervene effectively where appropriate. Chairman Gruenberg said that, if using the Ombudsman's office would improve post-examination survey results, the FDIC was open to considering having those surveys come from sources other than the examining

divisions. Chairman Gruenberg said he viewed the Ombudsman as an important intermediary who was not part of the examination operation and that he wanted the least hurdle possible for banks to make contact with the Ombudsman's office. He said the Ombudsman could provide a valuable reality-check for a bank's concerns and was also well-positioned to intervene and engage the decision-makers where warranted. Chairman Gruenberg indicated that he did not view the number of formal SARC cases as an accurate barometer of the effectiveness of the SARC process as a whole. He noted that a bank should have to rely on the formal and high-level SARC appeal only if impasse was reached at lower levels. Chairman Gruenberg acknowledged that there may not be a perfect solution to the issue of retaliation, but said that the FDIC was committed to having a process that is as open and responsive as people can make it and had zero tolerance for retaliation, which would harm the FDIC as an organization. He urged banks to report misconduct for the benefit of the system and said he was confident that the FDIC's executives would act to address any instances of retaliation. Chairman Gruenberg said the example of an examiner's statement about Member Castillo's bank being too small to be in business was inappropriate, a serious matter and a good example. He said that Member Castillo's presence on the Committee demonstrated that he disagreed with the examiner's view.

Ms. Ryan then introduced the moderators for the fifth panel, "Developments in Customer Due Diligence and Reporting Requirements," James Watkins, Senior Deputy Director, RMS, and Lisa Arquette, Associate Director, RMS. Mr. Watkins spoke about a proposed rulemaking that is expected from the Financial Crimes Enforcement Network ("FinCEN") concerning customer due diligence ("CDD") requirements. He said that CDD is fundamental to the safety and soundness of a bank's business model and was likely part of banks' underwriting and account opening process. Mr. Watkins noted that CDD includes gathering a customer's identifying information, deposit account expectations, the purpose of new loans and other accounts, the customer's business projections, anticipated wire activity and other procedural and monitoring steps. He said that CDD was a critical element of combatting all forms of illicit financial activity consistent with banks' Bank Secrecy Act/Anti-Money Laundering ("BSA-AML") obligations. Mr. Watkins reported that most banks have strong CDD programs; out of 2300 BSA/AML exams the FDIC conducted in 2013, only 22 programs had significant shortcomings requiring a formal response.

Concerning the expected FinCEN proposed rule, Mr. Watkins said that three elements of the rulemaking were already bank requirements and practices: 1) identifying and verifying the identity of customers; 2) understanding the nature and purpose of customer relationships; and 3) conducting ongoing monitoring to maintain and update customer information and to identify and report suspicious transactions. He said the rulemaking may also propose a new requirement- to require banks to identify and verify the beneficial owners of legal entities. Mr. Watkins said that the FDIC was not certain when FinCEN would publish its proposed rule but said that RMS wanted to make banks aware so they could consider providing feedback to FinCEN. Mr. Watkins noted that the FFIEC *BSA/AML Manual* also describes enhanced due diligence expectations and practices for higher risk customers and makes reference to a list of steps a bank might take in such a situation.

Ms. Arquette spoke about recent guidance concerning providing banking services to marijuana businesses in states where marijuana sales are legal. By way of background, she said

that the *Controlled Substances Act* makes it illegal under federal law to manufacture, distribute or dispense marijuana. She said that many states impose and enforce similar state laws but that 20 states make marijuana legal for medical purposes, and two have legalized recreational use. Ms. Arquette said that in August, 2013 and February, 2014, the Department of Justice ("DOJ") issued guidance to U.S. Attorneys concerning marijuana enforcement and set forth DOJ's enforcement priorities. She said that the DOJ guidance made clear that DOJ expected that states that authorized marijuana-related conduct would also implement clear, strong, and effective regulatory and enforcement systems. Ms. Arquette also indicated that DOJ expected banks to report and not offer services to marijuana businesses that operate outside such strong state regulatory and enforcement regimes. Ms. Arquette said that, in February, 2014, FinCEN issued guidance that described BSA expectations for banks seeking to provide financial services to marijuana-related businesses which had two primary focuses. First, she said, the FinCEN guidance emphasized that it is the financial institution's decision to open, close or refuse any particular account or relationship. Ms. Arquette said the FinCEN guidance also provided minimum due diligence procedures that banks should follow for marijuana-related businesses in addition to considering the DOJ's enforcement priorities as part of its CDD.

Ms. Arquette said the second focus of the FinCEN guidance was Suspicious Activity Reports ("SARs"). She indicated that a bank's obligation to file a SAR is not affected by state laws that legalize marijuana-related activity. Financial transactions involving a marijuana-related business would involve funds derived from activity that violates federal law; therefore, a bank is required to file a SAR. However, the FinCEN guidance identified two distinct categories of SARs that a bank could file, including a "Marijuana Limited" SAR or a "Marijuana Priority" SAR. Ms. Arquette explained that a Marijuana Limited SAR should be filed when the bank reasonably believes that none of the DOJ enforcement priorities are implicated and described the information that should be included in one. She said that a Marijuana Priority SAR should be filed when a DOJ enforcement priority is implicated and she described its more detailed reporting requirements. Ms. Arquette said that a bank should also file a specific SAR if it terminated a relationship with a marijuana-related business. Ms. Arquette described various BSA/AML resources available to banks from the FDIC, including FDIC examination staff and subject matter experts in regional and field offices, and a BSA/AML training program on the Director's Resource Center of the FDIC website.

Member Hesser, whose bank has decided not to open accounts for marijuana-related businesses, said there was still a concern about how the FDIC would examine loans that had a marijuana-relatedmarijuana-related business connection. What would occur, he asked, if a CRE borrower rented space to a marijuana-related business? In that situation, Member Hesser said there was a risk that the commercial property could be subject to civil forfeiture by federal law enforcement causing the bank's interest in the collateral to be eliminated. He reported that banks in such situations had taken a variety of approaches: some banks had informed the CRE borrower that it was going to foreclose; others informed the CRE borrower that they would foreclose if the borrower did not get the marijuana business out of the property; others had informed the borrower that they would foreclose at the end of the loan. Member Hesser asked if examiners would classify loans in such circumstances. Member Hesser said a second issue was the regulatory/law enforcement burden put on banks. Not only did the bank have to "know its customer," he said, but it would also have to evaluate the customer's activity for legality, which

raised large potential liability issues for the bank. Mr. Watkins said that it was the bank's decision to determine what customers to do business with, and the FDIC expected banks to have good internal policies for risk assessment.

Member Lundy said that he had heard that DOJ had recently wiped out a bank's lien in Georgia. In response to Mr. Watkins' observation about relying on a bank's risk assessment processes when it makes a loan, Member Lundy said that a CRE loan may have been within a bank's policy when it was made but that state law may have changed afterward such that the bank could no longer use a "violation of state law" clause to call the loan. Member Lundy said that his institution had decided not to open accounts with marijuana-related businesses but that it would feel aggrieved if an examiner took an aggressive view about money traceable to a marijuana-related business flowing through the bank. Member Williams asked if such a loan as earlier described would be classified based on a material weakness in the credit? Ms. Eberley said that the FDIC had not developed guidance on the issue, but indicated that the banks appeared to be on the right track, identifying the issue and considering whether it affected the borrower's ability to pay. She said that examiners would likely evaluate the bank's evaluation process although she indicated that classifying credits might require case-by-case determinations. Member Lundy said that banks would like guidance on whether to file a SAR on a CRE borrower who had a tenant with a marijuana-related business. Ms. Arquette said that if the CRE borrower's repayment capacity related to the loan involves tenants, and one of them was a marijuana-related business, the bank would be obligated to file a SAR (every 90 days if there was no changes in circumstances). Ms. Arquette added that banks were not expected to be part of law enforcement, they need only file the report in the FinCEN database and law enforcement would evaluate the SARs.

Member Blankenship expressed concern that banks might lose their collateral position if they get caught off guard on a CRE property that has been seized by federal law enforcement. Ms. Arquette said that a bank's CDD should be expanded when they have a higher risk customer. Member Blankenship observed that marijuana-related businesses might turn to money service businesses if banks would not open accounts for them and indicated that banks might risk liability if they had account relationships with those money service businesses. Member Savarese questioned whether a bank would be obligated to file a SAR on the executive director of a not-for-profit medical marijuana dispensary if the dispensary was the director's primary income source; she noted the bank might learn about the source of income after an account relationship had begun. Member Savarese inquired if regulators would have difficulty if banks had customers who were breaking federal law. Mr. Watkins acknowledged that there were risks for banks, but that regulatory guidance indicated that banks should do their own risk assessment and have a good understanding of their customers. He added that it was not unusual for a bank to file a SAR, that thousands are filed on a regular basis. Mr. Watkins said the FDIC appreciated the feedback on this emerging new topic.

Member Haskin said that the potential FinCEN rule requiring a bank to identify all the beneficial owners of a bank account would impose a big burden on community banks with relatively few employees to accomplish the added work. She said her bank had many Limited Liability Corporation ("LLC") accounts, and while it appeared reasonable for the bank to know the LLC's active members, it would be burdensome to identify all the minority owners (who

might also find the requirement intrusive). Member Haskin also noted that a community bank could not afford the fine for a BSA/AML violation and so would hire additional staff to comply with the rule. Ms. Arquette encouraged community bankers who shared that view to provide feedback to FinCEN after the proposal is made. In response to a question from Member Stevenson, Ms. Arquette said the FDIC was aware of banks that opened accounts for marijuana-related businesses and had filed SARs regarding them.

The Committee stood in recess at 12:22 p.m. and reconvened at 1:31 p.m. that same day.

For the sixth panel, "Qualified and Nonqualified Mortgage Discussion," Ms. Ryan introduced Mr. Eberley, Mr. Pearce, Jonathan Miller, Deputy Director, DCP, and Rae-Ann Miller, Associate Director, RMS. Mr. Pearce noted that the Committee had previously discussed the CFPB Ability to Repay/Qualified Mortgage rule ("ATR/QM") as the rule was developed. Under the ATR/QM Rule, creditors must consider a consumer's ability to repay a loan according to its terms for all closed-end residential mortgages. Mr. Pearce said that the ATR/QM rule had some elements focused on community banks. First, Mr. Pearce noted that some community banks (those with under $2 billion in assets, and which make fewer than 500 mortgage loans that they then then hold in portfolio) can make QMs that have debt to income ratios above 43 percent and have an Annual Percentage Rate of up to 350 basis points above the average prime offer rate. Also of interest to community banks, he said that mortgages with balloon payments can also be designated as a QM. Mr. Pearce said some banks had questioned how their business decisions in response to the ATR/QM rule might interact with fair lending and the CRA evaluations. He said that the regulatory agencies had issued guidance on the subject and that Mr. Miller and Ms. Miller would further discuss the issue.

Mr. Miller said that one banker concern had been whether banks would experience fair lending criticism if they decided to make only QM loans. He said that the CFPB and the banking agencies issued a press release in October 2013 that clarified that if a bank chose to do only QM lending, such a decision by itself would not run afoul of fair lending laws. Mr. Miller said that fair lending decisions were fact-specific and that his statement should not be viewed as a general safe harbor. He likened the QM situation to banks that chose not to participate in Federal Housing Administration lending or in secondary market lending. Mr. Miller said that most FDIC supervised institutions were portfolio lenders and that such business decisions alone did not result in fair lending or CRA violations.

Ms. Miller provided the Committee with a risk management perspective. She said that bankers had expressed concern that they would receive safety and soundness criticism if they chose to make non-QM loans; for example, non-QM loans might be automatically classified or there would be an inclination to finding legal risk for non-QM loans. Ms. Miller said that the banking agencies issued a December 2013 statement that indicated that institutions may originate both QM and non-QM loans based on their business strategy and risk appetite and that residential mortgage loans will not be criticized solely because they are QM or non-QM. She explained that the FDIC would continue to expect institutions to underwrite residential mortgages prudently, addressing key risk areas such as loan terms, borrower classification standards, loan to value limits, and documentation requirements regardless of whether the loans were QM or non-QM.

Ms. Miller said the FDIC examination manual focuses on lending and underwriting in general and emphasizes the importance of having a sound lending policy, sound underwriting, risk review systems, watch systems, and appropriate ALLL. She said the examination manual also states that ATR is the most important element of underwriting, regardless of the type of loan. Ms. Miller said that a bank's real estate policy needs to ensure that loans are granted with a reasonable probability that the debtor will be willing and able to meet the loan's payment terms. She noted that all the banking agencies required banks to adopt and maintain appropriate policies for real estate loans and discussed what those policies should entail. Ms. Miller said that banks are expected to monitor market conditions and adjust policies appropriately. She said that the FDIC had issued guidelines to help banks develop their policies and that the guidelines address matters such as loan portfolio management, loan administration, loan to value, and underwriting. She also provided additional specifics about underwriting. Ms. Miller said there was also guidance, commonly called the retail credit policy, which addresses the classification and modification of mortgages and other consumer loans. She said the retail credit policy indicates that classifications are generally based on a combination of delinquency status of the loan and collateral value, not on the loan's QM or non-QM status. Ms. Miller said that the agency's policies concerning residential mortgage lending was widely discussed within the agency because it was important that FDIC examiners understood the policies.

Mr. Pearce observed that a recent *American Banker* article discussed a survey indicating that, as a result of the QM rule, about one-third of banks had made no changes in their lending plans, about one-third decided to make only QM loans, another third decided to make some non-QM loans, and about one to two percent had ceased mortgage lending. He said the survey was generally consistent with what the FDIC had heard in outreach events and invited the Committee to discuss their observations. Member Williams said that his bank was aiming to make primarily QM loans but that there would be times it would make non-QM loans in order to meet its community's credit needs. Member Savarese said the her bank would aim to do QM lending plus carefully defined types of non-QM lending, for example, making loans to asset-heavy clients although the debt to income ratio would go above 43 percent. She said that her bank thought that non-QM lending presented banks with a significant litigation risk if a non-QM loan became delinquent. Member Williams said that many retirees had substantial assets that would not generally show as regular income in calculating a debt-to-income ratio and asked if the FDIC had discussed how to address that issue. Mr. Miller said that a borrower's assets was one of the eight underwriting factors identified by the CFPB that could be considered in making an ATR decision. Member Williams said that banks' concern was whether such a loan would be defined as QM or not. Member Savarese agreed and reported that there was a disconnect between the CFPB's eight factors and 16 pages of detailed guidance in Appendix Q to the rule. Mr. Pearce and Mr. Miller said that the FDIC would look into the question further.

Member Williams said that it would be very helpful to have definitive guidance on how assets might be considered from a QM definition standpoint (and not just from a safety and soundness standpoint). Mr. Miller said the key point to recall was that in making an ATR decision, the lender has made a good faith estimate to establish the borrower's ability to repay the loan. He said that most banks' normal underwriting would document their consideration of the eight ATR factors; he reported that a CFPB study indicated that over 90 percent of all loans originated in 2013 met QM standards. He also noted that the 43 percent debt to income ratio did

not apply to small lenders (as earlier defined) and it did not apply to loans eligible to be sold to Fannie Mae or Freddie Mac.

Member Haskin said that in Oklahoma about 35 percent of bank respondents surveyed indicated that they no longer made mortgage loans, and that among those who did make mortgage loans, 78 percent were offering only QM loans. She said that many rural bankers who had a volume of only 5-10 loans per year decided that it was not worth the effort required to revamp their systems to comply with the ATR/QM rule; this meant that there were many rural communities that lost many mortgage loan originators. Member Blankenship said that Texas had similar results and that, in many rural areas, there were no alternative mortgage lenders servicing the market. She said her bank had a branch in a location where the demographics made it hard to make a QM loan and that making a non-QM loan involved taking a substantial litigation risk. Mr. Miller agreed that uncertainty about litigation made lenders more thoughtful about their decisions. He noted that rural banks had more flexibility in lending terms and still obtain a QM determination; he also noted that the CFPB was giving further consideration to its definition of rural. Mr. Pearce said that the Committee's feedback was valuable because the FDIC was concerned about the issue of mortgage loan availability in rural communities. He said that there had been a lot of change in the mortgage lending rules recently and the FDIC was hoping to clarify as many issues as possible so that community banks choose to offer mortgage lending. Mr. Pearce noted that FDIC examiners were often a source of information for community bankers and that the FDIC was working to ensure its examiners were fully informed about the issues.

Member Blankenship said that community banks wanted to continue to offer mortgages but wanted to quantify their litigation risk if possible. Mr. Pearce said he appreciated the desire, but said there was not much the FDIC could offer about quantifying litigation risk. Member Savarese said that an effect of the litigation risk uncertainty was that bankers were cutting back on their mortgage lending and there had been a reduction in the availability of credit. She asked if the FDIC had seen any impact on mortgage lending volume. Mr. Miller said that, because mortgage lending was subject to so many economic factors, it was very difficult to determine the effect of the legal changes alone. He said he thought another driving force on mortgage lending was the unhappiness of investors who had purchased mortgage backed securities with warranties that did not protect them as expected.

Member Lundy said that his bank had decided not to engage in mortgage lending for reasons other than the ATR/QM rule. He said that bankers had perceived a difference between FDIC and OCC evaluation of mortgage loans (especially jumbo loans); if the loan to value ratio became too high, FDIC examiners wanted the bank to downgrade the loan even though it was current/non-delinquent while OCC examiners were not requiring the same downgrades for large banks. Ms. Miller said that the FDIC's policy was not to classify performing loans based solely on a drop in collateral value; she said the FDIC had done outreach and issued guidance on the subject.

Chairman Gruenberg said it was worth remembering that there had been significant problems in mortgage markets from 2005-2007 relating to mortgages that were made without determinations about borrowers' ability to pay. He noted that there had been no requirements

that lenders determine a borrower's ability to pay and the QM rule was designed to set reasonable standards to apply to the mortgage market. Chairman Gruenberg indicated that the financial crisis crimped access to mortgage credit and the economy had spent five years recovering from those problems so it was important that a real balance be struck.

Ms. Ryan introduced the panelists for the "Supervisory Policy Update," George French, Deputy Director, RMS, Bobby Bean, Associate Director, RMS, and Robert Storch, Chief Accountant, RMS. Mr. French said the panel would discuss IRR, Volcker Rule implementation, and recent developments from the FASB. He began by noting that IRR was a current supervisory focus. Mr. French discussed trends from mid-2008 to mid-2013, observing that the period was one of very weak loan demand and noting that the total loans on the balance sheets of all insured institutions had actually shrunk during the period. In the same period, he said, banks' securities portfolios grew at an annualized rate of about eight percent per year so that, by mid-2013, investment portfolios had grown in relative significance as a part of banks' balance sheets. Mr. French said that the quarterly annualized yield on the investment portfolio had reduced from about 5 percent to about 2.2 percent in that period while, maturities were increasing significantly (so that by the end of that period the average community bank had about 56 percent of its securities and assets with maturities over five years). He said that community banks now have a significant volume of low coupon, long maturity securities that would experience significant price depreciation in an increasing interest rate environment. Mr. French added that municipal bonds make up a large percentage of the securities so that there is additional potential for depreciation if there are marketplace concerns about municipal credit quality. Regarding the liability side of the balance sheet, Mr. French said that there had been an influx of deposits over the period and that a significant amount of those deposits might runoff faster than historical experience if interest rates rise.

Mr. French said that the examination process was indicating that, among institutions that have high levels of IRR exposure, many are not managing the risks well by: 1) not having adequate risk limits in place; 2) operating outside of risk limits that have been established; 3) not considering alternative deposit runoff scenarios; and 4) not having mitigation strategies in place. After noting that the FDIC and other banking agencies provided a variety of resources on IRR, he said that banks should be focused on the issue and invited comment.

Member Hesser said he thought that Mr. French's observations were correct; his bank looked at potential acquisitions frequently and often found what Mr. French had described. He said that his bank walked away from banks because of the securities portfolios more often than their loan portfolios. Member Hesser said that a typical bank for sale today has a loan-to-deposit ratio of about 50 percent and had taken all the bond gains they could in the last two years to increase their earnings. He indicated that such banks would soon be struggling for earnings. In response to Mr. French's inquiry if bankers are starting to strategize for interest rate increases, Member Hesser said that bankers worry about today. Member Blankenship said that her bank was fortunate to have good loan demand, but indicated that many banks are in a difficult position due to pressure on their net interest margins. She said that, as long as interest rates stay low and banks lose fee income, there will be more pressure on banks.

Mr. French said that the FDIC had seen some loan demand reemerging in parts of the country and said that about 60 percent of institutions were growing their loan portfolios to some extent. Member Blankenship said that loan growth would tend to mitigate the risk somewhat because it would reduce the need to buy long-term securities to generate income. She said that most bankers are cognizant of the dilemma but many just do not see a way out. Mr. French said that mitigation strategies described in the technical assistance videos and the guidance include having enough capital to absorb potential losses from securities depreciation, and reducing their exposure to IRR by balance sheet adjustments, sales, and purchases of different duration assets. He asked what actions bankers were considering. Member Blankenship responded that the options were limited, it was typically a choice between loans and securities, and if there was no loan demand there was not much that could be done. Member Stevenson said that his bank had configured all of its assets and liabilities to be of short duration so that the bank did not have much exposure in either direction. He said the challenge was just the pure margin and that a steepening of the yield curve would be beneficial to his bank.

Mr. Bean spoke about the Volcker Rule (final rule approved by the five signatory agencies on December 10, 2013) which, he said, had two primary elements: 1) generally prohibiting banking entities from engaging in short-term proprietary trading for their own account; and 2) generally prohibiting them from owning, sponsoring, or having certain relationships with hedge funds or private equity funds, referred to in the final rule as "covered funds." Mr. Bean said that only the very largest domestic and foreign banking organizations (about 15) had proprietary trading desks and regulators perceived that most of them were now closed. He said there was a concern that proprietary trading might migrate to market making and underwriting activities that are not prohibited, but that few banking organizations outside the 15 largest engaged in market making. He said that most community banks did not engage in proprietary trading. Concerning "covered funds," Mr. Bean said that the Volcker Rule prohibited ownership by a banking entity in a hedge fund or private equity fund unless the institution was a sponsor of it (and, if so, the ownership is limited to three percent and that ownership interest must be deducted from capital). He explained how the definition of 'covered funds' was structured to prevent a general evasion of the rule while allowing the origination of loan securitizations (which are specifically allowed under the section 619 of the Dodd-Frank Act which authorized the issuance of the final rule). Specifically, he said, all securitizations were included in the definition of 'covered funds,' but that securitizations backed solely by loans were then excepted from that definition. Thus, he said, a variety of securitizations he named fall outside of the "covered funds" definition (including: residential mortgage-backed securities; commercial mortgage-back securities; certain asset-backed commercial paper programs; and credit/ auto /trust and credit card securitizations).

Mr. Bean said that the regulators worked to scale the Volcker Rule's compliance burden appropriately. Community banks that engage in no covered activities would have zero compliance requirements. Institutions that have less than $10 billion in total consolidated assets, he said, would be allowed to tailor their compliance programs to their specific covered activities; for example, such a bank could state that it would limit its securitization investments or sponsorship to those not covered by the Volcker Rule, and that could constitute its compliance program. Mr. Bean said that larger institutions would be required to implement more complex compliance programs. While the final rule would become effective April 1, 2014, Mr. Bean said

that it was important to note that the Federal Reserve Board issued an extension of the conformance period until July 21, 2015.

Mr. Bean said that on January 14, 2014, the banking regulatory agencies issued an interim final rule concerning collateralized debt obligations backed by trust preferred securities ("TruPS CDOs") that grandfathered those securities from the prohibitions/restrictions on investments by banking entities in covered funds under the final rule. He said that the agencies' decision was consistent with the "Collins Amendment" of the Dodd-Frank Act (section 171 of the Dodd-Frank Act), and observed that no new TruPS would be issued and that the management of those already issued was such that the TruPS generally could not be used to circumvent the intent of the Volcker Rule.

Mr. Bean then discussed Collateralized Loan Obligations ("CLOs"), distinguishing between those issued before and after 2009. CLOs issued before 2009 often allowed for the inclusion of a variety of financial instruments other than loans, thus making them and a 'covered fund' prohibited by the Volcker Rule. CLOs issued after 2009 generally limited non-loan content to about ten percent of the underlying assets. He said that about half of post-2009 CLOs invested in nothing but loans and are not 'covered funds.' Mr. Bean said that large banks, particularly very large banks, had concerns about CLOs under the final rule, and in April, 2014, the Federal Reserve Board issued a Statement indicating its intent to extend the conformance period for certain CLOs until July 21, 2017. Mr. Bean explained that many CLOs will be paid off by the end of the conformance periods, in part because they are very interest rate sensitive and have call features that would allow issuers to respond to interest rate increases. He said that it was estimated that about 25 percent of pre-Volcker Rule CLOs would still be outstanding as of July 21, 2015, and that the large institutions that held them would be able to restructure that amount of CLOs prior to July 21, 2017.

Mr. Bean said that the Volcker Rule regulatory agencies had established an interagency working group to ensure its consistent application across agencies. He said that the agencies would issue a "Frequently Asked Questions" document that would probably focus on issues faced by the very largest banks which have the earliest compliance responsibilities. Mr. Bean said that the agencies would also issue additional information for all banks, including community banks. Until then, he said that banks were welcome to send questions to the FDIC (at capitalmarkets@fdic.gov) for general or individual guidance. Member Savarese said that the industry was grateful for the extension of the conformance period, which would allow for the development and evaluation of alternative compliance approaches under the final rule.

Mr. Storch first spoke about the recent history of the FASB's proposals concerning classifying and measuring financial assets and public response to them. He noted that, in May 2010, the FASB proposed that substantially all financial assets would be reported on the balance sheet at fair value and that the banking agencies and the banking industry had registered their opposition to that proposal. In response, Mr. Storch said, in February 2013, the FASB proposed that it would require financial assets to be classified based first on an asset's cash flow characteristics and second on the business model to be used to manage the asset. After providing more detail about these tests and the resulting measurements, he discussed banking regulatory agency criticisms of the February 2013 proposal. Mr. Storch said that in December

2013 and January 2014, the FASB determined that it would not further pursue the two classification criteria in its February 2013 proposal and asked its staff to consider whether any targeted improvements could be made to the current U.S. accounting standards for classifying and measuring loans and securities. He said that the FASB staff subsequently reported that they had not identified any significant targeted improvements. Since the effect of making no changes to the current standards would be to continue to rely on the "legal form" models of classification, Mr. Storch indicated the FASB asked its staff to consider whether there was a need to better distinguish between instruments that would be deemed *loans* for accounting purposes and those that would be deemed *securities*. Mr. Storch said that the FASB staff was currently pursuing that request.

Mr. Storch said that the FASB Board's decisions should be viewed favorably by banks generally because these decisions responded to banking agency and other public comments about the complexity and compliance costs of the FASB's proposal, especially where the proposed changes essentially achieved the same accounting outcome as the current standards. He said that whatever final standard the FASB adopts would not likely have a material effect on banks' current classification and measurement policies.

Mr. Storch then discussed the current state of the FASB's December 2012 proposal concerning the accounting for credit losses, which would replace the existing incurred loss model with a Current Expected Credit Loss ("CECL") model. He said that the proposed change to the CECL model was intended to address criticisms that the present model resulted in loan loss allowances that are too little and too late. The change to CECL would also broaden the range of information that should be considered when estimating credit losses, he said, by bringing reasonable and supportable forecasts into the assessment of the collectability of loans (something that, from a credit risk management standpoint, the FDIC hoped bank management already did).

Mr. Storch said the FASB received a lot of criticism for the CECL proposal because it was viewed as front-loading the recognition of credit loss expense. As a result, in December 2013 the FASB considered whether to pursue an alternative model. He said that the FASB decided that it would continue with the CECL model, but would try to refine it and make it more understandable and operational for financial statement preparers. Mr. Storch provided additional detail about subsequent FASB decisions on expected credit loss accounting and reporting. He said that the banking regulatory agencies had emphasized to the FASB that it needs to make clear that it is not imposing a requirement for banks to use a complicated and expensive model to comply with the new standard, an issue particularly important for community banks. Mr. Storch said the FASB had also agreed that it would include implementation guidance describing factors that an entity should consider when adjusting historical loss experience for current conditions and reasonable and supportable forecasts, and when an entity should revert to its historical average loss experience.

Mr. Storch reported that the FASB decided, for the time being, not to include formal nonaccrual guidance within generally accepted accounting principles ("GAAP"), which means for banks that the existing nonaccrual rules in the Call Report instructions will remain in place (and there would be no potential conflicts between a GAAP standard and bank regulatory reporting standards). Finally, he said, the FASB had decided it remained important to identify

which loans are TDRs and disclose information about TDRs. Mr. Storch said that the FASB anticipates that it will issue a final standard on credit losses by the end of 2014, but it would likely not take effect before 2017 and might provide different effective dates for public and private companies.

Member Seleski asked if regulators expected that there would be a regulatory standard for determining prepayment speed when determining loss factors and cash flows, or whether banks would be expected to make determinations for their individual market. He inquired how banks would obtain such data and whether it would be historical or market data. Mr. Storch said that regulators would expect the bank to make the determination based on management's experience, current conditions, and forecasts of prepayment speeds. He noted that prepayment speeds could change from period to period. Mr. Storch said that a bank would need to document how it reached its conclusion and what objective evidence it considered. He said that guidance to examiners should make it clear that they should accept a bank's prepayment assumptions as long as they have a reasonable basis, and that different banks with different circumstances could have different assumptions.

Member Williams expressed concern about how much the ALLL would need to increase when banks have to transition to CECL and about the cost of modeling, especially for a small bank, to comply with CECL. Mr. Storch said that the general opinion was that, once a bank has cleared the transition hurdle, it would have a higher ALLL, but that the fluctuation in the level of the ALLL from period-to-period under the CECL model would be similar to what occurs under the current model. He added that it is unknown what economic conditions, loan loss allowance levels, and the composition of banks' loan portfolios would be in 2017 or 2018 when the CECL standard becomes effective. Mr. Storch said that the Office of the Comptroller of the Currency had estimated most banks may experience a 30-50 percent increase in their ALLL levels, but some banks would see larger increases and others would see smaller increases. He noted that a bank with a very short term loan portfolio may not experience any ALLL change except for the incremental effect on the allowance from having to consider forecasts. Regarding the effect of CECL on regulatory capital, Mr. Storch said the regulatory agencies could consider whether transition rules might be appropriate. With regard to the cost of modeling, he said the FASB had indicated it would try to develop, as part of its implementation guidance, an example of how a community bank could apply the CECL model. Mr. Storch said the banking agencies have been conveying the message that they would not impose a requirement that a community bank obtain an expensive model. He said that a good starting point for a bank could be to build up information about its own lifetime loan loss experience. Mr. Storch said the banking agencies also realize that the CECL model will give them a large task to accomplish, including communicating the changes to financial institutions, retraining examiners, and updating examination and guidance materials. Member Williams said that banks would appreciate agency guidance early so that they could begin preparations.

Member Haskin observed that the loan loss model was reworked after every crisis but said that the current change was unlikely to be a cure-all because predictions about the future are so subjective. She said she was concerned that the effect of the change to CECL, including the need to predict the future, would be to take capital out of the system that could otherwise be used for loans. Mr. Storch said that many people interpreted the term "reasonable and supportable

forecast" in the FASB's proposal to be about two to three years in the future, after which banks would revert to their long-term historical loss experience. He indicated that banks would not be expected to make predictions five to ten years out.

Member Haskin inquired how balloon loans would be treated under CECL. Mr. Storch said that, while CECL expected banks to estimate prepayments, they were not allowed to consider anticipated extensions and renewals. Thus, he said, a bank would be estimating cash flows as of the balloon payment date (unless the bank has a troubled borrower and expects to undertake a TDR when the balloon payment is due at maturity). Mr. Storch said that the banking agencies would encourage the FASB to provide guidance on how to apply the CECL proposal to a balloon payment loan. He said that if the FASB does not provide guidance, the banking agencies would need to so that examiners would understand the agencies' expectations in this situation.

Chairman Gruenberg said the meeting had been very productive. He thanked the Committee members for their valuable contributions and said that he and the FDIC staff had a substantial "to-do" list as a result of the meeting.

There being no further business, the meeting was adjourned at 3:08 p.m.

Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
And Committee Management Officer
FDIC Advisory Committee on Community Banking

Minutes

of the

Meeting of the FDIC Advisory Committee on Community Banking

of the

Federal Deposit Insurance Corporation

Held in the Board Room

Federal Deposit Insurance Corporation Building

Washington, D. C.

Open to Public Observation

April 9, 2014 - 8:45 A. M.

I hereby certify that, to the best of my knowledge, the attached minutes are accurate and complete.

Martin J. Gruenberg

Martin J. Gruenberg
Chairman
Board of Directors
Federal Deposit Insurance Corporation