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

July 10, 2015 – 9:00 A.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: Cynthia L. Blankenship, Vice Chairman and Chief Operating Officer, Bank of the West, Grapevine, Texas; Pedro A. Bryant, President and Chief Executive Officer ("CEO"), Metro Bank, Louisville, Kentucky; Roger Busse, President and CEO, Pacific Continental Bank, Eugene, Oregon; Leonel Castillo, President and CEO, American Bank of Commerce, Provo, Utah; Jack Hartings, President and CEO, The People Bank Corp., Coldwater, Ohio; Jane Haskin, President and CEO, First Bethany Bancorp., Inc., Bethany, Oklahoma; Mark Hesser, President, Pinnacle Bank, Lincoln, Nebraska; James Lundy, CEO, Western Alliance Bank, Phoenix, Arizona; Arvind Menon, President and CEO, Meadows Bank, Las Vegas, Nevada; Mary Ann Scully, Chairman, President and CEO, Howard Bank, Ellicott City, Maryland; David Seleski, President and CEO, Stonegate Bank, Fort Lauderdale, Florida; John Tolomer, President and CEO, The Westchester Bank, Yonkers, New York; and Derek Williams, President and CEO, Century Bank and Trust, Milledgeville, Georgia.

Christopher Emmons, President and CEO, Gorham Savings Bank, Gorham, Maine, and Gwen Thompson, President and CEO, Clover Community Bank, Clover, South Carolina, were absent from the meeting.

Corporation staff who attended the meeting included: Willa M. Allen, Ruth R. Amberg, Steven O. App, Bobby R. Bean, Richard A. Brown, John P. Conneely, Joni Creamean, Carolyn D. Curran, Christine Davis, Nancy DelCastillo, Kareem T. Dorsey, Doreen R. Eberley, Diane Ellis, Lisa K. Ennis, Sarah E. Faust, Jeffrey S. Follis, George E. French, Janet R. Gordan, Shannon N. Greco, Matthew Green, Robert D. Harris, Craig R. Jarvill, Penny B. King, Geneva B. Kropper, Michael E. McGarvey, Roberta K. McInerney, Rae-Ann Miller, Robert W. Mooney,

Mark S. Moylan, Christopher J. Newbury, Richard Osterman, Mark E. Pearce, David W. Riley, Claude A. Rollin, Barbara A. Ryan, Robert F. Storch, James C. Watkins, and Charles Yi.

William A. Rowe, III, Deputy to the Chief of Staff and Liaison to the FDIC, Office of the Comptroller of the Currency, was also present at the meeting.

Chairman Gruenberg welcomed the Committee members and participants and provided an overview of the meeting agenda. He noted that the first panel would provide an update on the FDIC's Community Bank Initiative and the technical assistance videos that were being prepared for release, followed by a discussion of the FDIC's research project on closely held banks; and that the next two panels would provide an overview of the EGRPRA process focused on the issues of exam frequency and offsite monitoring, and of the work being done by the Federal Financial Institutions Examination Council ("FFIEC") to streamline the Call Report. After a recess for lunch, he continued, the first panel of the afternoon session would discuss the FFIEC's new cybersecurity tool; that the next panel would discuss the treatment of high volatility commercial real estate for supervisory and capital purposes; and the final afternoon panel would focus on recent rulemakings, particularly the small bank pricing rule recently proposed by the FDIC for deposit insurance assessments and a recent joint final rule on flood insurance. Chairman Gruenberg then introduced Barbara Ryan, Chief of Staff, Deputy to the Chairman and Chief Operating Officer, moderator for the day's proceedings.

Ms. Ryan introduced Doreen Eberley, Director, Division of Risk Management Supervision ("RMS"), Diane Ellis, Director, Division of Insurance and Research ("DIR"), and Richard A. Brown, Associate Director and Chief Economist, DIR, the panelists for the first panel, "Update on the Community Bank Initiative." Ms. Eberley began with a discussion of RMS's efforts to provide technical assistance to community banks, noting that RMS has developed a cybersecurity awareness training program to be presented to bankers in each of the FDIC's regional offices and, simultaneously, by teleconference or webcast; that a portion of the cybersecurity awareness training presentation would be developed into a "Cybersecurity 101" technical assistance video, which would discuss topics such as the cybersecurity threat environment, how to detect and address threats, and risk management controls; that a vendor management video would be available by the end of the year; and that RMS's interest rate risk and corporate governance videos were being updated. Ms. Eberley also discussed the development of a director's handbook that would be a practical guide for bank directors in carrying out their duties by providing resources on a variety of topics, including directors' duties of care and loyalty, corporate governance, risk management, business plan development, strategic planning, and supervisory examinations.

Next, Ms. Ellis recalled that the FDIC intended to pursue research on four topics related to community banks: mutual institutions; cost functions or economies of scale within community banks; structural profitability; and closely held institutions. She noted that the research on closely held institutions had generated a great deal of interest and input from Committee members, and that Mr. Brown would report on the preliminary results.

Mr. Brown began by noting that small, closely held banks may face some unique challenges relating to their size, limitations on their access to capital, succession planning, and

difficulties in recruiting talent; and that, at the same time, these institutions may have some unique opportunities due to their competitive strength in smaller communities, which may offer some degree of insulation from the quarter-to-quarter demands of the capital markets. He explained that the FDIC designed a short examiner survey to gather information on closely held banks; that the survey covers FDIC-supervised banks in the Kansas City, Chicago, and Dallas regions that were examined in 2014 and early 2015—representing about one-third of FDIC-insured institutions in these regions and more than 20 percent of all FDIC-insured institutions nationwide; that the survey collected information going back five years on ownership structure, operational control, and management succession; and that the survey information would be combined with Call Report data to provide some basic operational and performance comparisons of closely and widely held banks. He briefly discussed some of the preliminary information from the survey, noting that about three-fourths of the FDIC-supervised banks examined were considered closely held—which, overall, may not be a representative sample because the 1,400 banks in these three regions probably have a higher than average prevalence of community or closely held banks; that the most common organizational structure for both closely and widely held banks was a single bank holding company, with 73% of the closely held banks having this structure; that ownership and control were tightly aligned at about 61% of closely held institutions; and that about one-half of closely held banks had identified a successor from within the organization, while a substantial percentage were considered not to be well positioned to recruit qualified management talent from the outside. In summary, Mr. Brown noted that the preliminary survey results demonstrated that management succession was an issue facing a substantial number of community banks—both closely and widely held.

In response to Member Hartings asking how it was determined that institutions would have difficulty with succession planning and recruiting management from the outside, Mr. Brown explained that the examiners asked questions of bank management regarding succession planning, and used their judgment based on their knowledge of the institutions and the local areas. Member Hesser asked how much of the inability to recruit successors could be attributed to geographic factors and the inability to recruit bankers to community banks in rural areas. In response, Mr. Brown indicated that geography appeared to be a factor, and that additional data would need to be analyzed to determine if there was a correlation to rural counties. Member Blankenship agreed that this was most likely a factor, adding that attracting talent to rural areas has been difficult for institutions in small rural areas.

Mr. Brown continued, advising that the preliminary survey information indicated that closely held banks were more likely than widely held banks to be agricultural specialists or nonspecialist lenders; that closely held community banks rely more on retained earnings as a source of capital; and that closely held banks were relatively frequent raisers of external capital over the past five years. He noted that the five year period used for the survey may not be a typical period of time with respect to raising external capital, since there was a need to raise external capital during this period and federal programs to assist in doing so; and that widely held banks may have benefitted more from participation in the TARP and SBLF programs than closely held banks, but closely held banks were still able to raise capital. He briefly discussed other observations from the survey results, noting that closely held banks appear to have had stronger earnings performance than widely held banks over the last five years; and that closely

held banks have slightly lower efficiency ratios than widely held banks, which indicates an inherent performance advantage.

In the discussion that followed, Committee members offered a number of comments and suggestions. Member Scully began by asking about the difference between closely held and widely held banks in terms of growth rates. In response, Mr. Brown explained that there were no dramatic disparities in this category. Member Seleski asked if there was a trend over a period of time based on when the institutions were formed or structural changes. Mr. Brown responded by noting that, unexpectedly, closely held banks have done more acquisitions within the last five years than widely held banks, although they generally acquired smaller institutions. Member Hartings suggested that closely held banks may look at earnings differently and tend to be more conservative; and that they potentially pose less risk to the Deposit Insurance Fund, which should be taken into account for purposes of their CAMELS ratings. In response, Ms. Eberley advised that earnings, risk, and management were taken into account, emphasizing that the CAMELS ratings are based on an individualized analysis of the quality of an institution's earning stream and the risk profile of its asset base.

Member Lundy suggested that an area for further research may be the risk that closely held community banks face when expanding into different geographical markets; and that, in the Phoenix, Arizona, area, where a few large banks dominate the market, new banks entering the area are forced to go after a very small piece of the market, increasing the likelihood that these banks would be driven towards riskier investments. Mr. Brown noted that the FDIC has found that banks changing strategy in the early 2000s from business lines such as agricultural, diversified nonspecialist lending, and mortgage lending to other niches such as commercial real estate were more likely to fail than other community banks; and that changes in geography may be a factor that merits further research. Member Blankenship suggested that merger and acquisition activity was another area to be considered for further research, specifically to determine what type of institutions are doing acquisitions and what types of institutions are being acquired.

Member Busse asked whether the strategic planning part of the examination process takes into account proper succession planning, since that could force merger and acquisition activity, as well as a possible change in the institution's market and strategy. In response, Ms. Eberley said that the evaluation of management and succession planning has been a standing part of examinations. With respect to the future of community banks and management succession, Member Bryant observed that there are fewer training programs for smaller community banks; and that bringing someone into a community bank who has had training from a much larger institution does not ensure that the person would be prepared to run a community bank. Member Seleski opined that the bankers association meetings and other educational opportunities were useful, but that they could not replace a formal commercial banking training program followed by years of experience working in different areas of a bank.

Chairman Gruenberg commented that this research sheds some light on both the current state of the industry and the implications for its evolution going forward. He asked if it would be feasible to look back over the last 10 to 20 years at the absolute numbers among community banks to gain some understanding of the breakdown between closely and widely held institutions

and how their ownership has changed over time. In response, Mr. Brown explained that staff was fairly confident in the analysis looking back five years, but that the analysis of closely held institutions would get more difficult going further back in time.

Ms. Ryan then introduced the next panel, "Examination Frequency and Offsite Monitoring," with Ms. Eberley and James C. Watkins, Senior Deputy Director, RMS, who would provide an overview of the history of examination frequency, the evolution of the examination process, and an overview of how the examination process has been complemented by the FDIC's offsite monitoring program.

Ms. Eberley began with a brief summary of the FDIC's statutory authorities to conduct examinations and undertake enforcement actions. She outlined the FDIC's examiner training and commissioning program, noting that it involved an extensive corporate training program that included rotations working in each of the FDIC's business divisions, formal training through five bank examiner schools, and on-the-job-training. She briefly described the history of the examination frequency, noting that, prior to 1976, all institutions were required to have an annual examination; that, in the late 1970s to early 1980s, the examination cycle was significantly extended, reflecting a focus on monitoring the risk in the largest institutions and the increased use of offsite monitoring; and that, beginning in 1991, Congress mandated annual examinations, with an 18-month cycle for well-rated, well-managed institutions with assets of less than $100 million—that threshold subsequently was increased to $250 million, and then increased again to the current threshold of $500 million. She continued, noting that the examination process has evolved from one where examiners would show up for examinations without advance notice to more risk focused examinations, with the institution being given advance notice to allow time for pre-examination work prior to the onsite exam; that the CAMELS rating system was updated in 1996 to be more risk-focused; that, beginning in 1997, the FDIC formally adopted a risk-focused supervision program, began disclosing component ratings to provide the bank an opportunity to fix potential problems before the next examination, and adopted a continuous examination program for banks with more than $10 billion in total assets; that, in 2002, the post-examination banker survey was updated to improve the communication between examiners and bankers about how the examination process was working; that, in 2010, the FDIC adopted forward looking supervision; that, in 2013, the FDIC tailored its pre-examination request list in response to feedback from institutions; and that, currently, the FDIC has been updating the information technology examination work program to more specifically address cybersecurity threats. Before turning the discussion over to Mr. Watkins, Ms. Eberley emphasized that the examination process now consists of a combination of onsite examinations—starting with pre-examination planning and information requests, followed by a two to three week onsite visit and exit meeting with management, and, finally, a report of examination—and offsite surveillance.

Mr. Watkins then provided further detail regarding how the FDIC's examination process incorporates the offsite monitoring program, noting that there are two types of offsite monitoring activities: (1) those that occur routinely between examinations, and (2) those that occur immediately prior to, or following, examinations. He explained that offsite monitoring programs provide early warning signals that an institution's risk profile may be changing; that the FDIC has developed a number of offsite monitoring tools using data from a bank's Call Reports, which are analyzed to identify trends; and that one of the fundamental tools used for offsite monitoring

was the Uniform Bank Performance Report, which contains valuable comparative group statistics and percentile ratings for banks segregated into peer groups. He noted that these offsite monitoring tools help guide pre-examination planning and aid examiners in developing the initial information request list; that, in 2013, the FDIC launched an electronic pre-examination planning package, which helps to reduce the size of information requested by ensuring that request lists are tailored to the particular characteristics of the institution; and that, typically, one-third of the examination time was spent offsite, either in pre-examination planning or post-examination activities. Mr. Watkins concluded by emphasizing that the FDIC has several supervisory initiatives relating to examinations, including: identifying and implementing changes to improve the efficiency of the examination processes; providing technical assistance and other information to bank directors, officers, and employees on areas of supervisory focus and regulatory change; and identifying other opportunities to eliminate unnecessary regulatory requirements or address burden issues.

Following the panel's presentation, Committee members provided a number of comments and suggestions. Noting that the examination process experience has become significantly less disruptive over the years, Member Blankenship asked about the communication between the FDIC's bank examiners and state bank examiners, since there does not appear to be many redundancies. In response, Ms. Eberley explained that the FDIC may accept a state examination report on an alternating basis to meet the 12- or 18-month schedule, and that the FDIC's field examiners coordinate and work closely with the state examiners. Mr. Watkins added that state examiners often attend the wrap-up sessions or meetings with the bank's board of directors at the conclusion of an examination. Member Castillo asked if the offsite monitoring tools and reports identifying areas of concern could be shared with the banks. In response, Mr. Watkins noted that the FDIC has not published all of its monitoring tools, emphasizing that many of them are centered on identifying growth trends and changes; that staff are encouraged to contact a bank when changes are identified that make it an outlier in one of the FDIC's programs; and that the tools are a means of identifying trends and do not necessarily affect the CAMELS ratings. Ms. Eberley noted that, typically, the case manager would call the bank during the quarterly offsite review process and communicate any concerns raised in one of the offsite reports.

Member Bryant commented that taking a proactive approach of discussing any changes in the bank's balance sheet with examiners, either immediately before or after submitting the Call Report, has been very beneficial. Noting the improvements in technology, Member Haskin asked if the FDIC envisioned a time when the entire examination would be done offsite. Ms. Eberley responded by emphasizing that, while technology would enable the FDIC to do more offsite monitoring and potentially minimize the time spent onsite, the face-to-face communication between examiners and management during the onsite exam process was crucial to the process; and that, for that reason, examinations would never be done completely offsite.

Member Hartings asked whether the $500 million threshold was still appropriate for the 18-month examination schedule, suggesting that the FDIC's resources may be better served by focusing on the three-, four-, and five-rated banks rather than the one- and two-rated banks. He also asked how much the bank's risk rating was based on industry risk versus institution risk. In response, Mr. Watkins agreed that it was important for the FDIC to spend more time at three-, four-, and five-rated banks, but that it was also important, as a preventative measure, to spend

time identifying and addressing concerns at the one- and two-rated banks; and that, with regard to the risk ratings, the examination process was designed to focus on areas of greatest risk, particularly if a bank's focus has concentrated on a business line that has an elevated risk. Ms. Eberley added that the lessons from the crisis of the 1980s and early 1990s highlighted the importance of examining risk from both the macroeconomic and the microeconomic perspective; and that the FDIC has been both bank-centric and industry-focused in evaluating risk.

Ms. Ryan then announced that the meeting would briefly recess. Accordingly, the meeting stood in recess at 10:49 a.m.

* * * * * * *

The meeting reconvened at 11:04 a.m. that same day, at which time Ms. Ryan introduced Robert F. Storch, Chief Accountant, RMS, to present the third panel, "FFIEC Recommendations re: Call Report Streamlining," which would provide an update on activities underway to reduce burden associated with the Call Report requirements for community banks.

Mr. Storch began by explaining that the FFIEC had accepted the recommendations presented by the Task Force on Reports and directed it to launch a formal initiative to identify potential opportunities to reduce burden associated with Call Report requirements for community banks; and that the Call Report burden initiative identified five action areas: (1) implementing burden-reducing revisions to the Call Report; (2) accelerating the start of the next statutorily required review of the existing Call Report data items; (3) assessing the feasibility of a potential community bank Call Report; (4) promoting industry dialogue to gain an understanding of the significant sources of Call Report burden; and (5) providing Call Report training for bankers. He noted that the Task Force developed a set of guiding principles to serve as the basis for evaluating potential additions and deletions of data items to and from the Call Report; that the first principle provides that Call Report data items should serve a long term regulatory or public policy purpose that assists the FFIEC member entities in fulfilling their missions, which include ensuring the safety and soundness of financial institutions and the protection of consumer rights, as well as agency-specific missions that affect all institutions, such as deposit insurance, financial stability, and monetary policy; that the second principle acknowledges the balance that must be struck between maximizing the practical utility of the data items collected and minimizing, to the extent practicable and appropriate, the burden on institutions; and that the last principle seeks to ensure that the data items equivalent to those in a Call Report are not otherwise readily available to the FFIEC member entities through other means. He explained that, in general, any change to the Call Report would need to satisfy all three guiding principles, with the understanding that there may be situations where there was a legitimate need or statutory or legal requirement for certain data items.

Turning to the five action areas identified by the Call Report burden initiative, Mr. Storch explained that, as one action, the Task Force had prepared a *Federal Register* notice requesting comment on several burden-reducing changes and certain other proposed Call Report revisions; and that the notice would be published at a later date for comment following review by the agencies' senior management. He noted that, as a second action, the agencies have accelerated the start of the next statutorily-mandated review of existing Call Report data items, which

otherwise would have commenced in 2017 rather than 2015; that users of Call Report data items in the various functional areas of the FFIEC member entities are participating in a series of surveys over an 18-month period beginning in July 2015; that the surveys ask the users to identify each data item that they use and to explain their need for the item, how they use it, how often it was used, and the population of institutions from which it was needed; that the Call Report schedules are being surveyed based on the perceived burden, as cited by the banking industry; and that, based on the survey results, the Task Force would identify data items to be considered for elimination, less frequent collection, or new or upwardly revised reporting thresholds. With respect to the third action item, Mr. Storch reported that the Task Force was assessing the feasibility of creating a less burdensome version of the Call Report for community banks, which may be defined as institutions with less than $1 billion in total assets, or based on other indicators such as bank activities; that the Task Force has begun reviewing data items that could be eliminated or otherwise restructured from the Call Report for community banks without a loss of information necessary for supervisory or other public policy purposes; that the Task Force planned to present its findings on the feasibility of introducing a less burdensome Call Report for community banks to the FFIEC by the end of 2015; and that, if approved, the Task Force would then begin taking the steps necessary to implement this new version of the Call Report. He continued, noting that, as an initial form of industry outreach action, the Task Force would conduct onsite visits to a diverse group of nine community banks between July 2015 and September 2015; that these banks would offer potential dates for a one- to two-day onsite visit, during which each bank would explain and demonstrate its Call Report preparation process, and identify the aspects of the process that contribute to reporting burden, including the manual effort necessary to prepare and file the Call Report; and that, based on the findings from these onsite visits, future industry outreach activities could include meetings with bankers and data processors, as well as targeted requests for comment from the industry as a whole. Finally, with respect to action on Call Report training, Mr. Storch noted that the agencies conducted a banker teleconference on the revised Call Report regulatory capital schedule in late February 2015; and that another banker teleconference has tentatively been scheduled for later in 2015 to discuss the proposed burden-reducing and other Call Report changes.

In the discussion that followed, Member Blankenship commended the Call Report initiative, noting that any amount of reduction in the burden would be beneficial; and that, while banks generally wanted the agencies to have the information needed, there was probably some information that was not being utilized by the agencies that could be eliminated; and that, after the information categories were reexamined, it would be beneficial to seek bankers' perspectives on the information gathering process to determine whether it was an automated or manual process. In response, Mr. Storch explained that the intent of the survey was to challenge the data users of various portions of the Call Report to identify areas where there was not a strong justification for the information and to examine those areas for elimination; that the agencies would consider whether the costs of a scaled-back version of the Call Report for community banks would offset the benefits; and that the agencies would look to the industry to provide some guidance on whether a scaled-back version of the Call Report would achieve a meaningful reduction in burden. Member Williams agreed that requiring a justification of why certain data was needed would be beneficial. Member Castillo suggested that adding a comments section on the offsite reporting would be helpful, since it would allow banks an opportunity to reduce the back-and-forth between the bank and examiners.

Ms. Ryan then introduced Roberta K. McInerney, Deputy General Counsel, Legal Division, Ruth R. Amberg, Assistant General Counsel, Legal Division, and Mr. Watkins for the next panel, "Update on the FDIC's Regulatory Review under the Economic Growth and Regulatory Paperwork Reduction Act ("EGRPRA")," which would provide an overview of some of the general themes that have been discussed at the EGRPRA meetings. Ms. McInerney recalled that EGRPRA requires the banking agencies to review their regulations at least once every ten years to identify any outdated or otherwise unnecessary regulations; that the FDIC's last review was completed in 2006; and that the current review process underway would be completed by 2016. She noted that, as part of the formal outreach process, the FDIC has divided the regulations into categories and would publish four notices in the *Federal Register* seeking public comment on several categories of regulations identified in each notice; that the third and most recently issued of these notices was published in the *Federal Register* in June 2015, seeking comment on three categories of regulations: consumer protection, directors, officers, and employees, and money laundering; and that the final *Federal Register* notice would be published at the end of 2015, seeking comment on rules of procedure, safety and soundness, and securities regulations. She briefly explained that, in response to the first two notices, the FDIC has received 65 comments, which are currently being reviewed; that after the comments were reviewed, a report would be prepared on whether certain regulatory elements can be amended or eliminated; and that, as part of the EGRPRA review, the FDIC was holding six outreach sessions across the country, seeking direct input from bankers.

Mr. Watkins reported that five recurring themes have emerged from the comments and outreach sessions of the EGRPRA process: (1) Call Reports; (2) examination frequency; (3) appraisal thresholds; (4) Bank Secrecy Act ("BSA") requirements; and (5) communication in the examination process. He explained that bankers expressed a desire for streamlined Call Reports, particularly for community banks; that many bankers were seeking fewer examinations and an adjustment of the examination frequency requirements; that many bankers suggested raising the appraisal threshold to $500,000; that many commenters suggested raising the Bank Secrecy Act threshold and recordkeeping requirements, as well as allowing more exemptions from reporting; and that a number of banks suggested improvements to the examination process, such as maintaining open and regular lines of communication to ensure that supervisory expectations intended for the largest banks are not applied to community banks.

Member Hartings opened the discussion following the panel's presentation, noting that the FDIC's participation in the EGRPRA outreach and other initiatives have highlighted that both the bankers and the FDIC were interested in making the supervisory process as efficient and effective as possible. Member Lundy suggested that the FDIC consider adopting some of the continuous examination ideas applied to larger banks to the examination processes for smaller banks, which could result in more frequent, but less formal and burdensome, examinations. Member Bryant commented that a 24-month examination schedule would be beneficial because of the burden of the examination process on smaller banks. Mr. Watkins responded, noting that the examiner's knowledge and background brings value to an examination that may not be represented in the CAMELS ratings; and that, as a result, onsite examinations were helpful to identify issues at an early stage when they may be easier to address.

Member Williams commented that further consideration of the BSA thresholds was important because institutions often spend a significant amount of time on reporting requirements, without significant benefit in terms of reducing money laundering. Members Blankenship and Hesser agreed, expressing their concerns that considerable time was spent avoiding technical errors on compliance reporting that could lead to compliance issues; and that it would be very beneficial if the error percentages could be increased. Chairman Gruenberg responded by noting that BSA emerged as a significant concern during the FDIC's outreach sessions; and that, because BSA enforcement was a FinCEN responsibility, it may be beneficial to have FinCEN participate in further discussions. Member Hesser commented that the Home Mortgage Loan Disclosure Act ("HDMA") reporting also was overly burdensome due to concerns that technical errors could result in compliance issues. In response, Ms. McInerney acknowledged these concerns, noting that the FDIC has raised the enforcement thresholds for HMDA violations within the last year in an attempt to reduce the number of violations for technical errors.

Ms. Ryan then announced that the meeting would recess for lunch. Accordingly, the meeting stood in recess at 11:54 a.m.

* * * * * * *

The meeting reconvened at 1:06 p.m. that same day, at which time Ms. Ryan turned the discussion over to Ms. Eberley and Mark Moylan, Deputy Director, RMS, for the next panel, "Introduction of Cybersecurity Assessment Tool," which would focus on the new cybersecurity assessment tool recently released by the FFIEC.

Ms. Eberley recalled that one of the FFIEC's priorities for 2015 was the release of a cybersecurity self-assessment tool to assist institutions in evaluating their inherent cybersecurity risk and risk management capabilities. She briefly guided the Committee through the use of the cybersecurity assessment tool, explaining that the tool has two parts: an inherent risk profile and a cybersecurity maturity model; that the inherent risk profile uses a matrix to help banks determine the level of inherent risk of the institution in five different areas: technologies and connection types, delivery channels, online/mobile products and technology services, organizational characteristics, and external threats; and that the tool then determines the bank's cybersecurity maturity and level of preparedness, which consists of five levels: baseline, evolving, intermediate, advanced, and innovative. Ms. Eberley explained that there was no specific level of preparedness being recommended; that the level would be based on the inherent risk of the institution and its assessment of how the inherent risk aligns with the institution's level or preparedness; that there are five dimensions of cybersecurity maturity that are measured: cybersecurity risk management and oversight, threat intelligence and collaboration, cybersecurity controls, external dependency management, and cyber incident management and resilience; and that each of those five domains provides assessment factors. She explained that the inherent risk profile and the level of maturity of an institution can be changed, noting that, for example, if an institution finds it has a moderate level of risk and only a baseline level of preparedness, then either the level of preparedness could be increased, or the level of risk reduced by eliminating unnecessary internet connections or vendor contracts. She emphasized that the cybersecurity assessment tool provides a description of what the expectations would be to move to a higher

level of preparedness, which can serve as a road map for developing a plan to move to the next level; and that an institution considering the addition of a new delivery channel or implementation of other actions that would change their profile should use the tool to recalculate their risk assessment. Before turning the discussion over to Mr. Moylan to outline how the FDIC would be formally introducing the cybersecurity assessment tool, Ms. Eberley noted that there were a number of resources available on the FFIEC's website to assist banks in using and implementing the tool, including a videotaped presentation on how to use the tool and a written user's guide providing step-by-step instructions.

Mr. Moylan then explained that the FDIC planned to conduct a cybersecurity outreach program, which would serve as a complement to the cybersecurity assessment tool; that the FDIC's program would focus on the elements and sources of cybersecurity risk, as well as the principles within the information security program to identify control and respond to cybersecurity risks; and that the intent of the program would be to establish a culture of collaboration between the institution's technical staff and its management. He advised that the FDIC would begin holding a number of events for bankers in the FDIC's regional offices beginning in August and early September 2015; and that the basic framework of the outreach program would be made into a "Cyber 101" video that would be added to the FDIC's technical assistance video library.

Ms. Eberley concluded the presentation by emphasizing that the cybersecurity assessment tool was developed by the FFIEC in response to requests from bankers; that it was a voluntary self-assessment tool that banks are not required to use; that the FDIC would be updating its information technology ("IT") examination program used by the examiners; and that the FDIC would begin using a new examination program that more explicitly discusses cybersecurity preparedness in the examination process.

In the discussion that followed, Member Hartings noted that the tool itself was quite lengthy and suggested that it may be helpful if the FDIC's outreach sessions focused on examples for an institution with a moderate risk appetite to provide some indication of what the expectations would be for that level of preparedness. In response, Ms. Eberley explained that the agencies were aware of the size of the tool, which was one of the reasons for having a separate Appendix A to provide current expectations. She also explained that the FDIC anticipates that many institutions would be operating at the lower end of the risk profile spectrum, which would allow them to more readily map the baseline statements. Mr. Moylan added that one of the important aspects of the tool was management involvement in business continuity planning, including how to respond to a problem and plan for restoration of business.

Member Hesser asked what examiners would be looking for in future. In response, Ms. Eberley emphasized that the tool is voluntary for all FDIC-supervised institutions; and that it was possible that cybersecurity would become a more explicit part of the FDIC's examination program in the future. Member Castillo asked whether the cybersecurity assessment tool included a component to assess the cybersecurity risk inherent in the institution's own personnel. Ms. Eberley responded by noting that this issue was addressed in the training and culture assessment factor of the tool. Mr. Moylan added that another element emphasized within the cybersecurity assessment tool was threat intelligence—what that means and how to gather it; and

that the FDIC's outreach program would discuss these elements from the perspective of the management teams collaborating with IT staff to discuss potential risks and continuity planning.

Ms. Ryan then announced that the meeting would briefly recess. Accordingly, the meeting stood in recess at 1:38 p.m.

* * * * * * *

The meeting reconvened at 1:47 p.m. that same day, at which time Ms. Ryan introduced Bobby R. Bean, Associate Director, RMS, and David W. Riley, Senior Capital Markets Specialist, RMS, to present the next panel, "High Volatility Commercial Real Estate ("HCVRE"). Mr. Riley began by explaining that HVCRE exposure refers to the fact that commercial real estate values can change substantially over the economic cycle; and that the agencies have assigned a higher risk weight of 150 percent to HVCRE exposures because, over the years, HVCRE has had a higher loss rate and has been associated with the failures of community banks. He noted that there are four categories within acquisition, development, and construction loans excluded from HVCRE: one-to-four family residential projects, agricultural loans, community development exposures, and development loans which meet certain criteria—development loans are excluded if they have 15 percent cash equity from the borrower, the equity contributions (including internally-generated capital) stay in the project, the loans must meet the supervisory loan to value guidelines, and the hard equity should be cash or the cash value paid for the land contributed to the project. Additionally, he noted that permanent loans are not considered HVCRE. Noting that, in April of 2015, the agencies released a list of frequently asked questions on the HVCRE rule, Mr. Riley briefly described some of the most commonly asked questions. He explained that a majority of the questions are related to the 15 percent equity contribution, particularly as it relates to appraised values; that the rule indicates that the equity contribution should be hard cash or readily marketable assets, or the cash paid for the land contributed to the project; and that the agencies have been reluctant to accept appraised values for this purpose, because appraised values have been unreliable over the years as an accurate measure of value. Next, he noted that questions frequently arise regarding who would be considered the "borrower" for purposes of the rule; that the borrower would be the obligor on the note; that the borrower could be a limited liability company or an individual, with the key being that the borrower should have 15 percent hard equity in the project, or "skin in the game;" and that the rule does not prevent an investor from having a loan. He also noted that banks have requested more guidance regarding how to measure the 15 percent, especially in cases with a revolving line of credit or where the project has several phases, and how to measure internally generated capital; and that the agencies are currently trying to answer these questions. In terms of how to determine whether a loan would be considered a permanent loan, he explained that this was a qualification based on the bank's standards for underwriting long term mortgage loans, which can vary from bank to bank; and that the agencies generally require that the loan meet the bank's standards for a permanent long term mortgage.

In the discussion that followed, Committee members offered a number of comments and suggestions. Member Haskin asked for clarification that a separate property taken as collateral would not count as the 15 percent equity contribution. Mr. Riley answered affirmatively, explaining that the agencies have determined that that would not count, unless the property was

part of the same project. Member Haskin then asked if it would still be insufficient under the rule where collateral was taken that resulted in a 50 percent loan-to-value ratio on the project. Mr. Riley responded that the agencies have not accepted the collateral in that situation, emphasizing that they want to ensure that the hard equity was there. Member Haskin commented that he did not understand why the rule would assign a higher risk weight in that situation, since real estate developers may not have cash but do have other pieces of free and clear land that they want to use as collateral.

Member Tolomer suggested that a developer could obtain a loan against the land they intended to use as collateral, and then put that down to meet the 15 percent cash requirement, essentially resulting in the same end result but with added steps and additional risk. Mr. Riley explained that the agencies were attempting to address these challenges, noting that they do not want to create a situation that imposes extra burden to accomplish the same result, but that there had to be a balance between creating extra burden and ensuring that the 15 percent hard equity is there. Noting that the idea was to avoid the risk of overestimated appraisals, Member Williams commented that the rule should be reconsidered because borrowers using additional collateral in lieu of a cash down payment clearly have "skin in the game," since it involves property they own. Member Lundy noted that a much more disciplined appraisal process has been in place since the 1980s crisis; and that, while the appraisal process could be improved, the regulatory community was doing itself a disservice by discounting appraisals. Member Seleski asked why one-to-four family residential projects were considered lower risk, and what were considered "community development loans." In response, Mr. Riley explained that the exception for one-to-four family residential projects was not made for risk considerations, but for broader economic considerations; and that, for purposes of the rule, "community development loans" were loans to provide affordable housing or used in the provision of community services for low to moderate-income individuals, or they revitalize or stabilize low- to moderate-income geographic areas.

Member Hartings explained that one of the most difficult parts of this rule for a community banker was the discounting of appraisals, such as a scenario where a 50 percent loan-to-value ratio on a loan for an addition technically falls under the HVCRE rule if it uses an as-completed appraisal, even if the borrower has owned the building for ten years. In response, Mr. Riley agreed that this scenario would be a low-risk loan, but would indeed be considered HVCRE and assigned a higher risk rate under the rule, noting that the agencies were trying to find a uniform way to avoid capturing these types of low-risk loans. Acknowledging that the rule was intended to capture excessively appraised loans, Member Hartings suggested revisiting the rule because it results in capturing a lot of other loans that are low risk loans. Member Blankenship commented that the rule could have the unintended consequence of driving customers to other funding sources, particularly in smaller communities where customers may not have a lot of choice, which could impede economic development in those areas. Mr. Bean responded, noting that the regulators were aware that this was an important issue, and that the agencies wanted to get it right and implement it in a way that does not result in competitive inequities between the different institution charters.

For the final panel of the meeting, "Recent Rulemakings," Ms. Ryan introduced Ms. Ellis, Matthew Green, Associate Director, DIR, and Jonathan N. Miller, Deputy Director,

Division of Consumer Protection, who would discuss the small bank pricing rule and recent joint rulemaking on flood insurance.

Ms. Ellis began by briefly summarizing the small bank pricing proposal recently issued by the FDIC, noting that it was a proposal to update the manner in which the FDIC charges deposit insurance premiums for banks with total assets of less than $10 billion. She explained that, under the current system, each small bank would be assigned to one of four risk categories based upon their regulatory capital ratio and CAMELS composite rating; that one assessment rate would be applied to all banks in the three worst categories; that, for the majority of banks, which are one- or two-rated and well capitalized, there was a range of rates that would be applied based on each institution's financial ratios and CAMELS rating; and that the underlying approach for that model was a CAMELS downgrade prediction, which estimates the probability of a one- or two-rated institution getting downgraded to a three-, four-, or five-rated institution—which was intended to be a proxy for bank failure. She noted that, when the current approach was being developed in 2006, the FDIC had not had a significant number of bank failures for quite some time and the CAMELS downgrade prediction appeared to be the best approach to differentiate banks in the one- and two-rated categories as opposed to a failure prediction model; that the new approach better captures risk with an underlying failure prediction model, incorporating the failures from the most recent banking crisis, as well as the failures that occurred in the late 1980s and early 1990s; that the new approach estimates failure over a three-year period, as opposed to the current system which only looks at a one-year period; and that one measure added to the new system was the extent to which a bank's total assets include higher risk categories of loans, which are defined as those loans that tended to fare poorly during downturns, such as construction development loans. She explained that the other major change to the approach used in the proposal was to eliminate risk categories; that, instead of assigning all banks with less than $10 billion in assets to one of the four risk categories, financial measures would be used for all banks; and that there was a proposal to put a ceiling on the rates paid by one- and two-rated institutions, as well as a floor for the rates paid by three-, four-, and five-rated institutions.

Ms. Ellis advised that the proposal would become effective when the deposit insurance fund reserve ratio reaches 1.15 percent; that the FDIC had already built in an assessment rate reduction to the current system where the assessment rates would drop by roughly two basis points for most institutions; and that this new system would preserve that assessment rate reduction and be revenue neutral in the aggregate. Regarding the proposal's effect on individual institutions, she emphasized that the FDIC has estimated that, after the assessment rates decline, 92 percent of institutions would pay a lower rate, while eight percent would pay a higher rate based on year-end 2014 data. She noted that the FDIC believes that the proposed system would be a better, more accurate way of charging deposit insurance premiums, resulting in less cross-subsidization of the well rated institutions for the high risk institutions; and that the FDIC's back testing has shown that the proposed system overall would be better than the current system, particularly when things change and conditions are deteriorating. Ms. Ellis concluded by advising that no changes would be required to the Call Reports because the proposed system would rely on Call Report data currently being collected; and that the FDIC has made a calculator available on its website to allow individual institutions to evaluate this proposal and assess its effect on them.

Committee members offered a number of comments and suggestions in the discussion that followed. Member Tolomer began by commenting that the new approach would better reward good behavior. Member Lundy observed that this approach could have broader application, particularly with regard to how the FDIC looks at risk and the examination process.

Member Scully asked whether the FDIC was focused on the business model of the bank rather its ability to execute that business model, suggesting that banks with a certain business model would be penalized under the new approach, regardless of how well they executed that business model. In response, Ms. Ellis noted that the FDIC did not take advantage of the opportunity to incorporate something similar to a loan mix index when it put the current assessment system in place; that, based on the experience of two significant waves of bank failures, there are certain business models, funding models, and lending concentrations that result in high levels of failure, as well as significant losses; that the new approach attempted to take execution of the business plan into account whenever feasible, but doing so was limited by the available data—which was a reason for the continued emphasis on the CAMELS ratings. Member Scully responded by suggesting that this approach was inconsistent with other safety and soundness measures since it was the only instance, from a safety and soundness perspective, that banks with a particular business model would have to increase their levels of capital in order to avoid paying a higher assessment. In response, Mr. Green noted that the rates would be based on the combined effect of all of the measures; and that, under the set of overall rates currently proposed, 80 percent of institutions would experience a decrease in their rates or pay the same rates. Ms. Ellis also responded, emphasizing that there were multiple factors that all work together in a balanced approach to affect assessment rates; that the bank could increase capital, maintain a higher level of core deposits, or make other changes to affect their assessment rate; and that the new approach charges higher rates for certain business models that create higher risks. Chairman Gruenberg noted that this new approach was issued as a Notice of Proposed Rulemaking, and that bankers are encouraged to comment on the proposal.

Next, Mr. Miller briefly discussed the joint final rule recently issued by the FDIC and other agencies as part of recently enacted flood insurance laws. Noting that the joint final rule would become effective in 2016, he explained that the new rule has three primary elements: (1) escrow requirement; (2) detached structures; and (3) forced placement. Regarding the escrow requirement, he advised that the new rule requires escrow of premiums and fees for flood insurance for residential improved real estate or mobile homes originated, increased, extended, refinanced or renewed on or after January 1, 2016; that the new rule was no longer retroactive with regard to loans outstanding prior to January 1, 2016; that there would continue to be a small lender exception for institutions with assets of less than $1 billion; and that there would be other exemptions for types of loans that would not need flood insurance, including, HELOCs, condominium or co-op loans for individual units where the whole building has a flood insurance policy; and subordinate loans. With respect to detached structures, he advised that there was a new flood insurance exemption for structures that are part of a residential property but detached from the primary structure and do not serve as a residence, such as a detached garage or other structure. Finally, with regard to forced placement, Mr. Miller advised that the new rule (1) clarifies that the lender or the servicer has the authority to charge a borrower for flood insurance coverage once their coverage lapses or becomes insufficient, and (2) specifies when borrowers

must receive notice, how long they have to reply, and when the lender or servicer must terminate forced placement flood insurance and refund any outstanding payments.

In the brief discussion that followed, Member Hesser asked whether there was a time period for borrowers to respond to forced placement of insurance. Mr. Miller responded, indicating that he believed the consumer had 45 days to respond with evidence of insurance coverage. Noting that the detached structures could be a significant issue in rural areas, asked whether the detached structure exemption would be available in a situation where land was being purchased for hunting and it had an old unused barn standing on the property. In response, Mr. Miller indicated that it most likely would qualify for the detached structures exemption because it was not a residence. Member Bryant commented that the clarifications on the technical assistance videos were very helpful in understanding flood insurance.

Chairman Gruenberg thanked the attendees for their participation, noting that the comments from the meeting were genuinely helpful. He emphasized that the new cybersecurity assessment tool was an important initiative, and suggested that the Committee members may want to provide some feedback at a future meeting on how the new tool was working.

There being no further business, the meeting was adjourned at 2:52 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

Jul 10, 2015 – 9:00 A.M.

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

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