September 14, 2020

Comments on: RIN 3064-ZA18

Robert E. Feldman
Executive Director
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429

Dear Mr. Feldman:

The Invictus Group, LLC (Invictus) welcomes the opportunity to comment on the aforementioned "RIN 3064-ZA18." Invictus is an advisory firm specializing in corporate strategy, strategic planning, stress testing, Current Expected Credit Loss (CECL) analytics, and Merger & Acquisition advice to a range of banks. Additionally, we apply our unique analytics to publicly available data to derive information both for use in our practice and for sale to third parties such as institutional investors, regulators, accountants, lawyers, corporate treasurers, and investment bankers.

Invictus had its start in the peak of the subprime crisis in 2008 and has evolved by adopting its long-vetted stress testing concepts measuring capital adequacy to today's significant banking challenges: growing loans, increasing margins, and creating a stable capital and depositor base. We have fortunately been able to utilize our intellectual property to rapidly develop and modify our offerings for the current COVID-19 environment. Using public data including Call Reports, we stress test every bank in the country every quarter. The information we derive is crucial to the C-Level executives of our bank client base for strategic planning and M&A activities. Our customized offering for our client banks utilizing their internal data can then be compared to our analysis on the potential performance of banks in their footprint providing the best — and often times only — benchmarks available for *post-stress* performance of competitors, peers, and geographic regions. This information is crucial in the development and implementation of their respective strategies, how they fare versus their direct geographical competition, and where they rank on a state and regional basis. In the past Invictus also provided certain state bank regulators detailed reports on banks under their jurisdiction using publicly available information.

It is no secret that regulatory requirements add considerable reporting, operational and management costs. Smaller banks particularly struggle to comply with the sheer amount of regulation.

We applaud the above-addressed request for information (RFI) in attempting to help banks, particularly community banks, cope in an increasingly complex environment. Gone are the simple days embodied by Jimmy Stuart's management style in "It's a Wonderful Life." Technology has added efficiency. But as the complexity has increased, it is far more difficult for management and regulators to be comfortable that the technology is performing as intended. This is particularly true as third-party vendors (TPVs) have entered the market, offering a myriad of services from human resource screening to anti-money laundering software to interest rate risk management advice to stress testing. As is noted in the RFI, third-party models utilize computers, either in the bank or in the cloud, to perform complex tasks that would be virtually impossible for most banks to create efficiently on their own. The economies of scale that comes from a vendor providing services to a particular need ensures consistency and provides a cost

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saving to the client bank. TPVs also provide banks with a better solution than the banks could generally produce themselves, in that the third party has multiple clients engaged in a similar process and can learn from all of them. The third-party solution has a better chance of being "best practice" – it has embedded intellectual property and institutional memory from the heuristic learning that occurs from dealing with many banks, each with its own foibles and characteristics.

We have several observations, comments, and concerns related to the above referenced RFI:

The RFI is broad relative to what we perceive as the need. Specifically, it appears to cover almost all third-party models and software. We believe that there are at least three different categories of models and software pertaining to the operations of a bank:

- Category 1: Models that touch or can affect books and records. This can include anti-money laundering, underwriting, fraud, accounting, investment portfolio, and similar models.
- Category 2: Models that address regulatory issues.
- Category 3: Models that are management-oriented related to strategic decisions. These might include stress testing, M&A, strategic planning, and similar models.

We believe that treating all of them the same is a disservice to both the banks and the vendors. The first two categories depend on models that must ensure strict adherence to rules, regulations, and compliance. The third category is far different.

Since what Invictus provides is strategic assistance to management in the form of testing and M&A we believe our product offerings fall entirely into Category 3. We will limit our comments toward that category.

Banks employ varying business strategies, from organic growth inside the geographic footprint, to growth outside the footprint, to acquisitions. Strategic shifts can cause banks to change their loan category mix, their deposit taking focus, and the kinds of acquisitions they are willing to make. Strategies also alter the way banks look at non-lending businesses. Structural issues and shareholder issues are also part of the strategic mix. Every bank is different. Every situation is different, and therefore, every strategy is different. Modeling those kinds of decisions can vary from bank to bank and from vendor to vendor. While we believe we are the thought leaders on stress testing, we do not claim to have a monopoly on good ideas. We respect our competitors and accept the fact that one size does not fit all. We welcome the renegades and outsiders because of the fresh ideas that often come with them.

On Standards Setting

We established our company during the 2008 recession because we felt that the way credit was being analyzed at the time led to significant problems on banks' balance sheets. We created a methodology to look at credit a different way. We didn't realize at the time that we were creating what is now known as a stress test.

If Standard Setting Organizations (SSO) or Certification Organizations (CO) had the authority to certify our young company at that time, would our unique methodologies have "passed the test?" Or would more established and better-known advisory firms dominated the SSO and precluded us from getting our techniques "approved?" We believe an SSO or CO will embody what is known at the time, despite a stated goal of innovation. It is human nature to resist what is new in favor of something older and "proven"—even if what is proven leads to bad decisions.

The next question concerning SSOs is speed and timing. In a rapidly changing environment can an SSO respond quickly enough to meet market demands?

We assume certification would involve model evaluation against a standard that incorporates performance, quality, validation, audit, and verification. The stakeholders mentioned in the RFI include regulators, vendors, academia, and customers. Nimbleness and agility are not the hallmarks of bureaucratic organizations comprised of stakeholders with varying agendas. This suggests a lengthy process, which raises some questions. After all, what makes fintech so exciting is its ability to turn on a dime.

Using the current pandemic as an example, could an SSO evaluate what would be needed in a stress testing product to effectively understand the impact of the pandemic on credit quality? Could it do so in time to serve banks that are relying on innovation to assess their real-time risks? Let's imagine our product had already been evaluated, and we modified it for current conditions. Would that adaptation need to be recertified?

Invictus realized in March that the emerging pandemic would have a significant impact on our bank clients. We began modifying our technology so that we could supply banks with COVID-19 customized stress tests, the first of which was delivered in late April for a client's Board of Directors meeting. If we were required to submit our revised model to an approvals process, there is no way our client could have received important, strategy-influencing results that quickly.

In a fast moving, rapidly changing environment—the time when stress testing models are most needed—there could be such a delay that by the time a standard is set and a vendor's model evaluated, the train would have already left the station. That delay would ultimately negatively affect the ability of a bank client to get the information needed on capital adequacy to make an informed decision affecting the bank's safety and soundness.

The next topic is the breadth of the SSO. An SSO that will evaluate multitudes of products among the three categories noted above would need to have many employees across numerous disciplines including accounting, finance, strategy, mathematics, computer science, lending, credit, payments processing, etc. How does an SSO set the priority for what needs to be validated and when? If it's one organization that covers this much ground, is it practical to believe that expertise in all the disciplines would be readily available? We believe there is a natural bureaucracy that would develop in an organization of this size that would further slow standard setting in a dynamic environment.

On the Cost of Certification—Financial Implication

We compete against both organizations similar in size to us and against global consulting firms. Would the cost of certification be affordable to small organizations? Now we are a leader in stress testing, but as a start-up, Invictus had a small staff with limited resources. We can envision the cost being prohibitive to small vendors, which would have a chilling effect on innovation.

On the Protection of Intellectual Property

We have spent more than 10 years developing our intellectual property. We continually allocate resources toward improvement of methodology, scope, security, and quality of our models. We also jealously and aggressively protect this intellectual property. We do not think our competitors share the same rapid development mantra, but we are sure our competitors do evolve their technology and protect their intellectual property. We would have a concern with our intellectual property living outside of an environment that we control. We use the latest legal and cloud security techniques to ensure this protection. The responsibility is on us, which we accept. Once intellectual property moves outside the organization it becomes much more difficult to control. Since patent protection isn't necessarily a viable or even desirable path in this market the only way to protect intellectual property is trade secret. This becomes exponentially more difficult the more people outside our control are involved.

On the term "voluntary certification"

Commercial banking is a highly regulated industry. Banks interact with state and federal regulators on a continual basis. It is intuitively obvious to the most casual observer that "voluntary" certification will move to "expected." No bank reporting to a regulator will want to have an uncertified model. It's one more thing to worry about, one more potential exposure. It's much easier to "check a box" that says the model is certified. Once the certification is "expected" it then migrates rapidly into the "mandatory" bucket. This mandatory category might not be mandatory in a legal or regulatory sense, but since it has the imprimatur from regulators, it would by all intents and purposes be viewed that way. We fear that banks would only feel comfortable with "approved" models from "proven" vendors. This again could stifle innovation and hurt rather than help most community banks.

On the Certification Process

Category 1 and 2 models noted above would mostly include models producing "an answer"—correct accounting entries or correct interpretation of human resource regulations. Category 3 is a different species. All our models are fully customized for our clients. Our models target strategy, which doesn't have "an answer" but has degrees of impacts and a range of potential outcomes. That's what makes our product both effective and compelling. While many of the core models and modules are reused, much of our delivered product is bespoke. Would each client's individual models need to be certified? We are constantly redeveloping our product. We would need to ask what level of change in the model or the code triggers a revaluation process. Would a 10-line change in the code trigger a complete re-evaluation of the program and models? Would there need to be recertification every year? There would certainly be an underlying current to warrant some level of frequency for some models, since a model could be out-of-date, yet certified, leading to approved models producing inaccurate outsourced tasks.

On the Banks' Responsibility to Perform Due Diligence.

We believe that due diligence is more than a check- the-box exercise when working with strategic products. It is important that management not just follow blindly what a computer program, model or consultant says. Bank management needs to embrace the entire process from assumptions ownership to an understanding of the methodology. In fact, when it comes to safety and soundness, both the management team and the bank board are encouraged by regulators to understand what they are using, and why. Since strategy and M&A work is customized, we regard management's involvement in the due diligence process to be crucial to the success of the product and ultimate incorporation into management's planning. The unintended consequences of certification could be having less management and board understanding, not more, which would be counterproductive to safety and soundness regulations. Again, we emphasize that for models and services that touch the core operations of the bank—what we have labeled Categories 1 and 2 above—the comfort of certification might suit a bank's needs. It is simply not sensible for Category 3.

On innovation

Much of what we note here comes down to the role that innovation plays in the dynamic and ever-changing banking industry. New products are continually being developed, including new techniques for underwriting, methods to evaluate credit, etc. Banking today is far different than it was 20 years ago. Service providers, other than accountants and lawyers, are generally unregulated. Third-party providers serve a different need than the banks themselves. That flexibility to create new and useful products and services helps banks move forward. It particularly helps the community bank market compete with the money center banks and Internet banks. Community banks generally cannot afford to hire thousands of staff and pay for massive software development. They depend on TPVs to help them compete. Any impediment to that innovation will be felt more at the community bank's ability to compete than at the money center banks.

Summary

As noted above, we believe there are certain circumstances where certification is appropriate. However, we would caution regulators to err on the side of not creating impediments to innovation. We would encourage a measured approach. From that perspective, we applaud the FDIC in issuing this RFI and hope that the industry, both the providers and customers, offer valuable feedback in considering whether voluntary certification or self-certification is needed.

Sincerely,

[redacted]

Leonard J. DeRoma

Founding Partner and Chief Financial Officer