The 2016 FDIC Community Banking Conference

Strategies for Long-Term Success

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L. William Seidman Center
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On April 6, 2016, the FDIC hosted a Community Banking Conference in Arlington, Virginia, with the theme of exploring strategies for long-term success in the community banking sector. This important event drew about 250 community bankers and other industry participants, who took part in a daylong discussion about what the future holds for community banks in the United States.

FDIC Chairman Martin J. Gruenberg opened the conference with welcoming remarks that underscored the essential role community banks play in the U.S. economy. Chairman Gruenberg remarked that the community banking sector pulled through the financial crisis—and before that, decades of consolidation—as a steadfast pillar of the U.S. financial services industry. Drawing on FDIC research, he said that community banks today account for 13 percent of banking industry assets but hold 44 percent of the industry’s small loans to businesses and farms. In fact, for more than 20 percent of the nation’s 3,100 counties, the only banks operating in those counties are community banks. He drew the conclusion that these institutions therefore play a critical role in terms of access to basic banking services and credit for consumers, farms, and small businesses across the country.

Because community banks figure prominently in the U.S. financial system, they matter significantly to the FDIC. Chairman Gruenberg continued, “The FDIC is a lead federal supervisor for the majority of community banks in the United States, and the future of community banking has long been a priority for us.” He noted that “there is a very strong public interest in ensuring that they continue to function and serve their communities in the years ahead.”

Community banks are entering this next phase in a strong position, outpacing the banking industry as a whole, both in the rate of earnings growth and the rate of loan growth. “Community banks have evolved, changed, and grown to meet the needs of their customers and the challenges of the market,” he said. “They have succeeded to a remarkable degree.”

While acknowledging that the economic recovery since 2009 has been marked by below-average growth and low interest rates—not an easy environment for community banks—Chairman Gruenberg also noted that the majority of community banks have nevertheless addressed problem loans, strengthened balance sheets, and increased earnings. In other words, on balance, community banks have a positive story to tell, but they also recognize the challenges ahead.

Following the Chairman’s remarks, four separate panels addressed some of those challenges: the viability of the community banking model, regulatory developments as they pertain to community banks, how technology is affecting these institutions, and how community banks are managing ownership structure and succession planning.

The Community Banking Model

FDIC Dallas Regional Director Kristie K. Elmquist moderated the first panel, on the community banking model. Four community bankers and a professor of finance from Texas Tech University held a wide-ranging conversation about community bank strategies in response to market trends, strategies banks are developing in anticipation of new trends, and best practices to manage risks.

The strategies they mentioned included developing strong relationships with business customers and getting to know their products; taking advantage of the size of the community bank model to remain agile in acquiring assets; looking for innovative programs such as one bank’s tuition financing plan for private schools; providing bank employees with iPads when launching a mobile banking delivery channel; telling the bank’s story in schools to reach out to the next generation of customers and potential employees; embracing digital marketing as a cost-effective means of reaching customers; and consistently looking for opportunities that larger competitors are not interested in pursuing.
Doreen R. Eberley, Director of the FDIC's Division of Risk Management Supervision, moderated the second panel, which focused on regulatory developments pertaining to community banks. Three regulators joined Director Eberley in a discussion about steps regulators are taking—independently and together—to reduce regulatory burden and enhance the supervisory process for community banks. Such actions include separate efforts by the FDIC, the Board of Governors of the Federal Reserve System, and the Office of the Comptroller of the Currency to minimize the time on-site during a bank examination.

The regulators also described how their agency’s joint participation in the second Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA) review has generated thoughtful comments from bankers about how to reduce regulatory burden. They mentioned the EGRPRA outreach events that all the regulators participated in and the efforts by each agency to address the regulatory burden concerns raised by community bankers and others through the EGRPRA process.

FDIC Vice Chairman Thomas M. Hoenig delivered a luncheon address on his proposal to reduce regulatory burden for traditional community banks. His remarks, entitled, "A Framework for Regulatory Relief," included the Vice Chairman's views on why there has been considerable industry consolidation over the last 30 years and how it could be addressed. The Vice Chairman went on to define what he considers to be a traditional community bank and an appropriate framework to provide regulatory relief for such banks.

Mark S. Moylan, Deputy Director of the FDIC's Division of Risk Management Supervision, moderated a panel on the opportunities and risks of adopting new technologies. Three community bankers and an executive from a large technology service provider discussed a number of topics related to information technology, including how technologies have helped make their banks competitive, how technology figures into a bank's strategic planning, and how to manage risks associated with technology. The community bankers detailed the types of high-tech services and products their banks are offering—everything from online and mobile banking to remote deposit capture. Technology is also enabling some banks to reduce the size and number of branch facilities, as well as the number of branch employees, while retaining the bank’s brand and giving customers a place to go to make deposits. Another advantage that technology offers is retaining customers who leave a bank's community but remain loyal to their hometown bank. Emphasizing the importance of cyber security, the panel members described measures they are taking to protect bank information, from instituting employee education programs to informing customers of the need to protect their personal information.

Diane Ellis, Director of the FDIC’s Division of Insurance and Research, moderated the last panel, which included the FDIC’s Chief Economist, two community bankers, and an academic, and focused on community banks’ ownership structure and succession planning. The discussion began with a presentation by FDIC Chief Economist Richard A. Brown, who shared findings from recent FDIC research on the performance and ownership structure of small, closely held banks. The findings indicated that closely held banks outperformed widely held banks, and that closely held banks with overlapping ownership and management outperformed either widely held institutions or closely held institutions in which management was not part of the ownership group.

The community bankers discussed ownership structures and offered several succession strategies. The bankers mentioned several ideas for developing the next generation of bank leaders and managers. Their practices include developing employees who joined the bank after graduating from high school by offering college tuition programs and sending the
employees to graduate banking schools. Other strategies include providing formal internship and mentoring programs, rotating emerging leaders through 90-day assignments with executives, charting specific career paths to executive positions, and including emerging leaders in board meetings so they become comfortable participating in the discussions and making presentations. Finally, Professor Sorin M. Sorescu of Texas A&M University described an innovative program at his university that educates college students in commercial banking with an emphasis on community banking. The program was created in response to a request by Texas bankers who wanted to fill a perceived talent gap in the community banking industry.

Closing Remarks by Chairman Gruenberg

Chairman Gruenberg brought the conference to a close by thanking all of the participants and noting that he had been impressed with the panels and the speakers. He affirmed the FDIC’s commitment to community banking and emphasized the importance of developing “a narrative for community banks that is understandable and engaging.” He also stressed the need to communicate the value of a career as a community banker.
Good morning and welcome to today’s FDIC Community Banking Conference.

The FDIC is the lead federal supervisor for the majority of community banks in the United States, and the future of community banking has long been a major priority for us. In 2012, the FDIC released its Community Banking Study.1 This was the first systematic review of the community bank experience in the United States over the past 30 years.

In the study, we introduced a new research definition of community banks that was not based solely on asset size, but on the business model—relationship lending funded by stable core deposits focused on a local geographic area that the bank understands well.

At that time we also held a conference to assess the impact of the financial crisis on community banks. It seems to us, four years later, with the crisis largely behind us, to be an appropriate time to hold a conference to focus on the future of community banks.

The conference today will consider four key issues for community banks: the business model, supervision, the challenges and opportunities posed by information technology, and the significance of ownership structure and succession planning.

I would like to begin this conference by making two points.

First—you have heard me say this before, but I think it bears repeating—community banks play a critically important role in the financial system and economy of the United States.

As FDIC research has documented, community banks today account for about 13 percent of the banking assets in the United States. They also account for about 44 percent of all the small loans to businesses and farms made by all banks in the United States. Even that may underestimate the importance of community banks because most of the small business lending done by large banks is credit card lending. When it comes to a lender actually having first-hand knowledge about the small business seeking a loan, that lender is going to be a community bank.

The FDIC also found that for more than 20 percent of the 3,100 counties in the United States, the only banks operating in those counties are community banks. That means that for thousands of rural communities, small towns, and urban neighborhoods, the only physically present banking institution is a community bank.

The bottom line is that community banks matter in terms of access to basic banking services and credit for consumers, farms, and small businesses across the United States.

Second, for all the challenges community banks face—and we will be discussing a number of them during the course of this conference—community banks have emerged from the worst financial crisis since the Depression and most severe recession since World War II with substantial strength.

As the FDIC has documented in our *Quarterly Banking Profile*, community banks have been outpacing the industry as a whole in terms of both earnings growth and loan growth across a range of asset categories, including residential mortgages, commercial and industrial loans, and loans secured by commercial real estate.²

In short, the community bank business model has proven itself to be resilient and adaptable even under a challenging set of economic conditions.

It is important that the narrative about community banks be balanced and positive. The narrative should recognize the critical importance and substantial strengths of community banks in the United States while acknowledging the challenges going forward.

I would like to use the remainder of my time this morning to do three things: first, share our research results showing the resilience of the community banking sector after 30 years of industry consolidation; second, discuss the solid performance of community banks in what has been a relatively challenging post-crisis economic environment; and finally, outline the priorities for the FDIC in regard to our supervision of community banks that may be responsive to some of the challenges that lie ahead.

It is fair to say that banking industry consolidation is not a post-crisis development; it is a long-term process that began 30 years ago.

During that time, the total number of federally insured bank and thrift charters has declined by nearly two-thirds, from more than 18,000 in 1985 to just under 6,200 at the end of last year.

Almost a quarter of this net consolidation can be attributed to the more than 2,700 institutions that have failed since 1985. Most of those failures occurred during the thrift crisis of the late 1980s and early 1990s, and then the recent crisis beginning in 2008.

Even more important has been the voluntary consolidation of charters that has taken place across or within banking organizations.

Annual rates of voluntary consolidation peaked in the mid- to late-1990s as a result of changes in state and federal laws that permitted intrastate and interstate branching. As states repealed unit banking laws prohibiting branching within state borders, and the Congress passed legislation permitting branching across state borders, banking organizations consolidated banking subsidiaries into branch networks, dramatically reducing the number of bank charters.

Some have looked at the reduction in the number of bank charters over the past 30 years as evidence that community banks are disappearing in the United States and that the community bank business model is no longer viable. However, a more careful look at the data suggests a very different conclusion.

First, virtually all of this net consolidation has taken place among banks with assets less than $100 million.

² FDIC, Quarterly Banking Profile, https://www.fdic.gov/bank/analytical/qbp/.
Thirty years ago there were more than 13,600 banks in the United States with assets less than $100 million. Today there are fewer than 2,000. This decline in banks with less than $100 million accounts for all of the net decline in the number of bank and thrift charters since 1985.

However, for institutions with assets between $100 million and $1 billion, there are approximately the same number of institutions today as 30 years ago, and as a group they hold a higher volume of assets than they did in 1985.

For institutions with assets between $1 billion and $10 billion, most of which can reasonably be considered community banks, there are more banks today than there were 30 years ago and they also collectively hold a higher volume of assets than they did then.

Applying our research definition of community banks, we find that consolidation has actually taken place at a faster pace among non-community banks than among community banks over time. In fact, among institutions operating at the end of 2005, community banks have experienced a total rate of attrition around half that of non-community banks.

What happened?

First, those institutions that held less than $100 million in assets back in 1985 actually turned out to be the most resilient of any other size group over the ensuing 30 years. A higher percentage of those institutions are still operating today than those that started out in any other size group.

How did they manage this?

Mostly, they managed to succeed, and grow, and to continue to operate as independent community banks, but on a somewhat larger scale by merging with other community banks. Among community banks that have failed or merged since 2005, two-thirds were acquired by other community banks and continue to function as relationship lenders. Among failed and merged community banks with assets less than $100 million, 85 percent were acquired by other community banks. In all, the median size of institutions meeting our community bank definition has increased more than four-fold since 1985, from $38 million to $176 million.

Approximately 93 percent of FDIC-insured institutions currently meet the FDIC’s research definition of a community bank—the highest percentage in at least 30 years.

As I mentioned earlier, these institutions account for 13 percent of banking assets but hold 44 percent of the industry’s small loans to farms and businesses, making them the credit lifeline for entrepreneurs and small businesses of all types. As of June 2015, community banks held more than 75 percent of deposits in more than 1,100 counties in the United States, approximately one-third of all counties; and as I mentioned earlier, for one-fifth of the counties in the United States, community banks are the only banks with a physical presence.

Assertions have been made that community banks need to be of a certain size to be viable. I would note that FDIC research on this issue has found that most of the economies of scale for community banks are realized by the time they reach $100 million in assets. Some additional gains are realized at $200 million and $300 million in assets, but beyond that, our research has not identified significant benefits. I would note also that most of the institutions with assets below $100 million remain highly viable and important to the communities they serve.

In summary, community banks have evolved, changed, and grown to meet the needs of their customers and the challenges of the market.

They have succeeded to a remarkable degree. As I indicated, they continue to play a critically important role in the U.S. financial system and economy, and they have demonstrated their resilience in the aftermath of the recent financial crisis and recession.

So what are the key challenges facing community banks in the post-crisis period?

As I indicated, the conference today will focus on what we believe are four core issues: the community bank business model, supervision, information technology, and ownership structure and succession planning. We have four panels that will engage on each of these issues in depth.

There is a fifth challenge I would like to comment on briefly that at least in the short term is perhaps the most significant of all—the economic environment in which community banks have operated in the aftermath of the financial crisis.

The economic recovery we have experienced since 2009 has helped the vast majority of community banks to address their problem loans, strengthen their balance sheets, and increase their earnings. Yet, compared to previous economic expansions, this one has been marked by below-average rates of economic growth and exceptionally low interest rates.

One of the by-products of this economic environment has been a steady and substantial decline in community bank net interest margins. During the ten years leading up to the crisis, the average net interest margin for community banks was 4.04 percent. But by 2015, the average had fallen to 3.57 percent.

This decline is particularly significant for community banks, which derive a greater share of their net operating revenue from net interest income than larger institutions.

In explaining the current state of community bank profitability, margin pressure by far dominates all other factors—including overhead expenses. Community banks have actually been relatively successful in adapting to a low interest rate environment and maintaining margins, but this remains an ongoing challenge.

There also is evidence that downward pressure on margins in the low interest-rate environment has led to reduced interest by potential applicants to form new banking institutions—a subject I will return to shortly. A recent paper by economists at the Federal Reserve suggests that economic factors alone—including the long period of zero interest rates—explain at least three-quarters of the post-crisis decline in new bank charters.\(^4\)

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As we consider the challenges facing community banks going forward, there are three areas of activity by the FDIC that I believe can be helpful: tiered supervision, technical assistance, and the promotion of *de novo*, or new, community banks.

**Tiered Supervision**

The first step is a renewed commitment to the principle of *tailored supervision*. By tailored supervision, we mean smaller, less complex institutions are supervised and regulated differently from larger, more complex banks.

For example, the FDIC examines small, well-rated community banks every 18 months, while larger, more complex institutions are examined on a continuous basis throughout their annual examination cycle.

Before a community bank examination is started, examiners engage in a pre-exam planning process to determine the scope or breadth of the examination and to identify exam functions that can be automated or performed more effectively outside the bank. This reduces the number of hours spent on-site and enables tailoring of the on-site examination to the risks an institution presents.

The FDIC also takes a tailored approach to supervisory policy. When we say policy, we mean the FDIC’s framework of regulations, guidance, and examination policies and procedures.

We do this by adjusting regulations and guidance to account for the size, complexity, and risk profile of the institutions to which they apply. We have used input from the industry received through the notice-and-comment process, for example, to specifically address the concerns of smaller institutions in finalizing the rules on proprietary trading and the Basel capital standards.

Since 2010, the FDIC has added a statement of applicability to each of its Financial Institution Letters to clarify whether the guidance is applicable to banks with total assets under $1 billion. This allows community bankers to focus their efforts on the supervisory policies that apply to them.

And, as you know, for more than a year, the three banking agencies have been undertaking a review of the rules and regulations they have issued over the past ten years as required by the Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA). The agencies held six public outreach sessions around the country in 2014 and 2015 and issued notices seeking written public comment on a wide range of rules and regulations, including new regulations issued through the end of 2015.

We received a large number of constructive comments in response to which the agencies have already taken actions.

With the support of the banking agencies, at the end of last year the Congress enacted a statutory change raising the asset-size threshold from $500 million to $1 billion under which well-rated and well-managed banks can qualify to be examined on-site every 18 months instead of every 12 months. Earlier this year, the three agencies implemented the statutory change through an interim final rule, which resulted in the rule taking immediate effect rather than waiting for the conclusion of the 60-day comment period.

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**FDIC Priorities for the Future**

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5 For more information, see https://www.fdic.gov/EGRPRA/.
Working through the Federal Financial Institutions Examination Council (FFIEC), the banking agencies are currently considering ways to improve Call Reports and simplify the reporting process.7 The agencies issued a Federal Register Notice removing certain reporting requirements from the Call Report.8 An interagency working group also is assessing the feasibility of introducing a separate small bank Call Report for institutions below a specified asset-size threshold.

The FFIEC also has established a working group to consider adjustments in the asset thresholds for real estate appraisals. The agencies also will be considering ways to reduce the burden and complexity of complying with risk-based capital requirements, an issue that received extensive comment in the EGRPRA process.

The agencies will submit a final report on the EGRPRA review by the end of this year. Our intention is to pursue these and other issues raised during the course of the review and not wait for the issuance of the final report to take action.

**Technical Assistance**

The FDIC also has continued to build on our technical assistance program, which is designed to provide information that can help bankers and their board members address hot-button regulatory and accounting issues.

As you may know, the FDIC has a Community Bank Advisory Committee made up of 15 bankers from around the country that meets with our board members three times a year for a full day to review issues affecting community banks.9 I believe the members of the committee are all here today, and I look forward to our meeting tomorrow. The advisory committee has underscored in our meetings the value the members place on the technical assistance provided by the FDIC as a way to facilitate regulatory compliance and ultimately reduce cost.

Two years ago we asked the committee what was the best way for the FDIC to provide technical assistance. The answer was that providing the information online through videos that bank management and directors could access on their own time and at their own convenience would be the most effective.

We took that recommendation to heart and dedicated a team to develop a series of technical assistance videos on key risk management and consumer compliance issues. Our technical assistance video series now includes 25 videos covering topics such as interest rate risk, the Bank Secrecy Act, cyber security, vendor management, and flood insurance. All of the videos can be accessed on the FDIC website—fdic.gov—click on the “Community Banking Initiative” on the right side.10

As part of this effort, we introduced a virtual version of the FDIC’s Directors’ College Program that the FDIC regional offices deliver throughout the year.

There have been more than a quarter million views on the technical assistance videos. For those of you who have not yet made use of them, I do recommend them. And keep checking back as we are adding new videos regularly. For example, later this year we will be introducing a new video on corporate governance.

I should note in this regard that during the past few years the FDIC has significantly ramped up its efforts to improve awareness of cyber risks and practices at financial institutions.

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9 For more information about the FDIC Advisory Committee on Community Banking, see https://www.fdic.gov/communitybanking/index.html.
One of these efforts is a voluntary, self-assessment cyber tool issued by the FFIEC that institutions can use to assess their cyber-readiness.\textsuperscript{11} Another is a video program developed by the FDIC that introduces a series of “Cyber Challenges” institutions can use to evaluate their preparedness to respond and restore operations as a result of a cyber event.\textsuperscript{12} The Cyber Challenge exercise also is available free to all institutions on the FDIC website, and a copy is included in the Community Bank Resource Kit we distributed to you today.

This type of timely, targeted technical assistance can help community bankers stay current with regulatory issues at a minimal investment of time and money.

Finally, we need to find ways to facilitate the process of establishing new community banks. The entry of new banks has helped to preserve the vitality of the community banking sector during this 30-year period of consolidation. De novo institutions fill important gaps in our local banking markets, providing credit and services to communities that may be overlooked by larger institutions.

But we have seen the number of de novo applications decline to a trickle in recent years. As I described, research has shown that most of this decline in chartering activity can be attributed to the challenging economic environment of the post-crisis period. We expect chartering activity to pick up as economic conditions continue to normalize.

We have seen indications of increased interest in de novo charter applications in recent quarters. I want to emphasize that the FDIC welcomes applications for deposit insurance, and we clearly have a role to play in facilitating the establishment of new institutions.

In November 2014, we issued a list of answers to frequently asked questions to ensure our policies for approving these applications were made clear.\textsuperscript{13} In September 2015 we hosted a training conference regarding de novo applications to help promote coordination of state and federal regulatory review processes. I would note that while the FDIC approves applications for deposit insurance by new institutions, it is the decision of the federal or state regulator to grant that institution a banking charter.

We have designated subject matter experts and applications committees in the FDIC regional offices to serve as points of contact for deposit insurance applications. We also are in the process of planning outreach meetings with the banking industry to ensure that they are well informed about the FDIC’s application approval processes and the tools and resources available to assist them.

And I am announcing today that the FDIC will reduce from seven years to three years the period of heightened supervisory monitoring for de novo institutions. The seven-year period was established during the financial crisis in response to the disproportionate number of de novo institutions that were experiencing difficulties or failing. In the current environment, and in light of strengthened, forward-looking supervision, it is appropriate to go back to the three-year period.

I should note that establishing even a small community bank is a challenging endeavor. Developing a sound business plan, raising the needed financial resources, and recruiting competent leadership and staff takes work, and we want to ensure that every new institution that is established is in a position to succeed.

But we are very committed to working with, and providing support to, any group with an interest in starting a community bank. To that end, we are developing a handbook to guide applicants through the review process.

There is ample room for new community banks with sound funding and well-conceived business plans to serve their local markets.

It is essential that they have a clear path to approval.

## Conclusion

In conclusion, I am looking forward to a spirited and informative discussion today of some of the key issues affecting the future of community banks. I also am looking forward to hearing more feedback from the members of the FDIC Community Bank Advisory Committee in our meeting tomorrow.

Let me to leave you with these final thoughts.

Community banks are the very core of the U.S. financial system.

They are the vehicle through which a large segment of consumers, small businesses, and communities gain access to credit and banking services.

As the primary federal regulator for the large majority of community banks, the FDIC sees the continuation of a strong community banking sector in the United States as essential to the functioning of our financial system and economy.

We understand that the recent period has been uniquely challenging for community banks.

I hope my comments here today have conveyed both the FDIC’s commitment and our sense of optimism with respect to the future of community banking.

Thank you.
This panel focused on community bank business models, key marketplace trends and challenges, and strategies used to meet operational challenges and manage key risks. A central theme of the panelist remarks was the need for flexibility in community bank business models. Community banks often serve customers or markets that are overlooked or underserved by larger banks. As a result, they frequently must take creative approaches to serving these markets in order to stay relevant and profitable. Panelists noted that while community banks are primarily relationship lenders, they will also need to leverage new technologies, including web-based and mobile platforms, to meet the evolving needs of their customers. Engagement with the millennial generation, both as customers and as employees, remains a priority for community bankers as the nation’s demographics continue to shift toward younger cohorts.14

Ms. Elmquist opened the session by introducing the panelists. Each panelist briefly described their institution, the markets in which they operate, and their business model. Dr. Scott E. Hein gave a brief synopsis of his involvement in community banking research.

**Capital Bank of New Jersey**
President and Chief Executive Officer David J. Hanrahan Sr. described Capital Bank of New Jersey as a classic community bank that funds itself with “local, loyal, low-cost deposits” and lends back out to small and medium-sized businesses in the immediate area. Founded in 2007, the bank went through the recent financial crisis as a de novo institution. As such, the bank carried few troubled loans “on the books” through the crisis, and was therefore able to lend more than its more established peers. In addition, the bank has been the beneficiary of merger and acquisition activity that left gaps in which his institution could operate. The bank, with $378 million in total assets, is a privately held, non-SEC registrant with roughly 450 stockholders, almost all of which are local.

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Centinel Bank of Taos
Rebeca Romero Rainey, Chairman of the Board and Chief Executive Officer of Centinel Bank of Taos, characterized Taos as a tourism-driven market. The town has a population of roughly 7,000, while the largely rural county in which the bank operates has a population of roughly 35,000. Rainey noted that the local economy faces a number of challenges, as its largest employer is government and unemployment is roughly 9 percent. The bank, with $210 million in total assets, focuses on relationship-based banking with multigenerational local businesses, entrepreneurs, artists, and nonprofits, many of which require a creative approach to lending. The bank, a subsidiary of a one-bank holding company, is a subchapter S corporation with six owners.

Valley Republic Bank
President and Chief Executive Officer Bruce Jay described Valley Republic Bank as a “very traditional, very vanilla community bank.” The bank is located about 100 miles north of Los Angeles at the south end of the San Joaquin Valley, in a county that is first in oil production and third in agricultural production in the United States. Opened in February 2009, Valley Republic Bank, with about $491 million in total assets, is among the newest community banks in the nation. Organized as a C corporation, the bank is publically held by roughly 300 local shareholders and has an application pending to become a single-bank holding company.

Liberty Bank and Trust
Alden J. McDonald Jr. serves as President and Chief Executive Officer of Liberty Bank and Trust. Headquartered in New Orleans, the bank operates a high-volume, low-balance business model focused on the African-American community and serves a primarily low- to moderate-income customer base. The bank is a subsidiary of a single-bank holding company with fewer than 100 local shareholders, and has $605 million in total assets.
Marketplace Trends and Challenges

Nearly all panelists indicated that the prolonged low-interest-rate environment of the post-crisis period has posed significant challenges, especially for margins. Similarly, some noted that the relatively slow rate of economic growth during this period has also been an obstacle to balance-sheet growth. Accordingly, the panelists indicated that one strategy to help achieve growth was to target members of the millennial generation, both as customers and as employees.

The bankers described a number of strategies they have used to address the challenges posed by low interest rates and slow growth. They stressed the need for flexibility and the willingness to sometimes lend outside of traditional markets or products. Among the examples cited were underwriting mortgages on homes built with nontraditional materials, creating new tuition-payment products, expanding FHA and VA mortgage lending, and expanding Internet banking. Panelists described their efforts to increase profit margins by reducing expenses and stressed the importance of using and understanding their interest rate risk models in a historically unique interest rate environment. Governance was another priority cited by the panelists, who sought to ensure that their management team was on board with the direction of growth and that they maintained a strong relationship with bank supervisors in an evolving regulatory environment.

Dr. Hein noted that the examples discussed by the panelists provided evidence of the resilience of community banks. While each community bank employs a unique approach to serving its market, they each display a high degree of adaptability and creativity in responding to marketplace challenges.

Marketplace Changes

Ms. Elmquist asked the panelists to elaborate on some of the strategies they are implementing to respond to changes they see emerging in their marketplace. The panelists from the two newer banks cited stock liquidity as a particular challenge that could be addressed by conducting stock repurchases funded by low-cost debt issuance. The panelists from the two more-established banks discussed their efforts to integrate new technologies into their banking models by exploring new platforms, delivery channels, and digital marketing. Part of these efforts involved training staff members to be both technologically savvy and sales-oriented.

Ms. Rainey’s bank purchased iPads for its staff to help ensure that employees were fully conversant with the bank’s mobile platform. Dr. Hein remarked that the shift toward technology may be at odds with the traditional “soft information” used in community banking, and that embracing technology while retaining the face-to-face aspect of community banking will be challenging. He also noted that the trend toward urbanization is changing the markets and customer bases of more rural community banks.

Scott E. Hein, Professor of Finance at Texas Tech University in Lubbock, notes that community banks are an important part of the financial system and a primary source of economic growth for the country.
Questions from the audience focused on emerging marketplace trends. One audience member asked the bankers if they viewed the rise of financial technology (fintech) lenders as a threat or an opportunity. Panelists responded that they viewed the trend mostly as an opportunity. Mr. Hanrahan noted that he saw a specific opportunity when a large bank announced that they were going to outsource all small business loans under $250,000 to a fintech firm. Fintech lenders could well reject some of those small businesses due to a lack of adequate credit history or some other blemish on the application. Those small businesses would then be likely to turn to a community bank that would spend the time needed to understand their unique situation and find a lending solution that works for both parties. Ms. Rainey agreed, and added that there may be an additional opportunity to leverage the technology used by fintech firms. Mr. Jay noted that while fintech providers have a regulatory advantage at present, he expects that to change in the future. He also noted that there is a potential opportunity for community banks to use some of the technology solutions. Mr. McDonald agreed that there were opportunities in this space, noting that fintech lenders will likely struggle in making loans to small businesses using a purely standardized approach. He sees an ongoing need for the relationship banking approach that characterizes community banks, especially when businesses are first starting out and are looking for their initial loans. He noted that his push into technology and digital marketing is aimed at capturing some of the business that might otherwise be inclined to use fintech lenders.

One participant asked about the panelists’ loan-to-deposit ratios and how they expected them to change over the next four to five years. All of the panelists indicated a long-term target ratio of 70 to 75 percent. A second audience member asked for the panelists’ opinions on the FDIC’s Notice of Proposed Rulemaking on assessments that would affect banks with less than $10 billion in assets. Mr. Hanrahan voiced support for the proposed rule, noting that his institution’s assessment rate would decrease by around 30 basis points. He also noted that although he is not enthusiastic in general about many of the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), he did support the mandated expansion of the assessment base from total deposits to total assets less capital and the Deposit Insurance Fund restoration surcharge to large banks.
Ms. Elmquist invited each of the panelists to discuss their best practices for managing risks. Each panelist discussed different types of risk, some specific and some at the enterprise level. Mr. Hanrahan reflected on the risk of competition with bigger banks. He stated that his approach to mitigating that risk is managing to his organization’s strengths—relationship banking and personalized, high-quality customer service. Ms. Rainey discussed her bank’s focus on internal reporting and cultivating a risk-management culture among employees. She also noted that the bank was working to implement committee structures and other processes for decision-making in gray areas. Mr. Jay discussed focusing on the pieces over which his bank has control, such as hiring top talent, prudent underwriting, and minimizing costs. Finally, Mr. McDonald discussed his bank’s community involvement as crucial to not only staff development, but also the “people-to-people” piece of engagement with the next generation of customers. He also noted that his bank has centralized underwriting and collections, which is especially important given the bank’s low- to moderate-income customer base. Lastly, he mentioned that management extensively uses monitoring reports, dashboards, and models to understand how the bank is performing and to identify emerging trends. Dr. Hein commented that community banks are, in many respects, in a better position to monitor and manage enterprise risks than larger banks.

An audience member asked the panelists about managing risks related to the “talent crisis,” as increasing numbers of banking industry personnel are approaching retirement. The panelists agreed that the talent crisis is a definite concern for the industry. They attributed it in part to an image problem that arose during the financial crisis, but also cited a long-term decline in large-bank training programs that were instrumental in developing banking industry talent. They cited what they saw as a challenge in pitching traditional commercial banking as a fulfilling career choice for millennials, who might see more allure in the startup culture of fintech lenders. Hiring and training young, smart college graduates who are willing to learn continues to be a solid long-term strategy that can benefit from the efforts of banking-oriented college programs. Ultimately, many highly qualified millennials may come to realize the personal rewards of a career based on building relationships with their customers and serving their local communities.

Over the past few years, community banks have weathered the storm of the Great Recession and the relatively slow economic recovery that followed. Each panelist cited strategies for resilience and growth focused on good banking fundamentals, flexibility, and creativity. Banks will face more challenges as the industry changes, with demographic shifts, increased reliance on technology, and an evolving regulatory environment. Panelists agreed that in order to succeed in this changing environment, community banks will have to focus on the core strengths of their business model and continue to look for new, creative approaches to community banking.

Read the complete transcript of this panel discussion on the FDIC’s Community Banking Initiative webpage at www.fdic.gov/regulations/resources/cbi/conference/panel1.html.
Introduction

Just as the banking industry has undergone far-reaching changes over the past few decades, so has the job of the bank regulator. Advanced notice of examination start dates, pre-exam planning, and other off-site examination activities have helped make the on-site process more efficient and more productive. Regulators also have had to respond to new challenges related to technology and financial innovation while maintaining their focus on the principles of risk management. Panel 2 began with a discussion of recent initiatives to provide regulatory relief, and went on to address changes in the competitive landscape and shared services, before returning to a discussion of the long-standing fundamentals to be considered in the initiation of any new product or service.

Regulatory Relief

The panelists began by outlining the efforts their agencies are making to review regulatory requirements individually, under the ten-year review mandated by the Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA) and through the efforts of the Federal Financial Institutions Examination Council (FFIEC).

The ongoing EGRPRA review has collected input on the effects of regulations from community bankers in every region of the country. Among the themes identified by bankers have been the cumulative costs of complying with multiple rules; the need to simplify Call Reports, review regulatory thresholds, and simplify capital regulations; and the long-standing effort to make the examination process more efficient. Each of the federal agencies has already been acting on suggestions received under the EGRPRA process, which will continue through the end of 2016.

The FFIEC is another active venue for efforts to provide targeted regulatory relief. These include a review of Call Report requirements for community banks and the introduction of the Cybersecurity Assessment Tool to help bankers determine their vulnerability to and preparedness for the growing threat of cyber risks.

One example the panelists cited of the agencies working together to respond to the concerns of community banks was the recent rule expanding the extended examination cycle for small, well-rated banks. Ms. Hunter described those concerns: “There were some banks in their comments [that] said ‘We just do the exam, we get the report, we’re just responding to the report, and then the next request letter was coming in.’ So, I think the extended time period was intended to—and should—help alleviate some of that.”
Ms. Eberley described the long-term evolution of the approach the agencies have taken to the examination process: “All of us moved to risk-focused examinations in the late 1990s after the last crisis ... and we are all continuing to evolve how we do risk-focused supervision.” This approach provides flexibility for both examiners and bankers to tailor what they do to the particular situation of each bank, and it works best with two-way communication. “A lot of our guidance is broad and it’s principles-based. And it says that you should apply it to your bank based on the nature of your activities, the complexity of your bank, and your risk profile,” said Ms. Eberley. A conversation between the banker and the regulator can set the expectation up front, so both are considering the issues in the same context.

The panelists also described how improvements in pre-examination activities have affected the on-site exam process. Ms. Kelly explained: “Doing more of the work off-site ... reduces the burden that we’re creating by our presence there. Frankly, it allows us to be more efficient with the use of our resources, since we don’t have the travel time when we’re working off-site from the bank. So, hopefully, we can get the exam wrapped up more quickly.”

Added Ms. Hunter, “We’ve been really focused in on how we can, one, maximize the use of the information you’re already reporting to us through the Call Report and, two, minimize the time that we actually physically spend in the bank to those activities that have value added by being there.”

Panelists emphasized that regulation must constantly evolve in response to changes in the competitive landscape. High on the list of competitive challenges is the rise of fintech companies in making loans and providing other services through online platforms.

The OCC recently released a white paper on banks leveraging the innovations that are being introduced under fintech. In describing the OCC report, Ms. Kelly said, “What you’ll see in this white paper ... is that we want to be sure that we’re being perceived as being receptive to responsible innovation .... And we really want to make sure we’re striking the right balance between risk and innovation.”

Ms. Eberley added, “It’s clear that changing customer preferences and market developments are resulting in new types of technology and delivery channels for banks. We’ve paid attention to that, all of us, through the FFIEC.”
David Cotney of the Conference of State Bank Supervisors (CSBS) acknowledged that cost-cutting is a strategic priority for community banks. But he cautioned against losing focus on long-term, strategic opportunities: “Cutting costs is a big challenge. Whether you think about cutting personnel costs at branches, for most of you here in this room, that is not going to contribute to your long-term growth. Cutting back on IT or regulatory compliance costs, that’s not easy to do. I think that is when a lot of folks get caught in the trap that was mentioned on the last panel, of acquire-or-be-acquired. And it doesn’t, quite honestly, it doesn’t have to be that type of decision.”

Mr. Cotney also addressed the competitive challenge of developing new community bankers, describing a case study competition co-sponsored by the CSBS and the Federal Reserve Bank of St. Louis. According to Mr. Cotney, the competition in its first year attracted 33 entries from 25 colleges and universities in 18 states.

Shared Services

As community banks have sought to expand services and cut costs, the issue of shared services has come to the fore. Third-party technology service providers (TSPs) have assumed increasing importance as a means by which community banks can compete by providing online and mobile banking services while managing both the costs and the operational risks of doing so.

Reliance on TSPs introduces its own set of challenges. During Q&A, audience participants pointed to issues such as market dominance among a few leading TSPs that may lead them to restrict the use of new technologies and to impose liability caps that absolve them from acts of negligence or misconduct. The regulatory panelists acknowledged these challenges, and described their efforts to address them by sharing information through the FFIEC and making information available to regulated institutions through handbooks.

More banks have also experimented with sharing services among themselves, sometimes as a response to unforeseen challenges. Panelists described one instance when two banks shared a single chief information officer and other instances where banks shared the use of retail offices. In pursuing any type of shared service arrangement, the panelists pointed to the importance of dialog between banks and regulators. “We would just hate to have someone get too far down the road with something, and there may be something they’ve overlooked that comes to our mind, and we could just point it out early on. We don’t want to be at the point of saying, ‘Whoa, you didn’t even think about this.’ We really want to be a resource,” said Ms. Kelly.

Applying the Fundamentals

Amid the ongoing changes and new challenges facing community banks and their regulators, the panelists emphasized the enduring value that banks gain from upholding the standards of risk management and safe and sound banking. As always, these standards apply to banking operations in a number of different ways. Ms. Hunter referred to the ongoing regulatory attention to credit concentrations, particularly in commercial real estate loans: “With commercial real estate we have seen the concentrations growing again. This was clearly a source of problems back in the earlier part of the 2000s leading into the financial crisis. And we’re very committed to not getting behind the eight ball on that very issue again. So you’re likely to hear lots of conversations.”
Ms. Eberley pointed to the importance of governance and efforts the FDIC has undertaken to clarify guidance as to the expectations placed on directors and management. Part of this effort is a special edition of *Supervisory Insights* published in April 2016, titled “A Community Bank Director’s Guide to Corporate Governance: 21st Century Reflections on the FDIC Pocket Guide for Directors.” “We talk about the difference between the responsibilities and expectations of directors and management. … We’re all trying to be responsive to the concerns that have been raised, and make it clear in our guidance what our expectations are,” said Ms. Eberley.

Community bankers in attendance emphasized the importance of scaling regulatory expectations for risk management processes to the size and complexity of each institution. In discussing the implementation of new loan loss allowance accounting rules, Jane Haskins, President of First Bethany Bank in Bethany, Oklahoma, said, “I would implore you, when you’re considering the issuance of the guidance, that you understand that we don’t do complicated loans and make the loan loss reserve allocation comparable to the type of loans and the risk that we have in our community banks.” Ms. Eberley responded, “So, fair comment. And I can say that each of our Chief Accountants has been actively engaged with the Financial Accounting Standards Board (FASB) throughout this process … FASB has committed to making this a scalable pronouncement.”

**Conclusion**

As the community banking industry emerges from the post-crisis period, bankers and regulators alike continue to update their practices to increase efficiency and meet new challenges. Regulators have taken steps to provide regulatory relief where it makes business sense. They also are reaching out to community bankers through white papers and guidebooks to clarify regulatory expectations and assist the efforts of bankers to upgrade their governance and risk management practices. Meanwhile, community bankers are making the case that regulators should apply common sense in tailoring the application of risk management standards to the size and complexity of each institution. They are also updating their practices to cut costs and meet new competitive challenges such as fintech. Panel 2 demonstrated that constructive dialog between regulators and community bankers will continue to be essential as this innovation proceeds.

*Read the complete transcript of this panel discussion on the FDIC’s Community Banking Initiative webpage at [www.fdic.gov/regulations/resources/cbi/conference/panel2.html](http://www.fdic.gov/regulations/resources/cbi/conference/panel2.html).*
Thomas M. Hoenig, Vice Chairman, FDIC

Introduction

The United States has a long history of economic success under a decentralized and diversified banking system. Commercial banks, ranging in size from small to very large, have successfully served the credit needs of individuals, small businesses, and large international firms. This success was based on a business model wherein the banker serves as a trusted intermediary between savers and borrowers. Using this model, the banking and financial industry created and supported the largest, most dynamic economy in the world. But things have changed, and the community bank model has come under enormous competitive and operational pressure—so much so that some are asking if the model is sustainable. In my view it is, but not without some fresh thinking and concerted effort.

Consolidation

Over the past 30 years traditional community banks have become less influential as they have lost market share of credit allocation within the economy and as their numbers continue to decline.

The consolidation of the credit channel within the United States in recent decades has been dramatic.\(^{18}\) For example, in 1984 the distribution of assets among community, regional, and money center banks was nearly proportional, with more than 15,000 commercial banks serving a variety of borrowers, from consumers and small businesses to global conglomerates. Today, the 20 largest banks by assets control more than 80 percent of industry assets, and the number of banking firms has declined to less than 6,200. The group of community banks with less than $1 billion of assets, which in 1984 controlled nearly a third of banking assets, today controls less than 10 percent of industry assets.

These trends put us on a path toward a system in which a few very large financial firms control the allocation of credit within the national economy. It is unclear, to me at least, whether this structure in the longer term will support a vibrant, competitive system, able to serve the present and future needs of consumers and business, or if it will become a highly concentrated, controlled distribution system for credit. At a minimum, therefore, consolidation in the banking industry deserves attention regarding its effects on competition and reduced consumer and business options.

\(^{18}\) Consolidation of the Credit Channel: https://www.fdic.gov/about/learn/board/hoenig/creditchannels.pdf.
While any number of factors might contribute to consolidation, I would note at least four.

First, branch banking laws were substantially liberalized. Where banks were once confined to local or state boundaries, in the 1980s and ’90s state and federal laws removed these barriers. While this change was inevitable and necessary in an open economy, it also enabled and accelerated the banking industry’s consolidation.

Second, activities insured banks are permitted to conduct—including insurance, investment banking, broker-dealer activities, and trading—have significantly expanded, as codified in the Gramm-Leach-Bliley Act of 1999. The effect of this change has been to encourage and accelerate consolidation among the largest financial firms in the United States, both within the banking industry and among the largest commercial and investment banks and some insurance companies. It has contributed to an enormous increase in the concentration of the industry and an increase in the systemic risk facing our economic system.

Third, monetary policy has sustained an interest rate environment near zero for almost a decade. This has significantly affected the ability of community banks to maintain net interest margins, manage risks, and achieve returns necessary to operate safely and profitably. The result has been increasing numbers of community banks exiting the industry and fewer investors seeking new charters.

Finally, in recent decades there has been an obvious and significant increase in bank regulation and regulatory burden. Traditional community banks face a compliance burden that seems disproportionate to their risk profile and sometimes unrelated to their activities. One effect is further industry consolidation as small banks drive to reduce average overhead and compliance costs using mergers to build assets. I want to focus the remainder of my remarks on this trend and how we might address it.

To mitigate some aspects of regulatory burden and provide greater flexibility to the majority of banks operating in the United States, I have suggested a path that focuses on bank activity, complexity, and funding sources. Such an approach is designed to provide regulatory relief that is meaningful for all banks engaged in traditional commercial banking—mostly community and some regional banks—without diminishing safety and soundness, or consumer safety and access to service. The model I recommend is not mandatory and, importantly, it abandons the reference to size thresholds, with their confusing benchmarks and varied demands and exceptions that add confusion and burden.

First, I suggest defining a traditional bank eligible for regulatory relief as one that:

- holds no trading assets or liabilities;
- holds no derivative positions other than interest rate and foreign exchange derivatives;
- has total notional value of all its derivatives exposures—including cleared and non-cleared derivatives—of less than $8 billion; and
- maintains a ratio of Generally Accepted Accounting Principles tangible equity-to-assets of at least 10 percent.

A bank with sufficient capital that doesn’t engage in high-risk trading activities and investment strategies with funding subsidized by the FDIC and the Federal Reserve poses less of a risk to the financial system. Such an institution should not face the same regulations and supervisory requirements that apply to complex firms involved in both trading and traditional commercial banking with lower levels of capital. Banks with at least 10 percent equity capital have lower rates of failure and stable rates of lending over the course of an economic cycle.19 In addition, and importantly, a majority of commercial banks already meet the 10 percent equity capital level.

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Defining eligibility for regulatory relief around these specific criteria, rather than asset size, reflects the long-standing business models of traditional commercial banks. Doing so recognizes that many sources of regulatory burden have been put in place in reaction to the increasingly complex and risky nature of the activities that some banks have chosen to pursue. Since these criteria are objective and readily apparent from a bank’s balance sheet, the eligibility requirements can be enforced relying on existing Call Report fields and the regular exam process.

With this framework in place, regulatory relief for traditional banks can be achievable. Some of the regulatory changes that are imminently reasonable include:

- exempting traditional banks from all Basel capital standards and associated risk-weighted asset calculations.
- exempting these banks from several entire schedules on the Call Report.
- allowing for greater examiner discretion and eliminating requirements to refer “all possible or apparent fair lending violations to Justice,” if judged to be minimal or inadvertent and where restitution is voluntarily made.
- establishing further criteria that would exempt eligible banks from appraisal requirements allowing them to prepare internal appraisals to be reviewed by examiners.
- exempting banks, if applicable, from stress testing requirements.
- adjusting the examination cycle for well-rated banks to 18 months, from the current required 12-month cycle.
- defining mortgages made and that remain in a bank’s portfolio as qualified mortgages for purposes of the Dodd-Frank Act.
- reducing certain reporting requirements for HMDA.

The 10 percent capital level I have recommended as one of the criteria for meaningful regulatory relief, as I noted earlier, reflects a position from which banks are less likely to fail and a position from which they can best hold loans and serve customers during even the most severe downturns. This amount of owner equity, therefore, serves to assure the public that the bank is soundly capitalized and deserves its confidence.
It also is worth noting that most community banks currently meet this capital requirement and already would be eligible for relief under the framework I have outlined. Almost 95 percent of banks meet the business model tests. More than half meet the 10 percent capital requirement for eligibility, and 74 percent are over 9 percent. Those that are not at 10 percent would be given immediate relief if they commit to an 18-month phase-in period to reach 10 percent.

In putting forward this framework, I recognize that it is not a cure-all. It will not end consolidation caused by costs and other industry factors. However, it does address one source of cost for traditional banks, and it does so without weakening the overall strength and accountability of the sector. In addition, if community and regional bankers have other specific areas of law or regulation that could reasonably be eased for traditional banks, I encourage their recommendations.

As a side note, I have been told that the industry cannot support this proposal because not all traditional banks have 10 percent equity. I find this position unsettling because most banks can in fact obtain this capital threshold through retained earnings and because such a position by the industry as a whole effectively denies the majority of community banks significant regulatory relief. Remember, banks that choose not to meet the eligibility test I have suggested, because they prefer to operate with lower capital levels, may continue to do so, but at the price of greater regulatory oversight and compliance burden.

**Alternative Approaches**

The framework I’ve outlined is a legislative remedy to address regulatory burden. Other avenues are also available, including the EGRPRA regulatory review conducted every ten years as mandated by the Economic Growth and Regulatory Paperwork Reduction Act and other legislative proposals such the TAILOR bill designed to streamline rules through the regulatory process.

While I would encourage useful regulatory relief from any source, my point remains that to achieve meaningful and long-term regulatory relief, it is necessary to change the statutes from which the burden flows. I would encourage the community banking industry to review this proposal with those goals in mind.

**Closing Thoughts**

In closing, I want to caution community bankers on one vital point. Regulatory relief is important, but by itself it will not save the community bank model. Many among you have told me that your model of relationship banking, while strong, must adjust to the competition with its ever changing face and force. Attracting funds, developing loan products, and improving payments products is no longer a business unique to the banking industry. Other financial competitors are intensifying their efforts to capture your market, and community banks must adapt. While product platforms can be outsourced, products offered on those platforms must constantly be refreshed, which requires the community banking industry to apply its insights and inputs to improve its offerings.

The community banking industry, through its trade associations and other means, therefore must become ever more strategic and effective as it develops and delivers new products. Changes in technology are just one example of how the community banking industry must work together, not only to battle the challenges of the present but also to grasp the opportunities for the future.
Panel 3: Managing Technology Challenges

Moderator

Mark S. Moylan
Deputy Director, Division of Risk Management Supervision
Federal Deposit Insurance Corporation

Panelists

Shaza L. Andersen
Chief Executive Officer and Founder, WashingtonFirst Bank
Reston, Virginia

Neil D. McCurry Jr.
President and Chief Executive Officer, Sabal Palm Bank
Sarasota, Florida

Michael Seifert
Vice President, Enterprise Risk and Resilience, Fiserv
Brookfield, Wisconsin

Robert A. Steen
Chairman of the Board and Chief Executive Officer
Bridge Community Bank, Mount Vernon, Iowa

Introduction

This panel included three community bankers and a representative from a third-party service provider. The panelists discussed how technology is reshaping the banking industry and the challenges of managing the inherent risk of technology. They elaborated on what they saw as both the positive and negative effects of technological changes on community banks. Each panelist began by describing their background and sharing a profile of their institution. Though each said that technology has been beneficial to their business, they remain acutely aware of the potential drawbacks—in particular the increased threat of cyber attacks. They also agreed that new technologies will not replace brick-and-mortar banking, but represent a complementary element of what very much remains an in-person, relationship-driven business model.

Organizational Profiles

WashingtonFirst Bank, Reston, Virginia

WashingtonFirst Bank was established in 2004. The bank is headquartered in Reston, Virginia, a suburb of Washington, DC. The bank serves consumers, small businesses, and key DC-area industries such as government contracting, healthcare, and the title and escrow industry. The bank focuses primarily on commercial real estate lending. WashingtonFirst Bank has $1.7 billion in total assets and employs 223 people in 18 locations.

Sabal Palm Bank, Sarasota, Florida

Sabal Palm Bank was established in 2006 by local shareholders and a local board of directors. The bank is headquartered in Sarasota, Florida, and has a full-service branch in nearby Venice, Florida, and three additional offices in Sarasota. The bank has total assets of $131 million and employs 24 people. Its lending activities are primarily focused on commercial real estate.
**Fiserv, Brookfield, Wisconsin**

Fiserv Inc. is a technology service provider (TSP) for the financial services industry. Fiserv was established in 1984 when First Data Processing and Sunshine State Systems Inc. merged, and went public in 1986. Fiserv is involved in a myriad of financial services, including mobile and online banking applications, risk management, and core account processing. As of 2015, it reported $5.3 billion in revenue, 13,000 customers, and over 21,000 employees.

**Bridge Community Bank, Mount Vernon, Iowa**

Established in 1903 as Mechanicsville Trust and Savings Bank, Bridge Community Bank was the oldest institution represented by panelists during the conference. The bank is a subsidiary of Mechanicsville Bankshares Inc. and reports total assets of $84 million. Headquartered in Mount Vernon, Iowa, near Cedar Rapids, this employee-owned bank focuses primarily on agricultural lending. It has three offices and employs 18 people.

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**The Convenience Factor**

A major advantage of the growth in technology has been the added convenience to community bank customers, which has improved customer retention and increased the ability of community banks to compete with larger institutions. Services such as online banking, mobile banking, and remote deposit capture have made it easier to retain existing customers and add new ones. Ms. Andersen observed: “We have online banking, mobile banking, remote deposit capture, and Automated Clearing House (ACH) wire transfer … and that really has helped community banks like us to be able to compete by not having a location around every corner.” Mr. Sheen remarked that institutions such as Bridge Community Bank recognized the convenience associated with new technologies beginning in the early 1990s, and that his bank was one of the earliest to adopt ACH wire transfer. Additionally, he noted that they will adopt “same-day ACH” by September 2016.

Echoing these sentiments, Mr. McCurry noted that prior to the recent technology wave, Sabal Palm Bank would provide a car courier service to transport people to and from their branches. Now, the car courier service has been made obsolete by remote deposit capture. Mr. McCurry went on to suggest that while Sabal Palm Bank is not Internet-based, like Ally Bank, technology has very much played a complementary role. The panelists concurred that although technology does introduce some important new conveniences for their customers, the core business of community banking still requires the ability to interact with customers face to face.

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**Millennials, Technology, and the Prospects for the Future**

The transition to more sophisticated technology has enabled the community banking sector to keep pace with the millennial generation’s strong interest in new technologies. Mr. Seifert noted that the millennial generation is now the largest living generation and will inherit the savings of their baby boomer parents. This wealth transfer represents both a risk and an opportunity for community banks. In Mr. Seifert’s opinion, it is vital for community banks to adopt new technologies to attract millennial bankers to their workforce. Appealing to the needs and preferences of this large, younger generation is also important because its members are seen as trend setters whose preferences spill over into older cohorts. Mr. McCurry noted that even his father, who does not use technology, has asked about mobile banking, saying, “I like to know that my bank has these things.” This spill-over effect not only promises benefits in the future, but could help community banks compete today.

Members of both the panel and the audience were somewhat mixed in their level of optimism for attracting millennials to community banks. The opinion of one questioner was that in the area of technology, small banks are lagging behind other industries and larger banks. He mentioned Google Wallet as an example of a major competitive threat to the community banking sector, and suggested that their children might someday seek to bank with Google instead of a traditional bank. Mr. Steen was more optimistic. He argued that his bank was seeing higher rates of customer retention following the implementation of new technologies, and he pointed out that some of his younger customers have kept their accounts at Bridge Community Bank even after moving away from Eastern Iowa.
Efficiency Gains

New banking technologies have introduced significant efficiency gains. Ms. Andersen noted that many staff positions are no longer necessary because “customers are doing everything on their own.” Banks can economize on staff positions and also save on branch size. Ms. Andersen noted that modern branches have shrunk from 5,000 square feet to anywhere from 800 to 1,000 square feet. Mr. Seifert quantified the efficiency gain associated with new technologies by estimating the cost of a mobile transaction at about 10 cents, compared to $4.25 for a branch transaction. He sees this efficiency gain as an ongoing factor in lowering costs, as branch transactions continue to give way to a rising number of electronic and mobile transactions.

Technology and the Unbanked Community

Gwen Brady, Director of Banking and Insurance for the Virgin Islands, asked how the implementation of technology can help bankers reach the unbanked. Ms. Andersen provided some insight into attempts by the government of the District of Columbia to provide debit cards to individuals who would otherwise use check-cashing centers. She added that while this idea has merit, one drawback is that many vendors do not accept these cards for retail transactions. Mr. Moylan noted that given the growing prevalence of mobile banking services, the rising prevalence of smart phones among underbanked populations could do much to expand the availability of banking services.

IT Security Problems

While technology can benefit community banks, the threat of cyber attacks has become a major issue for community bankers and their boards. Ms. Andersen remarked that while her board is optimistic about the benefits of technology, it remains concerned with security. The panelists indicated that IT security departments have expanded rapidly and that expenditures in this area are becoming a larger part of community bank overhead. Ms. Andersen explained that the IT department of her bank grew from one person to between seven and nine employees in just four years. Community banks face real threats that are not dissimilar to those faced by larger, better-known institutions. Mr. McCurry also described the threat posed by a cyber attack as being potentially far more costly than a physical bank robbery, explaining that “somebody could come in and steal all the money out of the vault, all of it. … . A cyber event could really be a knockout punch to the whole organization.”
Strategies to Improve IT Security

The panelists also advanced potential strategies to counter the growing threats to their IT infrastructure. Ms. Andersen emphasized promoting consumer education in cyber security, even suggesting an important role for regulators in promoting such education. Mr. Steen pointed to the recent adoption of the .bank domain name to differentiate banks from organizations using similar website names that may have malicious software. Additionally, he cited the need to stay current with new and evolving technologies. Mr. Seifert emphasized the importance of updating existing systems frequently to minimize the emergence of technical problems, admitting that while it might not be as enjoyable as creating new, innovative products, it was necessary.

Conclusion

Although community banking represents a more traditional approach that is focused on customer relationships, those relationships are being continually reshaped by new technologies. Electronic and mobile banking offer new avenues for community banks to interact with their customers and to cut costs. As millennial generation customers become a more important part of the customer base, community banks cannot choose to simply opt out from technological changes—they must find ways to incorporate them into their business model.

Along with the opportunities associated with new banking technologies come increasing risks associated with cyber security—an issue that will continue to occupy the attention of bankers and regulators alike. While there are certainly costs associated with managing technology risk, the panelists agreed this is an area where bankers, bank customers, and regulators can work together to devise and implement strong business practices to address the problem. With this can-do attitude, the panelists expressed cautious optimism about the benefits that community banks can realize from the adoption of new technologies.

Read the complete transcript of this panel discussion on the FDIC’s Community Banking Initiative webpage at www.fdic.gov/regulations/resources/cbi/conference/panel3.html.
Panel 4: Ownership Structure and Succession Planning

The most common form of community banking ownership structure is a closely held form, where ownership is concentrated within an identifiable primary group. In many cases, the key officer who exerts day-to-day control over the operations of the bank is also a member of, or affiliated with, this ownership group. This particular form of ownership and management structure may offer certain advantages to the bank in terms of aligning the interests of owners and managers and permitting it to pursue long-term strategic goals. At the same time, this organizational form could inhibit the ability of the institution to raise new external capital or to adequately provide for the succession of management and ownership over time.

Recent FDIC research shows that closely held community banks, where ownership and management overlap, have outperformed their peers in terms of standard measures of profitability and efficiency. In practice, community bankers may use a variety of different strategies to structure their ownership and management teams to achieve these results. The two community bankers featured in this panel are cases in point. While one has depended on internal capital raises to weather adversity, the other has gone public to provide liquidity in its stock and raise funds for acquisitions. Both bankers have carefully cultivated the management talent and board experience that is needed to effectively operate their institutions.

Both closely held and widely held community banks face challenges with regard to succession and human capital development. The community banks represented on this panel have used a variety of strategies to identify potential future leaders for their institutions and to enable these individuals to gain the experience they will need to carry out these roles. Additionally, academic programs represent a promising avenue through which young professionals can gain the training and experience they will need to someday run community banks. Professor Sorin Sorescu described the partnership that has developed between the Commercial Banking Program of the Texas A&M Mays Business School and banks that have sponsored the program by conducting seminars and offering internships and post-graduate jobs to participating students.

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**Introduction**

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To summarize, management succession and human capital development will remain areas of intense focus for community banks due to the prevalence of closely held management structures in this sector. However, there appear to be a number of different strategies for meeting this challenge. Therefore, further work in this area appears to be warranted.

**Organizational Profiles**

**Mohave State Bank, Lake Havasu City, Arizona**
Established in 1991, Mohave State Bank is the second-oldest and second-largest community bank headquartered in Arizona. The bank’s five branches are located in Western Arizona, approximately midway between Phoenix and Las Vegas. The core markets of the bank are in Lake Havasu City, Kingman, and Bullhead City, all in Mohave County. Mohave State Bank describes itself as a full-service bank providing deposit and loan products to individuals, businesses, and professionals in Mohave County. Most of Mohave State Bank’s shareholders are also its depositors and local customers. The bank has about $325 million in total assets and 77 employees.

**Investors Community Bank, Manitowoc, Wisconsin**
Investors Community Bank was established in 1997 by a group of four banking entrepreneurs who are well-acquainted with the dynamic business environment of this area. The bank is headquartered in Manitowoc County in Eastern Wisconsin, near Lake Michigan. Investors Community Bank is 15th largest by total assets (about $884 million) among more than 200 community banks headquartered in Wisconsin. The bank focuses primarily on agricultural and commercial lending. Investors Community Bank operates two branches and employs 102 people. The bank went public in 2015 and announced its first acquisition later that year.

**Commercial Banking Program, Mays Business School, Texas A&M University**
The Texas A&M Commercial Banking Program was created in 2009. The program provides a rich developmental environment by combining formal learning, industry experience, and professional mentoring. The program is designed to equip students with the best practices for a career in commercial banking. A key strength of the program’s curriculum is its ability to bring in executives to share their experience in the field of commercial banking. Over 100 bankers from 35 member banks in Texas and across the nation serve on committees that are engaged in the admission process, curriculum development, summer internships, student mentorship, and program events that bring together bankers and students. The program graduates about 30 students per year. Most graduates end up working in commercial banking for member firms of the program’s advisory board.

FDIC Chief Economist Rich Brown (second from left) summarizes findings of a recent FDIC study on the financial performance and management structure of closely held banks.
Research on Small, Closely Held Banks

Ms. Ellis noted that organizational and management issues are critically important to the success of community banks. She opened the discussion by noting that the ownership and management structure of community banks have historically been hard to measure and quantify. However, the FDIC recently undertook a research project to identify the ownership and management structure of community banks operating in 21 states of the central United States and estimate how their structure has been related to financial performance. Mr. Brown presented findings from this research.

The researchers surveyed FDIC examiners in the Chicago, Dallas, and Kansas City Regions on the ownership and management structure of over 1,300 community banks. They found that three-quarters of these institutions can be considered closely held by ownership groups that are frequently linked by family or community ties or both. Moreover, in over half the closely held community banks studied, the day-to-day manager of the bank was a member of, or affiliated with, the ownership group. Given the generally small size and closely held status of these banks, Mr. Brown said that he and his colleagues wondered if they might face special challenges associated with limited access to external capital and with incentives to pursue goals other than strict profit maximization. Their research showed otherwise. They discovered that closely held institutions in which ownership and management overlapped tended to outperform their peers in return on assets, even after controlling for other firm characteristics (see Chart 1).

![Chart 1](chart.png)

**Chart 1**

Closely Held Community Banks Where Ownership and Managerial Control Overlap Have Consistently Reported Higher Profitability

<table>
<thead>
<tr>
<th>Year</th>
<th>Closely Held – Overlap</th>
<th>Closely Held – No Overlap</th>
<th>Widely Held</th>
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</thead>
<tbody>
<tr>
<td>2009</td>
<td>1.4%</td>
<td></td>
<td>1.2%</td>
</tr>
<tr>
<td>2010</td>
<td>1.2%</td>
<td></td>
<td>1.0%</td>
</tr>
<tr>
<td>2011</td>
<td>1.0%</td>
<td></td>
<td>0.8%</td>
</tr>
<tr>
<td>2012</td>
<td>0.8%</td>
<td></td>
<td>0.6%</td>
</tr>
<tr>
<td>2013</td>
<td>0.6%</td>
<td></td>
<td>0.4%</td>
</tr>
<tr>
<td>2014</td>
<td>0.4%</td>
<td></td>
<td>0.2%</td>
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Source: FDIC analysis of Call Report data on 1,357 FDIC-supervised community banks headquartered in the FDIC Kansas City, Dallas, and Chicago Regions that were identified in the April 2015 FDIC Examiner Survey as having an ownership structure that could be characterized as closely held or widely held.

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21 Ibid.
However, the researchers found that succession was an issue for both closely held and widely held institutions. Only around half of the institutions in each group had already identified a successor to their current key officer, and substantial percentages of both closely held and widely held institutions were deemed to be not in a good position to attract managerial talent from outside their organizations. So while closely held ownership, and overlap between management and ownership, appear to be successful organizational structures, they could pose significant challenges when new managers must be put in place or when existing owners wish to liquidate their shares. These challenges put a premium on efforts by the bank to continually develop future leaders from within, as well as to devise strategies to pass the institution along to new owners when that becomes necessary.

Individual community banks meet ownership structure and succession strategy challenges in different ways. Mr. Riley explained that Mohave State Bank of Lake Havasu City, Arizona, stays continually focused on sustainability and succession. A number of the bank’s key shareholders are nearing retirement age, and there are questions as to whether the next generation of shareholders will show the same type of long-term commitment to the community and to the institution. Mr. Riley described some of the steps the institution has taken to address these concerns, including an ongoing share repurchase program and a strong effort in investor relations. During the Q&A session, he addressed a question about his bank’s capital raises during the recession. Mr. Riley described how the raising of new capital started with him, as President and CEO, and how the members of the board and the community then stepped up to support the bank and replenish its capital position.

Mohave has also taken a number of steps to address the issue of management succession. Mr. Riley is actively working to identify and develop possible successors from within Mohave’s current staff. While it can be difficult to attract new employees to a remote or rural area, Mr. Riley reported a degree of success in recruiting millennial-generation employees that has created what he described as “an unbelievably outstanding second tier of leaders.” Mr. Riley described some of these junior and mid-level employees as people who came to work for the bank after high school, and then moved up through the ranks, thanks to the bank’s training and development programs.

Mohave tries to identify specific career paths through which these emerging leaders can rise to management and executive positions. The bank has provided tuition reimbursement for several employees and has also sent some to banking schools. Emerging leaders are frequently given the opportunity to attend board meetings so they can gain a comfort level with making presentations and participating in the discussions. They also participate in a formal mentoring program and rotate among executive officers for three-month assignments.

Yet effective career development may also require employees to gain experience that they cannot obtain at their own institution. Mohave has addressed this need by offering “secondments,” or assignments at companies in other locations that expose employees to new experiences on the condition that they return and apply their knowledge at the bank.

Mr. Schneider was a co-founder of Investors Community Bank and became CEO in 2013. In a novel arrangement, the former CEO and Mr. Schneider served in “co-CEO” roles for two years. The former CEO took a decision-making role during the first year, and Schneider took the reins during the second year.

Investors Community Bank has implemented formal succession plans for its eight executive-level roles, as well as an internship program to address the challenge of attracting new talent. It also sends employees to a graduate school of banking.

One element of the bank’s succession planning process is a mandatory retirement age of 70 for its board members. To ensure that the board has a varied skill set that is matched to its business needs, Investors has adopted a formal board matrix and tries to use its succession and retirement process to see that any gaps in that matrix are appropriately addressed.
The bank’s 2015 public stock offering was part of an overall strategy to diversify beyond agriculture and to attract new talent to the bank. The offering facilitated an acquisition that same year that gave Investors offices in both Appleton and Green Bay. During the Q&A session, Mr. Schneider was asked how the public offering had affected the bank’s regulatory compliance burden. He explained that while compliance costs increased, these costs were more than offset by the benefits associated with making the bank’s shares more liquid.

The two community bankers among the panelists agreed that the problem of liquefying outstanding equity shares is a long-standing challenge in community banking, particularly among privately held organizations. Many community banking organizations reach a stage in their life cycle when aging shareholders begin to look for ways to cash out for retirement or estate planning purposes. In this sense, ownership succession can be every bit as challenging as management succession.

**Academia’s Role in Developing New Community Bankers**

Professor Sorescu described Texas A&M’s Commercial Banking Program, which provides selected undergraduates in the Mays School of Business with a concentration in commercial banking. The program was developed in response to requests by Texas bankers who wanted to fill a perceived talent gap in the community banking industry.

The program recruits students who have a strong academic background and an interest in community banking. It is sponsored by an advisory board of community bankers who visit the campus regularly to meet with students and to lecture. These lectures are important, Dr. Sorescu noted, because the board members can teach a range of practical skills based on their community banking experience. These lectures address topics such as evaluating unaudited financial statements and making lending decisions.

Each student is assigned an advisory board member as a mentor, and each student is provided with a summer internship with a participating institution. Dr. Sorescu noted that the internships frequently give the students an opportunity to be considered for full-time positions after graduation.

Most graduates of the program go on to work in commercial banking for one of the institutions represented on the advisory board, Dr. Sorescu said. The program’s success rests in large part on the ability of the board members to show participating students that community banking is a challenging and exciting career. While many business school students are initially attracted to higher-profile segments of the financial sector, such as hedge funds or investment banking, the purpose of the Commercial Banking Program is to provide students with a skill set that is well-matched to the needs of community banks in Texas.
The program faces two primary challenges—growth and diversity. At present, there is a larger supply of available internships and jobs than there are students motivated to concentrate in this area. There is also a desire to make the graduating classes more closely resemble a cross-section of the state population. In spite of these challenges, Professor Sorescu stated that the long-term goal of the program is to be the premier educational program in commercial banking not only in the state of Texas, but in the United States.

During the Q&A session, the panelists addressed a wide range of questions related to financial education and bank ownership structure and succession. Dr. Sorescu was asked why he thought other colleges around the country do not have similar commercial banking programs. In his response, he stated that while advancing knowledge in new and innovative financial areas remained an important mission for business schools, it should not be pursued at the expense of preparing students for a variety of real-world professions, such as community banking.

During an exchange with one of the audience participants, Dr. Sorescu explained that one of the factors that may have contributed to a talent gap for community banks is that larger institutions cut back training programs as their lending decisions became more automated, and as they sought to cut costs. Mr. Riley and Mr. Schneider also emphasized the notion that on-the-job training was an essential complement to formal education in the process of developing successful community bankers. Finally, Mr. Riley and Dr. Sorescu described how the preferred methods of communication among millennials tended to differ substantially from those used by previous generations. While millennials rely more on technology, their communication style is frequently described as being highly collaborative and empathetic.

The panelists agreed that the organizational and management issues are both complex and critically important to the success of community banks. Closely held institutions are prevalent among community banks, and the overlap between ownership and management at these institutions appears to contribute to their near-term success. Nonetheless, community banks face considerable long-term challenges associated with succession in both ownership and management.

Recruiting talent and training employees remain high on the agenda of community bank managers as they develop strategies for long-term success. While academic programs do not appear to be a substitute for the on-the-job training that community bankers continue to rely on, it appears that business school programs can play a larger role in developing the next generation of community bankers. A case in point is the Texas A&M Commercial Banking Program. A greater focus by U.S. business schools on commercial banking skills could help to demonstrate the appeal of a banking career to talented students and contribute to the long-term success of the community banking sector by addressing succession management challenges.

Read the complete transcript of this panel discussion on the FDIC’s Community Banking Initiative webpage at www.fdic.gov/regulations/resources/cbi/conference/panel4.html.
## Acknowledgements

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