FDIC Community Banking Conference: *Strategies for Long-Term Success*

Transcript

Panel 2: Regulatory Developments

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MS. EBERLEY: Good morning, everybody. My name is Doreen Eberley. I'm the Director of the Division of Risk Management Supervision for the FDIC. Along with my cohorts here, I will be leading a regulatory developments panel.

Before I introduce my fellow panelists, let me just make an observation. As we listened to the first panel this morning, we heard about a lot of change that's happened to the industry over the last few decades, and how the industry has remained nimble and responded to that change.

And I would just like to submit to you, that as regulators, we've done the same thing. Between the four of us up here this morning, we have 126 years of regulatory and supervision experience—even though we all look very young. And we've been doing this for a while.

Interestingly, all four of us started as community bank examiners—myself in the Southeast; David Cotney, who's Commissioner of Banks for the Commonwealth of Massachusetts, in the Northeast; Maryann Hunter, who is Deputy Director for the Division of Banking Supervision and Regulation for the Board of Governors of the Federal Reserve System in the Midwest; and then on the far end, Jennifer Kelly, who is Senior Deputy Comptroller for Bank Supervision Policy and Chief National Bank Examiner for the Office of the Comptroller of the Currency (OCC), on the West Coast.

So we not only have all been community bank examiners, we have covered the country. It's something that we're very committed to. But we've seen an awful lot of change over the course of our careers in the way that we handle supervision.

We all remember the days when we showed up at your banks on a Monday morning, and we walked in and we showed our badge and we said, we're here from the FDIC, or the Federal Reserve, or the state, or the OCC, and we're here to examine the bank.

We didn't give you pre-examination planning calls and ask for material ahead of time. We didn't risk-focus the examination and figure out what we were going to do ahead of time. We showed up on Monday, and we asked for a loan trial balance, and we got started, right? We counted cash.

So what we do has changed a lot, and that's been in response to the way that the industry has changed. And so what we'd like to do with our panel this morning is talk about some topics that are top of mind with us as regulators. We'll talk about regulatory relief activities, changes in the competitive landscape, using shared services, and applying the fundamentals to both old and new products and services.

We'll talk a little bit about what we're doing in each area to provide guidance or assistance to community banks, and we'll also talk about what we're asking you to do. We'll get started with regulatory relief activities. And I think I'm going to start with Maryann.

Maryann, you've been to most of the EGRPRA [Economic Growth and Regulatory Paperwork Reduction Act] outreach events—all of them. Every single one. So, if you could give us a recap of what we've heard and what we're doing with that information, that will get us started.[1]

MS. HUNTER: Alright. Well, thank you, Doreen, and thank you for that nice introduction. I do have to add, there is one element of examining community banks that has not changed in all the years we've been doing it, and that is: Examiners still go to lunch at 11:30.

Jennifer told me that at the OCC they call it, "12 CFR 11:30,"—I think that's great. And they still do. Some things will not change.

Alright. Well, I really want to thank Chairman Gruenberg for doing an excellent job in outlining some of the background information on the EGRPRA process. This is a process, as he mentioned, every ten years, and we are charged with trying to identify regulations that are outdated or unduly burdensome or just flat out unnecessary.

And so we do take this process very seriously. We requested a lot of written comments and have received some very thoughtful written comments. We conducted six outreach sessions, and I did manage to attend all of those.

And I will say, I was really, really struck and impressed with the quality of the comments we heard. Yes, we heard a number of the same themes in each and every meeting, which tells me that those were some of the more significant and broadly held views.

But just to give you a flavor of some of the themes that we did hear about, we heard a lot about just kind of the cumulative effect of new rules. We've got a lot of new rules in place, and just that last little thing, even though it seems like a small thing, is added on top of everything else. It seems like that was the one thing that was going to break the back and strain the resources or

[1] The Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA) of 1996 requires that the Federal Financial Institutions Examination Council, OCC, FDIC, and the Federal Reserve System review agency regulations at least once every ten years.

require hiring an additional person, which in small banks, the smallest institutions really can have a dramatic impact on profitability.

Some of the comments that we heard most clearly and most often were around the Call Report, the volume, the complexity. How could you possibly use all of this information, the number of pages of instructions?

And related to that, the complexity around the capital rules. And they are very much related because a lot of the complex reporting schedules were related to the calculations necessary for the capital rules.

We heard a lot of comments about the examination process, the time it takes bankers to prepare for examinations, the volume of requests coming in letters. And, of course, the examination cycle, which Chairman Gruenberg already mentioned, where Congress, through the passage of the FAST Act, changed the law that allowed us to go ahead and change the thresholds to raise the asset size under which smaller banks would qualify for an extended examination cycle.[2]

We heard a lot about suggestions to look at thresholds—any threshold that had been around for a long time. For example, the appraisal threshold. Some of the numbers, the dollar values given in some of these rules, if they hadn't been looked at for a long time, I sense that we might want to look at and index those for what the new general price level might be, to see that we weren't expanding the scope of the regulations just through the passage of time beyond what was necessary.

I think we also heard quite a few themes around adjusting and updating regulations to reflect the introduction and use of technology. So, for example, under some of the comments around the Community Reinvestment Act, they're saying with the Internet and the ability to have competitors who aren't necessarily geographically based, yet we have rules that are geographically focused, and how do we square that?

Other kinds of comments, I know, even just around transaction limits on certain accounts: the Reg D limits on the numbers of transactions. And the way people use money and access funds electronically, the six withdrawals just seem like a number that wasn't matching how people actually use those accounts today.

I thought there were a number of themes that were quite interesting, and certainly a lot of food for thought there. So if I can just take a minute just to give a little flavor of what we have been doing, and I think you've got some of that in the opening remarks from the Chairman.

Of course, in the category of things we've already done, is to change the examination frequency schedules to extend that to 18 months. 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.

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[2] Section 830Q1 of the Fixing America's Surface Transportation Act (FAST Act) amended Section 10(d) of the Federal Deposit Insurance Act to have the FDIC issue Final Rules that amended 12 CFR § 337.12, Frequency of Examination, and 12 CFR § 347.211, Examination of Branches of Foreign Banks. Those changes permit institutions with up to $1 billion (rather than the previous $500 million) in total assets that received a composite rating of "outstanding" or "good" at the most recent examination, and which meet certain other criteria, to qualify for an 18-month on-site examination cycle.

Someone also mentioned the small bank holding company policy statement within the Federal Reserve. We took a look at that threshold after a Congressional change as well. And that provided some relief in the ability to access debt to support capital.

But more importantly, I think the real burden reduction comes from not having to report an FR Y-9C.[3] So, there are a couple things that have already been done, and that are currently under way, I would add to that, I think, within each of the agencies. I can speak for the Federal Reserve; I'm sure my other colleagues may have comments.

In addition to some of the regulatory changes, we are working through the FFIEC [Federal Financial Institutions Examination Council] on common changes, on taking a look at the Call Report and looking for opportunities to simplify the capital rule, for example, and taking a look at the appraisal regulations.

But within each of our agencies I know we've been taking a look at those things that are within our control that don't depend on even a regulatory change. So, I'll just take maybe a minute and talk about some of that, and then maybe some of the other panelists will want to join in as well.

One of the things we heard about at the Federal Reserve through the outreach sessions was the examination process. It's the 22 examiners when you've got 18 employees. They take the conference room for a couple of weeks. Your customers are kind of looking at what's going on, and maybe a little concerned about why are all these people in your bank.

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. That can't be done remotely.

We're expanding our use of offsite loan review, to the extent that banks are interested in that, and have the ability through their own systems to provide us information in a format we can use remotely. So that the examiners will actually read the loans in the office, and then come into the bank for the discussion, and to do whatever follow-up work might be there.

In addition to that, I'll just mention one other change that we're doing in the examination process. We're working on a process to refine how we use Call Report and reported information, to get a much better indicator of risk. We refer to it as our outlier project. Looking for outliers—both a high risk and looking at low risk—with the intention that through this model we're back-testing against the most recent period, but through this modeling and this surveillance tool, we would feed it into the programs—the automated programs—that the examiners use when they're actually setting the scope of the examination.

So you would expect once this is up—and we're actually in the process of implementing it now—you would expect to see if you've got, for example, loan risk and interest rate risk.

It really gives the examiner the information to say, "All of our information says this is low risk. It's okay not to do too much here. Instead, there's higher risk over here. Let's spend your time on the higher-risk activities—the ones where you're going to add more value to the bank and more value to the supervisory goals by spending your time and energy there."

[3] Form number FR Y–9C, "Consolidated Financial Statements for Bank Holding Companies," required quarterly of bank holding companies.

And, yes, there is some risk that the examiners will miss something. Examiners don't like missing things. But the way that we are really talking to our staff about it is, this gives you the ability to say, based on all the information I had, based on the best analysis we had at the time, I made the right choice in limiting my time on this area. And so, therefore, it's okay, so if something should happen later.

So, it's just a general concept of one thing we're trying to do to make the time in the field the most value-added for our supervisory goals and for the bank. So, I'll stop there and let some others maybe comment on that.

MS. EBERLEY: Okay. Great.

Jennifer, do you want to pick up a little more on maybe some of the other work that's happening through the FFIEC, and what the OCC is doing?

MS. KELLY: Sure, I'd be glad to.

Good morning, everyone. So, at the FFIEC, under the task force on supervision, our big project for the past year or so has been pulling together the Cybersecurity Assessment Tool.

And one of the things that we were very careful in doing was we wanted to provide something that was of use to bankers, to really help them understand where there was risk in their institution, what steps they could take to try and mitigate that risk, but make it tiered, and fit the bank, the individual bank and its risk profile.

So that was something that all the agencies worked on collaboratively. We rolled that out in June. We've been spending a lot of time talking with bankers about it.

In fact, we'll be appearing at a NIST [National Institute of Standards and Technology] workshop next week, I believe, or it's coming up shortly, where we'll be engaging with people that are participating in that workshop, to try and get more feedback on the tool and how we could make it more useful for bankers.

Because it really was intended to be something value-added for the bankers, but also very much scaled to different banks. Not recognizing that, what we expect of a community bank is not going to be the same as a very large bank. And, likewise, banks that are involved in different types of activities have differing needs.

The Call Report has already been mentioned. We are spending a lot of time looking at the Call Report and how we could make that more user-friendly and not as burdensome. But as Maryann ably highlighted, it's very important to balance that with our need for information.

Because, in fact, in terms of the data that we get from the Call Report, there are certain items that, if we don't have access to, it's going to limit our ability to do more offsite supervision.

So we're going through a very careful process of really thinking about what information we need to collect, how often we need to collect it, and whether there are ways we can make the report itself easier for small banks to manage. We expect to be coming out with a fairly fulsome proposal for comment in the relatively near future. So you can look out for that.

Another thing I would mention that the agencies are all spending a lot of time working together on, and it's kind of bleeding over into the FFIEC, is the new accounting standard for loan losses and the CECL [Current Expected Credit Loss] proposal. We've spent a lot of time in outreach with bankers. We've been working with the trade associations. We've had a lot of conversations with FASB [the Financial Accounting Standards Board]. And in those conversations, we specifically focused on the concerns of community banks about what this means for them, what the expectations are going to be.

And the fact is, there will be a long implementation period. All the agencies are standing ready to use that time to really both work with their examiners to train them, but also to help the industry understand what the expectations are.

So I'll stop there, and I'm happy to answer questions later on if anybody wants to talk about any of those issues further.

MS. EBERLEY: Great. David?

MR. COTNEY: So, from a state perspective, we have a role on the FFIEC through the State Liaison Committee. And I can tell you that being able to be a part of this process, I always want to be careful not to over promise and under deliver. But many of you in the audience, I think, had a less-than-satisfactory experience ten years ago through the EGRPRA process.

There is a lot of work going on throughout the agencies in coordination with the FFIEC, to make sure that everything that we heard through the outreach meetings, through your comments, is addressed. And if it's something that can be done by the regulators, there is a real effort to try to deliver. So, I'm hoping that by the end of this process, it will have a much more satisfying feeling than some of you expressed ten years ago.

Whether it's looking at the regulations at the federal level, or the regulatory relief in Congress, everybody seems to be unanimous in the opinion that we want to provide some relief to community banks. But the struggle is, okay, "If we want to do that, who's a community bank? Who gets the relief?" And so that's something that state regulators have been talking about through the Conference of State Bank Supervisors. I've served as chairman of the organization for the last year.

So we in fact struggled with how you define a community bank. And we finally came to the conclusion that there's a really good definition out there. And it's what the FDIC came out with a number of years ago, as part of this whole community banking initiative, through its research definition of who is a community bank.

So we are very supportive of ways to define a community bank that provides relief. The FDIC's definition starts with assets but doesn't end there. It presumes to be a community bank if you're under a certain asset threshold unless you engage in certain activities. But you can still be considered a community bank if you're over that asset threshold if you meet certain other tests.

So we've been very supportive of ways to define a community bank that could then trickle down into other forms of regulatory relief, whether that be in the Call Report or capital simplification or other means.

We'd like to find a way to get away from hard asset thresholds, which go all over the map, from less than $50 million for HMDA [Home Mortgage Disclosure Act] reporters, up to, $10 billion for interchange to $15 billion for the Collins Amendment [of the Dodd-Frank Wall Street Reform and Consumer Protection Act]. It's a reg-by-reg, law-by-law approach to defining who gets relief in this area versus not relief. So, that's something that we're looking at and trying to find ways to socialize, and we'd certainly welcome any thoughts on that.

MS. EBERLEY: Okay. Great.

And I'll just add in from the FDIC perspective, as we think about what we can do under the EGRPRA effort internally, the things that we have control over in terms of our examination program and the way we carry it out, we've gotten feedback a number of ways.

One is through the surveys that we ask bankers to complete at the end of every examination. We monitor those on a quarterly basis and track trends over time. And one thing that came out of that was, going back a few years, concern about the pre-examination planning process. And the concern expressed was that we were asking for an awful lot of information before an examination, and it wasn't transparent to bankers that (a) we had used it, or (b) how we used it.

We've had some conversations internally about that with our field supervisors and looked for some best practices on dealing with the pre-examination process. We talked to our Advisory Committee on Community Banking and got some thoughts from them.

And one of the things that came out of that was a best practice that we've established on examinations. To have the examiner in charge talk about how the pre-examination planning information, all the information that we request in the first-day letter is used to actually risk-scope the examination.

All of us moved to risk-focused examinations in the late 1990s after the last crisis. Through the FFIEC we changed the definitions of the Uniform Financial Institution Rating System to include risk management concepts in each of the component definitions and the composite definitions. And we are all continuing to evolve how we do risk-focused supervision.

And I just want to get across the point that the feedback that you give us all is very important, and it helps us do our job better. So, we've been discussing how we use the information to actually scope the examination and determine what activities we're going to do during the examination. Not every examination is alike.

And then, at the end of the examination, we're talking about how all the information that we used during the examination, how it was used. So as we're having the exit meeting, we talk about how the information that we collected fed into that process.

One other recommendation that we got at the Boston EGRPRA event was really a great one. We've moved to risk-focused supervision. We talk about risks during examinations. But the recommendation that came from a banker, who I believe is in the room today, was: We need to have the page talk, and have the banker and the regulator talk about whether we are in agreement about the risk profile of this institution.

A lot of our guidance is broad and it is principals-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. Well, what does that mean? Having that conversation between each other, regulator and banker, to set that expectation up front so that we're both kind of coming from the same place.

These are a couple of great ideas coming out of banker surveys and out of the EGRPRA meetings, and our meetings with our Advisory Committee on Community Banking.

So, let me just ask the panelists, are there other ideas that you've heard from bankers or coming out of EGRPRA that have changed processes or things that you're looking at through your examination processes?

MS. KELLY: Well, I can just say, from the OCC perspective, a lot of similar things to what have already been mentioned. Really focusing on how much time we spend in the bank, how many people we have in the bank, but making sure that that time is used in the most valuable way to the banker in terms of face-to-face conversation. Then doing more of the work offsite in order to reduce 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 offsite from the bank. So, hopefully, we can get the exam wrapped up more quickly.

The other thing I would say that we continue to stress to our examiners, and it relates to the risk focus that you've heard here, is that we do quarterly reviews on each bank. That usually involves a phone call conversation with the banker. And we stress to our examiners that that's the time to really zero in on making sure that you have a good understanding of the risk profile of that bank. And that that's an opportunity to adjust the strategy going forward, to think about where you want to spend your time during an upcoming exam, what information we're going to need, what information we don't need.

So it goes back again to the customizing. So that's something we've been spending a lot of time talking to our examiners about.

MS. HUNTER: I would just add one other thing that we have been working on. One of the comments we heard in many of the sessions was, a feature of guidance where it says, "Management and the board should … ." And it's not clear. Is it a board responsibility? Is it a management responsibility? Is the board expected to have a deep engagement in each and every one of the risk issues?

So we actually have been going through all of our guidance, a zero-based review of that, to look for all of the places where we're saying, "Management and the board should," and really being thoughtful about whether this is a board responsibility, and looking to provide better clarity on that point. Mostly to make it so that the management can manage the bank and the board can fulfill their roles, and not feel like that they are expected to have a checklist of 150 items just to match every expectation that they believe is communicated in the guidance.

MS. EBERLEY: Great. And let me make a real quick commercial plug.

Outside on the tables by the windows are the Community Bank Resource Kit that we've created for this conference. And there are copies for everybody. In here we have a Guide to Corporate Governance. It's a *Supervisory Insights* special edition on corporate governance, where we actually do talk about how to have that kind of risk profile talk and look at your risk profile for your institution.

Jennifer, maybe one other thing before we move into our second topic. Last week the OCC issued a white paper on banks leveraging fintech [financial technology] innovations and OCC's efforts to facilitate those kinds of collaborations.

So, as we move into collaboration, can you talk about that a little bit?

MS. KELLY: Sure, I'd be glad to.

So we did issue the white paper. It's available on our website, OCC.gov, for anybody who wants to take a look at it.[4] It's a pretty easy read. It's not a terribly long paper. But what we were really trying to do with putting it out there is to generate a conversation, a dialogue. And we are. There are a number of questions we pose at the end of the paper, and we really are interested in any kind of feedback people want to provide. We put a deadline of May 31st for those comments. They can be submitted by e-mail.

This is not a formal notice of proposed rulemaking or anything like that. It really is, again, just to stimulate conversation about this important area. But what we're focusing on here is, the way we've defined it is, responsible innovation. And that's the bank's use of new or improved financial products, services, and processes to meet the evolving needs of customers and communities.

And, of course, since we're regulators, we had to throw in the context that we want to ensure it's done in a manner that's consistent with sound risk management, and it fits the bank's overall business strategy. And that's something you've been hearing us talk a lot about for a number of years—this whole idea of strategic planning. And before you go into something new like this, making sure you've got realistic projections, that you're monitoring, that risk management systems are up to the task, that you've carefully considered potential reputation and compliance risks, and that in case things don't go as you're expecting them to, you have an exit strategy that you've thought through.

On our side, and what you'll see in this white paper if you read it, is that we want to be sure that we're being perceived as being receptive to responsible innovation. And I think because regulators are naturally risk-averse, we ask lots of questions, and we carefully study things. We're perceived as we start with the answer being "no," and it's kind of talking us out of the "no." So, we recognize we come across that way. But we also understand how important innovation is for the industry, including community banks. And we really want to make sure we're striking the right balance between risk and innovation.

So this paper was a way to put it out there that this is something we're spending a lot of time talking about. We want to position ourselves as being a resource for banks to come to us. Our hope would be that you come to us early, talk to us about it. We're going to be working to educate ourselves so that we can be responsive.

The other thing is that we tend to study things to death and ask lots of endless questions. Making sure we're positioned to make timely decisions and to provide meaningful guidance, both to the banks that are interested in considering these things, but also to nonbanks that are interested in partnering with banks. They aren't necessarily used to dealing with regulators operating in a regulated environment, and it's important for them to understand what our expectations are going to be of the banks that they're partnering with.

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[4] "Supporting Responsible Innovation in the Federal Banking System: An OCC Perspective," Office of the Comptroller of the Currency, March 2016, http://www.occ.gov/publications/publications-by-type/other-publications-reports/pub-responsible-innovation-banking-system-occ-perspective.pdf.

So, that's kind of a quick coverage of it. I'd really encourage you to take a look at the paper, and we'd be interested in any thoughts you want to share with us.

MS. EBERLEY: That's great. I want to restate something that you said, which is, that we ask a lot of questions and that doesn't mean "no." We're inquisitive by nature. That's the way we were raised as examiners. And so we do want to ask a lot of questions to understand what it is you're doing, so that we can give you the best possible feedback. And so take that as it stands, just as a question.

Moving into our second topic, which was really about changes in the competitive landscape—fintech being one of those changes. We heard a lot in the first panel about how competition changes things over time. And we have a panel this afternoon that will talk about how banks are managing technology challenges generally.

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. We all meet together on a regular basis. And Jennifer does chair the Task Force on Supervision.

But, Jennifer, maybe if you could kick us off with a little bit of a discussion about what we're asking bankers to do to keep pace with the change, and what we're doing at the FFIEC to help banks manage technology changes.

MS. KELLY: Sure, I'd be glad to. I would say, we talked earlier about some of the things we've been working on, and I think most of our time really has been taken up with technology-related issues.

I already mentioned the Cybersecurity Assessment Tool, which obviously has a big connection to technology, although it does go further than just technology. It's about governance and everything else that's going on in the bank related to managing those risks.

Another thing we put quite a big focus on is we have a series of Information Technology Handbooks that are produced jointly by all the agencies, through the FFIEC. It's been a joint project of ours for a long time. Keeping handbooks updated is always a challenge, but particularly in the area of technology where things have been moving so quickly in recent years.

So we've made a really concerted effort to work hard on getting those handbooks as up-to-date as possible, making sure that they link well with the information we're putting out in the Cybersecurity Assessment Tool.

You can expect, in the next week or so, we'll be putting out a new section of a handbook related to mobile financial services, which is obviously an emerging area. That's something it really isn't addressed in the existing handbook, so we knew we needed to get some more information out on that.

We're also working hard on an updated handbook related to information security that will be coming out in a couple of months. And the other area where we spent a lot of time focusing is technology service provider supervision. And I know that's something that comes up often in conversations with community bankers. As the world has changed, you've become more and more reliant on these third-party service providers. We recognize that. We don't have a problem with that. We just want to make sure that those relationships are being supervised effectively.

And for our part, the federal banking agencies do have authority to supervise the technology service providers under the Bank Service Company Act. We exercise that on a regular basis.

The three of us work closely together, the FDIC, the Federal Reserve, and the OCC. And then through the FFIEC it gives us an opportunity to partner with the other agencies that have an equal interest in this area, and we do a lot on an interagency basis there. So we're continuing to work on, I would say, enhancing our activities in this area, recognizing how critical it is to safe and sound operations in the banking sector.

So we've had this program in place since 1978. It's changed a lot over time, and we continue to focus on that. But we're really working on strengthening our oversight of the most critical service providers, obviously enhancing our focus on cybersecurity and incident response, which is very important, identifying new service providers that should come into this supervision program.

Most importantly, as I talk about enhancing it, that takes more resources on our part, and making sure that we have the right resources with the right background, and enough of them to fulfill this important part of our mission effectively.

The last thing that we've been working on is finding more effective and efficient ways for us to share the information that we develop through this supervision with the clients of these different service providers. So that's something, hopefully, you've seen some improvement on in recent years, and it's something we continue to work on, how we can do that.

MS. EBERLEY: David, the State Liaison Committee is a member of the FFIEC, so you've been a participant in all of these activities. But what else have the states been up to in terms of managing technology or the competitive landscape more generally?

MR. COTNEY: Well, in terms of the competitive landscape—and we've been thinking about these issues a lot—first, I want to give a thank you. You heard a reference from Scott Hein of Texas Tech to the research conference.[5] We realized that anecdotes are great, but they don't necessarily drive public policy. So, it's data and analysis that drives that. So that was really the reason why the CSBS [Conference of State Bank Supervisor] has co-sponsored the research conference, which is now entering its fourth year, with the Federal Reserve, to try to have better data around community banking. And certainly the FDIC has been a great contributor to the body of data here as well.

And so it was this last year, as you heard from Scott, that we decided to add, on a pilot basis, this case study competition. And we had a number of entrants into that.

You can imagine that despite the reputation of banking maybe being boring, that if you're a college student, you win a case study competition and you come and you get to present the results of your case study to a group of academics. And sitting there in the front row is Chair Yellen.

So there are opportunities here. And the great thing is that, in our first full year of doing this case study competition, we had 33 entrants representing 25 colleges and universities in 18 states.

[5] Community Banking in the 21st Century Research and Policy Conference. https://www.communitybanking.org/.

We're hoping that this is just building some excitement around community banking in the younger generation. This panel of judges includes representatives from the Federal Reserve, the FDIC, the states, and the academic community. So we're really excited about that.

And then just sort of another follow-up from, or a commentary on, the last panel. Looking at this whole topic of millennials and trying to compete today, whether you look at the surveys and studies out there about this group, or based on your own experience, we know they love technology.

They, quite frankly, they get bored a little easily and want new challenges all the time, and doing lots of different things. They hate huge nameless, faceless corporations, and they love being able to say that they have an impact in their local community, nationally, internationally.

Well, quite frankly, that's exactly where community banking can compete if we can get over sort of the reputational overhang from the crisis, and the fact that banking wasn't cool or was damaged by the reputation of Wall Street.

So, if we can get over those things, I think that community bankers are in a great place to be able to compete for millennials.

MS. EBERLEY: Great. Maryann, anything you want to add here?

MS. HUNTER: No.

MS. EBERLEY: Okay. Very good.

Well, let's move on to shared services. One idea that's been discussed in conference settings such as this one, is the idea that community banks can share backroom services to reduce expenses.

And we hear talk about that, but maybe a little bit of hesitation about how to actually move forward. And would you be sharing proprietary information? Can you really do it?

David, let me start with you and ask if you've seen any creative ideas or implementation of this kind of strategy in banks in Massachusetts?

MR. COTNEY: In the interest of transparency, despite the fact that on this topic of shared services I've been trying to talk about this in speeches or discussions in Massachusetts, there are some examples, and I'll try to share some of those with you. But nobody's really beating down the door on this topic.

In the interest of disclosure, this is not a huge wave but, quite frankly, I think that this is something that more bankers should be thinking about. When you think about the environment that we're in and the earnings pressure, clearly, if you could do something to drive up revenue, you'd be doing it.

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.

So, I think that that's 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.

And so, I know that the OCC released a white paper last year that was very supportive of this concept of shared services.[6] And the CSBS will also be releasing a white paper, trying to give some other examples of shared services.

And I'll just mention in Massachusetts, there was an unfortunate example of a small community bank where the CIO passed away. And a neighboring institution said, hey, we understand what's going on. We're happy to try to fill in the gap until you're ready to hire another CIO.

Well, lo and behold, both institutions came to the conclusion that this was working very, very well. One institution had some excess capacity, the other institution that had lost their CIO realized they just couldn't afford what they needed. So they memorialized this into a permanent relationship.

I don't want to get too deep into the details, but there is some information that this concept of three institutions wanting to get together and perhaps invest in some solar technology, to be able to help offset the costs of operating their branches.

There are many, many other backroom examples that you can think of: IT, BSA [Bank Secrecy Act], HR, accounting, compliance, go on down the list. There are many examples of costs that are not going down anytime soon that could be shared if we could get over some of the hurdles.

What are those hurdles? Well, I would say first and foremost they are cultural. So I'm going to say a bad word or two bad words: credit unions. Credit unions do this all the time. They have the CUSOs [credit union service organizations]. They share these costs.

There is shared branching, and some examples of small institutions that have shared CEOs. So this is not new, but for some reason, there are some cultural differences among bankers that make doing these difficult.

And maybe that's either for fear that you're going lose your customer to your competitor, or this is sort of the first step in a takeover. And so, I would strongly encourage you to think of ways of getting over it. To find ways of making those work.

So, I guess then the second barrier would be the perceived hesitancy on the part of regulators. And so I think certainly the OCC white paper, hopefully, goes a long way toward dispelling the notion that we're opposed to the idea of shared services. And maybe there are things that we can do to make it clearer. What is the path to be able to do this, to do it right, and to make it work?

So, like I said at the beginning, there are not a lot of banks in Massachusetts that are rushing into this. But when you're all out there looking at the pressures that you face, and then having to think about the different alternatives, I would say that this is a good alternative to going down the road of a merger.

[6] "An Opportunity for Community Banks: Working Together Collaboratively," Office of the Comptroller of the Currency, January 13, 2015, http://www.occ.treas.gov/publications/publications-by-type/other-publications-reports/pub-other-community-banks-working-collaborately.pdf.

MS. HUNTER: Well, I'll just add, as someone who does not have a white paper on this, I would just reiterate the key points that David just made—not opposed to it.

I think this is one of the examples of something that came up through the EGRPRA outreach meetings. We're hearing: "I need such a level of expertise, but I don't need it full-time, but I need to have a BSA officer, for example. How could we do this?"

And so I would just say that it seems like the biggest demand is where there's a need for expertise, not necessarily a full-time person. We have shared services right now and it's called "consultants," but they aren't on your payroll, they aren't your employee. And so the only real risks, or the kind of questions that come up from that, is access to the confidential information. And then how do you manage any potential conflicts of interest?

You would have somebody who would see information about customers from two different institutions, potentially, and then what kind of risk does that present? So that would be the thought process in thinking it through, and I'll really turn to Jennifer to maybe elaborate from your white paper.

MS. KELLY: My white paper Yes. It's available on OCC.gov. So, actually where the white paper came from, this was a topic that came up with our two advisory committees. We have one for minority depository institutions and one for mutuals. And both of those tend to be smaller institutions that have a lot of these same challenges we're talking about.

And there was a lot of conversation around, "Is this something we could do?" As a result of those conversations, we brought in some of our experts to talk about what would be the considerations, all of that.

And as this topic kept coming up, we thought, "Let's put this out there and at least let people know that it certainly is a topic where we're willing to have conversations about. Here's what you would need to consider to start with."

I think that the real key would be to get involved, get your regulator involved early on into the conversations as you're thinking it through. I would agree with David, that I think there's—we hear a lot of people talking about it. We don't see a lot of people doing it.

There are a few examples that we mentioned in the white paper. Several community banks came together and created a bank service company that prepares documents for their mortgage loans. Another one, another couple that had the same data processing hardware and software, they partnered to function as backups for each other.

We've seen a lot in the area of loan participations where a number of smaller community banks will join together and be able to go after deals that they wouldn't be able to do on their own, and effectively compete with larger banks. I wouldn't say we've seen it, but we have heard a lot of talk about community banks joining together to have more leverage in contract negotiations with their technology service provider.

And so I think it's as wide open as we talk about backroom services, but it really could be as wide open as where do you have a need and where could you see this possibility for partnering? Another thing we had some discussions about is even the possibility of community banks could collaborate to offer wealth management services through potentially a jointly owned national trust bank.

So a lot of different things that are being talked about, and the point we were trying to get across with the white paper a year ago was just we certainly are open. It's the same message that I talked about earlier on responsible innovation. We are open to talk about these things. And the sooner you engage us in the conversation, all of us, the better you will go into it, knowing what expectations you need to be aware of.

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. Because I think 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 in this.

MS. EBERLEY: So probably a good time to just say one more time, we're going to ask you a lot of questions about these things, but it's to understand what you're doing. How do the existing risk fundamentals apply to the new idea that you have or the new product or the new service, or how do they apply to the same old stuff?

One of the things that we've talked about is change, but some things are constant. And I think that is thinking about how the fundamentals of bank supervision, safe and sound operation, consumer protection, how they apply to any new product or service, and keeping in the front of mind how they apply to all of the existing activities.

And maybe, Maryann, I'll start with you. One of the things we've talked about recently is commercial real estate on an interagency basis. We put out a statement in December on prudent risk management for commercial real estate to highlight prudent risk management practices that are already an existing guidance.[7] But just to reinforce those principals again, because poor management of these principals has led to problems, and we want to avoid that. Do you want to pick us up on that topic?

MS. HUNTER: Right. I'll start off, and I'm sure others can join in.

You're exactly right, Doreen. One of the things I know we're talking about a lot is commercial real estate, and concentrations in particular. Although I will say another topic of late seems to be if you're concentrated in oil and gas, or you're in a geographic region that is, by its own very nature, concentrated in oil and gas, given what's happening in that market.

But 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.

If you have a concentration in commercial real estate, concentrations by definition are not bad or wrong, and there is no hard limit. But the guidance that we put out basically said, "Go back to the earlier guidance and pay attention to it." And if you really look at it, what it's saying is, "If you have these concentrations, we're really going to focus in on the risk management. How are you managing the risks in the type of lending that you're doing, the nature of the deals you're getting, and your growth strategies?"

[7] "Statement on Prudent Risk Management for CRE Lending," FDIC Financial Institution Letter FIL-62-2015, December 18, 2015, https://www.fdic.gov/news/news/financial/2015/fil15062.pdf.

So, we're really focusing in on risk management. I know we talk a lot about for small banks, stress testing is not required. If you have a concentration in real estate, you probably want to do some "what ifs," some testing if values do certain things, go up or go down, what would that do to your portfolio and your need to reserve for potential losses.

So we are going to be very focused on that, certainly talking with our examiners about that. And so, we'd anticipate that you might get some questions along those lines. And then, Jennifer, if you wanted to … .

MS. KELLY: I think that pretty much covers it. Obviously looking at reserve levels if concentrations are growing and are the reserves keeping pace.

MS. HUNTER: Actually, one other point I would make, and it is especially kind of tying back to our discussions on regulatory burden.

One message I've given to our examiners is, we want to do a lot to really focus on identifying areas of burden and reducing it. We're not telling you not to do your job. What we're really telling you is, safety and soundness is still important. Let's focus on the stuff that really adds value to our mission to the banks.

If there is a growing risk area, let's focus our attention there and try to get ahead of it. Try to help the banks see what we're seeing in the way of risk, what we might see in other institutions. But we didn't want them to hear, "Reduced burden means back off." Don't point out something that we think is truly an issue with respect to safety and soundness.

MS. EBERLEY: Okay. Well, I think that's a great message to end on.

MS. HUNTER: It's kind of a down note, Doreen.

MS. EBERLEY: No, it's not either. It's good that we all are focused on the fundamentals, and they do remain important.

And it is our job to make sure and remind everybody about the fundamentals, especially when things get going and you see markets increasing and values increasing, and everybody wanting to hop in and get the next deal.

And talking about the competition between bankers, we keep community banks around by preventing them from failing. And we do that by making sure they observe the fundamentals in good times and bad.

So, we've got time for a few questions if we want to open it up. Yes?

MR. WHITING: Good afternoon. My name is Richard Whiting, and I'm the Executive Director of the American Association of Bank Directors.

And I heard Maryann say earlier that you were reviewing your guidance and going to make a clarification between what burdens or responsibilities fell on directors, what fell on management. I think that's a great idea and we've been a long-time supporter of that.

So I have two questions. One: Is this something that all of the agencies are doing? And two: How are the results of your review going to be manifested in the end?

MS. HUNTER: I'll start with the last part, and then the others can. We are going through guidance. What we're really focusing on is clarifying expectations with examiners. So that we're clear about, "This is something that should be a board function, something that should be a management function." So going through that through our regular training and updating the materials, and that's going to be a long process in terms of actually looking through each and every piece of guidance and updating the examination programs to reflect that.

But we are having an ongoing dialogue about that with examiners. In particular, when we see examination results and they're saying, "Here's a matter requiring immediate attention of the board," is it really at the right level? That that would be part of the review, to make sure that the things we're asking the board to do are appropriate for a board role.

So, eventually you'll see something maybe in terms of—well, part of our review will, basically, eliminate outdated guidance. Just say it's being retired. And revisions to other pieces of guidance that might provide that clarity.

MS. KELLY: And I would just add to that. Certainly it's something that we're conscious of whenever we're drafting guidance or updating existing guidance, and trying to keep that right balance. It's something we spend a lot of time talking about.

But I think we also focus on, obviously, talking to our examiners about that. Making sure that they're really clear in their communications. But the guidance that we provide to directors, a director's handbook, we're in the process of updating and trying to be really clear about what we see the role of the director as and how they go about fulfilling that.

We also have a number of director workshops that we conduct around the country, again, to help directors understand where we expect them to really fit into the overall management structure of the bank.

Another thing we did. I know I've mentioned the Cyber Assessment Tool a couple of times. One of the pieces that we released along with that were actual questions that directors can use. Here are some questions you can be asking, because we kept hearing them from directors. They didn't even know where to start in terms of their conversation with management about these issues.

So, I understand the point you're making. It's something we're very aware of, and I think there's a lot of ways to come at it. Certainly being thoughtful in how we write the guidance, but also in other forms of communication we have.

MS. EBERLEY: I'll add from the FDIC perspective. In 1988 we issued a Pocket Guide for Directors.[8] It's a pamphlet that's available on our web site.

But the recent special edition of the *Supervisory Insights* that we published is "A Community Bank Director's Guide to Corporate Governance: 21st Century Reflections on the FDIC Pocket Guide for Directors."[9] So, you've got this little handbook. We talk about the difference between the responsibilities and expectations of directors and management.

[8] See: https://www.fdic.gov/regulations/resources/director/pocket/.
[9] See: https://www.fdic.gov/regulations/examinations/supervisory/insights/sise16/SI_SE2016.pdf.

So it's something that I think 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.

MR. WHITING: Okay. Thank you.

MS. HASKIN: My name is Jane Haskin and I'm President of First Bethany Bank in Bethany, Oklahoma.

One of the things that I talk to a lot of bankers about is the new CECL guidance that will be coming out, hopefully at the end of June.

I've tried to read up on what FASB's actual pronouncement was. And it appears to me that there is no given methodology that has to be used by banks to calculate the loan loss reserve. And so, it looks like there are multiple suggestions in the FASB regulation.

So I implore the examiners to realize that we do very simple loans at our bank. We do first mortgage commercial real estate loans. Most of our loans are first mortgage real estate loans. We have first liens on the equipment that we loan on. These are not complicated.

And so 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: So, fair comment. And I can say that each of our chief accountants has been actively engaged with FASB throughout this process. And FASB has released some preliminary information. The pronouncement itself is not out yet.

Once it is, you will certainly be hearing from us, on an interagency basis I would expect. All of our allowance guidance has been that way before. But we will share with you tips and ways to implement the new guidance once it's issued. The one thing FASB has committed to, and we'll be spending more time on this topic tomorrow at our Advisory Committee Meeting, which anybody who's not in attendance can watch by webcast, but they have committed—FASB has committed—to making this a scalable pronouncement.

Something that community banks can do using methodologies that they have in-house, so they won't have to go out and contract and buy models. So that has been a commitment.

MR. COTNEY: I'll just add that in addition to the conversations with FASB, certainly talking to each other, and from the state perspective, we've reiterated the need to have consistent messaging.

And that's something that I think everybody agrees on. And messaging and training for examiners and the message that we deliver to you. So we'll be spending a lot of time working on that.

MS. EBERLEY: Other questions?

MR. DAKRI: My name is Asif Dakri. I'm with Wallis State Bank in Houston.

My question is regarding commercial real estate. We all understand the 100 percent/300 percent thresholds. But in my recent exam from two months ago, there was a comment specifically added in there that said, while the bank is under the 300 percent threshold, if you add owner-occupied commercial real estate, they're way over it.

So where did owner-occupied now become part of this threshold? Is that the trend? Is that what you guys are going to do to us next, or what do we do?

MS. EBERLEY: I'll start and let others join in. Owner-occupied commercial real estate is not part of the 2006 commercial real estate guidance.[10] We certainly pay attention to concentrations in any form on bank balance sheets, and we understand that community banks are going to have concentrations on their balance sheets by definition. You're not going to have a hugely diversified balance sheet; you're going to have an area of specialization.

We want you to focus on how you're managing that concentration, and particularly for institutions that are in economies, operating in economy. So you've got concentrations in different ways. You've got concentrations that are asset-based, and you have a concentration geographically.

You're operating in a small geographic location, and if you're in an economy that's tied highly to the energy markets, you've got a different kind of concentration in terms of your whole asset base, which really can fluctuate based on what happens in the oil economy. You can have an indirect impact from that.

So, any comments like that, if you're in an oil economy, it would be related to that kind of a risk. That, what is the indirect risk to your entire portfolio that could happen from reductions in oil prices that could cause slowdowns in businesses in the marketplace in which you operate.

MR. DAKRI: Okay. So, there is no owner-occupied going to be added to our thresholds then?

MS. EBERLEY: The 2006 guidance is still outstanding. It has not been altered.

MS. HUNTER: And the most recent guidance would clarify that multi-family—but not necessarily owner-occupied—is part of the commercial real estate guidance.

MS. EBERLEY: Correct.

MR. DAKRI: Thank you.

MS. EBERLEY: Do you want to add anything?

MS. ZANCK: Good morning. My name is Charie Zanck. I'm with a bank in Northern Illinois.

One comment, one question. I agree with your comment relative to, by definition, community banks have a concentration just by geography. I also believe that that's exacerbated by CRA [the Community Reinvestment Act] and requirements in small business lending where we're being held to a standard of 73 percent of our total loans have to be made to businesses with revenues less than $1 million.

[10] See: "Commercial Real Estate Lending Joint Guidance," FDIC FIL-104-2006, December 12, 2006, https://www.fdic.gov/news/news/financial/2006/fil06104.html.

A very difficult threshold to meet, and in our case it's starting to manage our balance sheet. So, that is outdated. That $1 million threshold should be $5.5 million if adjusted for inflation.

I commented on that in an EGRPRA hearing. I'm reiterating because it still exists and it's a real challenge.

The question I have has to deal with technology and the core processors that most of the community banks deal with. There's generally five. It's an oligopoly. And the concern of our bank and other banks is that we do not have the money to invest in R&D in technology.

So we rely very heavily on other technology companies and the technology that our core processors bring to the table. Our core processor is working diligently to protect their oligopoly or their position, and they're not allowing new technology companies or products to be integrated to their core. This is a challenge.

Has there been any discussion about that in the regulatory arena? Because at some point that could really devastate the community banking sector and our ability to compete in a highly, vastly changing technology environment.

MS. EBERLEY: I'm not sure that we fully understand the question. We do regulate the technology service providers, the largest ones, the core ones particularly, on a joint, interagency basis. But I'm not—maybe you can tell a little bit more about what you mean by bringing in new technologies into that technology.

MS. ZANCK: The only way that we can compete in the technology world today with products, is if in fact our core processors will allow integration of other or new, innovative products to their core. And what they're doing is, the core processors are prohibiting that in many cases.

Is that a concern or something that the regulators have talked about? Or are you seeing it or are you hearing from banks that are complaining about it?

MS. EBERLEY: This is not something we've really heard about, so maybe we can talk a little bit at lunch and learn a little bit from you.

MS. ZANCK: It's just, it is a challenge, and it's something that we rely heavily on are these core processors. And if they don't keep up with new technology and changes that will allow us to offer current and modern products and services, we will not be able to compete. And that's a concern that we have. It's something evolving. There's a lot conversation around it right now.

MS. EBERLEY: Okay.

MS. GARUFIS: My name is Janet Garufis. I'm the President and CEO of Montecito Bank and Trust in Santa Barbara, California.

A follow-on to the question about the technology providers: I think, Jennifer, you were mentioning that you were looking for ways to more effectively supervise our technology vendors.

And one of the things that we've recently encountered, and I suspect many of the other people in this room who are negotiating or about to negotiate a contract with one of the major service providers, is that they are trying to shift the burden of responsibility for liability for their bad acts onto the backs of the banks who contract with them.

They're putting liability caps for their intentional misconduct, and all kinds of breaches of information that they may cause to happen.

In addition to that, patent violations that we would have no knowledge about, of services that they've used or in the patent trollers, they're trying to put all that liability on us as banks when we negotiate with them.

And because they all are unique out there—we only have four or five of them that we can contract with—they are all doing these kinds of activities in the contract negotiation. It makes it very, very difficult for us to come to agreement. I wonder if you have any comment on that.

MS. KELLY: Well, I understand that point you're making, and we've certainly heard this before. It gets tricky for us as regulators because they've said our authority comes under the Bank Service Company Act in terms of the services that they're providing to your institution that normally you could conduct on your own if you wanted to.

What you're talking about now are contract negotiations. And so we've certainly had conversations around it. It's just tricky how much we, as the regulators, can do.

I mentioned earlier when we were talking about shared services, one of the things that we had a lot of conversations with community banks about is ways that you can—because what we hear about is, you don't feel like you're dealing from a position of power in these negotiations. And are there ways for groups to come together and have more collective bargaining power.

So, it's definitely a conversation that we've had among the regulators. It's just where we can fit into this, and what you're going to have to do on your own or with the assistance of your trade associations.

MS. GARUFIS: Thank you.

MS. EBERLEY: I might just add that we do have guidance out on due diligence through the contracting process through our vendor management guidance. And it sounds like you're doing the right thing in terms of reading all the contract language and really paying attention and pushing back.

PARTICIPANT: You can actually push all you want.

MS. EBERLEY: Well, if there are no other questions, please join me in thanking our panelists.