

The Meeting of the Advisory Committee on Community Banking

of the

Federal Deposit Insurance Corporation

Held in the Board Room

Federal Deposit Insurance Corporation Building

Washington, D.C.

Open to Public Observation

November 4, 2011 8:38 - A.M.

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

The members of the Committee present at the meeting were: R. Daniel Blanton, President and Chief Executive Officer ("CEO"), Southeastern Bank Financial Corporation and Georgia Bank & Trust Company of Augusta, Augusta, Georgia; Charles G. Brown, III, Chairman and CEO, Insignia Bank, Sarasota, Florida; Deborah A. Cole, President and CEO, Citizens Savings Bank and Trust Company, Nashville, Tennessee; Craig M. Goodlock, Chairman and CEO, Farmers State Bank, Munith, Michigan; James H. Gray, Chairman, Beach Business Bank, Manhattan Beach, California; Jack E. Hopkins, President and CEO, CorTrust Bank, National Association, Sioux Falls, South Dakota; Timothy W. Koch, Professor and Chair, Finance Department, Moore School of Business, University of South Carolina, Columbia, South Carolina; John P. Lewis, President and CEO, Southern Arizona Community Bank, Tucson, Arizona; Jan A. Miller, President and CEO, Wainwright Bank & Trust Company, Boston, Massachusetts; Rebecca Romero Rainey, Chair and CEO, Centinel Bank, Taos, New Mexico; Bruce A. Schrieffer, President,

November 4, 2011

Bankers' Bank of Kansas, National Association, Wichita, Kansas; Laurie Stewart, President and CEO, Sound Community Bank, Seattle, Washington; and Ignacio Urrabazo, Jr., President, Commerce Bank, Laredo, Texas.

Dorothy J. Bridges, President and CEO, City First Bank of D.C., Washington, D.C. and Matthew Williams, Chairman and President, Gothenburg State Bank & Trust Company, Gothenburg, Nebraska, were absent from the meeting.

Members of the FDIC Board of Directors present at the meeting were: Martin J. Gruenberg, Acting Chairman, and Thomas J. Curry, Director (Appointive).

Corporation staff who attended the meeting included: Willa M. Allen, Valerie J. Best, Luke H. Brown, Kathleen S. Brueger, Kymberly K. Copa, Christine M. Davis, Patricia B. Devoti, Bret D. Edwards, Diane L. Ellis, Keith S. Ernst, Pamela J. Farwig, George French, Jeff Kopchik, Michael H. Krimminger, Alan W. Levy, Christopher Lucas, Roberta K. McInerney, Jonathan N. Miller, Rae-Ann Miller, Arthur J. Murton, Paul M. Nash, Christopher J. Newbury, Thomas E. Nixon, Jimmy Nguyen, Sylvia H. Plunkett, Carolyn D. Rebmann, Claude A. Rollin, Barbara A. Ryan, John V. Thomas, Sandra L. Thompson, Mindy West, James C. Watkins, and Katherine G. Wyatt.

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

Acting Chairman Gruenberg welcomed the Committee and observed that it was an extraordinarily effective vehicle for the FDIC to gain insight into the role and challenges faced by community banks. Noting that the Committee had an interesting agenda before it, he introduced Paul Nash, Deputy to the Acting Chairman for External Affairs, who moderated the day's meeting. Mr. Nash introduced the first panel, "FDIC Community Bank Initiatives" and the panelists: Barbara Ryan, Chief of Staff; Arthur Murton, Director, Division of Insurance and Research ("DIR"); Sylvia Plunkett, Senior Deputy Director, Division of Depositor and Consumer Protection ("DCP"); and James Watkins, Deputy Director, Division of Risk Management and Supervision ("RMS"). By way of introduction, Mr. Nash said that Acting Chairman Gruenberg had requested a study of community banking that involved several different projects, including a conference with community bankers, regional roundtables, research into community

banking history and their models, as well as an exploration into streamlining the supervisory process.

Ms. Ryan discussed the community banking conference, which would occur at the FDIC's Arlington, Virginia offices in the first quarter of 2012, and the regional roundtables, which would occur over the course of the year. She said that the FDIC's goal was to deepen its understanding of community banks and the current environment's challenges and opportunities. Among the topics to be addressed, Ms. Ryan said, would be how community banks have evolved, including differences in size, geographic footprint and business model. There would be discussions of raising capital, adapting to change, leveraging technology, dealing with resources and succession planning; there would also be input from community bank users, including consumers, small businesses, farmers and community development organizations. She said that the conference would also consider how community banks had weathered crises in order to identify lessons about the future of community banks.

Regarding the six regional roundtables, Ms. Ryan said that the Acting Chairman and FDIC senior executives would engage in a dialogue to explore more deeply the various issues facing community banks. Mr. Murton then generally described the community banking study. He said that, in addressing a basic question—"what is a community bank?"—FDIC staff would look at trends over the past 20 years, including the experiences of de novo banks, urban and rural banks, as well as exploring regional differences. The study would rely on Call Report data, the FDIC Summary of Deposits, a review of the economic literature, and consultation with experts. Some of the research would be presented at the spring 2012 conference. The FDIC also plans to publish resulting papers.

Ms. Plunkett described how DCP was reviewing its examination process for efficiency and transparency. She said that DCP was considering how it conducts examinations, as well as its informal and formal procedures to reduce burden. She noted that some examinations imposed different standards based on bank size and that the FDIC was looking for similar opportunities. Ms. Plunkett observed that many laws and regulations had changed recently and that, while the FDIC may not be able to change the law's content or deadlines, it could assist with compliance, including communicating about upcoming changes, clarifying procedures and explaining regulatory expectations. Mr. Watkins discussed similar risk management examination reviews and said that RMS was considering how it examined institutions of various sizes and levels of complexity. He added that the FDIC was considering how

to improve its communications with community banks including the use of more nationwide conference calls and training sessions.

Mr. Nash invited the Committee to provide comments about the general contours of the FDIC initiative. Members Blanton, Brown and Cole addressed the question of defining community banks and how they might be measured and described; they observed that characteristics of community banks include: the great diversity of their charter types; the different population densities of the communities where they operate; and, the different business models they pursue. Members Cole and Blanton discussed whether there was an optimal community bank size, and whether there was a minimum size to be able to comply with the regulatory requirements. Acting Chairman Gruenberg noted that many banks for which the FDIC was the primary federal supervisor were small and were concerned about their viability. He said that a key issue was to identify issues challenging them and if there were supervisory steps the FDIC could take to respond.

Member Urrabazo observed that community banks serve divergent communities, noting that his community was 97 percent Hispanic; banks in such communities served different credit needs and that understanding the community was to understand the bank. He suggested that the FDIC consider holding the conference after the roundtables and to use the initiative to promote community banking. Member Cole agreed that it was important to consider what a bank means to the community that it served and added that the FDIC should ensure that community bank concerns were communicated to its regional offices. Member Stewart observed that community banks were themselves small businesses that faced the same challenges as other small businesses and that viewpoint might help guide the FDIC's research. Member Goodlock added that, although community banks operated in a regulated environment, they remained independent businesses providing a return on investment to their investors. He cautioned that the FDIC's research could try to identify successful models, but that it was up to a bank's leadership to make the business decisions.

Member Gray said that community banks could benefit from the research into models that had worked in other situations because a banker can become so involved in their own business plan that they overlook others. He added that information about models that had not worked would also be important. Mr. Murton agreed that the FDIC's intent was to be descriptive, not prescriptive; he inquired about what other success measures would be useful to explore. Member Brown said that a bank's ownership characteristics would be revealing, for example, whether a bank was family-owned or if a

majority of its shareholders resided in the community. He cautioned the FDIC should avoid prescribing banking models that it preferred.

Member Koch identified additional subjects the FDIC researchers might consider, the first being a survey in which bankers estimated their costs of regulatory compliance. Mr. Murton said that the FDIC had considered conducting a survey, either using examiners, or a broader survey. Members Cole and Goodlock opined that a survey separate from examinations would be better while Member Schrieffer indicated that making the survey almost a part of an examination could be effective. Members Gray, Blanton and Goodlock cautioned against surveying too early because many regulations were unfinished and accurately estimating compliance costs would be difficult. Member Urrabazo said that many regulatory compliance costs are hidden or indirect in that they are included in lawyer, consultant or auditor fees. He and Member Hopkins indicated that it would be important for FDIC researchers to focus on a bank's lines of business in comparing banks because different lines have different business and regulatory characteristics.

Member Lewis expressed a concern about the viability of family-owned and other banks that have limited access to capital and whose borrowers are running out of liquidity. Member Rainey said that she greatly preferred to hear about upcoming regulatory and examination trends from the regulators themselves, rather than from consultants. In an exchange with Acting Chairman Gruenberg, she described a process of dialogue between the FDIC Dallas Regional Office outside of the examination cycle in which her bank is able to pose questions and hear directly from the regional office about its current concerns. Member Rainey said that the dialogue was a great resource to her bank and suggested that similar dialogues could be done through broader conference calls on specific banking subjects. Member Gray agreed that it was helpful for regulators to make banks aware of problems that the regulator was seeing—in advance of an examination—so that banks could consider if their internal focus was appropriate to the problems; he noted that, historically, banks had been surprised about the current "hot button" examination issues.

The Committee discussed the research aspect of the community banking initiative. Member Stewart observed that the FDIC has access to broad level data that individual banks do not have, as well as time to analyze the data. She said that the community banking sector could benefit greatly if the FDIC reviewed the data from the recent crisis and identified bank activities that

consistently did not work, or, alternately, produced strong results. Member Koch agreed that the FDIC's study could be productive because of the FDIC's data resources and suggested other subjects for consideration, including: the relationship between the makeup of a bank's board of directors and the bank's risk management practices; the link between compensation practices, incentive compensation and risk taking conduct; and the validity of claims that certain practices led to losses and troubled banks (such as out-of-market lending and loan participations). Member Urrabazo suggested that another subject the FDIC might consider was the relationship between new capital requirements and their effect on banks raising capital. Member Brown also observed that regulators should focus on return on equity ("ROE") because it affects access to capital. Members Blanton, Goodlock, and Gray discussed whether community bank shareholders, who have close ties to their community, may have different return expectations.

Ms. Ryan invited the Committee's recommendations about the regional roundtable discussions. There was general agreement that the regional sessions should be structured to avoid their becoming forums for unfocused complaints. Members Blanton and Brown suggested that breaking the regional meetings into two parts could work well. The first part of the meeting might involve an information exchange between regulators and bankers and limited to fewer participants, perhaps identified by the state banker's association. The second part of the meeting could be open to all, in which information from the first session, and other sources, could be communicated to a broader audience. Member Brown said that the FDIC's Atlanta Regional Office had participated in such a meeting, which was very productive; about 50 people attended the first meeting and about 300 attended the second. Mr. Nash said that whether the regional meetings would be open to the media was an open question. Members Koch and Brown observed that the meetings that they described had not been open to the media.

Member Urrabazo recommended that all community bankers have an opportunity to participate in some manner and suggested involving the state banking associations. Member Cole agreed the state associations could be important to help identify important discussion ideas and in communicating to a larger group. Director Curry observed that FDIC already has small-scale regional outreach sessions with 20-30 bankers and that the FDIC could explore ways to include those meetings' results into the regional roundtables. In determining the size of the meetings, Member Stewart suggested that the FDIC be guided by the goals it wanted to achieve in the regional meetings—whether it was to elicit specific information

from bankers, to communicate information out to bankers, or a combination. She said that a small group would encourage a candid, meaningful dialogue, while a large group would be more effective as a "tell and sell" approach. Member Rainey agreed and thought that both goals could be accomplished in one meeting.

In response to Member Schriefer's inquiry about the FDIC's view of the regional meetings' purpose, Ms. Ryan said that a goal was to elicit banker input, another was the "reporting out" at the end of the process. She added that a dialogue between bankers and Washington was key. Member Blanton suggested that holding the national conference after the FDIC had gathered information in the regional meetings might be effective. Ms. Ryan said that the FDIC was considering how to share the regional roundtable results; one option was a second conference after the roundtables or to present the results in conjunction with a Community Banking Advisory Committee meeting. Director Curry suggested that the project might involve a year of gathering information and a second year of reporting out the findings. He added that the FDIC's research should not overlook mutually-owned institutions, which have a distinct corporate organization form, are clearly tied to their communities, and whose capital limitations can reduce their risk appetite. Director Curry agreed with observations that the result of the FDIC's research should not be to identify an optimal form or corporate organization; as had been done in the past.

Mr. Nash then introduced the second panel, titled "Community Banking by the Numbers," and its panelists, Christopher J. Newbury, Associate Director, DIR, Diane Ellis, Deputy Director, DIR, and Keith Ernst, Associate Director, DCP, who further discussed the specifics of the FDIC research project. Mr. Newbury began by reviewing a handout of six charts that provided historical trend information about community banking. The first subject Mr. Newbury discussed was the decline in the number of insured institutions since 1985, especially in the number of institutions with assets below \$100 million. He observed that, in 1985, one might have considered a community bank to be one with assets of \$250 million or less, and that, for various reasons, one might now consider a community bank to have assets up to \$1 billion. Turning to a second chart, Mr. Newbury discussed sources of the net change in community banks from 1985 to 2010 (defining community banks as those with less than \$250 million in assets in 1985 and under \$1 billion in 2010). There were, he said, about 16,000 community banks in 1985 and about 9,200 fewer in 2010. Of the 16,000 in 1985, about one-third of them continued to operate independently with assets less than \$1 billion today. Mr. Newbury addressed why the other two-thirds of 1985 community banks would

not be considered independent community banks in 2010: about 260 had grown to have assets of more than \$1 billion; about 130 had closed voluntarily, about 1,900 had failed, about 3,900 had engaged in intra-company consolidations (and thus had stopped having independent charters); and about 4,800 had been purchased by an unrelated bank and merged into it.

Mr. Newbury then discussed five different time periods, noting that intra-company mergers, voluntary mergers, and failures had all been more prevalent at the beginning of the period, from 1986 to 1990, and that the percentage reductions in numbers had steadily declined over time. Discussing a fourth chart, Mr. Newbury observed that banks with assets under \$250 million at year-end 1985 had failed with less frequency than larger institutions over the succeeding 25 years; he added that the highest failure rate had been among banks in the \$1 to \$10 billion asset category. He said that one conclusion that could be drawn from the charts was that community banks were not going away faster than mid-sized banks, but that the trend was merely more visible among community banks because there were more of them in absolute numbers at the beginning.

Ms. Ellis reviewed the questions which would guide the FDIC's research. The first issue to be addressed, she said, was how to define a community bank, noting that the FDIC would not limit itself to size thresholds, but would also consider factors such as funding strategy, lending strategy and ownership structure. Another question that would be addressed was how community banks had changed over time. A third question would be where community banks are located and why, including such issues as rural depopulation and how it affects banking. Ms. Ellis said that the fourth issue would be the different types of business models used by community banks, including comparing them through time and comparing business models of small and large institutions. Mr. Ernst described the fifth question as an examination of the different products and services that community banks offer and how they compare to those of larger banks. The sixth question, he said, would consider whether community banks tended to serve sets of customers that are distinct from those served by larger banks. Ms. Ellis continued, indicating that the study would also explore how to measure the performance of community banks, noting that the FDIC would look beyond the measure of Return on Assets and ROE. Another question to be examined, she said, was whether and how local communities benefit from having a strong community banking presence in their area. Four other issues that would be considered included: developing a model that predicts the characteristics of successful community banks; looking at the cost

and revenue structure of successful community banks compared to larger banks; considering the ability of community banks to raise and deploy capital; and looking at the "lessons learned" from the current economic crisis. Ms. Ellis added that the study would also review how technology affected the performance of community banks, and, finally, how trends in the economy (in particular, the small business economy) affected community banks. Ms. Ellis said that the FDIC had data from Call Reports and other internal sources, but added that researchers would be looking for additional data, possibly including a community bankers' survey.

Ms. Ellis invited feedback and additional areas of inquiry. Regarding the definition of a community bank, Member Blanton said that the primary issue was whether the majority of shareholders were from the community and if the important decisions were made by people who live and work there. In response to a question from Mr. Nash about a relationship between out-of-market lending and banks becoming troubled, Member Blanton said that there had been some participations and out-of-market lending where community banks could not find enough loan demand in their local market; he added that the business model of a community bank was less totally focused on return so that they were not forced into alternative lending methods beyond their expertise. Member Hopkins said that he was concerned about the high failure rate of community banks between 1985 and 2010 and inquired whether the FDIC's research would identify common factors among the failed banks, for example, if they were de novo banks or had ownership changes.

Member Goodlock said that he would be interested to see how the broader economy related to bank failures or whether failures were caused more by internal bank issues. Member Koch observed that he saw a relationship between de novo banks that failed and fast-growing economic markets, which have different attributes than other markets; he added that de novos were often started with the intent of "flipping" them. Member Koch, who had earlier remarked that community banks were "relationship" banks, not merely lenders, commented that the FDIC's research should examine employee turnover, indicating that community banks would have lower turnover for comparable positions. Member Blanton observed that community bank stock had traditionally been viewed as an income investment but, in the last 20 years, had been viewed as an "equity play," which led to excessive chartering with the purpose of "flipping" the investment. He indicated that this led to an excess of community banks created for the wrong business purpose; he indicated that the industry was again viewing community banking stock as an income investment.

Regarding whether community banks provided unique products or services, Member Brown said that competitors could easily duplicate new products so that products are not likely to be special for long. Regarding the FDIC's research into identifying successful community banking models, he recommended reviewing various banking periodicals which often report on such topics. Member Stewart inquired whether the FDIC's research would support the existence of a correlation between extremely strong performance for a short time and subsequent failure, indicating such banks' excessive focus on short-term results. Member Urrabazo suggested that the research would support a conclusion that, when banks faced higher regulatory and other costs and simultaneous loss of income sources (such as interchange and overdraft fees), they resorted to riskier lending practices and became vulnerable to economic downturns. Member Lewis inquired whether the FDIC tracked why community banks migrated from being highly rated to becoming troubled. Ms. Ellis reported that the FDIC—as part of modeling losses for the Deposit Insurance Fund ("DIF")—continually reviewed migration trends, failure rates and their causes. Mr. Nash and Member Brown noted that the FDIC Inspector General published informative Material Loss Reviews that examined the causes of bank failures. Director Curry suggested that it would be useful to consider how FDIC supervisory personnel try to rehabilitate a troubled institution as well as to determine the reasons for an ultimate failure.

The Committee members discussed a variety of community bank advantages and disadvantages compared to their competitors, as well as the effects of the economic environment. Member Schriefer observed that some community bank competitors, such as credit unions and the Farm Credit Service, had the advantage of being tax-free. He said that community banks were thus encouraged to leave those business areas and were left with riskier lending opportunities; he suggested that these issues should be part of the research agenda. Member Stewart suggested that the research consider the consolidation occurring in other industries to help provide context and perspective for banking consolidation. Mr. Newbury agreed that it would be useful to examine how the small business economy and community banking interact. Members Blanton and Brown observed that new small businesses were being created as others declined and that they presented new lending possibilities.

Member Gray suggested that community banks may not provide services unique from large banks, but that they provide a consistently higher service level. Member Blanton observed that a community bank's greater knowledge of its community helped it better manage its business, but also said that being limited to a

single community increased risk if the community declined. Member Koch agreed that service levels brought customers to community banks, but cautioned that, if a product can be "credit-scored," larger banks would be able to undercut prices. Member Koch asked why community banks lost attractive customers and suggested that it was often because the needs of a small-business outgrew the bank's capabilities. Member Hopkins suggested that pricing was often the reason customers left; larger banks avoided a riskier start-up client, but undercut prices after it showed less risk. Member Gray posited that a community bank's personal service and the continuity of its relationship with a small-but-growing business made it harder for larger banks to take their business. Member Stewart cautioned against focusing strictly on a small-business banking model. She suggested that the research also consider consumer focused banking models and asking why community banks fail to attract or lose consumer clients.

Members Gray, Blanton and Stewart discussed technology issues in response to a question from Mr. Nash, observing that community banks often offer new technologies because customers demand them and are disinclined to go to a bank branch. Member Schriefer said that there was risk that banks invest in new technologies but fail to invest in the risk-management needs connected to the new technologies. Member Cole observed that her bank had recently made a substantial investment in new technology because the market required it; she said that the investment had increased efficiency but that the bank had to work to minimize the risks associated with it.

Acting Chairman Gruenberg inquired about recruiting capable staff to community banks, especially in rural areas, and how that interacted with other issues that had been discussed. Member Blanton observed that it was difficult to attract qualified compliance staff to small communities and that possible responses included outsourcing the work, or for banks in an area to share compliance staff and expenses. Member Urrabazo observed that hiring consultants was expensive and indicated that community banks usually trained personnel in-house. Member Gray opined that the challenge of recruiting qualified staff was greater in rural areas than in more urban ones.

The Committee stood in recess at 10:32 a.m. and reconvened at 10:49 a.m. that same day.

Mr. Nash introduced the next topic, "Mobile Financial Services," and Jonathan Miller, Deputy Director, DCP, and Jeff Kopchik, Senior Policy Analyst, RMS. Mr. Miller said that mobile

financial services could be divided into three groups—mobile banking, mobile payments, and mobile commerce—and that he would focus on the first. He described characteristics of U.S. mobile telephone users: about 90 percent of adults owned a mobile telephone, and about 35 percent owned a "smartphone;" low-income households owned smartphones at the same rate as the national average; racial and ethnic minorities are more likely to own smartphones than non-minorities (44 percent of African-Americans and Hispanics compared to 30 percent of Caucasian Americans). In addition, non-FDIC research has reported that ethnic minorities engaged in mobile banking more than Caucasians (46 percent of African-Americans, 37 percent of Hispanics, and 24 percent of Caucasians). Concerning under-banked consumers, Mr. Miller said that they were much less likely to have a high-speed computer connection in their home but were more likely to use mobile banking; this supported the hypothesis, he said, that under-banked consumers were substituting mobile banking for a home computer based form of banking.

Mr. Miller observed that non-banking businesses, such as telecommunications companies, may be attracted to being mobile payments intermediaries and inquired how much of a challenge that would be to the traditional banking model. He discussed the results of a 2011 community bank survey about mobile banking, which found that: 47 percent of community banks planned to offer mobile payments services before 2013 (up from 14 percent in 2011); and 21 percent planned to offer remote deposit capture. Mr. Miller said that remote deposit capture may offer a way for banks to create traditional bank customers out of people who previously used check-cashing businesses. Finally, he noted that mobile banking could result in lower costs; for example, citing outsider research, a typical branch transaction cost \$4, a call center transaction cost \$3.75, and an ATM transaction cost \$.85, while a mobile transaction cost \$.80.

Mr. Kopchik addressed risk-management aspects of mobile banking; observing that mobile banking and mobile payments had different characteristics. Mobile banking, he said, was a more mature service that was used to retain customers and reduce expenses but was less likely to be a big revenue producer. Mr. Kopchik said that, for banks to be involved in mobile banking, they had to engage customers in all three channels: text-based mobile banking; internet-based mobile banking, which relied on a smartphone's web-browser; and application-based mobile banking which required a customer to download an application onto their smartphone. Mr. Kopchik observed that each of the mobile banking channels presented unique risks, and that RMS had worked to

identify and categorize those risks and to explore ways to mitigate them. One risk in mobile banking is the involvement of non-banking businesses (such as telecommunications service providers, handset manufacturers, and mobile applications developers) with whom banks had not traditionally interacted. Mr. Kopchik said that there was a tension between banks quickly bringing mobile banking services to the public and engaging in appropriate due diligence for risks to banks and consumers. For example, he said, a risk in the fast-growing area of application-based banking was that consumers would download to their smartphone an application that was really "malware," designed to do harm or legitimate applications that do not adequately protect sensitive customer information.

Mobile payments are much less developed, Mr. Kopchik said. One type was "proximity mobile payments," in which a smartphone is waved over a retailer's point-of-sale terminal and substitutes for a credit card. Another type was "remote mobile payments," in which two smartphones interact to allow an exchange of value from one account to another. Regarding proximity mobile payments, Mr. Kopchik said that there was a lack of infrastructure in place for them. Mr. Kopchik said that the current credit card system worked reasonably well, and inquired whether proximity based mobile payment systems might be a "solution looking for a problem." Mr. Kopchik also spoke about the possibility of "disintermediation," where mobile payment systems are developed without the inclusion of financial services firms at all. He inquired whether the banking industry viewed disintermediation as a serious issue and, if so, how it might respond.

Member Blanton observed that U.S. credit card technology had not adopted the European chip technology and said that embedding a chip into a smartphone was a natural evolution, and consistent with the younger generation. He provided an example of a business switching its payroll system to prepaid debit cards instead of paper checks, and said that this approach would be helpful for the needs of that workforce. Members Blanton and Goodlock discussed the issue of whether a bank or non-bank held the money balance in prepaid debit card accounts. Member Goodlock said that, if the balances were held outside of banks, that disintermediation of banks from the payment system was already occurring; he added that prepaid debit cards were a consumer-driven product more than a bank-driven product. Member Stewart said that banks had been complacent and thought that they controlled the payment system when they may not. She discussed volunteer work she did with low-income families and observed that, while few had landline telephones or bank accounts, most had mobile telephones and used

prepaid debit cards; she said that, if community banks wanted them as customers, then the banks would have to incorporate the use of mobile telephones and alternate payment system technologies.

Member Urrabazo said that his bank had success in providing hands-on instruction to underbanked customers who had been reluctant to use technologies that his bank offered, such as ATMs and debit cards. Once the instruction was given, he said, the customers found the technologies easy to use; he added that such underbanked customers were a large potential market for community banks. Members Schrieffer and Miller expressed concern about the loss of personal information to non-bank providers, such as Google, who used the information for other business purposes. After discussing with Member Blanton how some people appeared unable to safely handle bank accounts, Member Goodlock inquired whether it was good policy for most Americans to have standard checking accounts. Member Stewart responded that she thought that a banking relationship was different than just a traditional banking account, and that community banks would have more to risk by failing to adopt new technologies than by adopting them. Mr. Kopchik inquired whether some disintermediation of banks occurred because banks and other businesses, such as wireless telecommunications providers, traditionally had little interface. Member Stewart observed that it would be difficult for a community bank to get the attention of a telecommunications company.

Mr. Nash inquired if Members' banks offered mobile banking. Member Brown said that his bank had invested substantial resources to offering remote deposit capture for small businesses and mitigating the risks involved; he added that mobile banking also raised the issue of costs, especially at smaller banks. He added that, although mobile banking was increasing, he did not perceive that his bank was losing customers because it did not offer it. Member Brown noted that younger people may be more attracted to a mobile banking application than to using a bank's branch. Member Blanton indicated that bankers who focused on traditional banking concerns, for example, obtaining signature cards, may not be able to successfully adapt to mobile banking issues. Member Goodlock indicated that consumers may not share the risk-focused paradigm under which banks and regulators operated. He said that consumers may adopt mobile banking systems that have less focus on risk mitigation than banks can offer, thus causing banks to lose more control over payments systems.

In response to a question from Mr. Nash, Mr. Kopchik said that the FDIC had assembled some information to alert examiners about possible mobile banking risk issues. Member Rainey said

that it would be helpful if the FDIC would share such resources so that bankers could be alerted to those risks; Acting Chairman Gruenberg said that the FDIC would try to compile useful information for distribution. Mr. Kopchik said that the FDIC had been alarmed at recent reports that there had been a 400 percent increase in mobile banking malware in 2011. He said that most of the malware had been obtained in a marketplace for mobile applications that appeared to be trustworthy but was not well-regulated; he advised that consumers should download applications only from their bank's website. Member Urrabazo said that, in his bank's experience, most frauds were originating at third parties and that relatively few problems had originated on the bank's website or in its mobile banking area.

Mr. Nash introduced George French, Deputy Director, RMS and Mindy West, Acting Associate Director, RMS, to lead the discussion of "Supervisory Issues: Capital and Concentration Risk." Mr. French began by observing that a fundamental shift was occurring in the area of regulatory capital. In the past, he said, the largest banks had operated with the lowest capital levels because of their size and perceived diversification, and within the last ten years, regulations would have allowed the largest banks to have lower minimum capital requirements. In the wake of the recent crisis, however, he said the largest banks would have to meet higher minimum capital requirements and the historical capital level gap between large and small banks could be expected to dramatically narrow. Among the reasons, Mr. French said, were the "Collins Amendment" to the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") which requires that the capital requirements applied to community banks act as the floor for the capital requirements applicable to bank holding companies and large, internationally active banks. A second reason, he said, was Section 165 of the Dodd-Frank Act, which requires bank-holding companies with assets of \$50 billion to maintain higher capital. Mr. French said that a third reason was the more detailed requirements of "Basel III" which aims to control systemic risk by requiring large banks to hold enough capital to address the risks they pose to the economy. A fourth reason, he said, was the capital surcharge applied to "systemically important financial institutions," that would range from 1 to 2.5 percent of risk-weighted assets. These reasons, as well as additional Federal Reserve requirements concerning stress-testing and capital planning, Mr. French said, were creating a fundamental shift in favor of community banks. Although the Basel III requirements would not be a "non-event" for community banks, he said, the FDIC's analysis, for the most part, indicated that community banks were already in compliance with those standards.

Ms. West spoke about concentration of risks, noting that if they were not properly managed, they could put capital at risk. She said that, during the recent crisis, the FDIC saw that many banks with concentrated commercial real estate ("CRE") portfolios had been at higher risk of failure than less concentrated ones. She inquired about the tools that Committee members used for managing concentration risks, and in particular whether they used some form of stress testing. In response to a question from Member Koch, Ms. West and Mr. French discussed the 2006 joint agency guidance regarding when CRE concentrations existed and the heightened risk management practices banks should take to respond.

Member Blanton observed that most bankers had a good understanding of concentration risk given the recent focus on it, but said that memories could lapse when the economy recovered. Member Schriefer observed that many banks in agricultural communities had a de facto agricultural lending concentration but appeared to be managing the risk reasonably well. Ms. West indicated that concentrations were not inherently bad; the key was how a bank managed its concentration.

Member Brown expressed concern that regulators would expect community banks to engage in stress-testing despite earlier agency statements that it would not be required; his impression of stress-testing models was that they were flawed and unnecessarily negative. Mr. French observed that stress-testing was an important subject among regulators because the Dodd-Frank Act required it for banks with over \$10 billion in assets but that he did not think that those requirements would trickle down to community banks. However, he said, supervisory expectations were expressed in the 2006 CRE guidance (and in a 2001 guidance on subprime lending) which indicated that banks with high concentrations should stress-test their portfolios to determine how the concentrations would behave in bad economic conditions. Mr. French observed that community banks may be unclear whether they were concentrated or how to conduct a stress-test and inquired if additional examples or definitions would be helpful; he noted that it was important that a stress-test be relatively simple to perform and that it provide value for a concentrated bank. Members Brown and Urrabazo indicated that vendor-supplied stress tests may not be accurate or useful without expensive customization. Mr. French agreed that regulators did not want to impose complex, numbers-driven exercises that added no value, but said that, if a bank is highly concentrated, it needed to consider the effects of a difficult economic environment.

Members Urrabazo and Brown observed that community banks had relatively few areas in which to diversify their lending because they could no longer compete on consumer loans, automobile loans and because residential real estate lending was handled as pass-throughs. Member Brown added that commercial and industrial loans were currently experiencing rapid default and loss rates. He cautioned against encouraging banks to, in effect, switch from one area of concentration (such as CRE) to another. Member Blanton observed that his bank did a risk underwriting at annual reviews of its customers by business lines; he said that that underwriting was, in effect, stress-testing. Members Urrabazo and Gray recommended distinguishing between owner-occupied CRE and more speculative investor CRE which presented different risk profiles if real estate values declined. Member Stewart indicated that thrifts faced a similar distinction in their residential real estate lending between borrower and non-borrower occupied homes. She added that most thrifts managed their residential mortgage concentration risks more by managing the underwriting risks than through stress testing. Ms. West agreed that lenders who live in the communities where they lend engage in ongoing stress testing by knowing and being in their communities.

Mr. Nash said that the FDIC often heard that the Basel III or Dodd-Frank Act requirements would have an adverse effect on community banks and invited members to share concerns in that area. Member Hopkins said that he was troubled about the Basel III limitations on mortgage servicing rights as a percentage of capital. He said that a smaller bank had to achieve a certain volume of mortgage servicing in order for it to be viable but that, if the bank had limited access to capital, it might be forced out of mortgage servicing, thus leaving the business to big servicers who did not perform the work as well. Members Stewart and Brown agreed that the capital limitations could be a factor for community banks or thrifts in determining whether to engage in mortgage servicing. Members Hopkins and Stewart added that the new mortgage servicing requirements would impose a standardization that could also discourage community banks from engaging in that business. Member Stewart observed that, if community banks did not service mortgages that they originated, they would lose another connection with a potential client for other business. She recommended that regulators reconsider both the mortgage servicing capital limitations and the mortgage servicing standards for their impact on community banks. Member Schrieffer expressed a concern that regulators were developing an expectation that a bank would have a senior "risk officer" rather than allowing the bank to handle risk functions based on the bank's circumstances. Ms. West said that there was no requirement for a separate risk

officer; regulators recognized that there was an issue of proportionality involved so that a smaller institution could manage risk in a way appropriate to it.

Mr. Nash and Deputy General Counsel Roberta McInerney then moderated a panel titled "Legislative and Regulatory Update." Mr. Nash said that there would likely be light legislative action in Congress in 2012; Congress would continue to oversee the agencies implementation of the Dodd-Frank Act but that the election year may result in fewer proposals being enacted. Ms. McInerney provided an overview of the FDIC regulation drafting process with a focus on Dodd-Frank Act initiatives. She noted that many regulations are required by statute. For example, three important FDIC regulations were required by the Dodd-Frank Act: the "Volcker" rule; the credit risk retention rule; and the incentive based compensation rule. Rules can also be prompted by industry clarification requests or because the FDIC identifies a need. Ms. McInerney emphasized that FDIC leadership and staff are attuned to the effect of regulations on banks, especially community banks, and try to minimize burdens; she also emphasized the importance of public and industry involvement in rule development.

Ms. McInerney said that the FDIC often uses interdivisional teams to draft rules, with one division being given the lead for a rule and receiving support from others. The teams gather information through various types of research, including conducting studies and meeting with experts in the affected fields; for example, in preparing for the incentive based compensation rule, FDIC staff met with compensation specialists from around the country. While drafting proposals, the interdivisional or interagency teams meet as often as necessary, typically once a week, but occasionally every day, and share their work product with other divisions, FDIC leadership, and other agencies where appropriate. For some regulations, such as the Volcker rule, the Financial Stability Oversight Council ("FSOC") has a consultative role; Ms. McInerney noted that the FSOC, which includes three non-voting state banking and insurance regulators as well as a variety of federal financial regulators, provided a helpful perspective that was not always formally included in the past. She said that the drafting process involves considerable give and take, including research into costs and benefits and a search for alternative ways to achieve goals more efficiently. The members of the FDIC Board of Directors are briefed on and provide input into a rule's contents, and the Board formally votes on the proposed rule before it is published for public comment. Ms. McInerney said that public comment was very important—she noted that the risk retention rule received about 11,000 comments.

Staff analyzes comments and considers how the regulation could be redrafted or reframed to respond to them; staff then briefs the FDIC leadership, who may consult with other agency leaders.

In response to a question from Member Urrabazo, Ms. McInerney and Acting Chairman Gruenberg discussed the progress that the FDIC had made on the 44 regulations that it was involved in drafting pursuant to the Dodd-Frank Act. Acting Chairman Gruenberg said that all 18 of the rules for which FDIC had sole responsibility were essentially complete and being implemented, these included: increasing deposit insurance coverage to \$250,000; changing the deposit insurance assessment base from a deposit focus to an asset focus; and the rules which apply to systemically important financial institutions. Regarding the change to an asset based assessment for deposit insurance, he noted that many community banks would experience a 30 percent reduction in their premiums as a result of the rule. Ms. McInerney noted that the agencies were making good progress on joint agency rules and that essentially all the statutory deadlines had been met. In response to a question from Member Stewart, she noted that there were limited statutory penalties for missing a deadline but that agency staffs nonetheless took the deadlines very seriously. Acting Chairman Gruenberg added that his periodic testimony before Congress (and those of other agency leaders) tended to act as an enforcement mechanism for agencies to meet their deadlines.

Member Urrabazo observed that it was difficult for community banks to digest long and complex rules to determine whether the rule, such as the Volcker rule, applied to them. He added that a further problem was that, although a rule appeared not to apply to a community bank when it was written, later interpretations tended to impose requirements on community banks. Member Urrabazo said that bankers often relied on the American Bankers Association or state industry groups to assist in interpreting the regulations; he encouraged the FDIC to provide clear guidance on a rule's applicability to community banks. Ms. McInerney noted that the FDIC had begun providing such guidance on Financial Institution Letters ("FIL") that distributed new rules to banks and also indicated that FDIC staff was available to answer bank questions about rules. Ms. McInerney also said that the FDIC tried to provide "bright line" guidance about when a rule would or would not apply to a bank. In response to a question from Member Koch, Ms. McInerney and Acting Chairman Gruenberg discussed the application of section 23A of the Federal Reserve Act regarding limitations on the transfer of assets from an affiliate to an insured institution. They noted that, if the transfer exceeded a ten percent of capital limit, the Federal Reserve's practice had

been to consult with the FDIC; pursuant to the Dodd-Frank Act, such consultations would be required beginning July 21, 2012.

The Committee stood in recess at 12:23 p.m. and reconvened at 1:53 p.m. that same day.

Mr. Nash reintroduced Sylvia Plunkett and James Watkins who lead the discussion regarding "Gaining Efficiencies in the Examination Process." Ms. Plunkett noted that the FDIC used a "scoping" process to differentiate community banks from larger, more complex banks and that examiners were required to perform a risk profile of each bank to identify what its risks were. Ms. Plunkett said that a bank's examination should respond to the products and services that the bank offered. She also said that the FDIC would try to improve its communications to banks about what would be expected in future examinations. Mr. Watkins said that RMS had recently asked its examiners and supervisors to try to identify areas that could be streamlined.

Mr. Watkins agreed with earlier comments that the FDIC could: provide better communications about its initial risk assessments; clarify some of its guidance, especially in technical or accounting areas; and provide the industry with quicker feedback on developing examination issues. Mr. Watkins discussed FDIC practices regarding banks facing difficulties; he noted that relatively minor problems could be addressed by an examiner asking a bank's board of directors to review an issue and provide a written response about it; in more serious cases, the FDIC might enter into an informal agreement with the bank; and, if there were quite pronounced problems, the FDIC might pursue a formal action such as a consent order. He noted that, in most cases, a bank's problems are successfully resolved. Mr. Watkins said that the FDIC aimed to be as responsive to a bank's improvements as to its problems; thus, if a bank was recapitalized or improved its financial standing, the FDIC would try to provide timely and appropriate upgrades and release the institution from constraints that might have been imposed.

Member Lewis said that his bank had recently experienced a relatively complex merger and that an examiner had become familiar with the bank's circumstances during the FDIC's review. He said that it would be time-saving if the same examiner who was familiar with his bank was assigned to the next examination. Mr. Watkins agreed and noted that, because the FDIC has 86 field offices, many examiners are already familiar with the economic circumstances of a bank's community. Member Brown made two observations about a bank's pre-examination submission of information to the FDIC.

First, he said that it recently appeared that examiners had not fully reviewed the information off-site before arriving at the bank; he said that since the bank had limited space to accommodate examiners, more offsite review would increase an examination's efficiency. Second, he noted that an FDIC request for information can occur as long as 90 days before the examination; he said that, with such a long lead time, it was possible that policies or procedures would be stale by the time the onsite examination began. Member Brown added that he thought that the offsite review of bank information was generally a good process.

Member Blanton said that the contact between examiners and the bank to clarify the pre-examination information helped create a rapport between the parties before the onsite examination began. He contrasted such a situation with one in which the examiners had not made contact with the bank before coming onsite; in that case, he said, the examiners had experienced a technical difficulty obtaining information that could have been addressed by the bank in the pre-onsite period. Member Urrabazo added that examiners do not always acknowledge the receipt of the information that they requested or if the information provided fulfilled their needs. He also inquired about FDIC time guidelines for the FDIC to respond to information that it had received and for completing examination reports. Mr. Watkins said that there were statutory deadlines for acting on various applications but not on completing an examination. He and Ms. Plunkett agreed that it was a good practice for examiners to acknowledge receipt of information and its adequacy.

Ms. Plunkett had earlier inquired about the effectiveness of the FDIC's communications to banks about new and important subjects, in particular, whether FILs were useful. Member Rainey complimented the use of the Frequently Asked Questions ("FAQ") format in describing supervisory expectations about overdraft payment programs, which she found very helpful because it provided sufficient detail and was in an accessible presentation. She and Ms. Plunkett noted that the FAQs followed a nationwide call-in between the FDIC and bankers which helped identify the areas that would benefit from further clarification. Member Rainey also suggested that, when new areas of supervisory concern develop--such as the mobile banking issues raised earlier in the meeting--that the FDIC share its observations with bankers, as well as examiners, so that banks are not surprised in examinations.

The Committee also discussed the timeliness of examination reports. Member Blanton observed that in Georgia, where the presence of more troubled banks results in more frequent

examinations, a bank may face a new exam before it has received the previous report. Member Urrabazo noted that a bank may not know what direction it needs to pursue if a problem was identified but the report has not been issued. Member Hopkins, whose bank is supervised by the OCC, questioned whether the FDIC and OCC operated under different philosophies. He said that OCC findings are reviewed and virtually agreed upon before their examiners leave the bank; he likened that relationship to what his bank had with its auditors--problems, resolutions, and the bank's commitment to fix the problems all occurred at one time. Member Hopkins said that his bank generally received its examination report within three weeks and that his bank had quarterly communications with its examiner-in-charge which helped identify and resolve problems quickly.

Mr. Nash and Mr. Watkins said that the timeliness of examination reports was an issue that was being addressed. Mr. Watkins observed that untimely reports were less helpful than timely ones; he said that many regions issue their reports within 60 to 90 days, but that there were exceptions. He noted that FDIC field offices could issue reports for banks with a certain risk level and that larger banks, or those with higher risk levels, were also reviewed at regional offices. Mr. Watkins noted that the examination process usually involved a closeout meeting in which the examiner would meet with the executives of the bank and provide preliminary findings and ratings. Member Brown observed that his bank had experienced long delays a couple years before but that its most recent examination report was promptly received. About exit interviews, he added that examiners often provided complimentary remarks about the bank's progress on various issues but said that those positive remarks "never" made it into the written reports; he said that his board of directors had commented on the written reports' more negative tone.

Member Brown and Mr. Watkins also discussed the need for the FDIC to provide clarification about the proper accounting treatment for troubled debt restructuring ("TDR"). Member Brown said that TDRs had become a matter of focus lately and that the uncertainty of supervisory treatment resulted in banks being reluctant to work with borrowers. Mr. Watkins said that the FDIC had received a number of inquiries about TDRs and that it was arranging a nationwide call-in between the FDIC's Chief Accountant and banks' chief financial officers. He added that the FDIC's basic message to its examiners was to be balanced and reasonable.

Mr. Nash told the Committee that the FDIC often heard from Members of Congress or other public officials that "regulators"

were not letting banks lend money and asked members to provide examples of how regulators might be thought to discourage lending. Members Goodlock and Urrabazo provided examples of changes to flood zone maps by the Federal Emergency Management Agency ("FEMA") which caused the bank to respond in a way that made its security interest less secure. Member Goodlock provided a second example involving making an unsecured loan on real estate rather than requiring the borrower to comply with mortgage regulatory requirements. He added that, occasionally, a banker might use regulatory difficulty as a convenient excuse for not making a loan that the banker did not want to make. Member Blanton said that his bank was mindful about concentration risk issues, but indicated that it would still make loans if they were good credits. Member Brown said that examiners' aggressive comments about CRE concentration risk in an exit interview had negatively affected the willingness of his board of directors to make CRE loans. In the subsequent examination, the examiners' statements were more tempered--encouraging the bank to mitigate its concentration risk, but not to pass up good loans--and had a positive effect on the bank board's willingness to make CRE loans. Member Brown recommended that regulators recognize that their statements, whether in examinations or in speeches, can have a tremendous impact on lending and adjust their statements accordingly.

Members Cole, Urrabazo and Blanton noted that fair lending compliance concerns could restrain lending in certain situations. They noted, for example, that if a borrower's credit score does not meet the lending criteria, the bank may be reluctant to act on its knowledge of the borrower's good credit history because of concerns that its decision would be difficult to explain in a fair lending review. Member Goodlock also indicated that new appraisal requirements, even in a refinance without new money, can create a reluctance to lend. Member Stewart added that uncertainty about capital level requirements could discourage lending; she said that a bank now had to consider each possible loan against its limited capital supply, a situation not present a couple years ago.

In response to Member Schrieffer's inquiry about the status of unlimited deposit insurance for non-interest bearing accounts, Mr. Nash said that, pursuant to the Dodd-Frank Act, the insurance would cease at the end of 2012, and that he was not aware of any current industry efforts to continue it. Ms. Ellis noted that there was some interaction between the extension of that insurance coverage and when the DIF would meet its 1.15 percent reserve ratio requirement. The FDIC currently projected that the DIF would achieve the 1.15 reserve ratio in 2018 and that the

insurance assessment rates could be lowered somewhat then; however, if the unlimited coverage of non-interest bearing accounts was extended, that exposure might delay the projected 2018 date for lowering the assessment rates.

In the "Roundtable Discussion," Mr. Nash invited Committee members to provide information about their local economies and banking conditions. Member Schriefer described the conditions in Kansas as muddling along; agriculture was relatively strong, as was energy development, but the Wichita aviation industry was flat. Member Goodlock observed that Michigan has a diverse economy, so that while the Detroit area was on the cusp of failure, western Michigan had fair growth. Regarding housing, he noted that in many cases it made economic sense to tear down foreclosed housing rather than rehabilitate it. Member Hopkins reported that South Dakota was doing well, that agriculture was doing well although commercial sectors were not; although loan demand was soft, there was some growth. Member Cole said that the Tennessee economy was varied, unemployment was in the single digits statewide but higher in some areas; she said that consumer confidence was a primary problem. Member Brown said that the Florida economy was stabilizing, but not yet stabilized. He noted that property appraisals were improving in some areas but declining in others; that there had been some positive absorption on CRE; and that a selection of area banks had recently gone from losing money to a profit. Member Lewis said that in the Tucson, Arizona area, unemployment was down to about seven percent and that an increasing number of economic positive signs were occurring. Member Urrabazo said that some areas of Texas were improving while pockets of urban areas still struggled; his area of south Texas had seen a significant increase in oil and gas exploration. He said that real estate continued to struggle; many people could not qualify for loans and that prices would likely drop. He said that unemployment rates remained steady and that he believed that Texas had seen the economic bottom.

Member Blanton said that the South Carolina economy would likely stay difficult for awhile but that it had probably bottomed out; he said that he expected elevated banking losses for a couple years and that it was becoming apparent which banks would and would not survive. Member Rainey reported that New Mexico continued to struggle economically, and that the northern part of the state was not diversified so as to be able to lead a recovery. In real estate, she said that there were very few transactions and that appraisals were occasionally half of what construction costs were. Member Gray said that California was in poor condition and getting worse, the unemployment rate was about 12 percent and

there was significant excess housing. He noted, however, that the state was diverse and that some areas were improving while others continued to decline. Member Gray said that there had been little loan growth in the first part of the year but that the third quarter showed an eight percent growth over the previous year. Member Stewart said that Washington State was diversified economically and was near the bottom of the trough if not already there; she said that while the statewide unemployment rate was about 9.6 percent, it was lower in the Seattle area. Concerning community banks, she said that she was encouraged that some that had come close to failure had attracted outside capital. Member Koch said that the South Carolina economy was bouncing along the bottom but noted that he was more optimistic due to several large employers moving into the area. He said that double-digit unemployment remained and that there were concerns about a double-dip in coastal housing values. Member Koch added that most banks were merely muddling through the situation but some were doing quite well.

Acting Chairman Gruenberg thanked the Committee for an extremely helpful meeting. Director Curry added particular thanks to the departing members of the Committee for their advice and counsel.

There being no further business, the meeting was adjourned at 2:59 p.m.



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

Minutes
of
The Meeting of the FDIC Advisory Committee on Community Banking
of the
Federal Deposit Insurance Corporation
Held in the Board Room
Federal Deposit Insurance Corporation Building
Washington, D.C.
Open to Public Observation
November 4, 2011 - 8:38 A.M.

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



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



Dated: February 2, 2012