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

October 10, 2018 – 9:00 A.M.

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

The members of the Committee present at the meeting were: Christopher Donnelly, President and Chief Executive Officer ("CEO"), Bank of the Prairie, Olathe, Kansas; James J. Edwards, Jr., CEO, United Bank, Zebulon, Georgia; Christopher W. Emmons, CEO, Gorham Savings Bank, Gorham, Maine; David J. Hanrahan, Sr., President and CEO, Capital Bank of New Jersey, Vineland, New Jersey; Jack A. Hartings, President and CEO, The Peoples Bank Co., Coldwater, Ohio; Danny J. Kelly, President and CEO, The Hometown Bank of Alabama, Oneonta, Alabama; Kenneth Kelly, Chairman and CEO, First Independence Bank, Detroit, Michigan; Arvind A. Menon, President and CEO, Meadows Bank, Las Vegas, Nevada; Tiffany Baer Paine, President and CEO, Security Bank USA, Bemidji, Minnesota; Mary Ann Scully, Chairman and CEO, Howard Bank, Baltimore, Maryland; Alan Shettlesworth, President and Chief Operating Officer ("COO"), Main Bank, Albuquerque, New Mexico; John M. Tolomer, President and CEO, The Westchester Bank, Yonkers, New York; Joseph W. Turner, President and CEO, Great Southern Bank, Springfield, Missouri; Louise Walker, President and CEO, First Northern Bank of Dixon, Dixon, California; and Len Williams, CEO, People's Intermountain Bank, American Fork, Utah.

Asif Dakri, Vice Chairman and CEO, Wallis State Bank, Houston, Texas; Fred DeBiasi, President & CEO, American Savings Bank, Middletown, Ohio; and Gwen M. Thompson, President and CEO, Clover Community Bank and Clover Community Bankshares, Inc., Clover, South Carolina, were absent from the meeting.

Martin J. Gruenberg, Director, was present at the meeting.

Corporation staff who attended the meeting included: Steven O. App, Ruth R. Amberg, Lisa Arquette, Ryan Billingsley, Carolyn Curran, Tim Davin, Chad R. Davis, Christine M.

Davis, Doreen R. Eberley, Bret Edwards, Diane Ellis, George E. French, Shannon N. Greco, William Henley, Jr., Martin D. Henning, Travis Hill, Nicholas S. Kazmerski, Vivek Khare, M. Anthony Lowe, Brandon Milhorn, Rae-Ann Miller, Patrick Mitchell, Michelle Ogren, Mark E. Pearce, Sylvia H. Plunkett, Lisa Roy, Betty Rudolph, Philip A. Shively, James C. Watkins, and Angela A. Wu.

Chairman McWilliams opened and presided at the meeting. She began by welcoming four new members to the Committee: Ms. Walker, Mr. Shettlesworth, Mr. Kenneth Kelly, and Mr. Edwards. Chairman McWilliams explained that Committee membership has been expanded to ensure representation of all geographic areas, including rural and agricultural areas.

Next, Chairman McWilliams advised that she wished to allow more time for dialogue and input from members, emphasizing that the Committee is designed to obtain feedback so FDIC analyses will better incorporate all perspectives and create an environment where community banks can thrive. Against that background, she introduced Mr. Davis, Deputy to the Chairman for External Affairs, who moderated the rest of the day's proceedings. Mr. Davis advised that the first item on the agenda was "Committee Member Discussions of Local Banking Conditions." The Committee members, in turn, described the opportunities for and challenges faced by their community banks.

The majority of members indicated that loan demand remained solid; small businesses benefited from the 2018 tax cut and experienced stronger profits; and small businesses had more confidence in the general economy and are therefore willing to expand. More recently, however, lending rates are creeping up; customers are therefore reluctant to borrow because they are accustomed to the low-rate lending environment of the recent past; and growth is beginning to moderate. The members agreed that charge-offs are virtually nonexistent and there are very few problem loans.

With respect to housing, several members observed that the real estate market, especially single-family housing construction, is showing signs of stress. Affordability is a big issue in many areas where the supply of new homes and buildable land is restricted. Construction firms say their biggest challenge is the tight labor market. Small and regional home builders, as opposed to national builders, bear the biggest impact of the tight market yet national builders aren't typically part of the customer base of smaller banks. Due to the competitive markets and escalating home prices, some members see signs of buyer fatigue. At the same time, however, rents are increasing, making it difficult for consumers to save a down payment. In light of these factors, several members anticipate a slowdown in the residential real estate market over the next several years but ultimately agreed that market conditions vary by location. With regard to the commercial real estate ("CRE") sector, some members advised that they are seeing aggressive pricing and other terms. Other members offered that components of the CRE market evidence lack of underwriting discipline; specifically, there appears to be more non-recourse financing and extensions of interest rate terms.

Turning to the issue of regulatory relief, one member recalled that they entered the mortgage business in 2010 but after five years found that the bank's cost to produce a loan more than doubled. He attributed this increase to the fact that the bank hired individuals to manage the burden of compliance; there were more employees in the bank's mortgage division than at the commercial bank. Although the bank determined it could keep mortgage lending profitable over the long-term by increasing production, they ultimately exited that business line rather than put undue pressure on capital. Other members concurred, noting that they were committed to serving the residential mortgage needs of their communities but, for small community banks, it is a challenge to manage compliance issues and stay profitable. With respect to capital regulations, several members noted that simplified capital rules are very important and urged the agencies to implement a lower minimum rather than a higher minimum because bankers will always aim to be above the regulatory minimum.

With respect to deposits, members noted there appears to be a nationwide struggle for deposits with larger banks attempting to bolster their liquidity by offering higher rates. As a result, banks are seeing their cost of funds increase which, in turn, puts pressure on profitability margins. One participant observed that past economic growth occurred, in part, because of the low interest rates paid to depositors; the return to higher interest rates is a factor that banks have to balance, he suggested.

Overall, members indicated the market for deposits has changed. At one time half a bank's balance sheet might consist of local certificates of deposit ("CDs"). Now, out-of-area entities, internet players, nonbanks, and even hedge funds, compete for deposits. The members were therefore glad to see that the subject of liquidity and national-rate caps were on today's agenda. In anticipation of that discussion they suggested, even though the national rate cap applies to banks that are less than well capitalized, the restrictions seem to be trickling down to well-capitalized banks potentially making it more difficult to manage funding sources. Members said whether the funds are sourced from local customers or brokers, if a bank makes bad loans, there will be a problem. The FDIC therefore needs to adopt an even-handed approach with respect to brokered deposits. In the current hyper-competitive market, discipline and reviewing one's balance sheet on a regular basis are essential, advised the participants.

The members also raised concerns with respect to predatory lending and scams targeting consumers. They described instances where consumers rely on sham credit-consolidation companies without fully understanding the fine print and then turn to local banks for help extricating themselves from the situation. In some states, minimal licensing and continuing training requirements pertain to brokers which sometimes lead to a lack of understanding of smaller markets.

Following additional comments from members regarding the adoption of new technologies, fintech companies, recruiting the next generation of bankers, and mortgage lending, Mr. Davis announced that the meeting would briefly recess. Accordingly, the meeting stood in recess at 10:27 a.m.

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The meeting reconvened at 10:52 a.m. that same day, at which time Mr. Davis introduced the presenters of the first panel, "Supervision Update," as Doreen R. Eberley, Director, Division of Risk Management Supervision ("RMS"); Rae-Ann Miller, Associate Director, RMS; Ryan

Billingsley, Corporate Expert-Capital Markets, RMS; and William Henley, Associate Director, RMS.

Ms. Eberley framed the panel's presentation by noting they would highlight a number of RMS initiatives, especially efforts to implement the Economic Growth, Regulatory Relief, and Consumer Protection Act (the "Economic Growth Act" or "EGRRCPA") signed into law May 24, 2018. These efforts included proposed rulemakings regarding reciprocal deposits, examination frequency, and the definition of "high-volatility commercial real estate" or "HVCRE" exposures.

Ms. Miller then referred to the "Supervision Update" hand-out included in the informational packet distributed to the members and asked them to turn to the "Interagency Statement Clarifying the Role of Supervisory Guidance," FIL-49-2018 (Sept. 17, 2018). Ms. Miller explained that, unlike a statute or regulation, supervisory guidance does not have the force and effect of law; agencies do not cite violations for a bank not following supervisory guidance. Rather, the purpose of guidance is to articulate the agencies' general views regarding appropriate practices for a given subject area. The FIL before the Committee was developed in an effort to reinforce that message for the public and for examiners.

Ms. Miller next directed the Committee's attention to a notice of proposed rulemaking ("NPR") entitled: "Limited Exceptions for a Capped Amount of Reciprocal Deposits from Treatment as Brokered Deposits," FIL-47-2018 (Sept. 13, 2018). She advised that the NPR is the first part of a two-part effort to revisit the brokered deposit regulations. This particular NPR is designed to conform FDIC regulations to the changes made by EGRRCPA. By way of background, section 29 of the Federal Deposit Insurance Act ("FDIA") restricts insured depository institution from accepting deposits by or through a deposit broker unless the institution is well capitalized for Prompt Corrective Action ("PCA") purposes. The FDIC may waive this restriction if the insured depository institution is adequately capitalized; the restriction cannot be waived if the institution is undercapitalized. The FDIA also imposes restrictions on the deposit interest rates that an insured depository institution may offer if the institution is not well capitalized. These interest rate restrictions cannot be waived. A "deposit broker," as defined by section 29 of the FDIA, includes "any person engaged in the business of placing deposits, or facilitating the placement of deposits, of third parties with insured depository institutions or the business of placing deposits with insured depository institutions for the purpose of selling interests in those deposits to third parties. . . ." Under the FDIC's regulations, a "brokered deposit" is thus defined as a deposit accepted through a "deposit broker."

Turning to reciprocal deposits, reciprocal deposit arrangements are based on a network of banks that place funds at other participating banks in order for depositors to receive insurance coverage for the entire amount of their deposits. Institutions within the network are both sending and receiving identical amounts of deposits simultaneously. Reciprocal arrangements are often managed by a third-party network sponsor. The institutions themselves (along with the network sponsors) are in the business of placing deposits, or facilitating the placement of deposits, of third parties with insured depository institutions. The involvement of deposit brokers within the reciprocal network means the deposits are deemed brokered deposits. Continuing, Ms. Miller advised that, for assessment purposes, reciprocal deposits have been treated more favorably than other types of brokered deposits. More specifically, when the FDIC updated its risk-based assessment rate methodology for established small banks in 2016, it replaced the "adjusted" brokered deposit ratio with a brokered deposit ratio. This new ratio measures significant reliance on brokered deposits but continues to exclude reciprocal deposits for institutions that are well capitalized and well rated. But, in any event, prior to enactment of EGRRCPA, all reciprocal deposits were classified as brokered deposits.

Returning to NPR before the Committee, Ms. Miller explained that with the enactment of EGRRCPA the FDIA is revised to except a capped amount of reciprocal deposits from treatment as brokered deposits for certain insured depository institutions. These revisions took effect upon enactment of EGRRCPA on May 24, 2018. The FDIC proposes to amend its regulations to conform to the statutory amendments. By incorporating the definitions from the new law, it excepts a capped amount of reciprocal deposits from being treated as brokered deposits for certain insured depository institutions. That cap is the lesser of either five billion dollars or 20 percent of total liabilities. A special cap also kicks-in if the institution is either not well-rated or not well-capitalized. In response to questions from the members concerning the use of reciprocal deposits by de novo institutions, Ms. Miller clarified that, generally speaking, de novos may use reciprocal deposits but would need to report them as brokered; a de novo institution would also need to consider the level of brokered deposits included in its business plan.

Ms. Miller acknowledged that the deposit market has changed since brokered deposit restrictions were first enacted through the "Financial Institutions Reform, Recovery, and Enforcement Act of 1989" ("FIRREA") and said that the FDIC is looking forward to receiving comments in response to this NPR as well as the proposal to be issued later this year on brokered deposit restrictions more generally.

Ms. Miller then directed the Committee's attention to an interagency interim final rule ("IFR") on the "Expanded Examination Cycle for Certain Small Insured Depository Institutions and U.S. Branches and Agencies of Foreign Banks," FIL-45-2018 (Sept. 7, 2018). She explained that the IFR implements provisions of EGRRCPA which increased, from $1 billion to $3 billion, the total asset threshold under which an agency may apply an 18-month on-site examination cycle for qualified banks that have an ''outstanding'' composite rating. The agencies are also extending eligibility for an 18-month examination cycle to qualifying banks with an ''outstanding'' or ''good'' composite rating with total assets under $3 billion. Continuing, Ms. Miller observed that the IFR increases the amount of institutions eligible for the 18-month cycle by approximately 420 institutions, bringing the total number of eligible banks to 4,798. The vast majority of all banks will therefore be subject to the extended examination cycle. With respect to the exam cycle, members observed that by concentrating the agencies' effort on those banks that are less than one- and two- rated, it could be a win-win for the agencies.

Ms. Miller closed her remarks by advising the members that the FDIC planned to retire a number of outdated or redundant FILs, as outlined in FIL-46-2018 (Sept. 10, 2018).

Mr. Billingsley then provided an overview of the NPR regarding the definition of HVCRE exposures. He noted that an interagency NPR was issued in September 2018; the NPR aligns the definition of HVCRE currently found in the agencies' capital rules with the definition mandated by EGRRCPA; institutions may report HVCRE on Call Reports using the new, statutory definition; if categorizations change for future periods the agencies are not going to ask banks to refile prior Call Reports simply because the banks obtain new information in the future. Overall, the NPR definition is similar to the current definition but the scope will change slightly and some exemptions will likely change. After discussing the potential classification of multi-dwelling properties, Mr. Billingsley emphasized that the purpose of the NPR is to make sure the agencies obtain feedback from banks regarding potential categories, associated risks, and ensure consistency with other regulatory requirements.

Next, Mr. Henley provided an update regarding a community bank cyber exercise called the “FDIC Cyber Challenge.” He explained that exercises are one of the best ways to prepare an organization to respond to an emergency. With that in mind, the FDIC has issued a total of nine “scenarios” that a community bank might encounter, designed training materials for conducting exercises, issued videos dramatizing each scenario, and issued questions designed to help bankers think through their recovery plans. The scenarios cover a number of challenges, such as an item processing failure, unauthorized withdrawals through a corporate account takeover, phishing scams, technology service provider problems, distributed denial of service attacks, ATM malware, and ransomware. The two latest scenarios concern reactions to a natural disaster (a flood) as well as a supply chain incident (a third-party software update infects the bank’s systems). In response to questions from members, Mr. Henley described the length of the training scenarios and said the exercises are not meant to require a significant investment of time.

Mr. Henley advised that October is “National Cybersecurity Awareness Month.” The Federal Financial Institutions Examination Council (“FFIEC”) will host a cybersecurity webinar on October 31st, he reported. In addition, the agencies are publishing a new guide designed to centralize cybersecurity resource information available from the government and private sector. Community banks report it is challenging to wade through the mass of cybersecurity resources available, he said, and the guide is designed to reduce that challenge.

In response to Mr. Henley’s remarks, members confirmed that phishing attacks are an everyday occurrence; they asked if there is anything the FDIC can do to facilitate fraud reporting, otherwise it will continue. Mr. Henley noted that the FDIC encourages participation in information-sharing groups such as the “Financial Services Information Sharing and Analysis Center” (“FS-ISAC”); they compile data about such threats and issue member-alerts. The members then referred to the practice of masking phone numbers and asked if the FDIC was seeing consumers and businesses defrauded by criminals using masked numbers to pose as financial institutions. Mr. Henley responded that there is simply no end to the schemes criminals create. The FDIC is aware of masking; it is another attack vector that criminals use. Mr. Henley agreed with the comments of several members that state banking associations are also a source for guidance when dealing with cybersecurity issues and can get the word out to other members. Members noted that, aside from bank staff, bank customers can trip-up and many customers fall for scams involving wiring funds to bogus accounts.

After further discussion of the cybersecurity challenges bankers are seeing in their community and businesses, Ms. Eberley closed the discussion by reminding participants that the FDIC has available on its website cybersecurity pamphlets that banks can distribute to customers. There are pamphlets targeted to retail customers and pamphlets targeted to business customers. The FDIC also produced a Consumer News edition providing cybersecurity tips and tricks for customers of banks.

Next, Mr. Davis introduced the FDIC's Ombudsman, Mr. Lowe. Mr. Lowe reminded the members that on October 13, 2018, Chairman, McWilliams announced a new, agency-wide "Trust through Transparency" initiative at the FDIC. The Transparency Initiative unites each business area across the FDIC behind the goals of being accessible, understandable, responsive, and accountable. As part of that initiative, the FDIC issued a request for information on how to make communication with insured depository institutions more effective, streamlined, and clear. Mr. Lowe explained that, in support of the Transparency Initiative, the Office of the Ombudsman ("OO") proposes to issue annual reports outlining the activities of the OO. Mr. Lowe directed the members' attention to the proposed 2018 Report in their information packet and invited them to share suggestions to strengthen and enhance the report.

Members of the Committee commended Mr. Lowe for proposing the report, noting it would help clarify the role of the OO; they applauded his efforts to establish one-on-one relationships with bankers through the OO's on-site visitation program; and they agreed that, when exploring difficult issues, it helps to have the OO available to serve as a confidential sounding board and a mechanism to probe issues more deeply.

Several members voiced appreciation for the direct line of communication they have with the RMS Regional Director for their respective areas, noting that if they have an issue, they simply telephone the Regional Director for assistance. When promoting the services of the OO, they suggested the FDIC make it clear that bankers should still contact Regional Directors as their first level of recourse, emphasizing again that the Regional Directors are typically responsive and accessible and they value that one-on-one availability. Mr. Lowe assured the members that, when working through an issue, the OO staff routinely asks if the issue has been discussed with the Examiner-in-Charge, the Regional Director, or other relevant staff, and in that way tailors a more effective resolution. Ultimately, however, discussions with the OO are confidential and therefore appropriate in some situations.

With respect to the format of the proposed report, participants suggested that the topic "Examination Issues" would be more helpful if it could be more specific. Moreover, as community bankers, some members noted that they really want to hone in on issues raised by other bankers and it will be helpful to share successful outcomes. In response to questions posed by the members, Mr. Lowe clarified that, with respect to contacts classified as originating with the public, a large number of those contacts originated with "whistleblowers." Overall, members indicated it was a great idea to promote the role of the OO; it might be appropriate, however, to implement the report for a while, examine feedback, and revisit the report to gauge its value

After further discussion of the proposed report, Chairman McWilliams closed the discussion by noting that agencies such as the FDIC have a range of formal and informal dispute resolution procedures. The FDIC, she emphasized, wants to make the OO position as robust as possible, ensure its independence, and confirm that OO communications are confidential.

Mr. Davis announced that the meeting would recess for lunch. Accordingly, at 12:00 p.m. the meeting stood in recess.

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The meeting reconvened at 1:04 p.m. that same day, with Mr. Davis introducing the panel for the Committee's next presentation, "Industry Collaboration Initiatives," as Lisa Arquette, Associate Director, RMS; Betty Rudolph, National Director for Minority and Community Development Banking; and James Watkins, Senior Deputy Director, RMS. Mr. Davis advised that Ms. Arquette would highlight the "Bank Secrecy Act Interagency Statement on Sharing Bank Secrecy Act Resources," ("Statement") FIL-55-2018 (Oct. 3, 2018); Ms. Rudolph would discuss collaborative arrangements in the context of Minority Depository Institutions ("MDIs"); and Mr. Watkins would outline collaboration with de novo institutions.

Ms. Arquette recalled that the federal depository institutions regulators and the U.S. Department of the Treasury's Financial Crimes Enforcement Network ("FinCEN") issued the Statement on October 3rd in an effort to address instances in which banks and credit unions may decide to enter into collaborative arrangements to share resources to manage their Bank Secrecy Act ("BSA") and anti-money laundering ("AML") obligations more efficiently and effectively. The Statement allows community-focused banks and credit unions to share anti-money laundering resources in order to better protect against illicit actors seeking to abuse those institutions. At this point, Ms. Arquette paused to note that, aside from the Statement, there is a broader initiative underway to enhance efficiency and effectiveness in BSA/AML area. The agencies are working hard to determine what can be done to possibly streamline the examination process, reduce the burden of BSA/AML compliance, recognize innovation in AML techniques, while fully supporting law enforcement.

Returning to the October 3rd statement, Ms. Arquette described the nature of "collaborative" arrangements; outlined the components of an effective BSA/AML program; and, with reference to each component, described examples of collaborative arrangements that could be beneficial for banks.

She emphasized that appropriate safeguards should be in place to ensure confidentiality of sensitive business information; participants must ensure that shared resources conducting BSA/AML independent testing are qualified; employees should be trained and independent. She acknowledged it might be challenging to acquire personnel with BSA/AML expertise in some communities. Further, it might be cost prohibitive to attract a qualified, off-site BSA/AML trainer. A collaborative arrangement therefore provides latitude in hiring a qualified instructor and allows banks to share costs. She also acknowledged that sharing a BSA officer could be challenging due to the confidential nature of suspicious activity reports and the ability of the BSA officer to coordinate and monitor each bank's day-to-day BSA/AML compliance. Moreover, sharing a BSA officer might create challenges with effective communication between the BSA officer and each bank's Board of Directors and senior management. Accordingly, she acknowledged it may not be appropriate for banks to enter into collaborative arrangements to share a BSA officer. If, nonetheless, banks plan to share an officer, they are encouraged to discuss the issue with the appropriate regulator beforehand. Ms. Arquette then described strategies to mitigate risks, including implementing clear contractual agreements and providing periodic reports to management and the Board regarding collaborative arrangements.

In response to questions posed by the Committee, Ms. Arquette advised that the agencies do not have data available concerning anticipated savings of collaborative efforts but indicated some banks are already engaging in such arrangements. One member commented that his institution has been assisting institutions that did not have the in-house expertise to conduct internal audits for several years. Ultimately, the parties created an engagement letter and the collaboration is working well for both parties. Ms. Arquette also agreed with the members that there is a role for state bank associations; they would be similar to any third-party provider.

Next, Ms. Rudolph discussed collaborative arrangements in the context of MDIs. As outlined in the "Resource Guide for Collaboration with Minority Depository Institutions" included in the information packet, Ms. Rudolph advised that MDIs as well as non-minority banks can recognize regulatory and business benefits by forming collaborative relationships with other MDIs. She then discussed at length various types of collaborative arrangements, including direct investment in an MDI, loan participations, sharing of bank staff, and information networking.

In response to questions by the members, Ms. Rudolph advised that FDIC staff had occasionally brought together MDI trade groups and CEOs of non-MDI institutions in an effort to facilitate exploration of opportunities, the most recent effort being a session held in Salt Lake City with industrial loan companies. The members suggested it would be helpful to involve a broader audience. Ms. Rudolph concurred and noted that the FDIC is promoting the Resource Guide to state associations and exploring a number of channels to locate potential partners. She highlighted one of the benefits of such arrangements: Community Reinvestment Act ("CRA") consideration. She clarified that all banks receive consideration under CRA for activities in their assessment areas and the broader state-wide or regional area if it's responsive to the community development needs in their assessment area. Non-MDIs may also receive consideration if they partner with a MDI outside of their geographic area. After further describing mechanisms of partnering with MDIs, Ms. Rudolph returned to the topic of locating a partner. She advised that the FDIC has regional MDI coordinators in each regional office. In addition, FDIC community affairs regional managers, state/regional trade associations for community development or CRA officers, and MDI trade associations can all help banks find collaborative opportunities. When asked to prioritize who to contact to learn about opportunities, Mr. Watkins suggested calling the FDIC's MDI coordinator and the FDIC's regional CRA specialist. Ms. Rudolph noted that she is available to assist as well.

Next, Mr. Watkins summarized FDIC efforts to encourage "de novo" or new bank formation. He recalled that, in 2016-2017 the FDIC participated in day-long sessions at each regional office, meeting with potential new organizers in an effort to discuss the application process. The highlight of those sessions was hearing from a panel of bankers describing their experiences and "lessons learned" in forming de novo banks. He discussed how helpful other bankers can be in the development of essential documents. For example, bankers provided organizers with sample loan policies, interest rate risk policies, funds management policies, and

CRA policies. The organizers used those samples to develop policies appropriate to their business plans. He indicated that the early stages of formation can be difficult and it takes time to achieve profitability. Loan participations might help, he suggested. Existing banks can provide, essentially, initial credit via loan participations and correspondent banking relationships. Another important aspect of these de novo sessions was the ability to discuss information technology challenges for de novos. Again, de novos benefited when existing banks shared their experiences in developing IT contracts. Overall, existing banks are a remarkable resource to those creating de novo institutions. The FDIC is seeing renewed interest in new bank formation, he indicated, and the FDIC appreciates the support provided by existing banks to de novos.

One member agreed that cooperation was important but said one of the more challenging aspects in new bank formation is the perception that regulators are ratcheting up the capital levels required for a new bank. He recalled that the RMS Division Director explained at a meeting he attended that the FDIC does not have a minimum capital level other than that de novo banks must maintain an eight percent leverage ratio for the first three years and show the bank can turn a profit inside of those three years; the onus is on the organizers to tell the FDIC how much capital will be needed to fulfill that business plan. He observed that de novos therefore have a varied range of capital levels approved, depending on their business plan. He agreed with that approach, he advised. Another member concurred, noting that organizers often want to provide as little capital as possible but, ultimately, the calculation is based upon the business plan, the niche the de novo will fill, and potential customers.

In response to concerns that organizers must continually return to regulators with more detailed information, Mr. Watkins emphasized that in the formation of a de novo bank, the business plan is paramount; where banks have encountered challenges is when they deviate sharply from the original business plan and grow more rapidly than originally anticipated. If significant business plan changes occur without control systems in place, he cautioned, de novos could assume excessive risks. He clarified that banks can deviate from their business plans as long as the changes are well-informed, thought through, and structured in such a way that it will lead to sustained profitability.

The panelists for the next discussion concerning “Deposit Insurance Assessment Pricing for Small Institutions,” were Diane Ellis, Director, Division of Insurance and Research (“DIR”), and Patrick Mitchell, Deputy Director, DIR.

After summarizing past assessment pricing models, Ms. Ellis noted that the FDIA allows the FDIC to establish separate risk based assessment systems for large and small institutions. Turning to the scheme currently in place, she explained that all of the measures in the assessment pricing regulation are derived from a statistical model that estimates a bank’s probability of failure, and the model uses data going all the way back to the mid-1980s.

Against that background, Mr. Mitchell directed the Committee’s attention to charts included in the information packet and discussed, in turn, the average assessment rate over time; the effect of assessments on bank income; small bank assessments as a percentage of total assessments; and the distribution of assessment rates for all small banks (those with less than $10 billion in assets). Mr. Mitchell then described for the benefit of the Committee the factors used in small bank pricing. He indicated the factors were straight-forward and included (1) weighted-average CAMELS, (2) leverage ratio, (3) net income before taxes/total assets, (4) nonperforming loans and lease/gross assets, (5) other real estate owned/gross assets, (6) a brokered deposit ratio, (7) the Loan Mix Index, and (8) one-year asset growth. He clarified that the biggest factors in determining the price of deposit insurance for small banks, in order, are the leverage ratio, Loan Mix Index, and weighted-average CAMELS.

Following the panelists' presentations, the Committee members and staff discussed the assessment pricing regulation applicable to small institutions at length. The members asked several clarifying questions with respect to the factors used in small bank pricing. Ms. Ellis referred the members to the assessment rate calculator found on the FDIC's website at: https://www.fdic.gov/deposit/insurance/calculator.html. One member asked about the reliability of the calculator for budgeting purposes.

Mr. Mitchell assured the members that, to the extent a bank can project accurately what its balance sheet and the relevant components will look like, the model is 100 percent accurate and completely transparent. In response to concerns regarding the lack of granularity in the model, Mr. Mitchell noted that one of the biggest challenges is to use data the FDIC has available; thus the model is limited by the granularity of the Call Report. Overall, however, he suggested that this pricing model is a significant improvement over prior models. He acknowledged that the Loan Mix Index is a significant component. He explained that the FDIC is attempting to look forward and make sure risks are being priced as they are incurred. Those risks may or may not be realized, he acknowledged, but as they are incurred, the FDIC needs to make sure it is charging for those risks.

Members suggested that as the FDIC weighs the loan mix too heavily and is not taking differences in underwriting standards into account. As a result, the loan mix formula might indicate a higher risk than actually exists in a given bank. Participants suggested the FDIC conducts annual bank examinations and is equipped to actually review a bank's asset quality. An examination might reveal that a bank has a higher asset quality than that suggested by the loan mix formula. The FDIC could achieve more granularity and be more precise as to any given bank, they urged.

Staff then briefly reviewed the outlook for the Deposit Insurance Fund ("DIF") and the background on the assessment credits for community banks. Staff noted that current regulations require that each small bank be notified of the amount of credits it would receive as soon as practicable after the reserve ratio reaches 1.35 percent and that the calculation of the total amount of credits would require information available only after the reserve ratio reached 1.35 percent, including the amount of insured deposits at that time.

Referring again to the information packet, Mr. Mitchell advised that, when the reserve ratio is at or above 1.38 percent, the FDIC will automatically apply credits to reduce the assessments of small banks in order to offset the effect of their contribution to raise the reserve ratio from 1.15 percent to 1.35 percent. The credits will offset in whole each small bank's assessment until the credit is exhausted. The expectation is that, for most banks, the credits will fully or partly offset their deposit insurance assessments for two to four quarters. The members indicated that was positive news.

Mr. Davis then announced that the meeting would briefly recess. Accordingly, the meeting stood in recess at 2:20 p.m.

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The meeting reconvened at 2:37 p.m. that same day, at which time Mr. Davis introduced the next agenda topic, “Interest Rate Restrictions Applicable to Less than Well-Capitalized Banks,” presented by Ms. Miller and Vivek Khare, Counsel, Legal Division.

Ms. Miller opened the discussion by reminding the members that the FDIC plans to engage in a broad review of brokered deposit and rate restrictions and indicated that today’s discussion will be helpful to that broader review. She then reviewed the history of brokered deposits and the reasons that statutory rate restrictions exist. She noted that CDs were a new product in the late 1960s, as financial markets became more global and investors sought higher rates; at the same time brokerage accounts became available to more consumers and were no longer the domain of wealthy investors. She discussed a linkage between institutions that have used brokered deposits and high rate deposits for excessive risk taking and excessive growth. She cited FDIC annual reports and other reports produced in the 1980s that noted that many of the failures and problem institutions had heavy levels of brokered deposits. Congress therefore instituted restrictions on brokered and high rate deposits through FIRREA and again in the Federal Deposit Insurance Corporation Improvement Act of 1991 (“FDICIA”). In summary, she said, the statutory restrictions are designed to prevent rapid growth, minimize volatility, and preserve franchise value in the event of failure.

Next, Mr. Khare provided an overview of the legal framework underlying the rate restrictions. He explained that, although the statute prescribes a general framework with respect to rate restrictions, it does not prescribe definitions for key terms such as “significantly higher” or “national rate.” To address those gaps the FDIC promulgated regulations in 1992 and, leveraging data collected over the years, refined the regulations in 2009. The interest rate restrictions currently in place provide as follows:

- A well capitalized insured depository institution has no restrictions on the rates it pays on deposits.

- An adequately capitalized institution that has a waiver to accept, renew, or roll over brokered deposits may not pay an effective yield which, at the time the deposit is accepted, renewed, or rolled over, exceeds by more than 75 basis points: (1) The effective yield paid on deposits of comparable size and maturity in the institution's normal market area for deposits accepted from within its normal market area, or (2) the national rate paid on deposits of comparable size and maturity for deposits accepted outside the institution's normal market area. The national rate is a simple average of rates paid by all insured depository institutions and branches for which data are available and is determined by the FDIC.

- An undercapitalized insured depository institution may not solicit deposits by offering an effective yield that exceeds by more than 75 basis points the prevailing effective yields on insured deposits of comparable maturity in such institution's normal market area or in the market area in which such deposits are being solicited.

He noted that the regulation permits flexibility so that if a bank believes prevailing rates in its local market area are higher than the national rate they may provide evidence supporting that conclusion. If the FDIC Regional Office agrees, the bank may then pay 75 basis points over its prevailing local market rate. Mr. Khare then invited Ms. Miller to discuss emerging trends impacting rate restrictions and the FDIC’s plans to update restrictions.

Ms. Miller directed the members’ attention to a chart included in the information packet, explaining that it illustrated rate caps for a 12-month certificate of deposit product under the 1989-2009 methodology based on Treasury rates, caps under the methodology in effect 2010 to present based on a national average published by the FDIC, and a proxy for high-rate payers derived from a listing service. The high-rate CDs tracked the Treasury rates until the 2007 disruption when investors rushed to safety and Treasury yields were driven down. This meant that beginning in 2007 banks that were less than well capitalized were running out of options. They were running into a liquidity crunch because the rate restrictions were quickly impactful. In 2009, the FDIC revised the methodology and implemented a national rate that the FDIC publishes weekly based upon a national rate survey. During this time, the survey results were above the high-rate payers. This change allowed banks that were less than well capitalized to access funds from ListServs and other high-rate sources. That added flexibility was challenged in 2015, however, when the Board of Governors of the Federal Reserve System started raising rates. The rate caps became applicable on weakened banks, and they could no longer compete for deposits. The FDIC had a few failures. Banks had not been dealing with rate restrictions for a number of years. The FDIC published its observations of liquidity stress at some banks in an article titled, “Community Bank Liquidity Risk: Trends and Observations from Recent Examination (Supervisory Insights, Summer 2017), included in the packet. In response to market trends, the FDIC is re-considering its current methodology. Ms. Miller then asked the members to share their insights with respect to the rate restrictions.

The members observed that large banks have access to a range of liquidity sources. Consequently, rate restrictions could be perceived as penalizing small banks. Members also questioned the concept of a national cap and suggested it may be more realistic to approach caps from a regional perspective. Since the rate restrictions do not apply to well-capitalized banks, the members acknowledged that most banks would not run into restrictions. The reason bankers are nonetheless concerned, the members advised, is the potential danger that the definitions used to identify high-rate deposits will be incorporated into the evolving definition of high volatility deposits. Explaining further, one member advised that when discussing liquidity with regulators during a recent examination they mentioned high volatility deposits but it does not seem to be a defined term.

Commercial deposits often exceed insurance limits and even though banks consider these deposits to be core deposits, bankers perceive the danger that the FDIC might consider them high volatility deposits. Members also noted that rates paid by credit unions should be included in the calculation. There was additional discussion regarding FDIC staff statements noting that failed banks with significant levels of brokered deposits were costly to the FDIC since acquiring banks don't pay for brokered deposits and in some cases, the FDIC does not even pass brokered deposits to the acquirer. One member noted that the FDIC seems to be placing a higher value on cost to the insurance fund associated with failed banks that have brokered deposits versus the liquidity available to the institution before it fails. The member noted that when an institution becomes troubled local certificates of deposit are just as likely to flee and thus there are similar issues relating to franchise value as those raised about brokered deposits. Other members agreed that as soon as rates are lowered, deposits tend to move even if they are derived from the local market. The members advised that it is in no one's interest to allow an otherwise viable bank to fail due solely to a lack of liquidity. Ms. Miller acknowledged that brokered deposits and high-rate deposits are part of many institutions' business models and, when used appropriately, provide liquidity.

Staff conceded that credit union rates are not included in the national rate sponsored by the FDIC but emphasized again that a bank that is less than well capitalized is encouraged to bring evidence of rates to the FDIC and may certainly include credit union data if they are finding that in the bank's region. As to why FDIC staff does not automatically include credit union data, staff indicated that when the FDIC began calculating the national rate, it may not have had access to reliable data concerning credit union rates.

In response to questions posed by the members, Ms. Miller indicated that rates posted nationally by online banks are not included in the calculation nor are special promotion products. Rather, the rates are aggregated by a service that surveys an extensive range of bank offices and branches. Members countered that if the survey company includes 3,000 branches of the same national bank in the mix the calculation could be skewed. They also suggested the market is evolving so rapidly that the industry does not have the luxury of studying the appropriate markers over time. Instead, the issues must be dealt with in a much compressed period of time. Further challenging the calculation methodology, the members advised that it was not precise because it did not capture offers unless they were widely known. One member also questioned the methodology by noting that a bank could pay half the cost of the rate at which the U.S. Treasury borrows yet still be regarding as paying a high rate of interest.

Following further discussion of alternative models for determining the national rate and other rate restrictions, Mr. Davis thanked the members for their contribution and brought the discussion to a close. Chairman McWilliams thanked the panelists and the Committee members for their very helpful and insightful discussions. Director Gruenberg commended the Chairman for initiating the previous roundtable discussion with the members, noting that it was as fine a seminar on community banking as he had ever participated in.

There being no further business, the meeting was adjourned at 3:16 p.m.

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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

October 10, 2018 – 9:00 A.M.

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

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Jelena McWilliams
Chairman
Board of Directors
Federal Deposit Insurance Corporation