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, 2019 – 9:00 A.M.

The meeting of the FDIC Advisory Committee on Community Banking ("Committee") was called to order by Brandon Milhorn, Chief of Staff, Federal Deposit Insurance Corporation ("FDIC").

The members of the Committee present at the meeting were: Dick J. Beshear, Chairman, President, and Chief Executive Officer ("CEO"), First Security Bank and Trust Company, Oklahoma City, Oklahoma; Fred DeBiasi, President and CEO, American Savings Bank, Middletown, Ohio; Christopher Donnelly, President and CEO, Bank of the Prairie, Olathe, Kansas; James J. Edwards, Jr., CEO, United Bank, Zebulon, Georgia; Keith Epstein, Executive Vice President and CEO, Roxboro Savings Bank, Roxboro, North Carolina; Sarah Getzlaff, CEO, Security First Bank of North Dakota, New Salem, North Dakota; Kenneth Kelly, Chairman and CEO, First Independence Bank, Detroit, Michigan; Bruce Kimbell, President and CEO, First Community Bank of the Heartland, Clinton, Kentucky; Thomas Leavitt, President and CEO, Northfield Savings Bank, Northfield, Vermont; Lori Maley, President and CEO, Bank of Bird-in-Hand, Bird-in-Hand, Pennsylvania; Gilbert Narvaez, Jr., President and CEO, Falcon International Bank, Laredo, Texas; Mark Pitkin, President and CEO, Sugar River Bank, Newport, New Hampshire; Alan Shettlesworth, President and Chief Operating Officer, Main

Bank, Albuquerque, New Mexico; Cathy Stuchlik, Chairman and President, Clackamas County Bank, Sandy, Oregon; Louise Walker, President and CEO, First Northern Bank, Dixon, California; and Len E. Williams, CEO, People's Utah Bancorp & CEO, People's Intermountain Bank, American Fork, Utah.

Shaza Anderson, CEO, Trustar Bank, Great Falls, Virginia, was absent from the meeting.

Director Martin J. Gruenberg attended the meeting, and Corporation staff who also attended the meeting included: Dustin Allison, Lisa Arquette, Michelle Baker-Dubbs, Shannon Beattie, Benedetto Bosco, Annmarie H. Boyd, Kitty Chaney, Leonard N. Chanin, Kymberly K. Copa, Carolyn D. Curran, Timothy J. Davin, Chad R. Davis, Christine M. Davis, Michael Dean, Doreen Eberley, Kristie Elmquist, Margaret M. Hanrahan, Todd L. Hendrickson, William Henley, Martin Henning, Ashby G. Hilsman, Edward J. Hof, Nicholas S. Kazmerski, Arleas Upton Kea, Sandra Kerr, Constantine P. Lizas, M. Anthony Lowe, Christopher Lucas, Thomas Lyons, Patrick Mitchell, Misty Mobley, Shayna Olesiuk, Elizabeth Ortiz, Mark E. Pearce, Harrel M. Pettway, Nicholas J. Podsiadly, Ariana L. Rambuyan, Crystal L. Randall, Lisa K. Roy, Betty Rudolph, Scott S. Schreiber, Michael Shaheen, Susan L. Sturc, Maureen E. Sweeney, James C. Watkins, and Angela A. Wu.

Chief of Staff Brandon Milhorn opened and presided at the meeting. He noted that Chairman McWilliams could not attend due to overseas travel. On her behalf, Mr. Milhorn welcomed the new members of the Committee present, including Ms. Getzlaff, Mr. Pitkin, and Mr. Narvaez.

Mr. Milhorn then introduced Mr. Chad R. Davis, Deputy to the Chairman for External Affairs and the Committee's Designated Federal Officer, who moderated the proceedings.

Mr. Davis introduced the first session, which was a roundtable discussion of local banking conditions. He noted that, following the Committee member discussion, FDIC staff would share observations in this area. Shayna Olesiuk, Associate Director of Regional Operations, Division of Insurance and Research ("DIR"), would cover the FDIC Risk Review published in July 2019. Further, two of the FDIC's regional directors, Kristie Elmquist and Michael Dean, from Dallas and Atlanta respectively, would discuss local observations of supervisory staff. Mr. Davis advised that, going forward, two regional directors would participate in this session of the meeting. As a result, during each year, the Committee would hear about supervisory observations from all six FDIC regions.

The Committee members discussed a range of issues, including the following:

Banking Conditions. The members reported that, generally, their local areas were economically strong; loan growth was generally robust, and delinquencies and levels of problem assets were low. Several bankers noted the low national and regional unemployment rates and commented on the shortage of skilled labor in their areas. However, a few Committee members noted preliminary signs of economic concern in rural, predominantly agricultural, areas. Although there were no apparent, significant weaknesses, Committee members are monitoring a range of issues, including margin compression; competition for deposits; lending competition with institutions that have relaxed financial covenants, loan structures, and underwriting standards; cybersecurity; and compliance challenges.

Housing Markets. Some members reported that housing market fundamentals remain strong. Members generally noted that high demand for residential and multi-family homes has resulted in higher prices and reduced affordability. Member Debiasi questioned whether these trends could lead to an overinflated real estate market or a real estate "bubble."

Rural Communities. Committee members discussed certain challenges with respect to rural communities. Member Epstein noted that mortgage loan origination costs tend to be greater in rural communities, where desktop valuations are generally not available due to a lack of data on comparable sales and there are more limited abilities to instantly verify income or employment due to the number of self-employed individuals, including those in the agricultural field. Member Getzlaff echoed that sentiment and noted that large mortgage originators focus on mortgages in larger cities that are easier to underwrite. Both she and Member Kimbell commented on the appraiser shortages in their areas. Member Donnelly commented that there are rural areas of his state where there are only one or two banks serving five or six different counties. He stressed the need to take preemptive action to address any signs of economic stress in rural markets and ensure that community banks remain viable in a downturn.

Regulatory Issues. Several members discussed the Community Reinvestment Act ("CRA") and noted the desire for banks to automatically receive CRA credit for activities in designated Opportunity Zones. Member Edwards urged the FDIC to cautiously consider deposit insurance applications from non-banks and seek to ensure a level playing field. Member Stuchlik suggested the need for a more thorough vetting of the timeframes for implementing regulations or accounting changes. She mentioned the time and effort expended by her bank as well as the costs incurred to comply with the current expected credit losses ("CECL") standard prior to the Financial Accounting Standard Board's ("FASB") change in the effective date of the standard.

Bank Examinations. Several members mentioned that the FDIC had completed, or was in the process of completing, examinations of their banks. Generally, they expressed appreciation for the FDIC's examination planning efforts, and several members complimented FDIC examination staff on their professionalism, communication and collaboration during the examination process.

Industry Consolidation. Several members touched on industry consolidation, with some expressing particular concern regarding recent credit union acquisitions of community banks. Member Stuchlik noted that regulatory inequality between banks and credit unions may give rise to safety and soundness concerns and suggested that credit unions should be held to the same standards as their same-size peers in the banking industry, noting that nine out of ten financial institutions in Oregon are now credit unions. Member Kimbell suggested that community banks might be a better fit than credit unions with respect to banking agriculture and small businesses in rural communities. Member Getzlaff noted her concerns regarding consolidation in the industry and indicated that she is regularly asked about the asset size the bank needs to achieve to survive.

Minority Depository Institutions. Member Kelly specifically thanked Chairman McWilliams, Director Gruenberg and Betty Rudolph for their participation in the National Bankers Association and their support of minority depository institutions. Mr. Kelly mentioned that unbanked status disproportionately impacts low- and moderate-income communities and people of color, and requested that the FDIC consider developing some form of cost analysis aimed at encouraging the unbanked to enter the banking system.

Other Issues. Several members indicated that the legalization of marijuana and hemp production continues to raise certain compliance issues. These members indicated a need for further clarification of compliance and reporting requirements in this area.

Following the discussion of banking conditions by the Committee members, Mr. Davis announced that the meeting would briefly recess. Accordingly, the meeting stood in recess at 10:31 a.m.

The Committee reconvened at 10:40 a.m., at which time Mr. Davis introduced Ms. Olesiuk, Ms. Elmquist, and Mr. Dean to continue the discussion of local banking conditions.

Ms. Olesiuk discussed the 2019 FDIC Risk Review and stated that she was encouraged that the risks mentioned by the Committee members in the roundtable discussion generally coincided with the risks covered by the Risk Review. Ms. Olesiuk indicated that the FDIC intends to return to regular publication of the Risk Review. She highlighted the three sections of the Risk Review: an executive summary; a summary of key economic, financial market, and banking industry trends; and a section highlighting key banking risks.

Ms. Olesiuk noted that the risks covered in the Risk Review are broken into two broad categories: credit risk and market risk, and she emphasized that the Risk Review highlighted risks relevant to community banks. She began by discussing risks related to agriculture, pointing out that the majority of banks that lend to agriculture are in the Midwest. There are approximately 1,300 banks with loan concentrations in agriculture (over 300% of total capital). Community banks hold the majority of agriculture loans, at almost 70%, or $127 billion of the $184 billion outstanding. This risk area is being closely followed by the FDIC. Ms. Olesiuk then highlighted a chart illustrating a steady decline in net farm income from the high in 2013. However, this decline contrasts with strong farmland values, which have helped to keep agriculture loan delinquencies relatively low. She commented that banks are managing this risk well.

Ms. Elmquist discussed agriculture lending by banks headquartered in the eight states that comprise the Dallas region. Those banks lead national production in cattle, cotton and rice. She noted that there are around 200 banks in the Dallas region that have a sizable engagement in agricultural lending. From an examination perspective, the banks are generally doing well; they continue to have solid earnings and steady, but slower, loan growth. Loan delinquencies are rising in some institutions; farm borrowers are more leveraged than in the past and are making more use of government-guarantee programs. Overall, however, indicators are positive. Examiners have observed good underwriting and credit administration with regard to agricultural loans. Although FDIC examiners are seeing higher levels of carryover debt, they observe that it is well collateralized and structured appropriately with regard to amortization. She noted that the Dallas Region expects to see additional carryover debt along the Mississippi Delta, due to significant flooding. The FDIC is encouraging banks to work with the affected borrowers to the extent they can do so. Ms. Elmquist noted that examiners are recommending that, if banks are not already doing so, they should track and monitor carryover debt on a portfolio-wide basis and track and report any policy exceptions that exist. She also noted that, in a very few situations, examiners are recommending that banks better document crop inspections.

Ms. Olesiuk continued with a discussion of commercial real estate ("CRE") credit risk. CRE is an area of exposure for many community banks across the country, and the FDIC is following the area closely. A map of exposure levels indicated that approximately 1,400 banks have at least 300% of total capital in CRE loans, primarily in metropolitan areas in the west, northeast and south. She noted that, while there is some community bank exposure, it is relatively less than in the agriculture sector. About 30% of total outstanding CRE loans are held by community banks, and the remainder are held by non-community banks. Ms. Olesiuk referred to a chart illustrating that market conditions seem strong. There are low vacancy rates and relatively high property prices, although she indicated that the Committee members' comments about prices being inflated and lender concessions did resonate.

Ms. Olesiuk next highlighted a chart showing the volume of CRE lending. In the aggregate, CRE exposure was at record levels during the first quarter of 2019. While there are some similarities with the high property prices and real estate values prior to the last downturn, one current distinction is growth in the multi-family segment. The trend is a combination of big multi-family lenders growing their portfolios and other lenders entering the multi-family space.

Mr. Dean noted that, although CRE concentrations are building in the Atlanta region, the levels remain well below pre-crisis levels. Importantly, acquisition, development and construction ("ADC") lending has declined by almost 40% since 2010 in the Atlanta region, and a significant portion of the CRE concentrations in the Atlanta region are in owner-occupied properties. Mr. Dean shared that CRE concentrations are heaviest in metro Atlanta; Florida; Charlotte and Raleigh, North Carolina; as well as coastal Carolina. Overall, he observed that banks are doing a better job of managing their CRE concentrations.

Next, Ms. Olesiuk highlighted the growth in leverage lending and corporate debt; she noted that this is an area of exposure primarily for large banks and generally throughout the economy. She referred to charts demonstrating the record high debt-to-gross domestic product ratio and growth in corporate bonds. This is reflective of very low interest rates and corporations taking advantage of those rates by increasing their debt levels.

Ms. Olesiuk then discussed interest rate risk and competition for deposits, noting that the 2019 Risk Review aligned with the views expressed by the Committee members. She referred to a chart representing community banks and non-community banks, showing the ratio of non-interest-bearing deposits to assets, demonstrating that in 2018 and 2019, the ratio of non-interest-bearing deposits to assets is trending down and demand for interest-bearing deposits is trending up, which has implications for net interest margins. Mr. Dean commented that this phenomenon is very pronounced in the Atlanta region. During the artificially low interest rate environment, customers generally placed their money in non-interest-bearing accounts. As the Federal Reserve incrementally raised interest rates, customers moved their money into interest-bearing accounts. Mr. Dean indicated that, with the Federal Reserve lowering interest rates recently, there is some uncertainty as to what may happen next. Ms. Elmquist encouraged banks to back-test their interest rate risk models and evaluate their stress testing assumptions. Mr. Dean added that the bulk of the examination recommendations he has seen relate to the assumptions being used in banks' interest rate risk models.

Ms. Olesiuk discussed the final Risk Review topic of liquidity. She referenced a chart displaying the relationship between the share of liquid assets and wholesale funding industry-wide for banks with less than $100 billion in assets. The trends demonstrate increasing use of wholesale funding and declining use of liquid assets, in large part to fund loan growth. She noted that the gap between wholesale funding and liquid assets is even greater for banks with higher concentrations in lending.

Ms. Elmquist noted the Dallas region observed a decline in balance sheet liquidity over the last several years as well as a movement toward greater diversification of the funding base. She referenced the 2019 Conference of State Bank Supervisors ("CSBS") National Survey, which showed that one-third of the respondents ranked either core deposit growth or the cost of funds as their greatest challenge. In the Dallas region, the cost of funds has increased around 40 basis points from a year ago. She observed that, although rates recently declined, reversing that trend may be difficult due to competition for deposits and the desire to retain customers. Ms. Elmquist also commented on examination recommendations regarding liquidity and funds management, noting that examiners have been making recommendations to address certain gaps identified in cash flow analyses and encouraging banks to review and update contingency funding plans. She stressed that assumptions should be reviewed to ensure they are reasonable and that banks appropriately consider the effects that different scenarios may have on collateralization requirements for lines of credit. Ms. Elmquist recommended that banks establish appropriate risk limits for alternative funding sources in their policies.

Member Donnelly asked whether the FDIC had noted differences between agriculture declines in the 1980s and the current trend. Ms. Olesiuk indicated that the FDIC does not issue forecasts, but noted some differences in current conditions relative to the late 1980s, including higher equity and the relatively stronger positions of farmers and farm banks.

Mr. Davis then introduced Patrick Mitchell, Deputy Director, DIR, who provided an overview of national conditions for community banks based on highlights from the FDIC's

Quarterly Banking Profile for the second quarter of 2019. He also discussed small bank deposit insurance assessment credits.

Mr. Mitchell began by discussing continued strong growth in community bank net income. Net income was up 8% year-over-year in the second quarter, an across-the-board improvement. Mr. Mitchell noted that the chart does not necessarily tell the story for the future since it is a challenging interest rate environment. He recalled that, there have been nine interest rate increases since 2015, as well as two interest rate cuts since the end of the second quarter, and he mentioned that the yield curve is currently flat, or inverted. As interest rates increased since 2015, the repricing of deposits was slow. He noted that just recently, in the aggregate, there was some traction for deposit cost increases, even as rates had subsided. However, given the recent rate cuts, the direction of deposit pricing is less clear. Mr. Mitchell stressed that community bank net interest margins continue to exceed the overall industry.

Member Epstein commented that community banks' favorable net interest margins as compared to the industry are a result of higher-yielding assets. He questioned how community banks' costs of funds compared. He cited that his bank is asset sensitive and will see a retreat in asset yield, but he questioned whether the bank would be able to reprice deposits in any meaningful way since that would put funding at risk. Mr. Mitchell responded that, for the last six quarters, community bank funding costs have been lower than those of non-community banks. However, he pointed out that this was a reversal of the trend from the first quarter of 2008 through the first quarter of 2018, and it is unclear how quickly deposits will reprice.

Member Williams asked whether the FDIC was noticing a downward trend regarding deposit betas. Mr. Mitchell indicated we're not seeing it yet, but he noted that the second rate cut was at the end of the third quarter. He thought the third quarter numbers might provide more information.

Mr. Mitchell then discussed pretax return on assets, which increased at community banks during the second quarter, but declined modestly at non-community banks year-over-year. He also indicated that 96% of community banks reported a profit last year. He then referred to a chart that demonstrated that net operating revenue as a percentage of average assets has been stable over an extended period of time. Net interest income was up 5.1% last quarter and non-interest income was up 4.7%, indicating strong growth in both areas.

Mr. Mitchell reported that asset quality continued to be strong, even with respect to farm loans, where there was only a slight diversion. Farm loans had a 1.28% non-current rate during the last quarter. He noted that this is still a relatively low non-current rate, particularly given the sustained period of low farm income. Mr. Mitchell referenced two charts that provided more granular detail regarding non-current agriculture loans. The first chart detailed non-current rates for farmland loans and agricultural production loans, and the second chart provided some state-by-state data on past due and non-accrual agriculture loans. Mr. Mitchell then discussed a chart describing charge-off rates, showing rates at 11 basis points, 2 basis points off the recent low.

Overall loan growth remained strong, at 6.3% year-over-year for community banks and 4.5% for the industry. Mr. Mitchell commented that there has been a five- to six-year period where community banks outpaced non-community banks in loan growth, and that the growth has been broad-based.

Next, Mr. Mitchell described a long-term trend post-crisis relating to loans and securities with maturities greater than three years. The current level is 47%. Overall, the chart shows a material change since, just coming out of the crisis, the data showed 37% of combined loans and securities greater than three years. Mr. Mitchell next discussed a slide describing community bank liquid assets and wholesale funds, noting that both have stabilized. Moving to capital, he indicated that it continued to improve for community banks and was higher than the industry.

Mr. Mitchell then turned to industry consolidation. He explained that the long-term average rate is about 4% for the industry from 1985 to 2019, and community banks have had a slightly lower, long-term average rate closer to 3% over the same time period. He indicated that, post-2012/2013, there has been an increase in the percentage of inter-bank mergers, with prices and multiples rising in terms of acquisitions. He also noted that the trend has leveled out and is slightly slower this year. During the second quarter, it was about 4% year-over-year, which was close to the long-term average but slightly lower than the most recent time. Member Epstein asked whether the FDIC was anticipating an uptick in merger activity, as banks need to find economies of scale to combat pressure on their margins. Mr. Mitchell noted that studies indicate that economics of scale are reached at around $500 million in assets and that there is less of an impact from a merger after that point, but noted that the situation is likely to be different for every bank. He also mentioned that consolidation activity also depends on the overall economic outlook.

Mr. Epstein indicated his concern about another wave of consolidation as banks see pressure on earnings, and noted that other issues may come to bear, such as succession planning. He also urged the FDIC to look closely at sales of community banks to credit unions.

Mr. Mitchell next discussed small bank deposit insurance assessment credits. He mentioned that most, if not all, of the banks represented on the Committee should have received credits covering the surcharge period, which was the time period when the deposit insurance fund ("DIF") reserve ratio grew from 1.15% to 1.35%. In the second quarter, the FDIC announced that the DIF reserve ratio was 1.40%, and that credits would be paid once the DIF was at 1.38%. In this regard, he commented that most banks should not have had an assessment charge last quarter.

He mentioned that there are still $445 million of credits remaining to be applied over the near term. The FDIC expects to apply $238 million in the third quarter of 2019 and $144 million in the fourth quarter, with remaining amounts to be applied tailing off quickly after that. Mr. Mitchell commented that most institutions will use the credits over three to four quarters.

Mr. Davis then introduced Anthony Lowe, FDIC Ombudsman, to provide an update. Mr. Lowe discussed an actual case demonstrating how the Office of the Ombudsman ("OO") helped to resolve an issue relating to an examination. Earlier this year, during an examination of a bank with assets under $5 billion and favorable ratings, examiners raised questions regarding how the bank had booked certain transactions. The bank made the case that state law provided a very unique and narrow exemption in their situation. Ultimately, the matter was cited as a violation, and the bank reached out to the OO after receiving the Report of Examination ("ROE"). The bank was concerned about the cost to remediate the situation since the assets had been booked over fairly long time period. The OO discussed options with the bank, ranging from discussions with supervisory personnel to filing a formal appeal. The OO also suggested that it might be advantageous for the bank to provide a legal opinion that supported its position. With the OO acting as an intermediary, the supporting information was shared with the supervisory team and the Region's Legal Division staff. The Legal Division agreed with the bank's position, and a revised ROE was issued with the violation removed. The OO was able to facilitate a positive outcome in this case, and the bank did not have to submit a formal appeal. Mr. Lowe stressed that, although no two cases are alike, many issues can be resolved through communication between the bank and the examination team at the regional level.

Member Pitkin commented that he appreciated Mr. Lowe sharing a success story involving an instance where the FDIC was not correct, and he asked about potential reimbursement to the bank. Mr. Lowe responded that the FDIC would typically take steps to ensure that similar issues do not recur in the future.

Member Kelly also thanked Mr. Lowe for sharing the story. He asked whether there were policies or guidelines concerning the look-back period for potential corrections the bank would have been required to undertake if the violation had remained in place. Mr. Lowe responded that, in this particular case, the bank likely would not have been required to go back a significant period of time and that the intent is to be prudent and reasonable. Member Donnelly then asked if Mr. Lowe could clarify the type of legal opinion that the bank provided. Mr. Lowe responded that the bank used outside counsel to prepare an opinion. Mr. Milhorn clarified that a legal opinion is not required, however, and he stressed that a bank could approach the OO for assistance even in the absence of one.

Member Edwards also shared an experience that he had a few years ago regarding concerns about a recommendation in a trust examination, where his bank was able to reach a successful outcome through dialogue with supervision staff in the Atlanta Regional Office. He emphasized that conversations can occur directly with the supervision staff. Mr. Milhorn stressed the FDIC's willingness to engage with bankers at the regional and headquarters levels.

Member Pitkin also asked whether the OO tracks actions and outcomes. Mr. Lowe responded that the FDIC uses certain internal metrics to track cases. Mr. Milhorn mentioned that Chairman McWilliams has instituted a recurring operational review with RMS, the Division of Compliance and Consumer Protection ("DCP"), senior FDIC leadership and the OO. As part of this review, the Ombudsman shares feedback that his office is receiving from the industry.

Mr. Davis announced that the meeting would recess for lunch. Accordingly, the meeting stood in recess at 12:01 p.m.

The meeting reconvened at 1:10 p.m., at which time Mr. Davis advised that the next item on the agenda was a Supervision Update. Presentations were delivered by Doreen Eberley, Director, RMS; Lisa Arquette, Associate Director, RMS; Shannon Beattie, Section Chief, RMS; Benedetto Bosco, Section Chief, RMS; William Henley, Associate Director, RMS; Martin Henning, Deputy Director, RMS; and Thomas Lyons, Section Chief, RMS.

Before turning to the panel, Ms. Eberley discussed a financial institution letter ("FIL") issued in August, titled *Risk-Focused, Forward-Looking Safety and Soundness Supervision,* FIL-47-2019. She explained that this FIL announced an update to the FDIC's Manual of Examination Policies in the form of a new section on "Risk-Focused, Forward-Looking Safety and Soundness Supervision."

Ms. Eberley then highlighted several items covered by the FIL, including that examination planning has been accelerated. Activities that previously happened closer to the examination date now occur earlier in the process. Approximately 90 days prior to the examination, the field supervisor or supervisory examiner will contact the bank to ask logistical questions, such as whether a loan review can be conducted off-site and to address connectivity. The bank then will be sent an information technology ("IT") risk profile script that banks are accustomed to receiving for the FDIC's Information Technology Risk Examination Program ("InTREx") as well as a new examination planning script that asks about changes that have occurred at the bank since the last examination. Six to eight weeks before the examination, the examiner in charge ("EIC") will review the materials provided by the bank, prior ROEs, the Uniform Bank Performance Report, and correspondence; talk to the case manager; and learn more about what has happened at the bank since the last examination. Importantly, the EIC will contact bank management as well. The EIC then will develop a preliminary view of the institution's business model, risk profile and complexity as well as a preliminary examination plan. The EIC also will develop a request list that is even more tailored to the institution, with the goal of making the response less burdensome for the bank. In addition, the EIC will make a determination regarding activities that can be conducted off-site. The second phase of examination planning will occur about two weeks before the examination's start date, when the EIC and available staff will begin working off-site to review the materials that have been submitted. In combination, the changes made to the planning process should provide for a more focused examination and less time spent on-site. The changes became effective October 1, 2019 for examinations that start in January 2020. Ms. Eberley added that RMS has been training examiners on these procedures over the course of this year.

Next, Ms. Eberley mentioned that this new section in the Manual of Examination Policies reemphasizes principles that the FDIC adopted as a member of the Federal Financial Institutions Examination Council. These principles concern the importance of clear and transparent communication and risk tailoring during the examination process. Ms. Eberley emphasized that bankers should let the FDIC know if they are experiencing difficulty during an examination. She noted that, with respect to the matter discussed previously by Mr. Lowe, the matter was resolved fairly quickly once it was brought to the attention of regional management.

Thomas Lyons then addressed the interest rate restriction rule for institutions that are less than well capitalized and changes to the appraisal rule relating to residential real estate loans. In February 2019, the FDIC issued an Advance Notice of Proposed Rulemaking ("ANPR") on the brokered deposit and interest rate restriction regulations. The comment period ended in May, and the FDIC received approximately 130 comments, including 59 focused on the rate restrictions. The comments particularly highlighted concerns regarding the national rate calculation. On September 4, 2019, the FDIC published a Notice of Proposed Rulemaking ("NPR"), titled *Request for Comments on Interest Rate Restrictions Applicable to Institutions that are Less than Well Capitalized*, with a comment period ending November 4, 2019.

Section 29 of the FDI Act restricts an institution that is less than well capitalized from paying rates of interest on deposits that significantly exceed the rates in its normal market area. The FDIC adopted rules to implement these restrictions in 1992 and revised them in 2009. From 1992 to 2009, the rate restrictions for different bank products were tied to United States Treasury rates. This worked well because there was a close correlation between Treasury rates and deposit rates. However, during the financial crisis, this close correlation no longer existed as Treasury rates fell to a very low level. Therefore, in 2009, the FDIC revised the rules. The interest rate restrictions were based on an average of rates available from all banks on various products, such as for savings, checking and money market deposits. These changes worked for a period of time, but issues arose again as the average posted rates were not the same as the rates actually being offered by larger institutions and via new business models, such online deposit gathering. Therefore, the NPR would amend the methodology for calculating the national rate and the national rate cap. The national rate would be a weighted average of the rates paid by all insured depository institutions on a given product, with the weighting based on the institution's market share of total domestic deposits. The national rate cap would be set at the *higher* of the 95th percentile of the rates paid by insured depository institutions weighted by each institution's share of domestic products, or the proposed national rate plus 75 basis points. The rationale is that this approach would allow institutions to compete while not necessarily being at top of the market, but for products where there was a convergence of rates, there would still be the option of using 75 basis points above the national rate.

Mr. Lyons noted that there are also several alternatives proposed in the NPR, based on suggestions received through the ANPR process, including using the higher of the two previous caps, or using an average of top rate payers, among others. The NPR would also greatly simplify the current local rate cap calculation by allowing less than well capitalized institutions to offer up to 90% of the highest rate within their local area for deposits gathered locally.

Mr. Lyons then discussed the new appraisal threshold for residential real estate loans. In December 2018, the FDIC, Office of the Comptroller of the Currency, and Board of Governors of the Federal Reserve System ("Agencies") issued an NPR to raise the threshold for residential real estate appraisals, which received over 600 comments as of February 2019. The final rule, which was published in the *Federal Register* on October 8, 2019, defines a residential real estate appraisal transaction as one being secured by a one- to four-family residential property. It increases the threshold for requiring an appraisal on a residential property from $250,000 to $400,000. For residential properties valued at less than $400,000, the final rule requires an evaluation to be performed on those transactions. The final rule incorporates a self-effectuating exemption from section 103 of the Economic Growth, Regulatory Relief and Consumer Protection Act ("EGRRCPA"). This rural appraisal exemption allows rural lenders to obtain an evaluation if they are unable to obtain an appraisal. The rule also incorporates a conforming amendment from section 1473(e) of the Dodd-Frank Act, which requires lenders to subject appraisals for federally-related transactions to appropriate review for Uniform Standards of Professional Appraisal Practice compliance.

Member Shettlesworth suggested that it would be helpful if interest rate calculations in the interest rate restriction NPR included data from credit unions, as they are the source of his bank's competition for rates. Member Leavitt asked whether the FDIC would be limiting its examination analysis to the new calculation of the national rate cap and not conducting local market studies for banks that are less than well capitalized. Mr. Lyons indicated that, assuming that the NPR becomes the final rule, if a bank that is less than well capitalized elects to use a local rate cap, then examiners would evaluate how the bank determined its highest rates. Member Leavitt then asked whether well-capitalized banks would be critiqued relative to the national rate cap. Ms. Eberley responded that the answer is no. She indicated that there was some confusion about where national rate caps do and do not apply. She noted that all commissioned examiners were trained during this year on national rate caps. Ms. Eberley relayed that some of the confusion may have existed because examiners were asked to review contingency liquidity funding planning for institutions that are heavy users of rate-sensitive deposit products – essentially, brokered and listing service ("listserv") deposits – that would be subject to the national rate cap if the institution fell below well capitalized. Therefore, this should only be a discussion item if an institution is a heavy user of brokered, listserv, and other rate-sensitive deposits.

Next, Mr. Bosco discussed the community bank leverage ratio ("CBLR") final rule. In February 2019, the Agencies published an NPR to implement section 201 of EGRRCPA. The Agencies proposed to establish a CBLR for qualifying community banking organizations as a simple alternative methodology to measure capital adequacy. The Agencies received approximately 50 unique comments and 500 form letters. The Agencies made several modifications to the final rule, including the adoption of Tier 1 capital and therefore, the existing leverage ratio, into the CBLR framework; removal of the qualifying criteria for mortgage servicing assets and deferred tax assets arising from temporary differences; removal of the prompt corrective action ("PCA") proxy levels; and allowing a banking organization that ceases to satisfy any of the qualifying criteria required under the CBLR framework a two-month grace period to either meet the qualifying criteria again or to comply with the applicable capital rule. He further explained that, under the final rule, a qualifying community banking organization that opts into the CBLR framework is only required to calculate and report a leverage ratio to measure its capital adequacy and therefore is not required to calculate and report its risk-based capital ratios. A qualifying community banking organization must meet the following criteria: (a) Tier 1 leverage ratio greater than 9%, (b) less than $10 billion in total consolidated assets; (c) off-balance sheet exposures of 25% or less of its total consolidated assets; (d) trading assets plus trading liabilities of 5% or less of total consolidated assets; and (e) the institution must not be an advanced approaches banking organization. Qualifying community banking organizations that elect to use the CBLR framework and that maintain a leverage ratio of greater than 9% are considered to have satisfied the risk-based and leverage capital requirements in the Agencies' generally applicable capital rules. Additionally, such insured depository institutions are considered to have met the well-capitalized ratio requirements for PCA purposes.

Mr. Bosco emphasized that the CBLR framework is optional and intended to reduce burden for banks that meet the qualifying criteria. He stressed that a bank can opt out of the framework without restriction by reporting its risk-based ratios in the Consolidated Reports of Condition and Income ("Call Report"). If a bank is using the CBLR framework and an event causes it to no longer comply with the CBLR framework for an extended period of time, the bank can go back to the risk-based framework by reporting those ratios in its Call Report. The bank can then opt back into the CBLR framework again through its Call Report when it so chooses, assuming it meets all of the qualifying criteria. If an electing banking organization fails to satisfy one or more qualifying criteria and maintains a leverage ratio of greater than 8%, the banking organization would have a grace period of up to two quarters during which it could continue to use the CBLR framework and be deemed to meet the well-capitalized ratio requirements. Such a banking organization is only required to report the risk-based ratios if it is unable to restore compliance with all of the qualifying criteria during the two-quarter grace period; its leverage ratio is 8% or less; or it ceases to meet the qualifying criteria due to consummation of a merger transaction. For example, if a bank meeting all of the criteria elects to use the CBLR framework on its March 31 Call Report, and subsequently the bank reports off-balance sheet exposures of 30% or more of total consolidated assets on its June 30 Call Report, the bank would have to either come back into compliance with the 25% requirement by the December 31 Call Report or, if it cannot, it would have to report its risk-based leverage ratios on its December 31 Call Report. The bank must also continue to maintain a leverage ratio of greater than 8% during the grace period.

Mr. Bosco noted that, based on reported data as of March 31, 2019, there are 5,221 insured depository institutions with less than $10 billion in total consolidated assets. The Agencies estimated that approximately 85% of these insured depository institutions would qualify to use the CBLR framework. He concluded by stating that the Agencies believe the final rule provides a simple framework that meets safety and soundness goals and responds to commenters' concerns.

Member Shettlesworth asked whether there were restrictions on a bank's ability to opt in and out of the CBLR framework. Mr. Bosco confirmed that institutions can go back and forth with respect to using the CBLR or risk-based frameworks.

Next, Ms. Beattie discussed FASB's exposure draft issued over the summer that proposes to extend the effective date for the implementation of the CECL accounting standard. Currently, institutions would begin adopting CECL in 2020, with staggered implementation in 2021 and 2022 depending on the institution's characteristics. The FASB exposure draft would extend the effective date for entities that are either non-public business entities or smaller reporting companies. SEC public filers that are not smaller reporting companies would continue to start implementation in 2020, but if the exposure draft becomes final, many community banks would have until 2023 to implement the CECL standard. Ms. Beattie noted that FASB proposed to extend the effective dates for CECL and two other standards involving leases and hedging, in part to allow more time for entities that are not public filers to learn from public filers' implementation.

The FDIC is encouraging institutions to work towards implementation and the regulators are continuing to work with the other Agencies and the NCUA, with input from the CSBS to draft an interagency policy statement on allowance for credit losses that will eventually supersede the current policy statements. Ms. Beattie noted that there are 2006 and 2001 policy statements on allowances for loan and lease losses ("ALLL"). As institutions adopt CECL, those policy statements will no longer be relevant. The policy statement was approved by the FDIC Board in August 2019 and once the other Agencies and NCUA reach agreement, it will be published in the *Federal Register*. Similar to the ALLL policy statements, it will cover how institutions should implement the accounting standards, board and management responsibilities, and how examiners will conduct their reviews.

Member Pitkin asked whether examiners would be aware that the reserves at a bank may be substantially less following CECL implementation. Ms. Beattie responded that the FDIC has been training examiners since the FASB issued the CECL standard, in order to make them aware of the differences between CECL and the incurred loss methodology.

Member Maley commented that it may be difficult for de novo banks to develop loss history if they have no charge-offs. She referenced potentially using peer data based on asset size, but noted that asset size is only one determination and portfolio composition could be different. Ms. Beattie indicated that the additional time to implement CECL should allow institutions to gather more relevant data and potentially use proxy data to fill in gaps. She emphasized that the FDIC is neither suggesting nor requiring institutions to use third parties, but recognized that some entities may elect to use third parties to assist with filling in data gaps.

Member Epstein stated that institutions such as his have spent considerable time and resources preparing for the adoption of the standard. However, he noted that his institution recently documented its intent to put further implementation efforts on hold given the delayed implementation date. He indicated that his bank will continue to monitor developments and is seeking feedback from its auditor and peer institutions that are early adopters. Ms. Beattie noted that it was partly FASB's intent to lengthen the effective dates for that purpose. She recommended that institutions conduct parallel runs to validate the methods they are using to implement CECL, similar to what they would have done with the current incurred loss methodology. Ms. Beattie stated that the regulators expect institutions to make a good faith effort regarding implementation; however, the FDIC realizes it will be an iterative process and expects improvement over time.

Member DeBiasi commented that the current methodology has evolved quite a bit and noted that there will likely be further evolution with CECL, as well. He expressed the hope that regulators will have patience with banks that are making a good faith effort. He stated that it would be a difficult transition, especially for smaller banks with fewer resources than larger institutions. Member Shettlesworth asked how the regulators would handle a situation where there is a conflict between regulators and accountants regarding the appropriate allowance. Ms. Beattie indicated that the allowance for credit losses is detailed in Call Reports, which are prepared in accordance with generally accepted accounting principles.

Ms. Arquette presented an update regarding depository institutions' onboarding and maintaining of customers involved in the hemp industry. By way of background, she discussed the Agricultural Act of 2014 ("2014 Farm Bill") and the 2018 Agricultural Improvement Act ("2018 Farm Bill"). Ms. Arquette noted that the 2014 and 2018 Farm Bills have very similar definitions for hemp. The 2014 Farm Bill addressed "industrial hemp" in the context of academic research and research for growing hemp. It defined industrial hemp as having delta-9 tetrahydrocannabinol ("THC") concentration of not more than 0.3% on a dry weight basis. The 2018 Farm Bill refers to "hemp" and not "industrial hemp" – but the chemical component is the same at 0.3% THC or less.

The 2018 Farm Bill removed hemp with 0.3% or less THC as a Schedule 1 controlled substance under the Controlled Substance Act and directed the U.S. Department of Agriculture ("USDA"), in consultation with the U.S. Attorney General, to regulate hemp production. The 2018 Farm Bill states that hemp production will be subject to a plan established by the USDA, states or tribal governments. The USDA has issued a legal opinion and other guidance interpreting the 2018 Farm Bill and announced that it expects to issue regulations by year-end 2019. According to the USDA, hemp may be produced by properly licensed hemp producers in accordance with the 2018 Farm Bill only after the USDA issues regulations and guidance for commercial production of hemp in the U.S. The USDA intends to have regulations in effect to accommodate the 2020 planting season. These regulations are expected to provide details on sampling procedures, testing requirements, licensing, compliance and other procedures that production facilities and oversight authorities will be required to follow.

However, institutions of higher education and those that are growing hemp for agricultural purposes and research remain subject to the 2014 Farm Bill, pending USDA's issuance of regulations by year-end to establish a regulatory infrastructure. Ms. Arquette further explained that individual states, tribal governments and territories can each submit plans to the USDA that establish policies and procedures for growing hemp. Until that time, USDA regulations will continue to govern the growing of hemp in the U.S.

In terms of onboarding and maintaining hemp customers, Ms. Arquette stated that the FDIC does not direct banks on the types of customers it can serve. The FDIC does not discourage or prohibit any type of customer as long as the bank manages its customers and the associated risks and complies with regulations. The Bank Secrecy Act and anti-money laundering regulations are pertinent, as are customer due diligence requirements and suspicious activity monitoring.

Ms. Arquette observed that most states have legalized the production of hemp, but haven't established policies and procedures for measuring its production, while awaiting the USDA regulations. She noted that cannabis, however, remains a controlled substance. If a bank has a customer that grows marijuana or provides marijuana-related services, the bank is still required to file currency transaction reports and suspicious activity reports ("SARs") consistent with 2014 Financial Crimes Enforcement Network ("FinCEN") guidance. If a bank has a customer that is a hemp producer, the bank would not be required to file a SAR based solely on that activity.

Ms. Arquette noted that the FDIC has also received questions around cannabidioil ("CBD oil") and various related products, such as food and cosmetics. She stated that the FDA has to approve any product containing CBD oil, so there are other stakeholders that banks may need to consider. In general, she commented that there are signs that there will be a regulatory structure in place soon and that most banks appear to be performing appropriate levels of customer due diligence on marijuana- and hemp-related businesses.

Next, Mr. Henley made a presentation on managing IT and cybersecurity risk. The FDIC introduced InTREx on July 30, 2016 and is now nearing a complete examination cycle using the program. He reviewed various insights and lessons learned. He also noted that the FDIC instructs examiners to evaluate the adequacy of short- and long-term IT strategic planning and the budgeting process. Examiners consider the following: involvement of appropriate parties, including senior management and the board; identification of significant planned changes; alignment of business and technology objectives; ability to promptly incorporate new or updated technologies to adapt to changing business needs; and control, compliance, or regulatory issues.

Mr. Henley then discussed some common examination recommendations, such as board oversight or involvement consistent with the institution's complexity; increased consideration of business continuity to avoid disruptions and recover services as quickly as possible; and the use of standard assessments to guide increasing cybersecurity maturity, such as the FFIEC's cybersecurity assessment tool ("CAT"), the National Institute for Standards and Technology ("NIST") cybersecurity framework, or the Financial Services Sector Coordinating Council ("FSSCC") profile. With respect to the cybersecurity assessments, Mr. Henley stated that the FDIC does not direct the use of a specific tool; rather, he emphasized the value of using a standardized assessment because it is a repeatable process that provides measurable and meaningful indicators over time.

Member Leavitt requested confirmation that the CAT followed and was largely modeled on the NIST framework. Mr. Henley agreed that this was an accurate assessment, as the NIST tool cut across all of the 16 critical infrastructure sectors, while the CAT was developed with a focus on the financial services sector. Mr. Leavitt also asked whether the FDIC had examination data regarding how institutions are progressing along the cybersecurity maturity spectrum. Mr. Henley indicated that the FDIC did not have specific data, but has observed an increase in community banks using the CAT or adopting other repeatable processes. Ms. Eberley emphasized that institutions are not directed to use any specific tool, but they need to do a risk assessment and have a repeatable process in place.

Member Donnelly commented that his bank uses the CAT tool, and asked how often the FDIC would expect the bank to conduct reassessments, given rapid changes in technology. Mr.

Henning suggested that a bank might approach this issue from a risk-based standpoint; for example, a good time to reassess might be after a bank changes its core system. In addition, he suggested that banks consider findings and recommendations from IT audits to focus their resources. In connection with further discussion regarding whether banks need to have a separate IT strategic plan and the potential costs involved, Mr. Henning indicated that the FDIC's procedures are not prescriptive, and the need for such a plan is institution specific and dependent on a number of factors.

Mr. Davis announced that the meeting would take a mid-afternoon break. Accordingly, at 2:25 p.m., the meeting stood in recess. The meeting resumed at 2:39 p.m.

Mr. Davis then introduced Betty Rudolph, National Director for Minority and Community Development Banking, and Sandra Kerr, Senior Program Specialist, RMS, to discuss tools and resources related to Opportunity Zones.

As a follow up to the July Committee meeting where there was an initial conversation about Opportunity Zones, Mr. Rudolph noted that the presentation at this meeting would focus on tools and resources that the FDIC developed for community bankers. She also explained that Opportunity Zones are a tax incentive as opposed to a federal program, and that a lot of activities take place at the local level.

First, she introduced an excerpt of an FDIC draft publication about Opportunity Zones. The publication will describe the tax incentives and discuss the role that banks can play in that process. She also referenced a section in the excerpt of the publication that addresses CRA consideration. It specifically states that investments in Qualified Opportunity Funds do not automatically receive CRA consideration. However, she noted that, based on discussion with FDIC CRA experts and lawyers, a lot of investments may qualify for CRA credit, and she encouraged bankers to reach out to their FDIC regional office for further consultation.

Second, Ms. Rudolph discussed the potential roles of banks, and cited examples in the excerpt, such as serving as facilitators for Opportunity Zone investments; providing financing to a Qualified Opportunity Fund or to an investor in such a fund; and acting as brokers by bringing projects to Qualified Opportunity Funds and helping to structure the transactions. She welcomed comments on the draft publication, which will be available on the FDIC's website.

Next, Ms. Kerr demonstrated an interactive website with resources on state and local incentives, tax credits, and information on Opportunity Zone funds in each state. Ms. Kerr introduced Dustin Allison and Sasha Rybak from DIR, who created the interactive map, as well as Counsel Susan Sturc of the Legal Division, who worked on the Opportunity Zone publication.

Ms. Kerr conducted a visual demonstration using various interactive maps and highlighted some key features. She explained that the webpages being demonstrated were still in development; as such, they are not yet in the production environment and available publicly. She welcomed feedback on the webpages.

The first map pinpointed Opportunity Zones, tribal lands, and Opportunity Zones located within tribal lands. Ms. Kerr discussed how Opportunity Zones are designated by census tract, and there are more than 8,700 census tracts across the country that are qualified as Opportunity Zones, with almost 300 located in tribal lands. She next directed attention to a map that illustrated community banks, minority depository institutions (“MDIs”), and community development financial institutions (“CDFIs”) headquartered in Opportunity Zones. Almost 900 community banks are headquartered in Opportunity Zones and 36 are headquartered in an Opportunity Zone within a tribal area. Further, there are another 4,000 community bank branches located in Opportunity Zones. Finally, using the state of Georgia as an example, she demonstrated how one of the maps can be used to search for banks headquartered in an Opportunity Zone and having branches in Opportunity Zones, the number of census tracts designated as Opportunity Zones, etc. She also noted that, in each of the states, there are links to groups collecting information on specific Opportunity Zone funds, including information on the size of the fund, geographic and investment focus, and contact information. Ms. Kerr mentioned that there are presently at least 235 self-reported Opportunity Zone funds across the country that collectively hold between $62 billion and $72 billion. She stated that the funds are growing rapidly because of the requirement to be created by the end of 2019 in order to receive the maximum tax incentives.

Member Kelly asked when the webpages might be publicly available. Ms. Kerr responded that the publication is in the review and clearance process, and staff members are reviewing the webpages and interactive maps to ensure they are complete, accessible and compliant with section 508 of the Rehabilitation Act of 1973. Ms. Rudolph indicated that the goal is to have the webpages publicly available either at the end of 2019 or in early 2020. Member Epstein thanked Ms. Rudolph and Ms. Kerr for their work on the program and asked about whether an Opportunity Zone fund might be a viable alternative to an Internal Revenue Code section 1031 tax exchange. Ms. Kerr indicated that the publication would discuss such issues.

Mr. Milhorn then provided an update regarding one of the Committee’s subcommittees – the Supervision Modernization Subcommittee. This subcommittee was designed to bring together bankers, technology experts, and former examiners to provide ideas and recommendations regarding what bank examinations might look like in the near future and over the next ten years and how technology would change the process. The subcommittee met three times in 2019 and is currently preparing a report and recommendations for presentation to the Committee. The subcommittee expects to complete its report and recommendations early next year.

Mr. Milhorn thanked the Committee members for their service and relayed the Chairman's appreciation for their participation. He emphasized that the Committee members' advice, guidance and input is crucial to the Corporation. Mr. Milhorn adjourned the meeting at 3:11 p.m.

Robert E. Feldman
Federal Deposit Insurance Corporation
Executive Secretary
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, 2019 – 9:00 A.M.

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

____

Jelena McWilliams
Chairman
Board of Directors
Federal Deposit Insurance Corporation