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

May 11, 2011 8:34 A.M.

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

The members of the Committee present at the meeting were: R. Daniel Blanton, President and CEO, Southeastern Bank Financial Corporation and Georgia Bank & Trust Company of Augusta, Augusta, Georgia; Dorothy J. Bridges, President and CEO, City First Bank of D.C., Washington, D.C.; Charles G. Brown, III, Chairman and CEO, Insignia Bank, Sarasota, Florida; James H. Gray, Chairman, Beach Business Bank, Manhattan Beach, California; Jack E. Hopkins, President and CEO, CorTrust Bank, National Association, Sioux Falls, South Dakota; Timothy W. Koch, Professor and Chair, Finance Department, Moore School of Business, University of South Carolina, Columbia, South Carolina; John P. Lewis, Vice Chairman, Bank of Tucson, Tucson, Arizona; Jan A. Miller, President and CEO, Wainwright Bank & Trust Company, Boston, Massachusetts; Rebecca Romero Rainey, Chair and CEO, Centinel Bank, Taos, New Mexico; Bruce A. Schriefer, President, Bankers' Bank of Kansas, National Association, Wichita, Kansas; Laurie Stewart, President and CEO,

Sound Community Bank, Seattle, Washington; Ignacio Urrabazo, Jr., President, Commerce Bank, Laredo, Texas; and Matthew Williams, Chairman and President, Gothenburg State Bank & Trust Company, Gothenburg, Nebraska.

Members Deborah A. Cole, President and CEO, Citizens Savings Bank and Trust Company, Nashville, Tennessee, and Craig M. Goodlock, Chairman and CEO, Farmers State Bank, Munith, Michigan, were absent from the meeting.

Members of the FDIC Board of Directors present were: Sheila C. Bair, Chairman; Martin J. Gruenberg, Vice Chairman; Thomas J. Curry, Director (Appointive); and John E. Bowman, Director of the Office of Thrift Supervision (Acting).

Corporation staff who attended the meeting included: Ruth R. Amberg, Steven O. App, Luke H. Brown, Richard A. Brown, Glenn E. Cobb, Kymberly K. Copa, Christine M. Davis, Patricia B. Devoti, Doreen R. Eberley, Diane L. Ellis, Robert E. Feldman, Ralph E. Frable, George French, Steven D. Fritts, Alice C. Goodman, Shannon N. Greco, Tray Halverson, Nancy W. Hunt, Kenyon T. Kilber, Ellen W. Lazar, Alan W. Levy, Robert W. Mooney, Tariq A. Mirza, Paul M. Nash, Christopher J. Newbury, Thomas E. Nixon, Sylvia H. Plunkett, Grace Pyun, Carolyn D. Rebmann, Claude A. Rollin, Barbara A. Ryan, Christopher J. Spoth, Robert F. Storch, Jesse O. Villarreal, Cottrell L. Webster, Melinda West, James R. Wigand, and Katherine G. Wyatt.

William A. Rowe, III, Deputy to the Chief of Staff and Liaison to the FDIC, Office of the Comptroller of the Currency; and Charlotte M. Bahin, Senior Counsel for Special Projects, Office of Thrift Supervision, were also present at the meeting.

Chairman Bair welcomed the attendees and, noting that she would be stepping down from office on July 8, 2011, thanked the Committee for its service providing the FDIC with input on the effects of the FDIC's various initiatives. She said that Vice Chairman Gruenberg, the Board of Directors, and FDIC staff fully embraced the Committee's work and would continue to rely on it.

Chairman Bair observed that the banking sector generally, and community banks particularly, had turned a positive economic corner, and reviewed a variety of banking performance indicators. She then introduced Paul M. Nash, Deputy to the Chairman for External Affairs, who moderated the day's meeting. Mr. Nash then introduced Christopher J. Newbury, Associate Director, Division of Insurance and Research ("DIR"),

Luke H. Brown, Associate Director, Division of Depositor and Consumer Protection ("DCP"), and Steven D. Fritts, Associate Director, Division of Risk Management Supervision ("RMS"), who moderated the first panel, "Trends in Community Banking."

Mr. Newbury provided an overview of trends that the FDIC was tracking. He noted community banks' reputation as survivors and innovators and observed that small businesses, which create two-thirds of new jobs, prefer to do business with community banks, where decisions can be made locally and products can be customized for them. Mr. Newbury recognized that banks of all sizes had struggled in the recent financial crisis, but noted that community banks were showing signs of recovery and he then reviewed a variety of performance statistics that illustrated his point. He said that the FDIC continues to be concerned about concentrations, particularly those in commercial real estate ("CRE") loans, but noted that concentrations were starting to improve as well. Mr. Newbury observed that the Wall Street crisis had impacted Main Street businesses such as community banks, but noted that various aspects of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") were intended to create conditions that would assist community banks. He recognized that community bankers had a variety of concerns and invited Committee members to provide their input.

Member Blanton responded that Georgia continued to face a difficult economy and banking environment but that conditions were significantly improved over the previous year. He observed that the FDIC has bank resolution work to complete in Georgia, and that loan demand remained weak although bank customers were calmer. Member Brown of Florida echoed those observations, adding that the improvements were perhaps a quarter or two earlier than he had expected.

Member Brown noted that community banks would soon face revenue changes, some additional expenses and higher capital requirements, and observed that community banks needed to transition to a business model of providing an income stream and a return on investment to shareholders. Member Blanton said that community banks had long been income stocks, and had suddenly become growth stocks only more recently. Member Urrabazo stated that the key component to the capital situation was earnings; he indicated that community banks needed to focus on profitability to attract capital from small investors, since they would not get capital from institutional investors.

Member Gray expressed the view that community banking had a very bright future; in California, institutional investors were approaching them; merger activity was beginning to occur; the industry would be healthier because sloppy or tired participants were exiting the business; and he expected an increase in new charters. Member Urrabazo expressed the view that newly chartered banks might engage in high-risk lending using high-cost deposits. On the topic of de novo banks, Chairman Bair observed that the FDIC had input on new charters and was conscious of avoiding excessive risk. Member Williams was also optimistic about community banks' long term prospects but noted that agricultural lending was an emerging risk in Nebraska and supported the FDIC's close monitoring of it.

Member Bridges, speaking from the perspective of a community development financial institution, observed that banks appeared to be merely trading assets among themselves and that the problem was the lack of real loan growth. She added that liquidity was not a problem and that there was demand for building affordable housing, a focus of her bank. Regarding innovation, Member Bridges stated that she modified larger bank innovations to create programs that worked for her smaller institution and aligned with its mission. Member Miller, speaking from the perspective of a mutual bank, viewed the next challenge to be how to create earnings, which are necessary for a mutual bank to increase capital. He stated that community banks currently enjoy attractive interest margins but that margin compression was a problem on the horizon. Member Miller, observing that non-interest income was under challenge and that operational costs were increasing, expressed concern about potential community bank consolidation. Member Stewart agreed that the current favorable margins were probably not sustainable so that community banks needed to evaluate future sources of revenue and earnings. She added that more merger dialogues were occurring in Washington, partly because boards of directors were tired and their work was no longer fun.

Member Urrabazo said that margins were critical. He observed that a conservatively run bank would generally have small margins and, if they were being compressed, then banks would have to consider alternatives such as fees or cutting costs; he said that banks were near the end of their ability to cut costs. Member Gray agreed that banks would be challenged as interest rates rose but noted that his bank, a business bank, has used adjustable rates and floors in its lending portfolio. Member Gray observed that large banks did act as innovators but were also slow to act compared to community banks. Member

Blanton also observed that community banks work with small businesses, which large banks do not pursue because they find more profit elsewhere. Member Stewart and Member Blanton further observed that community banks are small businesses themselves. Member Gray opined that community banks have the competitive advantage of longer tenured employees who can better learn the business of small customers.

Member Brown noted that the Committee had previously discussed the impact of regulatory change and observed that his bank had recently spent substantial hours complying with a mortgage lending change that had probably been intended to be simple. He expressed concern about chaos in the secondary market mortgage industry and the difficulties it caused for borrowers. Member Brown further noted concern that community bank interests would not be sufficiently considered as changes were made to the operations of Fannie Mae and Freddie Mac, and that a move toward greater privatization would tend to exclude lower volume community banks.

Chairman Bair inquired why loan demand from small business remained relatively sluggish. Member Blanton stated that his customers did not want to take on any additional debt; in the building industry particularly, there was no backlog of work. Member Bridges added that businesses had learned to operate more efficiently and were not anxious to add expenses; they would do so only when they saw true demand growth. Member Schriefer observed that a bank's lending decisions were based on borrower projections and that bankers were somewhat more skeptical in their reviews. Member Urrabazo agreed that uncertainty was the main driving force of low loan demand but added that delays in receiving Small Business Administration ("SBA") approvals for SBA loans also contributed to the problem. Later in the panel, Member Williams observed that it is difficult for government programs, such as those providing extra capital to banks, to create loan demand. He said that loan demand was constrained by small business owner uncertainty about a variety of factors, including healthcare costs. Member Hopkins added that energy cost uncertainty was also a consideration.

Member Brown said that contractors were using less leverage than they had previously so that projects had more cushion in case of a downturn. Member Gray observed that contractors may be contributing more equity to projects because alternate investments for their money were not as attractive. Member Brown noted that he had seen substantial numbers of large, all cash transactions, and suggested that, when there

were better uses for excess cash, more leverage would be used. Members Koch and Miller expressed concern about a double-dip in housing and the effect of that concern on current lending; Member Miller added that his bank required a 20 percent down payment to cover potential ten percent declines in property values. Mr. Newbury indicated that analysts expected continued housing declines. Member Brown suggested that an effect of the current concerns was a move toward multi-family housing construction. Member Gray observed that foreclosures would have to occur eventually which would affect their neighborhood values. Chairman Bair indicated that the FDIC encouraged more short sales in its resolution processes, as an alternative to foreclosures, which appeared to become increasingly delayed. She noted that short sales can reduce costs and clear the market faster than foreclosure, and also had the advantage of maintaining continuity of owner presence in a house.

Chairman Bair inquired on different occasions how product innovation or FDIC actions could encourage mortgage lending. Member Urrabazo described a situation in which certain affordable properties were hard to sell because potential buyers could not qualify for a mortgage and discussed the possibility of using a rent-to-own approach to resolve the problem. Chairman Bair noted that there had been discussions about a secondary market for rent-to-own mortgages, and suggested that the topic was worth further pursuit since so many people do not qualify for mortgages. At the Chairman's request, Mr. Fritts discussed some legal limitations on bank ownership of property.

Member Schriefer, a banker's banker, stated that many of his small bank customers were frustrated with new real estate and escrow regulations and that the new rules encouraged banks to stop making real estate loans. Member Brown indicated that his bank had to increase real estate lending staff and that those increased costs could result in higher rates being passed on to borrowers. After describing some risks associated with long-term fixed rate mortgages, he suggested that the market might see a seven or ten year fixed rate mortgage that remained in a bank's portfolio. Member Miller stated that his bank had experienced good customer interest in a ten year fixed rate loan that the bank kept on its books; he noted that the bank closely monitored its interest rate risk on the product. Member Urrabazo described a similar loan product from his bank.

Chairman Bair inquired what Committee members saw as the future of mortgage financing if it was assumed the government-sponsored entities (Fannie Mae and Freddie Mac) ceased existing

in their current form. Member Blanton indicated that the housing market would be significantly slowed if there was no government-backed mortgage market and suggested that there needed to be some government-backed program for 30 year mortgages. Member Stewart stated that some customer need for mortgage financing could be met by innovative products such as a ten year mortgages held in banks' portfolios.

Member Hopkins expressed concern about new rules affecting the compensation structure of servicing portfolios. The new incentive structure, he said, punished banks that had been selective in purchasing loans for servicing and warned that banks such as his would be forced out of the business. He suggested that these circumstances could lead to further consolidation, which would not be good for the industry. Member Stewart and Chairman Bair discussed new risk retention rules, clarifying that the retention requirement applied to mortgage securitizers, not originators. Member Brown reported that his conversations with bankers indicated an expectation of constrained credit availability for home loans; he added that community bankers were concerned about not having access to mortgage funds if there was a trend to privatization. Member Hopkins noted that Fannie Mae and Freddie Mac had operated successfully for decades before they changed course; he suggested that the Federal Home Loan Bank model could be a good model to pursue, one with public backing but private capital.

Several members shared observations about borrower and banker trends and difficulties in obtaining mortgage financing in the present environment. Member Gray observed that mortgage financing required excessive disclosures. Members Brown, Urrabazo, Blanton and Hopkins agreed that the mortgage process was frustrating for bank customers; Member Brown said that his bank worried that the frustration could lead to reputational damage. Member Williams cautioned that customer frustration was not limited to mortgage financing and noted that opening a new account could also require excessive time due to required disclosures and explanations.

Member Williams asked Chairman Bair about her thoughts concerning the future of community banking and consolidation. Chairman Bair noted that she had heard mixed reports and acknowledged that concerns had been expressed, but she thought that community banks had a good business model and a bright future once the problems with the broader economy and borrower demand were righted. She observed that community banks provided high touch service, could be more nimble and innovative, and

were not the focus of consumer frustrations. Chairman Bair added that regulatory costs were a significant issue and suggested that a more formalized, two-tiered regulatory structure was worth considering, so that when regulators had to address a big bank problem, it did not always have to negatively affect community banks. She noted that more regulation about mortgage servicing was likely and that she was concerned that those rules might create another obstacle for small banks providing mortgages. Member Schriefer later indicated that he supported such a two-tier regulatory approach.

The Committee discussed whether economies of scale or other issues meant that a bank needed to be at least one billion dollars of assets in size. Vice Chairman Gruenberg shared the results of his inquiry on the distribution of insured institutions by asset size, observing among other things, that a substantial majority of the 7,650 insured institutions had below $250 million of assets. Geographically, he noted that smaller institutions were concentrated in the center tier of the country in smaller towns. Vice Chairman Gruenberg said that although consolidation among smaller banks was occurring, most community banks had weathered the economic downturn, had business models that worked quite well, and played an important role in meeting the needs of their communities.

Member Hopkins inquired about the possible relationship between the smaller number of insured institutions and consolidations of charters within holding companies. Mr. Newbury said that, although he did not have precise numbers, he generally agreed that a big factor in the reduction in the number of insured institutions (from about 15,000 to 7,500 over the last two decades) resulted from holding companies responding to the end of unit banking and other restrictions. Member Hopkins indicated that an analysis of the issue could help allay fears that community banks were not viable; the Vice Chairman agreed that such an analysis would be helpful.

Committee members indicated that talk of a minimum one billion dollar asset size for viability often came from bank consultants. Member Brown later added that he suspected that billion-dollar institutions were not necessarily more profitable than smaller institutions; that leaders of smaller banks might think that a larger size would allow them to do things that they currently could not; and that the market helped establish the billion-dollar marker, because at that level, a franchise might be appealing to potential investors and buyers. Member Blanton said that a study indicated that $250 million bank had roughly

half as much return on assets and equity as a billion dollar bank, and thus, an investment in a billion-dollar bank was more attractive. Member Koch added that chartering agencies were also signaling that smaller institutions were less viable. Member Urrabazo said that he obtains many resources from his bank's holding company, and that it would be significantly harder to perform his work if his bank were independent.

Vice Chairman Gruenberg noted that staff at the FDIC's Kansas City office had observed that many community banks were essentially family run businesses and that intergenerational transfer was an issue in community bank viability. Members Urrabazo, Rainey, Lewis, Hopkins, Schriefer, Blanton discussed various related issues: attracting the necessary expertise to smaller communities; family member participation in family owned banks; the extent to which community banking is related to monetary returns; and how to value nonmonetary elements of personal satisfaction, such as community involvement and being an entrepreneur. Member Blanton noted that excessive regulatory burden can play a big role in balancing the various interests. Member Stewart noted that the mutual form of organization had been vibrant for many years, thus supporting the idea that shareholder return was not the only factor.

In response to a question from Chairman Bair about possible positive effects of recent legislation and regulation, Member Brown observed that his bank had hired well-qualified mortgage brokerage staff members who were no longer employed by less-regulated mortgage companies, and that more consumers were attracted to banks based on the factor of trust. Member Blanton noted that many non-bank competitors were now gone from the marketplace. Member Hopkins noted that his bank had regained substantial market share in mortgage brokering.

In response to a question from Mr. Nash, Members Urrabazo, Gray and Blanton discussed the use of consultants and how they can provide an expertise that a community bank may not have at a particular time. Mr. Luke Brown noted that, while consultants can be useful, some third-party vendors did not provide quality advice on all subjects for which they might be hired, and that it is important for banks to provide proper oversight.

Mr. Nash observed that the first two panels scheduled for the day had been merged; the panel titled "Community Bank Lending" was not separately convened. The Committee stood in recess at 10:19 a.m. and reconvened at 10:35 that same day.

Chairman Bair introduced James R. Wigand, Director of the Office of Complex Financial Institutions ("OCFI"), and David Wall, Assistant General Counsel, Legal Division, who spoke about "The End of Too Big To Fail." Mr. Wigand noted that the FDIC created OCFI to respond to important new FDIC responsibilities under the Dodd-Frank Act and described three primary ways the new legislation and implementing regulations would work to prevent a future taxpayer bailout of a systemically important financial institution ("SIFI"). First, he noted, there is a supervisory component for SIFI's, including more stringent capital, leverage, and contingent capital requirements, which would help avoid the likelihood of a default. If a SIFI nonetheless started on a default trajectory, Mr. Wigand said, there were also early remediation supervisory requirements, which are similar to the prompt corrective action requirements that already exist for FDIC insured institutions.

Mr. Wigand described a second category of Dodd-Frank Act requirements as resolution planning and credit exposure requirements. Regarding resolution planning, SIFI's will be required to establish resolution plans (also called "living wills") for themselves under the United States ("U.S.") Bankruptcy Code, which would allow for their resolution without creating systemic risk to the overall economy. This resolution planning requirement, he noted, is being implemented by joint rulemakings by the FDIC and the Board of Governors of the Federal Reserve System ("Federal Reserve"). Mr. Wigand indicated that SIFI's will benefit from resolution planning because it will cause them to review how they are structured, funded, manage risk, and how they are interconnected with the financial system. Regulators will benefit, he said, because they will better understand the risks SIFI's pose and will dialogue with the institutions to mitigate those risks. Mr. Wigand indicated that another element of this second category of Dodd-Frank Act requirements will be periodic credit exposure reports that will help provide transparency about where counterparty risks actually reside in a highly interconnected financial system.

The third category of new requirements Mr. Wigand described was the FDIC's orderly liquidation authority over SIFI's, which is modeled after and similar to the FDIC's resolution authority over FDIC insured institutions. He observed that, with regard to FDIC insured institutions, the FDIC is often able to collect information and pre-plan a resolution strategy before an institution actually fails, resulting in a lower cost

resolution. The FDIC also has conservatorship authority that allows it to maintain the going concern value of a failing entity. Mr. Wigand observed that in the 2008 financial crisis, no regulator had pre-planning or conservatorship authority, which resulted in a very disruptive resolution of Lehman Brothers, where simultaneous liquidations created damaging economic ripple effects.

Mr. Wigand stated that the recently created OCFI will have about 155 staff members: about half of whom will be dedicated to monitoring the risk that SIFI's pose to the financial system; a second group will review resolution plans and consider how the FDIC would resolve such institutions if necessary; and a third group would deal with cross border international issues that would almost necessarily arise. The OCFI would also participate in the working of the Financial Stability Oversight Council, whose membership includes the FDIC Chairman and the heads of other financial regulatory agencies, and which will monitor financial system risk and provide interagency coordination. Finally, Mr. Wigand stated that the FDIC was establishing a Systemic Resolution Advisory Committee.

Mr. Wall then discussed various FDIC rulemaking activities to implement its Dodd-Frank Act responsibilities, noting that good regulations would help provide credibility to the assertion that there would no longer be firms that are too big to fail. The process proposed in the joint FDIC-Federal Reserve rules, he said, would require SIFI's to submit their resolution plan to the agencies for an initial review to determine if the plan contained the minimum elements, was credible, and would lead to an orderly transition. If a plan did not meet those requirements, the agencies could issue a notice of deficiency and request resubmission. If subsequent resubmission also did not meet the criteria, the agencies could impose more stringent liquidity, capital or other regulatory requirements. Finally, he stated, if that did not work, the agencies could require an institution to restructure itself to promote an orderly resolution.

Mr. Wall said that the agencies expected the plan development process to be cooperative; affected firms could recognize risk management issues in their structure and complexity, and make changes to promote efficiency. He then discussed related rulemakings that are in process.

Member Hopkins expressed some skepticism whether the resolution process was credible, observing that the firms

perceived to be "too big to fail" had only gotten larger through the recent crisis. Member Blanton indicated that community bankers had to rely on the FDIC's reputation because the issues were beyond members' ability to judge. Member Urrabazo observed that the issues were still critical to community bankers because they have correspondent relationships with large institutions and could be directly affected in a crisis. In response to a question from Member Urrabazo, Mr. Wigand agreed that the circumstances of a systemically important failure would be complex, but indicated that a goal of the resolution planning process would be to achieve certain increased simplicities that do not exist currently. He noted that in some resolutions, it would be important to keep critical operations intact and working; that systemic risk could occur if an important firm broke apart without a good plan and the predictability of a chain of events faltered, such as occurred with Lehman Brothers.

Mr. Wigand observed that, in many of the largest firms, separate business lines may have a greater cumulative dissolution value than the firm as a whole, in part because there could be multiple bidders for a business line but a very limited market for the entire firm because of its size. However, some of the largest firms have legal entity structures that are inconsistent with their business lines, which could make it difficult to sell parts of the firm while keeping other critical parts intact. Mr. Wigand said that the resolution planning process is much more than the creation of a document; it is a risk management practice and a dialogue between business and regulator with two main components, one informational and one strategic analysis.

Committee members provided a variety of comments and questions. Member Urrabazo said that requiring more capital for SIFI's was key but he was concerned that such increased capital requirements would trickle down to community banks. Member Koch indicated that he was skeptical that there would be sufficient political will to carry out the Dodd-Frank Act's resolution process when it became necessary. He added that he felt that the systemically important firms had been given a "Mulligan" in the recent crisis, and that they should be restructured into smaller entities if it occurred again. Chairman Bair later noted agreement with these observations; Mr. Wigand stated that there is a market and a regulatory aversion to the largest firms becoming bigger in a subsequent crisis and that some form of immediate dissolution or containment would likely occur if there was such a subsequent crisis. In response to a question from Member Bridges concerning the transparency of resolution plans,

Mr. Wigand stated that there is a tension between providing transparency to provide credibility in the marketplace and the presence of confidential business information in the plans. How to balance that tension, he said, is under consideration. Chairman Bair later added that she did not foresee entire resolution plans being made public, but that making credible summaries of them public would help convince the market that there would not be future taxpayer bailouts.

Chairman Bair also indicated that serious thought should be given to requiring foreign subsidiaries to be legally separate so that the entities could be marketed separately, although she recognized that structural change would be expensive. In response to a question from Member Hopkins about the possible repeal of the Gramm-Leach-Bliley Act and reinstatement of the Glass-Steagall Act, Chairman Bair stated that she did not think that there was political support for those changes although one could make strong arguments for both sides. In response to a question from Member Schriefer, Mr. Wigand described a study that the FDIC had published analyzing how the Lehman Brothers resolution might have occurred if the Dodd-Frank Act orderly liquidation authority had been in place. He added that a benefit of there being credible liquidation authority and a resolution plan was that a failing firm would be more likely to accept being acquired in a crisis, or to raise more capital, rather than expect a bailout. In response to questions from Members Bridges and Urrabazo concerning how community banks could perform due diligence on systemically important firms with whom they have correspondent relationships, Mr. Wigand indicated that the FDIC could not release supervisory information such as CAMELS ratings, but indicated an expectation that the marketplace would develop financial condition metrics that all SIFI stakeholders could review. Members Schriefer and Hopkins, Chairman Bair and Mr. Wigand also discussed the relationship between early remediation authority of SIFI's and prompt corrective action orders; it was noted that there was a tension between using these authorities and their potentially destabilizing impact on the subject firms.

Member Hopkins' observed that community bankers were frustrated that no one had been punished for causing the recent crisis. Chairman Bair responded that the FDIC's new orderly resolution authority involves a harsh process that gives the FDIC no discretion; executives would be removed and there is potential for a two-year clawback of compensation, so that leaders have incentive to right their own ship. In response to a question from Member Lewis about the recent failures of three

large Puerto Rico banks, Chairman Bair and Mr. Wigand clarified that those had been classic bank failures resolved in a traditional way and were not liquidity failures that raised systemic issues.

On the subject of big institutions getting bigger when there is a failure, Member Rainey reported that New Mexico community bankers had not been able to bid on branches of a failed mid-sized regional bank that was instead sold to a much larger bank. Mr. Wigand indicated that, when possible, the FDIC tried to expose branches of failed banks to a broader market, including competing community banks, but that the reality often was that a failed bank's branches are so integrated that it is difficult to break them up. He added that resolution planning process could ease such problems. Member Brown reported public reaction to the creation of "living wills" was that they made general sense but that people were skeptical that they could work in the reality of very complex organizations.

Mr. Nash then introduced the moderators for the panel titled, "Alternative Lines of Credit," Mark E. Pearce, Director, DCP, Melinda West, Chief, Policy and Program Development, RMS, and Michael W. Briggs, Supervisory Counsel, Legal Division. Mr. Pearce referred to the FDIC's guidance on overdraft payment programs and said that a goal of the day's discussion was to get members' insights into alternatives to automated overdraft programs; the FDIC was interested in learning about challenges that bankers faced in offering alternatives, and if unnecessary regulatory challenges could be reduced.

Since the last Committee meeting, Mr. Pearce said, the FDIC had received substantial feedback on the overdraft program guidance, had used the information to arrange a nationwide call-in with over 4,000 bankers to clarify the FDIC's expectations, and followed that by providing a written set of questions and answers. One area the FDIC clarified, he said, was that the guidance applied only to automated programs, where the decision to pay an overdraft did not involve much bank employee involvement; the guidance did not apply to ad hoc overdraft programs (operated by about 60-70 percent of community banks) where bank employees made more individualized decisions on overdrafts. A second clarification, Mr. Pearce said, were FDIC's expectations concerning a bank's response to a customer who frequently overdrafted their account. The original guidance had discussed a targeted outreach to the frequent overdraft customer, and Mr. Pearce said that such an approach was illustrative and that banks could respond to frequent overdraft

use in a variety of ways. Another method, he said, could be to include on the monthly statement of frequent overdraft users, a highlighted statement which noted the frequent overdraft use and a description of alternatives available to the customer.

Mr. Pearce said that the FDIC wanted to explore all aspects of alternatives to automated overdraft programs: could customers frequently using overdrafts qualify for lines of credit; what are marketing challenges of alternatives; did regulators create an unlevel playing field in scrutinizing lines of credit, and could those obstacles be reduced? Ms. West noted that the FDIC was at a preliminary point in considering alternative lines of credit and noted that cost was an element that the FDIC had heard was a barrier. She inquired if it would be helpful if examiners placed less focus on the bank's underwriting of the alternative lines, since potential customers would usually be customers with a record of paying their overdrafts, and the loan amounts would generally be small?

An exchange between Member Brown and Mr. Pearce indicated that there had been some uncertainty among banks about what steps banks needed to accomplish by July 1, 2011 to comply with the FDIC guidance. Member Brown said that his bank had cancelled its automated overdraft program because it did not think that it had sufficient time to achieve compliance; he also noted his staff had experienced regulatory fatigue on the issue. He said that in order to implement a customer notice in a monthly statement, the bank had to work through its vendor, which involved a lag time and cost uncertainties. Regarding possible alternative lines of credit, Member Brown indicated that most bankers would run various models to choose the best one from a revenue and resources standpoint, but bankers probably would not be attracted by the concept of lower examination scrutiny of underwriting, because the underwriting would have to make sense to the bank in any case. Member Miller observed that frequent users pay their overdrafts because they have no choice but to pay, so he did not think that a criterion of a history of overdraft payment would be useful in making a credit decision. The difficult question was how could line of credit customers be made to make payments? In response to a question from Member Blanton about the different treatments of ad hoc and automated overdraft payment programs, Mr. Pearce explained that traditionally, ad hoc programs had been one-time accommodations based on a banker's knowledge of the customer, while automated programs can run with limited bank employee oversight which raised regulator concerns. Member Urrabazo expressed a concern that ad hoc programs created the potential

for Regulation B fair lending violations if bankers accommodated people who they knew without treating everyone else similarly; he noted that automated systems allowed his bank to pay about 80 percent of overdrafts in contrast to an historical record of returning 80 percent.

Member Urrabazo said that automated overdraft payment programs are driven by the market, and exist because people want them, adding that very few of those customers would qualify for a line of credit. Chairman Bair inquired -- if a bank has credit risk on overdrafts and uses criteria to qualify overdraft users for fee-based payments -- what prevented the bank from applying the same credit qualifications for issuing a line of credit? She added that the credit could be tied to having direct deposits, or could require that the loan be repaid over several pay periods. Member Urrabazo said that there were two points: first, opening a line of credit almost always implied a subprime lending situation because most of the customers do not really qualify for a loan; second, the bank's decision is not driven by credit scores or borrower qualifications, rather, it is driven by volume, like a credit card type of business. Chairman Bair indicated that she thought that the FDIC understood that, but wanted to know if the economics of lines of credit could be streamlined so that they became an economically viable alternative. Member Blanton indicated that one issue was how certain customers managed their finances, and that certain people would draw their entire line of credit and soon return to relying on overdrafts; he also expressed the view that many customers do not have employment that could result in direct deposit relationships.

Member Stewart stated that, in her understanding, the models banks used for automated overdraft scoring were different than the credit model; overdraft scoring is tied to factors such as the nature of the deposit relationship, how long a person has been a client, their average deposit and the number of overdrafts; in contrast, the credit model is based on a credit score and possibly a bankruptcy indicator score. In addition to the different data sets, she said, a history of consistent deposits into a checking account may indicate that an overdraft would soon be paid. Member Stewart then described her bank's overdraft line of credit: the lines of credit can go up to $1,500; they are not considered subprime although they can be based on somewhat lower credit scores than other loans because of their limited size; and payments are set to automatically come from checking accounts. She said that the loans are offered to customers when they open a checking account or upon

their first overdraft, and while the accounts do have a higher interest rate and a transfer fee, they do not generate as much revenue as an overdraft program. In her experience, about 15 percent of clients with the line of credit later have overdraft issues. Chairman Bair congratulated Member Stewart on profitably offering an alternative line of credit.

Member Miller stated that charge-off rates for overdraft programs were likely between 5 and 10 percent and suggested that the economics of lines of credit charging 12 to 15 percent interest would not support a similar charge-off rate. Chairman Bair responded that the FDIC recognized that any lending had to be supported by economics, and referred to guidance that allowed banks to charge higher interest, which, she noted, would still be lower than the effective interest rates on overdraft programs. Member Miller noted that state usury laws often prohibited higher rates.

Member Williams indicated that his rural bank was done debating whether the overdraft guidance was good and had decided to embrace it. He had observed his customer service representatives becoming defensive in responding to customers about overdrafts, and thought that offering alternative products would help build customer relationships. Members Blanton and Urrabazo indicated that their banks also offered overdraft lines of credit but that some customers' management of their finances made the products unattractive and unused. Member Urrabazo complimented the FDIC's national conference call as being critical to his bank's decision to continuing its overdraft program. Mr. Pearce expressed appreciation for the members' feedback and echoed Chairman Bair's desire to continue the conversation about how the FDIC could help remove regulatory obstacles to support alternative lending products.

The Committee stood in recess at 12:09 p.m., and reconvened at 1:41 p.m. that same day.

Mr. Nash introduced Christopher J. Spoth, Senior Deputy Director, RMS, and Sylvia H. Plunkett, Senior Deputy Director, DCP, who moderated the panel titled, "Overview of Latest Findings in Bank Examination." Mr. Spoth reviewed recent banking statistics, including those about bank failures and problem banks. He said that the peak in bank failures occurred in the third quarter of 2009; that there had been about 40 to date in 2011, with a possibility of somewhat over 100 for the year; regarding problem banks, their number remained high but was not growing. Mr. Spoth said that credit risk was among the

issues seen in examinations, and that the past due or non-performing ratio was slightly better than last year in almost every loan class. He said that CRE continued to be the highest non-performing loan category, even after some troubled debt restructurings ("TDR") and write-offs, and that the FDIC continued to monitor redefaults. Mr. Spoth said that a quarter of all banks were unprofitable in the fourth quarter of 2010, but that he expected a significant drop in unprofitable institutions in the first quarter of 2011. He observed that community banks had not generally reduced their allowance for loan and lease losses, unlike the largest banks.

Ms. Plunkett then discussed issues the examiners are finding in consumer law compliance examinations. She noted that the FDIC risk scopes its examinations by considering the size and complexity of a bank and the types of products it offers, and then identifying areas that pose risk to consumers as well as to the bank, for example, reputational or legal damage. Ms. Plunkett said the FDIC had seen a slight increase in the number of problem-rated institutions and observed that compliance problems sometimes occurred when a bank facing financial problems reallocates resources away from consumer protection. She said that significant components of a smaller bank's compliance management program include audit and monitoring; the best way to do those functions, she said, is to have a dedicated compliance officer, but that less expensive options existed, including: sharing an audit program within a holding company structure, sharing an audit program among different community banks in a geographic area, or by hiring an outside consultant.

Ms. Plunkett said that a significant risk area was bank oversight of vendors that offer products in the bank's name. She said that banks may consider using a vendor to offer a product to increase fee income, and that the vendor may perform the product's marketing and administration, but that it remained the bank's responsibility to assure consumer law compliance as if the bank offered the products directly to consumers. Mr. Spoth noted that problems with third party vendors can also raise risk management issues, particularly if the product involves a credit or payment system issue. Mr. Spoth and Ms. Plunkett invited members to raise issues of interest to them.

In response to questions from Members Blanton and Hopkins, Mr. Spoth discussed banks' use of brokered deposits; when their use was a concern to the FDIC; and the relationship of brokered deposits to de novo banks and bank failures. He noted that the FDIC was conducting a study of brokered deposits pursuant to the

Dodd-Frank Act. Member Brown provided examples of examiner communications to bank representatives during examinations; some had been helpful and supportive, others appeared to be aggressive; he added that examiner communications can have big effects on a bank's board of directors. Member Urrabazo also provided feedback about a recent examination. Mr. Spoth and Chairman Bair said that the FDIC encouraged bankers to provide feedback to help ensure an effective supervisory process, and that a recent Financial Institution Letter (FIL 13-2011) addressed the issue. Member Schriefer spoke about high levels of classified loans. He suggested that it would be good if banks and examiners could discuss loans with well-defined weaknesses and obtain examiner concurrence that deficiencies had been corrected earlier than the next regular examination. Mr. Spoth said that the FDIC was trying to reflect improvements in composite ratings as soon as the facts made it appropriate, much as the FDIC had done in downgrading ratings; he added that conversations between banks and examiners about improvements could occur at the individual loan level as well.

In response to a question from Member Urrabazo about the relationship of classified loans to capital, Mr. Spoth said that there were not rules of thumb about ratios, that asset component ratings were driven by the particular characteristics of a given loan portfolio. Member Miller commented that it appeared that the FDIC was inconsistently applying guidelines concerning real estate reappraisals, and that there were also unresolved questions about TDR's. In response to a question from Member Bridges about a possible double dip in real estate, Mr. Spoth said that there could be a continued slide in commercial or residential real estate in certain geographic areas. He added that there was a concern about the effect of an interest rate increase on concentrated CRE portfolios, as some of those loans come due in the next 18 months, and that the FDIC was monitoring the issue. Member Brown and Mr. Spoth discussed possible risks in the recent trend toward building multi-family rental properties. Member Brown indicated that he was pleasantly surprised that many loans were underwritten based on income rather than property appreciation, and that owners were drafting leases to protect against future inflationary pressures.

The Committee discussed problems associated with appraisals and the requirement for independence of a bank's appraisal reviewer. Member Brown said that his bank understood recent regulatory guidance to impose a harder line, so that any bank personnel involved in the credit approval process could not perform an appraisal review. He observed that all the people

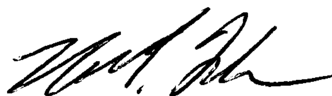
who were capable of doing a review were involved in the credit administration process. Member Blanton noted that the problem was especially acute in rural areas, where appraisal services are harder to obtain. Member Hopkins said that appraisals and reviews were his bank's current top issues. Member Bridges stated that her understanding of the regulators' concern was that lenders did not have the skills to appropriately evaluate the risk in-house, and that increased training of bank personnel might respond to the problem. Mr. French, Deputy Director, Policy, RMS, said he believed that the guidance had not been intended to add new requirements, and thanked the members for the feedback, which the FDIC would evaluate. Member Bridges reported that her bank was having success in lending to multifamily housing projects. Member Blanton observed that CRE loans were coming due and borrowers were trying to renew them. He discussed an example of his bank's successful negotiation of a CRE loan that had been previously made by a nontraditional lender. Mr. Spoth said that he hoped that the Dodd-Frank Act would level the playing field so that community banks could make more loans that previously went to nontraditional lenders.

Mr. Nash observed that the Committee had moved into the "Roundtable Discussion" part of the day's agenda and asked if there were other issues members wanted to raise. In response to a question from Member Gray about the status of Dodd-Frank Act regulations, Chairman Bair reviewed rules that were in process and noted that most of them would have almost no direct impact on community banks. She and Mr. Nash noted that the FDIC had added community bank impact statements to transmittal memos of new regulations so that bankers needed only to read the first paragraph to determine if further review was required. Mr. Gray renewed an earlier recommendation that the various Dodd-Frank Act rules be reviewed for their interaction with each other and existing rules.

Member Hopkins and Mr. French and Mr. Spoth discussed the use of credit rating agencies' ratings of municipal securities by banks and regulatory agencies. Mr. French clarified that regulators were required to remove reliance on credit agency ratings from their rules, but said that banks were not prohibited from relying on credit agency ratings as part of their internal risk management. Mr. Spoth said that some banks had an emerging vulnerability in their municipal bond portfolios and that FDIC examiners would review highly concentrated banks.

Chairman Bair and Director Curry thanked the members for a valuable meeting; the Chairman added that she hoped that they would enjoy their continuing work with the FDIC.

There being no further business, the meeting was adjourned at 2:31 p.m.



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

Minutes

of

The Meeting of the FDIC Advisory Committee on Community Banking

of the

Federal Deposit Insurance Corporation

Held in the Board Room

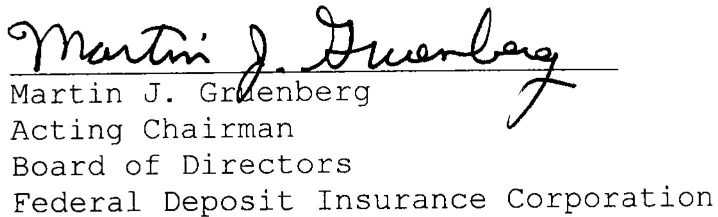
Federal Deposit Insurance Corporation Building

Washington, D.C.

Open to Public Observation

May 11, 2011 - 8:34 A.M.

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



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

Dated: August 5, 2011