Minutes

of

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

April 21, 2010 - 8:30 A.M.

The meeting of the FDIC Advisory Committee on Community Banking ("Committee") was called to order by Martin J. Gruenberg, Vice Chairman, Federal Deposit Insurance Corporation ("Corporation" or "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; Deborah A. Cole, President and CEO, Citizens Savings Bank and Trust Company, Nashville, Tennessee; James H. Gray, Chairman, Beach Business Bank, Manhattan Beach, California; Jack E. Hopkins, President and CEO, CorTrust Bank, National Association, Sioux Falls, South Dakota; Timothy W. Koch, Professor and Chair, Finance Department, Moore School of Business, University of South Carolina, Columbia, South Carolina; John P. Lewis, President and CEO, Southern Arizona Community Bank, Tucson, Arizona; 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. Committee members Jan A. Miller, President and CEO, Wainwright Bank & Trust Company, Boston, Massachusetts; and Craig M. Goodlock, Chairman and CEO, Farmers State Bank of Munith, Munith, Michigan, were absent from the meeting.

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

Corporation staff who attended the meeting included: Ruth Amberg, Valerie J. Best, Michael W. Briggs, Luke H. Brown, Glenn E. Cobb, Kymberly K. Copa, Patricia DeVoti, Diane L. Ellis, Robert E. Feldman, Ralph E. Frable, George E. French, Steven D. Fritts, Tiffany K. Froman, Mitchell L. Glassman, William F. Harral, Tray Halverson, Herbert J. Held, Ellen W. Lazar, Alan W. Levy, Roberta K. McInerney, Tariq A. Mirza, Arthur J. Murton, Paul M. Nash, Christopher J. Newbury, Thomas E. Nixon, Richard J. Osterman, Jr., Sylvia H. Plunkett, Jeanne R. Rentezelas, Claude A. Rollin, Lisa K. Roy, Barbara A. Ryan, Christopher J. Spoth, Kimberly Stock, Sandra L. Thompson, Jesse O. Villarreal, and Mindy West.

Charlotte M. Bahin, Senior Counsel for Special Projects, Office of Thrift Supervision, was also present at the meeting.

Vice Chairman Gruenberg opened and presided at the meeting. After noting that Chairman Bair was unable to attend the meeting, he welcomed the Committee members. He then provided a brief overview of the meeting agenda and introduced Paul M. Nash, Deputy to the FDIC Chairman for External Affairs, as the overall meeting moderator.

Sandra L. Thompson, Director of the FDIC's Division of Supervision and Consumer Protection ("DSC"), and George E. French, Deputy Director, Policy, DSC, moderated the first panel discussion titled, "Funding and Liquidity Issues Facing Community Banks." Ms. Thompson thanked the Committee for its previous feedback and noted that the FDIC had made various supervision changes based on it. She noted that interagency guidance had been issued recently which spelled out sound practices for identifying, measuring, monitoring, and controlling funding and liquidity risk.

Ms. Thompson noted that the FDIC is not critical of wholesale funding if it is used as part of an overall sound

funding and liquidity program. She asked the Committee members to share their experiences concerning whether examiners viewed wholesale funding adversely. Ms. Thompson also spoke about core deposit funding and the Certificate of Deposit Account Registry Service ("CDARS"). She noted that although CDARS provides a useful service for bank customers, they are still brokered deposits, and are not core deposits. She acknowledged that reciprocal CDARS deposits may be more stable than other brokered deposits, if the originating bank has developed a relationship with the depositor. While recognizing that the use of CDARS was a continuing topic of discussion, she indicated that reciprocal CDARS should not be criticized in examinations if they are effectively used as part of a comprehensive funding strategy. She asked the Committee if examiners investigate whether there are reciprocal and long-term relationships behind CDARS holdings.

Mr. French spoke about interest rate caps, the statutory requirement that prevents less than well-capitalized banks from paying significantly more than the prevailing interest rate (whether national or local market area rates, depending on where the deposits are solicited). Interest rate caps, he continued, have become more important as more banks are not well-capitalized. Concerning rates for nationally solicited deposits, Mr. French stated that the FDIC has published on its website a schedule of nationally prevailing interest rates based on nationwide data. Any bank may comply with the interest rate regulation by paying up to 75 basis points more than the posted nationally prevailing rates, he continued.

Mr. French observed that, in a previous meeting, the Committee had raised the negative impact on community banks of the FDIC's method of calculating local area rates in geographic areas with many branches of large banks. The FDIC's previous method resulted in relatively low interest rate caps, he explained, because each of the large bank branches was counted separately in calculating the prevailing local interest rate, and such branches have access to cheaper funding by being part of a large bank. Mr. French said that the FDIC had studied how to equalize the situation, and, several weeks ago, Chairman Bair announced a new methodology for calculating the local area market rate. Under the new approach, he explained, the FDIC regional office could collapse all of the rates paid by branches of the same legal entity into a single rate when looking at a geographical area. After computing the prevailing rate on that basis, he continued, if the FDIC determines that the market is high-cost compared to the national rates schedule, a bank may

use the locally prevailing rate for its interest rate cap. The net effect, Mr. French concluded, is that the community banks in such areas will be able to pay a little bit more, based on the difference between the average rates paid by the large banks and by the smaller banks (at present, the difference is about 40 basis points).

A second issue discussed by Mr. French was whether the Uniform Bank Performance Report definition of core deposits should be changed. He noted that core deposits are currently defined to be the sum of demand deposits, NOW accounts, other transaction accounts, money market deposit accounts, savings deposits, and time deposits less than $100,000, and he observed that the significance of the $100,000 threshold had diminished over the years. Mr. French noted that there was nothing magical about a particular dollar threshold such as $100,000, and that examiners were expected to look behind the dollar amount to determine whether the particular deposit was from a stable deposit relationship or "hot money." He also noted that the FDIC had raised the issue of changing the core deposit definition with other banking agencies but there was no consensus for making a change. He asked the Committee for its views about changing the core deposit definition, including the impact on a bank's core dependency ratio (which measures the degree to which the bank is funding longer-term assets with non-core funding, such as brokered deposits).

Mr. Blanton noted that examiners in a recent examination had properly allowed the bank to demonstrate that certain deposits were long-term, core deposits. He noted, however, that outside rating agencies who looked only at the core dependency ratio–as affected by the current definition of core deposits–do not do further investigation, and banks are incorrectly viewed as "running hot" as a result. Committee members Urrabazo and Hopkins agreed with this observation. They observed that the misleadingly high dependency ratio is reported by newspapers and an incorrect impression of a risky liquidity position is created.

Ms. Thompson asked the Committee whether examiners were properly looking at CDARS and not lowering the liquidity component of the CAMELS rating if the CDARS were legitimate and reciprocal. In response, Ms. Cole noted that examiners allowed her bank to show that their CDARS were from long-term customers who were moving their money into CDARS for safety. Mr. Blanton agreed about the examiners' treatment and noted that CDARS are often held by elderly clients. Committee members Lewis and Cole

observed that a bank's use of CDARS should be described in its liquidity plan and made available to examiners so that the examiners are not surprised. Mr. French noted that large deposits can be less stable if a bank gets into a troubled condition, so that a bank's liquidity plan should include stress testing for the effect of a downgrade below well-capitalized on a bank's deposits and funding capacity.

On behalf of field supervisors, Ms. Thompson asked the Committee to comment on the use of QwickRate, a non-brokered marketplace for funding and investing that connects institutional buyers and sellers directly to help maximize net interest margins, and gathering deposits off the Internet in the context of the discussion of core deposits and volatile funding. Professor Koch responded that, as an economist, core deposits should be considered on the dimension of interest elasticity. Banks using QwickRate or running a certificate of deposit ("CD") special are essentially buying rate-sensitive money, he observed, and those deposits should not be viewed as core deposits, even if they are below the $100,000 threshold. He noted that to measure volatility in an economically correct way, examiners would need to measure the interest elasticity of every account. Mr. French said that an interagency project examining deposit data and liquidity data is addressing those questions. Concerning QwickRate, Mr. Brown noted that they often provide a lower cost of funds than the local market, so that banks look at them as a source of funds.

Mr. Blanton stated that he views the discussion about Internet CDs and related items as a concentrations issue, not a product issue, and that it is important for banks to diversify their portfolio concentrations rather than follow an easier path of concentrating in a single area. Mr. French noted that interagency guidance agreed about funding concentrations. Ms. Thompson confirmed that concentrations-on both the liability and asset sides-were an important issue for banker and regulator focus. Ms. Cole observed that a bank's deposit mix required proper management, but noted that it was critical to community bank deposit gathering to have reciprocal CDARS deposits available for customers who need insurance coverage.

Noting that volatile funding sources had played a role in recent bank failures, Ms. Thompson inquired whether members thought that supervisory thresholds would be helpful on the liquidity side. Committee members generally did not think that thresholds would be helpful, that they would be overly prescriptive, and might have unintended negative consequences.

Mr. French asked the Committee for comments about a recent proposal on liquidity by the Basel Committee on Banking Supervision, which would first apply on the international level, but may eventually impact community banks. The proposal, he said, would require large, international banks to maintain a liquidity coverage ratio and those banks to have high quality liquid assets sufficient to withstand a 30-day severe stress period. Professor Koch noted that he liked moving the regulatory focus toward cash flow, rather than the current, more static approach of community bank liquidity standards.

Mr. Williams commented that bankers have traditionally managed risk and was concerned about a supervisory trend toward focusing on worst-case scenarios. Ms. Thompson said that the FDIC did not want to be too prescriptive; however, difficult circumstances can arise quickly and it is important for bankers to fully understand their portfolios. Ms. Bridges commented that community banks pride themselves on relationship banking, and that prescribing ratios cause banks to be more formulaic, like large banks, and inhibit developing relationships. Concerning liquidity guidance, Ms. Stewart stated that she preferred specific guidance that allows bankers to articulate why they do not fit in over non-specific guidance which allows bankers not to plan, or not to think through why they can maintain a higher concentration. She suggested that perhaps bankers had paid too little attention to liquidity in the past.

The Committee also discussed the issue of credit risk in a rising interest rate environment. Mr. Brown had earlier noted that a problem on the horizon in the next year may be a conflict between interest rate management and liquidity management. Mr. Lewis noted that he would need to be looking at asset quality in a rising interest rate environment. Mr. Koch indicated that community banks may not be developing sufficient sophistication on the subject.

Ms. Thompson solicited comments on the recently extended Temporary Liquidity Guarantee Program's Transaction Account Guarantee ("TAG") program, which provides customers of participating insured depository institutions full insurance coverage on transaction accounts, and thus acts as an important funding source for community banks. Vice Chairman Gruenberg inquired whether the TAG program had brought in new customers. Several Committee members responded, indicating generally, that the TAG program brought deposit growth, and helped keep customers, even if it did not substantially increase the number

of new customers. Ms. Stewart indicated that Washington state community bankers had expressed appreciation for the competitive deposit pricing that the TAG program made possible.

Before the session ended, Director Bowman recommended reviewing the FDIC Inspector General's Material Loss Reviews ("MLRs"), which analyze the causes of failed banks and are publicly available. Director Bowman and Vice Chairman Gruenberg noted that they found the MLRs helpful, and that they revealed some common factors leading to bank failures. Committee members Brown and Blanton agreed and noted that they reviewed MLR findings with their boards of directors. Director Curry invited the Committee to suggest ways in which the FDIC could better share information on emerging issues and risks concerning liquidity and funding without being excessively prescriptive.

Vice Chairman Gruenberg then called for a short recess. Accordingly, at 9:59 a.m., the meeting stood in recess.

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The meeting reconvened at 10:20 a.m. that same day. Ellen W. Lazar, Senior Adviser to the FDIC Chairman for Consumer Policy, and Luke H. Brown, Associate Director, Compliance Policy Branch, Policy, DSC, moderated the discussion titled, "Consumer Protection - Level Playing Field for Community Banks." Ms. Lazar noted that community banks face a substantial burden complying with regulations designed to solve problems for which they were not the driving force in creating, such as subprime and non-traditional loans. She recognized that banks have concerns about the proposed new consumer financial protection agency, but noted that regulatory reform would help level the regulatory playing field between banks and non-banks that offer competing financial products. Ms. Lazar noted that Chairman Bair has often spoken about the important, positive, relationship between consumer protection and safety and soundness. She requested the Committee to share its observations.

Committee members discussed compliance with the Real Estate Settlement Procedures Act ("RESPA"), which several viewed as overly burdensome with relatively little consumer benefit. Generally, Committee members Hopkins and Blanton observed that consumers do not read the voluminous documentation provided to them. Committee members Hopkins and Blanton also suggested that the new RESPA rules might increase costs to consumers because banks, which now have to provide a firm estimate, will make

their estimates higher. Committee members Williams and Hopkins indicated that the increased cost of RESPA compliance could cause community banks to withdraw from real estate lending, especially in rural areas where there is inadequate volume to justify the compliance cost. Mr. Urrabazo suggested that the lack of financial responsibility of some consumers was a partial cause for the country's recent real estate financing problems. The FDIC's Mr. Brown indicated that an interagency group was gathering feedback from this committee and other sources to share with the Department of Housing and Urban Development, which is responsible for RESPA.

The Committee discussed whether the proposed financial reform legislation would adequately level the regulatory playing field between banks and non-banks. Ms. Bridges stated that she, like all community bankers, favors consumer protection, and finds the robust enforcement environment that banks experience to be acceptable on the whole. She was concerned, however, that non-banks would not experience similarly robust oversight. Committee members Brown, Schriefer, and Hopkins expressed similar views. Mr. Williams expressed concern that the new law and regulation would impose compliance burdens that are not currently anticipated.

Vice Chairman Gruenberg stated that he thought the strongest case for the new law was that it would fill in regulatory gaps which contributed to predatory lending practices and the financial crisis. He noted that the majority of subprime lending was driven by non-bank financial companies which were not subject to adequate rules or enforcement. Under the new law, he continued, the non-banks would be subject to the rules and enforcement of the new consumer financial protection agency. Although the non-bank enforcement authority may not be as strong as that of the banking regulators, it would, in his view, be a significant step in the right direction.

The Committee discussed whether the new law, or other forces, would create opportunities for community banks to provide consumer banking services. Mr. Brown commented that he heard that the financial reform law would prompt large banks to exit consumer banking, which could provide opportunities for community banks.

The Committee also discussed why consumers choose to be unbanked and the impact of fees on their decisions. Vice Chairman Gruenberg mentioned the January 2009 FDIC National Survey of Unbanked and Underbanked Households. He noted that

many respondents reported that they did not maintain bank accounts because they did not have sufficient income to justify an account, while another significant percentage cited the fees associated with accounts, including overdraft fees. Committee members Brown and Williams noted that fees generated by overdraft protection provide the revenue that allows banks to offer free checking accounts. They suggested that if banks charged less overdraft fees, they would have to find a new way to balance their expenses, and may no longer offer free checking.

Mr. Urrabazo stated that his bank had reviewed over 340,000 of its consumer accounts and found that about 5 percent of the holders had excessive overdraft fees, while about 60 percent used the overdraft function infrequently, perhaps once a quarter. He felt it would be unfair to penalize the majority of people who used overdraft protection as intended because a small minority abuses it. Vice Chairman Gruenberg indicated that the FDIC survey results were similar: about 75 percent of customers did not use overdrafts; another 10 to 15 percent used it fewer than five times per year; and the great concentration of overdraft use was by repeat users. He noted that a small percentage of customers were driving a large percentage of the revenue. For those frequent users, he suggested, overdraft protection was not a protection but an extraordinarily expensive source of credit, and one used by persons at the lower end of the income spectrum.

Several Committee members offered examples of their banks' experiences with overdraft protection. Mr. Urrabazo stated that not all chronic overdraft users were poor; rather, some were wealthy and apparently not dissuaded by the fees. Mr. Blanton said that his bank had identified chronic overdraft users, refunded their fees, and counseled them concerning alternatives that would avoid the fees, but found that they would soon resume chronic overdraft use. Ms. Bridges found that some chronic users were on fixed incomes, used overdrafts to pay necessary bills, and that their usage of overdrafts became pro-cyclical. She said that her bank determined it could not continue overdraft protection when used for that purpose. Mr. Brown noted that agency guidance recommended that banks monitor accounts for excessive use. He said that once the bank identified excessive use, it was important to guide the customers to more affordable, alternative products.

Mr. Nash and Roberta K. McInerney, Deputy General Counsel, Consumer and Legislation Branch, FDIC Legal Division, moderated

the discussion titled, "Legislative Update: Status of Regulatory Reform Legislation." Mr. Nash began with an overview of the Senate financial reform bill proposed currently under consideration, and the House bill which passed in December 2009. He noted that the FDIC has focused on the resolution authority of firms that had been considered "too big to fail." By making the very large firms face the same type of resolution consequences that small banks face, Mr. Nash's view was that it would help end the funding advantage that large banks currently have over community banks.

Ms. McInerney provided the Committee with a comparison of corresponding parts of the Senate and House bills. Under the House bill, she noted, the consumer financial protection agency would be funded by assessments on financial service providers (insured institutions below $10 billion would be exempt), and under the Senate bill, all of the agency funds would come from the Federal Reserve System, with no fees on banks. Under both bills, she continued, the consumer financial protection agency would have rulemaking and enforcement authority over non-banks, while enforcement authority for community banks would remain with their primary regulators.

A significant part of the discussion concerned the resolution process of financial institutions determined to be systemically important, the outcomes of such a resolution, and how a resolution would be paid for. Mr. Hopkins asked if the bill had the necessary ingredients to successfully complete the resolution process of banks and non-banks. Mr. Nash responded that Chairman Bair had had a lot of input into the subject and that the FDIC thinks that the process can work. He indicated that resolution will be a credible process that makes clear that firms going into it will not be "bailed out," thus giving them a great incentive to avoid being subject to it. There would be, he continued, a very high bar to trigger the resolution process, involving a range of decision makers, after which the FDIC would run the process. Mr. Nash explained that the FDIC would place the firm in a bridge bank, then work to preserve its value and mitigate systemic risk while winding the firm down.

The Committee also discussed the liquidation fund provided for in both bills. Mr. Urrabazo asked about the FDIC's opinion between the House bill's $150 billion fund and the Senate's $50 billion one. Mr. Nash noted that the liquidation funds were not funded by taxpayers, but rather would be risk-based assessments imposed on eligible financial companies. He indicated that $50 billion would likely be sufficient for the FDIC to start the

resolution process. If $50 billion would be insufficient, he said, the FDIC would have the ability to borrow funds from the Treasury. Ms. McInerney pointed to the pre-paid aspect of the liquidation fund as further evidence that the resolution provisions could not be fairly characterized as a bailout.

In response to a question from Professor Koch about the effect on firms that go into the new resolution process, Mr. Nash clarified that such a firm would not be reconstituted. Its management and board would be removed, the firm would be sold off for parts, and its shareholders would be wiped out. In response to a question from Director Bowman, Mr. Nash noted that, after the bankruptcy bar had expressed a concern, the bill clarified that creditors would be treated equally whether a firm went through bankruptcy or the new resolution process. He noted that this outcome would help bring market discipline to systemically large firms.

The Committee discussed the relationship between firms that would be assessed for the proposed liquidation fund and those subject to resolution. Mr. Nash clarified that firms assessed for the liquidation fund would be identified, but that assessment would not necessarily mean that the firm would be resolved through the systemic process instead of bankruptcy. Those two decisions would be separate, he indicated. In response to a question from Director Curry, Mr. Nash noted that the law would prohibit any comingling of funds between the Deposit Insurance Fund ("DIF") and the new liquidation fund. Ms. McInerney stated that the bank resolution process would not be changed by the new law.

In response to Director Bowman's request for a review of some of the proposed bills' impacts on community banks, Mr. Nash noted that DIF assessments would be based on assets rather than deposits, and that this should generally reduce costs to community banks. He also noted that in the Senate bill, the Board of Governors of the Federal Reserve System would no longer supervise state member institutions, and all holding companies would be supervised by the primary bank regulator (for example, a state chartered holding company would go to the FDIC). Ms. McInerney noted that the legislation would promote financial stability and the avoidance of liquidity crises, which would benefit community banks. She also thought that the elimination of the idea that some firms are too big to fail would help reduce the funding advantage that large banks have over community banks. Finally, Ms. McInerney indicated that the bills' placement of consumer protection enforcement authority

with community banks' primary regulators would be helpful. Director Curry added that insurance assessments should be generally lower if it is no longer believed that some firms are too big to fail.

Mr. Gray noted that increased reporting requirements and other regulatory burden may result from the new legislation. Mr. Nash indicated that it is difficult to quantify the additional regulations that will result and added that, while there is reasonably a fear of the unknown, the legislation dealt with known problems of great magnitude, such as those that the economy has recently experienced.

The Committee discussed various other subjects impacted by the legislation. In response to a question from Ms. Stewart about proposals to limit the size of systemically large institutions, Mr. Nash indicated that he felt it unlikely that such a proposal could muster sufficient votes to be passed. In response to a question from Mr. Hopkins, Mr. Nash noted that the United States Senate Committee on Agriculture, Nutrition & Forestry had passed a provision that would bring more transparency to the derivatives market.

Mr. Williams indicated that he thought that the issue of preemption should be cleaned up. Ms. McInerney stated that, currently, the Office of the Comptroller of the Currency takes a preemption approach; it preempts the state law that interferes with the national bank's ability to conduct lending and other business. She indicated that both the Senate and House bills provide a more case-by-case approach.

Vice Chairman Gruenberg had been obligated to depart during the panel for a previous engagement. Mr. Nash called for a lunch recess at 12:16 p.m. The afternoon session was convened by Director Curry at 1:26 p.m.

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Christopher J. Spoth, Senior Deputy Director, Supervisory Examinations, DSC, and Steven D. Fritts, Associate Director, Risk Management Policy Branch, Policy, DSC, moderated the panel titled "Temperature Check on the Lending Environment and Real Estate Values." Mr. Spoth discussed several financial metrics that may affect lending markets for CRE, renewals, restructuring, and lending in general. First, concerning capital, he noted that nearly $12 billion of capital was added to the industry in the fourth quarter of 2009. In 2010, some

failing banks had been able to raise capital, avoid failure and restructure themselves; these developments, he said, may indicate that banks had the ability to restructure loans or provide new lending. Mr. Spoth noted that profitability is improving and would show strength in the first quarter, particularly among community banks. He noted that reserves are at the highest level they have ever been, and this may indicate that some of the credit risk may now be accounted for in bank earnings. On the other hand, he noted that the level of reserves to non-performing loans had diminished, and that FDIC analysts were studying that data. Non-performing loans had not peaked in the last quarter of 2009, nor had they likely peaked in the first quarter of 2010, Mr. Spoth observed, but they may be increasing at a slower rate. Finally, he noted that the dollar volume of lending declined 7.5 percent in 2009, with 90 percent of that decline among the very largest banks, while the smallest banks had a slight increase in lending.

Mr. Fritts began his remarks by noting that he had recently spoken with members of the National Association of Home Builders who had indicated that it is very difficult for a builder to obtain loans, regardless of their credit characteristics (particularly in certain markets). He observed that the credit retrenchment has been most pronounced in the big banks and may be driven by economic and financial modeling, not by relationship banking. Mr. Fritts stated that small business guidance emphasized that credit decision-making should be predicated on the borrower's merits and the banker's prudential underwriting standards, not primarily on balance sheet, economic-driven models.

Mr. Fritts discussed collateral valuation under the FDIC's regulation and supervisory guidance, noting that loans that had been reasonably underwritten several years ago are coming due but cannot be easily re-underwritten because of declines in real estate values. He then reviewed valuation methodologies that are available from a credit administration standpoint. He noted that the regulation requires an appraisal only at origination and that if a loan comes up for renewal or refinance, without new money involved, banks can perform an evaluation of the loan as an alternative to an appraisal. Mr. Fritts stated that an evaluation is not specifically defined and that examiners have been instructed to consider what is appropriate for making the business decision. He noted that banks have flexibility and may rely on relatively inexpensive sources of information that have developed in the last decade, including sales activity, and market and industry information. He indicated that examiners

would first look generally at a bank's program for collateral evaluation, and then, when individual loans are reviewed, confirm that the bank's collateral valuation information is adequate and accurate.

In response to a question from Mr. Lewis, Mr. Fritts clarified that an account's loan officer should not make the collateral evaluation in order to preserve the independence of the process. He added that the FDIC would expect the bank to establish a realistic estimate of a loan's collateral position, relative to the overall risk factor of the loan. Mr. Schriefer complimented the usefulness of the interagency Policy Statement on Prudent Commercial Real Estate ("CRE") Loan Workouts (October 30, 2009) and asked whether is might be updated. Mr. Fritts said that he would inquire if the other agencies would update the guidance but noted that it had been a lengthy, labor intensive effort. He suggested that bankers could call their regulator and obtain good directional advice from a bank supervisory standpoint, but that advice about accounting aspects can be more complex.

Mr. Brown remarked that in restructuring a loan pursuant to the CRE workout guidance, it had been difficult to document the borrower's ability to make payments because of changes in borrowers' cash flow characteristics. In response to a question from Mr. Spoth, Mr. Brown indicated that the FDIC examiners had been cooperative in evaluating the bank's decisions pursuant to the workout guidance. Mr. Spoth indicated that the FDIC wants to examine the borrower's ability to pay, and only if that is not well-documented, would the examiner focus on the collateral (unless it was a collateral dependent loan). Mr. Brown reported that, based on his experience speaking to a number of organizations, there was good news on the issue of non-performing asset reserve coverage. In his estimation, the slide in property values is moderating. Ms. Cole noted that appraisers in certain parts of her region were more conservative than those in other parts, especially with loans where the collateral was atypical, such as a church.

Finally, the Committee had an extended discussion of the proper time for a bank to charge off a loan for which it had established a specific reserve. Mr. Brown suggested that clarification would help because he was aware of several cases in which examiners had required charge-offs of loans that banks had not previously taken. Mr. Fritts agreed that the issue should be addressed because examinations should generally validate a bank's financial statements, and big charge-offs

following an exam were undesirable. Committee members Brown, Blanton, Cole, and Schriefer provided various factual examples and accounting interpretations. Mr. Fritts and Mr. Spoth indicated that it was understandable that banks had used the approach that they had with regard to certain types of loans in transition, where the bank is awaiting information before making a decision. Ultimately, however, Mr. Spoth indicated that, when the bank knows it has a loss, it should go through the charge-off line.

The panel discussion titled, "Deposit Insurance Assessment Issues," was then moderated by Arthur Murton, Director, FDIC Division of Insurance and Research ("DIR"), and Diane L. Ellis, Deputy Director, Financial Risk Management and Research, DIR. Mr. Murton first discussed the status of the DIF, which had a negative balance of $21 billion at the end of 2009. Deterioration was slowing down, and, perhaps, flattening out, he indicated. He noted that the three year pre-pay of deposit insurance premiums (of $46 billion) had provided necessary liquidity for the fund, and that the DIF ended the year with $66 billion of liquidity. The bank failure rate had been slightly less than had been projected, he observed, while the cost of failures had been less than projected because the FDIC had been able to pass more assets through by using more loss-share agreements.

Mr. Murton discussed the notice of proposed rulemaking and request for comment on large institution insurance pricing issued by the FDIC Board on April 13, 2010. He noted that the FDIC had separate pricing systems for small and large banks, and that the small bank pricing formula was based on financial ratios and weighted CAMELS. The large bank pricing formula had changed since inception, he explained, so that, in addition to the original two-element formula of weighted CAMELS and debt ratings, the FDIC had added a financial ratios component. Having undergone the recent crisis, he said that the FDIC is proposing to eliminate the debt ratings component as well as the existing four risk categories. Under the proposal, he explained, large banks will get a performance score, which measures how likely it is that the bank will fail, and a loss severity score, which measures how large the losses would be if a bank failed.

Mr. Murton indicated that, under the proposed pricing system, larger, riskier banks would pay more into the DIF, and that additional amount would flow to larger, safer banks and to the majority of small banks. About 75 percent of small banks

would pay a lower insurance rate, 15 percent would pay about the same, and 10 percent would pay more, he said. The proposal would not affect the assessment base in any way. Mr. Murton stated that the FDIC back-tested the proposed scorecard approach to the period before the recent crisis and it performed significantly better than the CAMELS system alone, or the current pricing system.

Several Committee members provided feedback about banking conditions and likely first quarter results in response to a question from Mr. Murton. Mr. Schriefer observed that business conditions in his area were slowly getting a little better, but that it remained a "hunker down" mentality. Mr. Blanton noted that banks' numbers get worse after they fully recognize the problems facing them, after which the numbers get better. What banks report will depend on where they are in that recognition and response process. Mr. Williams reported that the majority of bankers he had spoken to were feeling positive about their banks generally, but that a minority, in certain locations, was still facing fresh bad news. Mr. Blanton stated that there are still many banks on the edge of failing or surviving in the Atlanta area. There was some agreement that the bottom had been reached, but that conditions might remain there for some time.

Ms. Ellis reported about the FDIC's January 12, 2010, Advance Notice of Proposed Rulemaking regarding Incorporating Employee Compensation Criteria Into the Risk Assessment System. She reported that a common response was that banks should not award bonuses or promotions based on volume metrics such as number of loans booked, for example. Some comments opposed to the proposal, she said, had questioned whether there really is a causal relationship between compensation practices and the risks that an institution takes, while others cautioned against using a one-size-fits-all approach. At this early stage, she stated, the feedback suggests that the FDIC should take a principles-based approach and that some compensation should be deferred.

Responding to a question of Mr. Urrabazo, Ms. Ellis noted that MLRs had suggested a relationship between bank failures and compensation practices that rewarded people for loan volume. She said, in response to Mr. Schriefer, that bank examiners had always been able to criticize compensation practices and ask for changes. She clarified, however, that examiner criticism might be viewed as setting a minimum standard, while adjusting the assessment system to a bank's compensation program could reward safer practices. Mr. Blanton observed that there are many different types of banks and ownerships and that it would be

difficult to set a compensation standard affecting so many different models. Mr. Brown cautioned against overreaction and expressed concern over how a rule would affect the banking industry's ability to attract and keep talented employees.

Mr. Nash moderated the discussion titled, "Roundtable Discussion." At the start, Mr. Lewis distributed a document from a Florida business that is about to launch a program to community banks across the country that involves Small Business Administration ("SBA") paper. He explained that he was not endorsing the program or answering questions about it, but had been asked to gather member comments. It was agreed that the Committee would review the document and provide any comments to Mr. Lewis after the meeting.

The Committee discussed the possible use of money from the Troubled Asset Relief Program ("TARP") to provide small business funding and/or a capital program aimed at community banks. In response to a question from Mr. Brown, Mr. Nash noted that TARP and other programs had lacked a community bank focus. Mr. Nash observed that there had been a serious effort some months earlier to create a program to stimulate small business lending but that the momentum had dissipated, perhaps because of the focus on financial regulatory reform. Ms. Cole emphasized the need for funding to be provided to community banks for capital, to preserve their existence, and not necessarily tied to making small business loans. Mr. Brown commented that the plan that had been under consideration was good, because it would both stimulate small business lending and provide capital to community banks. Ms. Stewart observed that, even if the program did not stimulate new lending, it would have a positive impact if it merely helped banks avoid calling in credits. Mr. Urrabazo expressed doubt that any new capital injection into the banking system would stimulate demand for business or jobs because people are very reluctant to take any kind of risk. He did note that the SBA had restructured some of its programs and that community banks should be able to make more SBA loans as a result.

Mr. Nash asked the Committee whether there was loan demand in their local markets, explaining that he often heard from Congress that regulators are too tough and are not "letting" banks make loans. Mr. Blanton said that his customers are currently frightened of debt, and that there was very little demand for loans. He and Committee members Cole, Bridges, and Urrabazo noted that the primary demand for loans at community banks was from borrowers whose performing loans were being

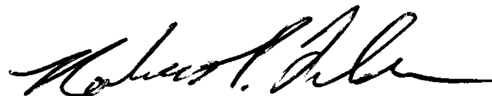
pushed out of regional banks. Ms. Stewart observed that loans were limited by a combination of capital constraints, the economy, and regulatory crackdown. Ms. Rainey observed that in her market, there was a pickup in loan demand but that all of the demand was in areas where the bank already had concentrations so that the loan demand could not be met. Mr. Blanton indicated that his bank was looking to develop relationships, not just accepting a hot loan that had been pushed out of a larger bank.

Mitchell L. Glassman, Director, FDIC Division of Resolutions and Receiverships ("DRR"), and Herbert J. Held, Associate Director, Resolution Strategy Section, Franchise and Asset Marketing Branch, DRR, also answered Committee questions. Mr. Hopkins, whose bank had made bids on failed banks shared concerns about changes the FDIC had made in contracts with purchasers. Mr. Held noted that transactions are evolving with the market. He said that the FDIC's documents were under review to simplify them and make them more consistent, and that questions and feedback from acquirers was welcome. Mr. Glassman added that the FDIC contacts acquirers a week after a bank failure to obtain feedback, and again after a month. He noted that issues facing acquiring banks are important and that the FDIC would try to resolve them.

Mr. Schriefer reported that a recent Federal Reserve seminar had been titled "Now that the financial crisis has passed" and said that he hoped that this was not the generally held view because the situation is still quite tender. Vice Chairman Gruenberg responded that the financial crisis for the big systemic institutions may have passed last year, but that regional and community banks were now being particularly impacted. For those smaller banks, the peak of bank failures may occur this year and be followed by a downward trend next year, so that much of the FDIC's work is still ahead of it.

In closing, Vice Chairman Gruenberg stated that he found the Committee's meetings to be very valuable experiences. Directors Curry and Bowman agreed and noted that the meetings provide valuable exchanges of ideas.

There being no further business, the meeting was adjourned.



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

April 21, 2010 - 8: 30 A. M.

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

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

and

Presiding Officer
April 21, 2010, Meeting of the
FDIC Advisory Committee on Community Banking

Dated: July 20, 2010