

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 9, 2014 - 8:45A.M.

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

The members of the Committee present at the meeting were: Robert F. Baronner, Jr., President and Chief Executive Officer ("CEO"), Bank of Charles Town, Charles Town, West Virginia; Cynthia L. Blankenship, Vice Chairman and Chief Operating Officer, Bank of the West, Grapevine, Texas; Leonel Castillo, President and CEO, American Bank of Commerce, Provo, Utah; Jane Haskin, President and CEO, First Bethany Bank & Trust, Bethany, Oklahoma; Mark Hesser, President, Pinnacle Bank, Lincoln, Nebraska; James Lundy, Chief Executive Officer, Western Alliance Bank, Phoenix, Arizona; Joseph G. Pierce, President and CEO, Farmers State Bank, Lagrange, Indiana; Kim D. Saunders, President, CEO and Director, Mechanics & Farmers Bank, Durham, North Carolina; Dorothy A. Savarese, President and CEO, Cape Cod Five Cents Savings Bank, Orleans, Massachusetts; David Seleski, President, CEO and Director, Stonegate Bank, Fort Lauderdale, Florida; Mark Stevenson, President & CEO Capital Pacific Bank; Alan Thian, President and CEO, Royal Business Bank, Los Angeles, California; and Derek Williams, President and CEO, First Peoples Bank, Pine Mountain, Georgia.

Carolyn "Betsy" Flynn, President and CEO, Community Financial Services Bank, Benton, Kentucky and Joseph G. Pierce, President and CEO, Farmers State Bank, Lagrange, Indiana were absent from the meeting.

Members of the FDIC Board of Directors present at the meeting were: Martin J. Gruenberg, Chairman, Thomas M. Hoenig, Vice Chairman and Jeremiah O. Norton, Director (Appointive).

Corporation staff who attended the meeting included: Willa M. Allen, Ruth R. Amberg, Steven O. App, Lisa D. Arquette, Heather L. Basnett, Bobby R. Bean, Michael W. Briggs,

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divisions. Chairman Gruenberg said he viewed the Ombudsman as an important intermediary who was not part of the examination operation and that he wanted the least hurdle possible for banks to make contact with the Ombudsman's office. He said the Ombudsman could provide a valuable reality-check for a bank's concerns and was also well-positioned to intervene and engage the decision-makers where warranted. Chairman Gruenberg indicated that he did not view the number of formal SARC cases as an accurate barometer of the effectiveness of the SARC process as a whole. He noted that a bank should have to rely on the formal and high-level SARC appeal only if impasse was reached at lower levels. Chairman Gruenberg acknowledged that there may not be a perfect solution to the issue of retaliation, but said that the FDIC was committed to having a process that is as open and responsive as people can make it and had zero tolerance for retaliation, which would harm the FDIC as an organization. He urged banks to report misconduct for the benefit of the system and said he was confident that the FDIC's executives would act to address any instances of retaliation. Chairman Gruenberg said the example of an examiner's statement about Member Castillo's bank being too small to be in business was inappropriate, a serious matter and a good example. He said that Member Castillo's presence on the Committee demonstrated that he disagreed with the examiner's view.

Ms. Ryan then introduced the moderators for the fifth panel, "Developments in Customer Due Diligence and Reporting Requirements," James Watkins, Senior Deputy Director, RMS, and Lisa Arquette, Associate Director, RMS. Mr. Watkins spoke about a proposed rulemaking that is expected from the Financial Crimes Enforcement Network ("FinCEN") concerning customer due diligence ("CDD") requirements. He said that CDD is fundamental to the safety and soundness of a bank's business model and was likely part of banks' underwriting and account opening process. Mr. Watkins noted that CDD includes gathering a customer's identifying information, deposit account expectations, the purpose of new loans and other accounts, the customer's business projections, anticipated wire activity and other procedural and monitoring steps. He said that CDD was a critical element of combatting all forms of illicit financial activity consistent with banks' Bank Secrecy Act/Anti-Money Laundering ("BSA-AML") obligations. Mr. Watkins reported that most banks have strong CDD programs; out of 2300 BSA/AML exams the FDIC conducted in 2013, only 22 programs had significant shortcomings requiring a formal response.

Concerning the expected FinCEN proposed rule, Mr. Watkins said that three elements of the rulemaking were already bank requirements and practices: 1) identifying and verifying the identity of customers; 2) understanding the nature and purpose of customer relationships; and 3) conducting ongoing monitoring to maintain and update customer information and to identify and report suspicious transactions. He said the rulemaking may also propose a new requirement- to require banks to identify and verify the beneficial owners of legal entities. Mr. Watkins said that the FDIC was not certain when FinCEN would publish its proposed rule but said that RMS wanted to make banks aware so they could consider providing feedback to FinCEN. Mr. Watkins noted that the FFIEC *BSA/AML Manual* also describes enhanced due diligence expectations and practices for higher risk customers and makes reference to a list of steps a bank might take in such a situation.

 Ms. Arquette spoke about recent guidance concerning providing banking services to marijuana businesses in states where marijuana sales are legal. By way of background, she said

that the *Controlled Substances Act* makes it illegal under federal law to manufacture, distribute or dispense marijuana. She said that many states impose and enforce similar state laws but that 20 states make marijuana legal for medical purposes, and two have legalized recreational use. Ms. Arquette said that in August, 2013 and February, 2014, the Department of Justice ("DOJ") issued guidance to U.S. Attorneys concerning marijuana enforcement and set forth DOJ's enforcement priorities. She said that the DOJ guidance made clear that DOJ expected that states that authorized marijuana-related conduct would also implement clear, strong, and effective regulatory and enforcement systems. Ms. Arquette also indicated that DOJ expected banks to report and not offer services to marijuana businesses that operate outside such strong state regulatory and enforcement regimes. Ms. Arquette said that, in February, 2014, FinCEN issued guidance that described BSA expectations for banks seeking to provide financial services to marijuana-related businesses which had two primary focuses. First, she said, the FinCEN guidance emphasized that it is the financial institution's decision to open, close or refuse any particular account or relationship. Ms. Arquette said the FinCEN guidance also provided minimum due diligence procedures that banks should follow for marijuana-related businesses in addition to considering the DOJ's enforcement priorities as part of its CDD.

Ms. Arquette said the second focus of the FinCEN guidance was Suspicious Activity Reports ("SARs"). She indicated that a bank's obligation to file a SAR is not affected by state laws that legalize marijuana-related activity. Financial transactions involving a marijuana-related business would involve funds derived from activity that violates federal law; therefore, a bank is required to file a SAR. However, the FinCEN guidance identified two distinct categories of SARs that a bank could file, including a "Marijuana Limited" SAR or a "Marijuana Priority" SAR. Ms. Arquette explained that a Marijuana Limited SAR should be filed when the bank reasonably believes that none of the DOJ enforcement priorities are implicated and described the information that should be included in one. She said that a Marijuana Priority SAR should be filed when a DOJ enforcement priority is implicated and she described its more detailed reporting requirements. Ms. Arquette said that a bank should also file a specific SAR if it terminated a relationship with a marijuana-related business. Ms. Arquette described various BSA/AML resources available to banks from the FDIC, including FDIC examination staff and subject matter experts in regional and field offices, and a BSA/AML training program on the Director's Resource Center of the FDIC website.

Member Hesser, whose bank has decided not to open accounts for marijuana-related businesses, said there was still a concern about how the FDIC would examine loans that had a marijuana-related marijuana-related business connection. What would occur, he asked, if a CRE borrower rented space to a marijuana-related business? In that situation, Member Hesser said there was a risk that the commercial property could be subject to civil forfeiture by federal law enforcement causing the bank's interest in the collateral to be eliminated. He reported that banks in such situations had taken a variety of approaches: some banks had informed the CRE borrower that it was going to foreclose; others informed the CRE borrower that they would foreclose if the borrower did not get the marijuana business out of the property; others had informed the borrower that they would foreclose at the end of the loan. Member Hesser asked if examiners would classify loans in such circumstances. Member Hesser said a second issue was the regulatory/law enforcement burden put on banks. Not only did the bank have to "know its customer," he said, but it would also have to evaluate the customer's activity for legality, which

raised large potential liability issues for the bank. Mr. Watkins said that it was the bank's decision to determine what customers to do business with, and the FDIC expected banks to have good internal policies for risk assessment.

Member Lundy said that he had heard that DOJ had recently wiped out a bank's lien in Georgia. In response to Mr. Watkins' observation about relying on a bank's risk assessment processes when it makes a loan, Member Lundy said that a CRE loan may have been within a bank's policy when it was made but that state law may have changed afterward such that the bank could no longer use a "violation of state law" clause to call the loan. Member Lundy said that his institution had decided not to open accounts with marijuana-related businesses but that it would feel aggrieved if an examiner took an aggressive view about money traceable to a marijuana-related business flowing through the bank. Member Williams asked if such a loan as earlier described would be classified based on a material weakness in the credit? Ms. Eberley said that the FDIC had not developed guidance on the issue, but indicated that the banks appeared to be on the right track, identifying the issue and considering whether it affected the borrower's ability to pay. She said that examiners would likely evaluate the bank's evaluation process although she indicated that classifying credits might require case-by-case determinations. Member Lundy said that banks would like guidance on whether to file a SAR on a CRE borrower who had a tenant with a marijuana-related business. Ms. Arquette said that if the CRE borrower's repayment capacity related to the loan involves tenants, and one of them was a marijuana-related business, the bank would be obligated to file a SAR (every 90 days if there was no changes in circumstances). Ms. Arquette added that banks were not expected to be part of law enforcement, they need only file the report in the FinCEN database and law enforcement would evaluate the SARs.

Member Blankenship expressed concern that banks might lose their collateral position if they get caught off guard on a CRE property that has been seized by federal law enforcement. Ms. Arquette said that a bank's CDD should be expanded when they have a higher risk customer. Member Blankenship observed that marijuana-related businesses might turn to money service businesses if banks would not open accounts for them and indicated that banks might risk liability if they had account relationships with those money service businesses. Member Savarese questioned whether a bank would be obligated to file a SAR on the executive director of a not-for-profit medical marijuana dispensary if the dispensary was the director's primary income source; she noted the bank might learn about the source of income after an account relationship had begun. Member Savarese inquired if regulators would have difficulty if banks had customers who were breaking federal law. Mr. Watkins acknowledged that there were risks for banks, but that regulatory guidance indicated that banks should do their own risk assessment and have a good understanding of their customers. He added that it was not unusual for a bank to file a SAR, that thousands are filed on a regular basis. Mr. Watkins said the FDIC appreciated the feedback on this emerging new topic.

Member Haskin said that the potential FinCEN rule requiring a bank to identify all the beneficial owners of a bank account would impose a big burden on community banks with relatively few employees to accomplish the added work. She said her bank had many Limited Liability Corporation ("LLC") accounts, and while it appeared reasonable for the bank to know the LLC's active members, it would be burdensome to identify all the minority owners (who

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might also find the requirement intrusive). Member Haskin also noted that a community bank could not afford the fine for a BSA/AML violation and so would hire additional staff to comply with the rule. Ms. Arquette encouraged community bankers who shared that view to provide feedback to FinCEN after the proposal is made. In response to a question from Member Stevenson, Ms. Arquette said the FDIC was aware of banks that opened accounts for marijuana-related businesses and had filed SARs regarding them.

The Committee stood in recess at 12:22 p.m. and reconvened at 1:31 p.m. that same day.

For the sixth panel, "Qualified and Nonqualified Mortgage Discussion," Ms. Ryan introduced Mr. Eberley, Mr. Pearce, Jonathan Miller, Deputy Director, DCP, and Rae-Ann Miller, Associate Director, RMS. Mr. Pearce noted that the Committee had previously discussed the CFPB Ability to Repay/Qualified Mortgage rule ("ATR/QM") as the rule was developed. Under the ATR/QM Rule, creditors must consider a consumer's ability to repay a loan according to its terms for all closed-end residential mortgages. Mr. Pearce said that the ATR/QM rule had some elements focused on community banks. First, Mr. Pearce noted that some community banks (those with under \$2 billion in assets, and which make fewer than 500 mortgage loans that they then then hold in portfolio) can make QMs that have debt to income ratios above 43 percent and have an Annual Percentage Rate of up to 350 basis points above the average prime offer rate. Also of interest to community banks, he said that mortgages with balloon payments can also be designated as a QM. Mr. Pearce said some banks had questioned how their business decisions in response to the ATR/QM rule might interact with fair lending and the CRA evaluations. He said that the regulatory agencies had issued guidance on the subject and that Mr. Miller and Ms. Miller would further discuss the issue.

Mr. Miller said that one banker concern had been whether banks would experience fair lending criticism if they decided to make only QM loans. He said that the CFPB and the banking agencies issued a press release in October 2013 that clarified that if a bank chose to do only QM lending, such a decision by itself would not run afoul of fair lending laws. Mr. Miller said that fair lending decisions were fact-specific and that his statement should not be viewed as a general safe harbor. He likened the QM situation to banks that chose not to participate in Federal Housing Administration lending or in secondary market lending. Mr. Miller said that most FDIC supervised institutions were portfolio lenders and that such business decisions alone did not result in fair lending or CRA violations.

Ms. Miller provided the Committee with a risk management perspective. She said that bankers had expressed concern that they would receive safety and soundness criticism if they chose to make non-QM loans; for example, non-QM loans might be automatically classified or there would be an inclination to finding legal risk for non-QM loans. Ms. Miller said that the banking agencies issued a December 2013 statement that indicated that institutions may originate both QM and non-QM loans based on their business strategy and risk appetite and that residential mortgage loans will not be criticized solely because they are QM or non-QM. She explained that the FDIC would continue to expect institutions to underwrite residential mortgages prudently, addressing key risk areas such as loan terms, borrower classification standards, loan to value limits, and documentation requirements regardless of whether the loans were QM or non-QM. . . .