CSBS YEAR IN REVIEW

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INTRODUCTION

Good morning and thank you for that kind introduction. And thank you to Commissioner Jan Owen for welcoming us to your beautiful state and this magnificent city. It is certainly a pleasure to be in gorgeous San Francisco, and to be here for the CSBS State-Federal Supervisory Forum.

Yesterday David Cotney of Massachusetts assumed the honor of being elected CSBS's new Chairman. David: congratulations on becoming Chairman, and best wishes for your tenure. I think CSBS is in very capable hands with you at the helm!

It was truly my honor and privilege to serve as the Chairman of CSBS for this past year. I am proud of the work we as state regulators accomplish individually, and particularly all we are able to do together through CSBS. I also value the relationships with our federal counterparts. We as regulators must work together to ensure the best possible system of supervision, and I appreciate your participation in this event.

PURPOSE OF SUPERVISION

Last year I spoke of the rapid changes underway in the financial system. But as I mentioned last year, the more things change, the more they stay the same. I imagine the same will hold true with financial supervision.

Our goals and objectives of supervision – to create a sound financial services industry – are still the same. I see this to mean a diverse, resilient industry that provides credit to all corners of the nation, holds the confidence of its customers, and is empowered to compete, innovate, and thrive.

In my 35 years as a state regulator, it has become clear to me that community banks are essential to economic development, job creation, and financial stability. Our system of financial supervision must work to strengthen the best parts of the financial services industry – such as community banks – while protecting consumers and correcting illegal or inappropriate behavior when necessary.

Those of us in this room and the policymakers on Capitol Hill must rethink how we all approach regulating and supervising community banks. The statistics are clear – most banks are community banks that operate in local markets:

- Nearly 90 percent of today's 6,518 banks have less than $1 billion in total assets.
- The 5,829 banks with less than $1 billion in assets hold less than nine percent of the banking industry's total assets.
- The average community bank has $230 million in total assets.

On the other end of the industry spectrum, we find a very different type of bank:

- There are four U.S. banks that exceed $1 trillion in total assets, and one of these has more than $2 trillion in assets.
- These four banks hold more than 41 percent of the banking industry's total assets.

The community bank and megabank business model are also radically different. Community banks derive primary funding from local markets, lend primarily to local markets, and engage in relationship lending.

Conversely, megabanks leverage economies of scale and lending models to offer standardized financial products across U.S. and global markets, provide services to multi-national corporations, and engage in capital markets activity.

Following the Great Recession, regulatory reform efforts were rightfully centered on addressing the risks posed by the largest, most systemically important banks. However, these statutes, rules, and supervisory practices are posing an undue burden for the vast majority of the nation's banks.

Instead of a one-size-fits-all approach to supervision, we need a flexible approach that is tailored to banks of varying sizes. Regulation must ensure safety and soundness and consumer protection, while still allowing banks to contribute to the economic stability and growth of the local, state, and national economy.

REGULATORY RIGHT-SIZING

<u>A Definitional Approach</u>

CSBS calls this approach to supervision "regulatory right-sizing." However, to successfully implement a right-sized regulatory framework, we first need a consensus definition of a "community bank."

A definitional approach to identifying community banks that looks beyond assets size would facilitate a broad range of regulatory right-sizing initiatives. In the past year, CSBS began to advocate for a more comprehensive, holistic definition for community banks. I believe the FDIC provided an example in their research study that is far more reflective of our diverse banking system than looking solely at asset sizes. While the method was created for research, there is no reason the model cannot be adjusted and adopted for policy. Let's seize the opportunity to stop the debate over what banks right-sizing should apply to and adopt a definition of a community bank.

Specifically, lawmakers should consider a community bank definition that, in addition to asset size, considers qualitative factors that allow for flexibility in interpretation and application. Some characteristics that may help identify community banks include:

- Operating primarily in local markets;
- Deriving funding primarily from a local market, specifically through deposits of members of the communities in which the bank operates;
- Its primary business is lending out the deposits it collects to the communities in which it operates;
- The lending model is based on relationships and detailed knowledge of the community and its members, not volume-driven or automated;
- Focusing on providing high-quality and comprehensive banking services; and
- Locally based corporate governance.

I believe we are gaining traction among policymakers for the need for a definitional approach to ensure safety and soundness and consumer protection requirements can better reflect the community banking business model.

CSBS-Federal Reserve Community Bank Research Conference

To achieve a right-sized framework, however, we need more than just a clear definition of the institutions we're trying to address. We must also fully understand the impact financial policy and regulation have on our supervised institutions. To this end, CSBS partners each year with the Federal Reserve System for the Community Banking in the 21st Century Research Conference.

This conference brings an innovative approach to the study of community banking. Unlike many other research conferences, community bankers have direct input on the research compiled and presented at the CSBS-Federal Reserve Community Bank Research Conference.

The second annual conference was held in September 2014, and industry engagement was outstanding.

More than 1,000 community bankers from 38 states participated in a national survey. The goal of the survey was to provide a national view of how bankers are thinking about key issues facing the industry and how they are responding to changes in the market.

In preparation for this year's conference, CSBS and the Fed are once again surveying community banks. This year's survey should provide a unique opportunity to evaluate changes in these banks over time.

Additionally, state regulators from 30 states held "town hall" meetings to learn directly from community bankers about the challenges and opportunities they face. Last year more than 1,300 bankers participated in these town hall meetings. State regulators are once again hosting these roundtable discussions to gather input from bankers in preparation for this year's research conference.

Hearing the views of bankers over the past several years, trends are beginning to emerge that deserve our attention. For instance, banks are finding it difficult to customize and find solutions that meet their customers' needs. Banks are feeling the need to standardize and streamline their products to meet compliance requirements. Furthermore, banks are reporting that compliance itself is more costly. The increase in and complexity of compliance regulations is having a direct impact on bank profitability, forcing banks to focus their efforts and time on compliance, rather than on providing services and attention to customers.

Finally, at the research conference itself, 11 research papers were presented by academics and researchers. On each of the three panels where the papers were presented, a community banker also provided his or her real-world reaction to the research presented. There was also a panel comprised only of community bankers to discuss the future of community banking.

The industry participation – through the national survey, the town hall meetings, and the panels at the conference itself – was the highlight of the 2014 conference. Their stories, expertise, and practitioner's perspective added context and color to the academic research and findings.

Research on community banking and feedback from the industry is very important. But ultimately, there is no replacement for personal experience. For that reason, CSBS has been vocal in advocating for state regulatory representation on the Federal Reserve Board of Governors and the FDIC Board of Directors. Equipped with local, on-the-ground experience, state regulators are uniquely positioned to understand the challenges facing community banks and their local economies.

At the end of 2014, Congress recognized the value of this expertise, and included a provision in the Terrorism Risk Insurance Program Reauthorization Act that a member of the Federal Reserve Board of Governors must have experience either as a supervisor of community banks or a community banker.

Additionally, the current FDIC Board does not include an individual with state regulatory experience, as required by federal law. The Federal Deposit Insurance Act and congressional intent indicate that the FDIC Board include an individual who has worked as a state official responsible for bank supervision.

In my year as CSBS Chair, I have had the opportunity to work closely with members of the Fed Board of Governors and the FDIC Board of Directors. They are both comprised of talented and devoted individuals. Our efforts in this area are not a sign of disrespect, but rather our conviction that the most effective system of financial supervision is one that incorporates multiple experiences and perspectives at the highest levels.

Congress recognized the value of the state perspective, and asked CSBS to testify twice during the 2014 calendar year on the supervision of community banks and proposals for regulatory relief. Sally Cline of West Virginia and Charles Vice of Kentucky did a tremendous job representing the states.

One of the topics discussed in CSBS testimony in 2014 is establishing QM status for mortgages held in portfolio by a community bank. When a community bank retains a mortgage in portfolio, the interests of the borrower and the lender are inherently aligned, as the lender retains 100 percent of the risk of default. Portfolio lenders are incentivized to work with borrowers to fix problems when they arise.

Along with portfolio lending, our testimony also discussed establishing a petition process for interested parties to seek rural designation under the CFPB's Ability-to Repay rule. Since then, the CFPB has proposed changes to its mortgage rules to provide more exemptions for small creditors and new safe harbor provisions related to rural or underserved markets. This is a clear indication that the CFPB has been receptive to our feedback. Even with this positive step, there is still a need for regulatory and legislative action to ensure we have a right-sized approach that meets the needs of our rural communities. A rural petition process supports community bank portfolio lending and would provide a flexible process for local input.

Earlier this year, I was also honored with the opportunity to testify on behalf of CSBS. In February, I was invited to testify before the Senate Banking Committee along with my federal colleagues on "Regulatory Relief for Community Banks and Credit Unions."

It was a very rewarding personal experience to represent this industry in which I have spent my life's work, and I am hopeful that Congress continues to recognize and respect the state's opinion going forward. And, by the way, my family – Roger and Ava – thought this was a pretty great deal!

<u>Executive Leadership of Cybersecurity</u>

Regulatory burden is definitely a concern for our regulated entities, and has been worthy of our collective attention. But in recent years, cybersecurity has emerged as a regulatory and industry priority, as more and more of our regulated entities, and even we, become attractive targets of cyber criminals.

The states have been dedicated partners on the work of the FFIEC on cybersecurity. The work of the FFIEC has not been about additional burden for the industry but has provided guidance on what the industry can do to protect itself. The FFIEC is also in the best position to ensure the technology services providers are doing what they need to do. This may prove to be the FFIEC's finest hour. In conjunction with initiatives by the FFIEC, in 2014 CSBS launched the Executive Leadership of Cybersecurity initiative, known as ELOC. This two-month campaign and the accompanying "Cybersecurity 101: A Resource Guide for Bank Executives," is a plain-English, non-technical guide that bank CEOs may use to help mitigate cybersecurity threats at their banks. The guide puts into one place industry recognized standards for cybersecurity and best practices currently used within the financial services industry. We have also started holding ELOC summits across the country, inviting bank executives out to learn more about best practices for managing their cybersecurity preparedness.

I don't think it's any secret that cybersecurity has the potential to be the next great crisis in our industry. Denial of Service attacks, destructive malware, Corporate Account Takeover, over-reliance on outdated technology or supposedly secure servers, has made us all vulnerable. As cyber threats grow, state regulators are working to stay abreast of the best practices and provide guidance on addressing threats and communicating with the industry.

Cyber threats are on the rise for financial institutions as cybercriminal activity becomes increasingly sophisticated and increasingly common among financial institutions of all sizes, not just the country's largest banks. This has become a heightened area of concern for financial regulators as these threats could put the entire U.S. financial system at risk.

Cybersecurity is not just an IT issue; it is an issue that requires the engagement of bank executives and state and federal regulators.

ADDRESSING NEW CHALLENGES

Non-Depository Supervision

In addition to insured depository institutions, state regulators also oversee a host of non-bank financial services providers, such as mortgage providers, payday lenders, debt collectors, money services businesses (MSBs), and a variety of other entities.

State regulators are the front line of non-depository supervision, but we can't do it all alone. To promote consistent and efficient supervision, state regulators coordinate with one another to examine multi-state, non-bank financial services providers. We also work extensively with the Consumer Financial Protection Bureau to coordinate supervision and advance regulatory policy among state and federal regulators of non-depository institutions.

The State Coordinating Committee (SCC), the Multi-State Mortgage Committee (MMC), and the Multi-State MSB Examination Taskforce (MMET) are each integral to creating comprehensive and seamless examination of multi-state companies. Through these groups, state and federal regulators are engaged in an unprecedented level of coordinated non-depository supervision. This work ensures consumer protection, provides better supervision, and delivers more efficient supervision.

I commend our sister organizations – AARMR, MTRA, NACARA, NACCA, and NASCUS – and our federal partner the CFPB for the work we've done together in this area. I am aware of a current situation where the states and various federal agencies, including the OCC, are working together on a supervisory issue, sharing information and strategies for the good of the financial system. This has the potential to be a new era of coordination across the financial sector.

<u>Nationwide Multi-State Licensing System and Registry (NMLS)</u>

The SCC, MMC, and MMET provide the forums of coordination for state-to-state and state-federal supervision. The NMLS, launched by state regulators through CSBS and AARMR in January 2008, remains the primary tool and database state regulators use for mortgage supervision. As the system of record for state regulators, NMLS is able to track the number of unique companies and individuals operating in the state system, as well as the number of licensees these companies and individuals hold in each state. Based upon the success of using NMLS for supervising mortgage companies, states are now using the NMLS as the system of record for expanded non-depository providers, including payday lenders, MSBs, and debt collectors.

Enhancements constantly being made to NMLS have made the System truly indispensable and invaluable to regulators and an integral part of the regulatory system.

<u>Prudential Standards for Non-Bank Mortgage Servicers</u>

State financial regulators also took proactive steps in 2014 to address the growth of mortgage servicing assets held by non-depository servicers. These servicers provide a critical function in our housing finance system, and it is important for us to understand how this growth should inform changes to the regulatory framework. To that end, CSBS launched the Mortgage Servicing Rights Task Force in October 2014 to analyze this growth.

The Task Force determined increased prudential regulation of these companies would help achieve the following goals:

- Provide better protection for borrowers, investors, and other stakeholders;
- Enhance effective regulatory oversight and market discipline over non-bank mortgage servicers; and
- Improve transparency, accountability, risk management, and corporate governance standards.

For this reason, in March 2015 CSBS and AARMR issued for public comments proposed prudential regulatory standards for non-bank mortgage servicers. This is a significant project that should help address a potential systemic risk to the financial system.

The need for this work was highlighted in the annual report of the Financial Stability Oversight Council. CSBS and AARMR approached this work in a collaborative manner with the CFPB, FHFA, Treasury and other federal agencies. This was the ultimate intent of the FSOC's creation.

Emerging Payments Task Force

Technological innovation has served us well, as NMLS clearly demonstrates. It has also spurred rapid developments in the financial services industry, as consumers are experimenting with virtual currencies and increasingly using mobile technology to conduct their financial businesses.

Recognizing this change, CSBS established in 2014 the Emerging Payments Task Force to study changes in payments systems and to determine the potential impact of these changes on consumer protection, state law, and banks and non-bank entities supervised by the states.

Among several major achievements in 2014, the Task Force held a public hearing in May 2014 to gather information from industry participants and stakeholders on legacy payment systems, innovations in the retail payments arena, and virtual currencies.

During the public hearing which was also webcast, state regulators heard from 11 speakers on three panels.

At the end of 2014, the Task Force issued for public comment a draft Model Regulatory Framework that aims to promote consistent state regulation of virtual currency activities. Industry and regulators alike have called for greater consistency and clarity for virtual currency activities. It is our hope the Model Regulatory Framework, when finalized, will set out requirements for licensure and minimum standards for specific business practices in this arena. This is tremendous work, and I appreciate the efforts of the entire Task Force.

PROFESSIONAL DEVELOPMENT

As we engage in supervision of additional entities and new technologies, we must ensure our departments and our staff are up to the challenge. Understanding the challenges facing community banks, right-sizing regulation, and researching emerging technologies and market shifts are just the starting point of sound supervision. We must also ensure that our examiners are well-trained, well-informed, and have the necessary tools to most effectively do their job.

This is why CSBS provides cutting-edge training and professional development opportunities and holds state regulatory agencies to certain standards through supervision accreditation programs.

In 2014, 11 state agencies were re-accredited through the CSBS Bank Supervision Accreditation Program.

Eight agencies were accredited or re-accredited through the CSBS-AARMR Mortgage Accreditation Program.

David Cotney's department served as the guinea pig and earned the first join bank, credit union, and mortgage supervision accreditation through CSBS, NASCUS, and AARMR. This initiative will improve the efficiency and effectiveness of all of these programs.

More than 1,000 state examiners were certified by CSBS in 2014.

And CSBS held 25 on-site training programs, in addition to state-of-the-art online programs and schools.

Equipped with knowledge, training, and local, on-the-ground experience, state regulators are uniquely positioned to understand the challenges facing community banks and their local economies.

CALL TO ACTION / CONCLUSION

As the financial services industry continues to evolve, state regulators and CSBS are evolving as well. The core principles we have held dear for decades will remain the bedrock of our approach to supervision.

But I do want to challenge those of us in this room. We must ensure we have the necessary resources and expertise to conduct this business effectively. And we must take a bigger role in supervisory areas beyond just safety-and-soundness, such as compliance supervision. I hope each of us can live up to the mission of CSBS: to advance the system of state financial supervision by ensuring safety, soundness, and consumer protection; promoting economic growth; and fostering innovative, responsive supervision.

Our system is tenuous and the industry is ever-changing. None of us in this room can go it alone. Like it or not, we need one another. State regulators must continue to work together and state and federal regulators must continue to build relationships and coordinate our efforts.

We must be vigilant and try to prepare for the next crisis. In the meantime, however, let us be wary of damaging the industry or our system of supervision during this – hopefully – time of calm. We must seek to better calibrate our supervision to allow the financial services industry to thrive and contribute to economic development.

It has been my honor and privilege to serve as your Chairman.

I would like to thank my staff at the Arkansas State Bank Department, my colleagues, our federal partners, and of course my family for your support this past year.

And most of all express my sincere regard and appreciation of John, Mike, Tom, Bill, Catherine, and Margaret, and all of our incredible CSBS staff who devote their professionalism to this wonderful industry.

I look forward to continuing the work we have begun together through CSBS. We have achieved much this past year, and there is much to do in the coming years. I know our new Chairman Cotney will do a tremendous job leading our organization through the days and months ahead.

Thank you very much.