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SHARED RESOURCE ARRANGEMENTS:

AN ALTERNATIVE TO CONSOLIDATION

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About the Conference of State Bank Supervisors

The Conference of State Bank Supervisors (CSBS) is the nationwide organization of banking and financial regulators from all 50 states, the District of Columbia, Guam, the Northern Mariana Islands, Puerto Rico, and the U.S. Virgin Islands.

Established in 1902 as the National Association of Supervisors of State Banks, CSBS is uniquely positioned as the only national organization dedicated to protecting and advancing the nation’s dual-banking system.

For more than a century, CSBS has given state supervisors a national forum to coordinate supervision and develop policy related to their regulated entities. CSBS also provides training to state banking and financial regulators.

SHARED RESOURCE ARRANGEMENTS: AN ALTERNATIVE TO CONSOLIDATION

I. BACKGROUND

Nearly half of small business lending and a meaningful amount of consumer lending is conducted through community-based banks. These institutions currently face competitive pressures to remain viable. State bank supervisors, who regulate these institutions, have a duty to ensure the broad, safe access to credit within their jurisdictions. To this end, these supervisors have been responding to bank requests to enter into shared resource arrangements with like banks, as a means to improve operating efficiency, maintain regulatory compliance, and expand customer access to products and services. These shared resource arrangements often come in the form of contractual agreements, jointly-owned operating subsidiaries, and non-profit entities. By sharing certain resources with comparable institutions, community banks may be able to realize the benefits that come with a larger size and scale, yet preserve their core character, function, and independence. This white paper explains the rationale and typical examples for shared resource arrangements, while identifying the flexibilities and restrictions within current regulation.

SHARED RESOURCE ARRANGEMENTS SNAPSHOT

- Shared resource arrangements may achieve (or exceed) the same regulatory cost savings or economies of scale as consolidation.

- Shared resource arrangements dedicated to BSA/AML compliance could provide community banks more latitude to attract and acquire skilled BSA compliance professionals.

- Shared resources often come in the form of contractual agreements, jointly-owned operating subsidiaries, and non-profit entities.

- State regulators believe that, with the proper controls and ongoing oversight, shared resources may be a viable component to a community bank's overall strategic objectives to remain an independent provider of financial services in the local market.

Challenges Facing Community Banks

Community banks[1] face particular regulatory and operational cost challenges compared to their competitors. Community banks often compete with large banks who benefit from economies of scale and nonbank financial institutions that are not subject to the same degree of regulatory requirements.[2] Though regulatory risks often increase with size, smaller institutions may expend greater resources on compliance relative to their overall revenue than their larger counterparts.[3] In a recent study, the Congressional Research Service cited costs associated with software and information systems, manpower and specialized expertise as possible areas where "compliance may become relatively more costly for small firms than large firms."[4] The number and pace of regulatory changes following the financial crisis has also intensified this underlying dynamic. Moreover, continued downward pressure on community banks' profit margins[5] from the historically low-interest rate environment[6] has forced them to look for cost savings in other areas, such as how they perform critical services.

A joint survey-report issued by CSBS and the Federal Reserve System found that a significant number of bankers have considered merging with another banking institution to achieve economies of scale and more efficiently comply with regulations.[7] Consolidation is one option available to banks, but it is not the only option to improve efficiency or achieve gains in economies of scale. Indeed, a well-structured, mutually beneficial arrangement in which two or more institutions share personnel or resources may achieve (or exceed) the same regulatory cost savings or economies of scale as consolidation.

The preservation of the community bank business model is a concern for industry leaders, regulators, and consumer advocates given these institutions' outsized role in providing financial services in otherwise underserved communities. Regulatory filings between 2006 and 2014 demonstrate the 10 largest banks in the U.S. have decreased their small business lending by 38 percent in less than 10 years, leaving small business owners with fewer options for safe and affordable credit.[8] According to the Federal Deposit Insurance Corporation (FDIC), community banks are the only banking service providers with physical branches in 20 percent of U.S. counties, and they are responsible for nearly 50 percent of all small business loans despite holding only 14 percent of the banking industry's assets.[9]

Community institutions face unique, considerable challenges not experienced by their larger and more complex counterparts. For instance, by choosing to operate in rural or remote markets, community banks may struggle to attract the requisite subject-matter experts to fulfill critical compliance or regulatory roles. Costly compliance solutions are often unaffordable for small institutions. To the extent that institutions are considering consolidating, sharing of certain resources provides an alternative worthy of exploration.

What are Shared Resource Arrangements?

Broadly defined, shared resource arrangements are those in which institutions pool human, technological, or compliance resources in order to reduce costs, increase operational efficiencies, and leverage specialized expertise. There are many different approaches banks may take to share resources. For instance, banks can share resources through contractual agreements, or indirectly by creating subsidiaries that provide services to multiple institutions.

Banks have structured these arrangements in innovative ways, allowing them to keep pace with technology-driven changes in the financial services industry.

Shared resource arrangements represent a more collaborative effort among institutions as opposed to those where responsibilities are merely handed off to a third party. Accordingly, it is important to distinguish shared resource arrangements from other relationships like outsourcing, using independent consultants, franchising, and networking between different financial institutions. Contrary to these relationships, which are more transactional in nature, shared resource arrangements are more cooperative and constitute a combining of resources to maximize effectiveness.

II. Shared Resources Opportunities

State banking regulators have seen a rise in interest among bank board members about sharing resources, especially in the context of lowering the costs of non-income producing activities (e.g., credit review, auditing, information technology services, and regulatory compliance). Through their supervisory responsibilities, state regulators have reviewed a number of ways two or more financial institutions have successfully shared resources to either improve compliance, increase efficiency, or both. The categories and examples below serve to highlight a few of those opportunities available to financial institutions for sharing resources, but do not describe the full range of possibilities where sharing resources may be beneficial. Furthermore, bankers should bear in mind that these examples may not be appropriate for all institutions. Bankers should conduct their own due diligence to ensure a shared resource arrangement would fit well within their business model and their safety and soundness compliance programs.

Information Technology

Technological advances are changing the financial services landscape. In order to compete with emerging technology-driven financial services providers, banks are revamping their information technology systems to assess risk, improve customer service and manage regulatory compliance. A poll of 50 bank chief information officers found that data security, data analytics, mobile banking and compliance will drive increased technology spending among banks in 2016.[10] By sharing resources with other institutions, community banks may be able to provide better services, security and compliance at a lower cost than had they purchased or developed these solutions independently.

Example One:

A smaller community bank (approximately $120 million in assets) found itself without a Chief Information Officer. A larger community bank (approximately $1 billion in assets) found itself with excess IT capacity. After conversations between the banks, the larger bank offered to share its IT services, including its CIO, to support the smaller bank's entire IT operation for a fee. The arrangement worked so well that both banks agreed to continue the arrangement well beyond their initial agreement. Furthermore, the larger bank is considering providing a variety of services to other banks in the area.

Cybersecurity has commanded increased resources and focus from banks in recent years. Maintaining the necessary cybersecurity posture requires expertise and resources that may be too costly for the smallest institutions. By partnering with other institutions to share human or operational resources, an institution may be able to better protect its customers and reputation from a cyber-attack.

Example Two:

In one known case, a group of four community banks partnered together to share ownership of a data processing provider. In addition to cutting costs, the arrangement was structured in an innovative way to avoid the operational risks that arise when a single bank maintains its own processing system onsite. The service-provider was housed in the basement of one bank, yet a backup site was established at a second bank. The service provider also served banks outside of the arrangement on a fee basis and generated income for the four partner banks.

Regulatory Compliance

In the CSBS/Federal Reserve survey-report, the Bank Secrecy Act and its anti-money laundering rules (BSA/AML) were found to be the costliest regulations to comply with by community bankers. In this space, community bankers expend a considerable amount of resources to recruit professionals, train them, and achieve regulatory compliance through reporting. However, smaller institutions – especially those in rural areas – often have difficulty attracting and affording BSA/AML expertise due to a limited number of qualified practicing professionals in their geographic areas.

Shared resource arrangements dedicated to BSA/AML compliance could provide community banks more latitude to attract and acquire skilled BSA compliance professionals. For instance, two or more banks might be able to share the costs of a highly skilled BSA/AML compliance officer under an arrangement that would provide mutual benefit to both banks' compliance operations. Small and rural institutions that operate with relatively low BSA/AML risk, may be particularly well-suited to shared BSA/AML resources. Since BSA/AML compliance at small institutions is typically overseen by an individual who has numerous other responsibilities, it is reasonable to consider that one highly skilled individual may be able to effectively manage the BSA/AML compliance process for two or more community banks.

Example Three:

More than a decade ago, four community banks with a small degree of common ownership were facing the challenges of an increasingly complex and costly compliance program. In addition, the rural areas in which most of the banks operated made it somewhat difficult to attract the type of compliance expertise the management teams desired. The respective management teams explored various options to address these challenges and eventually agreed to share the costs of a compliance team. Since its inception, the arrangement has allowed the banks to realize costs savings, provide greater compliance expertise, and has become a permanent arrangement among the banks. An advantage of this arrangement is that the compliance officers are able to live and work in various parts of the state since they serve multiple banks and since much of their activities can be conducted remotely. Under the arrangement, costs such as travel, benefits, and salaries are shared equally since institutions are of common size and complexity. Importantly, while each bank maintains a separate Bank Secrecy Act officer, the compliance team is able to perform a number of BSA compliance activities, including audits. The compliance team also oversees the mortgage and internal audit functions of the banks under the arrangement. When one bank compared its compliance costs with similar institutions, it found that it saved approximately $30,000 per year.

Sharing the resources of an experienced mortgage compliance staff may also be more cost effective for certain small banks than maintaining a fully trained staff for a limited level of mortgage origination activity. In the CSBS/Federal Reserve survey-report, 65 percent of the respondents indicated they anticipate their 2015 mortgage lending would remain the same or decrease in size relative to the preceding year. This trend is likely to continue due to the expansion of the Home Mortgage Disclosure Act's reporting requirements, which will increase compliance costs for covered community banks. Shared resource arrangements could relieve banks of much of that burden and spur mortgage lending in communities.

Expanded Powers

Under the Federal Deposit Insurance Act (FDI Act), state-chartered community banks are permitted to engage in activities beyond those typically afforded to national banks.[11] For example, many states allow banks to provide title insurance, property and casualty insurance, travel agency services, real estate holdings, leasing services, and tax preparation services. As a result, state-chartered banks have a unique opportunity to utilize these additional privileges and create jointly owned subsidiaries with their counterparts. Shared resource arrangements through jointly owned subsidiaries may allow state-chartered community banks to offer additional services to their customers that would otherwise be unfeasible on their own.

III. <u>RISK CONSIDERATIONS AND MITIGATION</u>

Operational and Business Risks

Although sharing resources between community banks is different from contracting with a nonbank third party service provider, many of the core risk management principles associated with third party contracting apply. Operational risks – those "resulting from inadequate or failed internal processes, people, systems or external events"[12] – may increase when sharing resources. For example, uncertainty over which institution has control over a shared employee or property in times of need may result in a conflict. In order to limit such occurrences, it is important that banks engaging in shared resources arrangements develop clear and strong contracts prior to the sharing of any resource. Contracts should clearly identify the responsibilities and expectations of each financial institution party to the agreement. Furthermore, these provisions should be closely reviewed by legal counsel so that no particular bank assumes all, or a disproportionate amount, of the liability.

Shared resource arrangements can be structured in such a way that they do not negatively affect the public perception of the associated institutions. Bankers should consider the Office of the Comptroller of the Currency's (OCC) rule on sharing space and employees as guidance on how to best portray their shared resource arrangements.[13] To avoid public confusion and to protect customers, the OCC instructs banks sharing resources to disclose that they are separate entities as opposed to partnerships or joint ventures. In general, when a shared employee interacts with the public on behalf of a bank, the shared employee should reveal the nature of their employment so that customers fully understand with whom they are banking.

It is important that banks ensure that their shared resource arrangements do not obfuscate lines of authority. A Federal Reserve Supervision and Regulation Letter[14] ("SR Letter") discusses why certain institutions that share facilities or staff should have proper policies and internal controls in place to readily identify the authority and responsibilities of their officials and employees. Although the SR Letter focuses on affiliated institutions that share facilities or staff, the guidelines are a good starting point for non-affiliated banks looking to share resources since the principles are risk management fundamentals. The SR Letter encourages appropriate policies and controls so that institutions and the public can readily identify the authority and responsibilities of shared employees. Ultimately, the Federal Reserve recommends creating well-defined job descriptions and public disclosures so customers could identify which entity an employee is acting on behalf of.

Example Four:

When intellectual property, technology and copyrighted materials are shared among entities, legal disputes may arise unless agreements are created to provide equal access to the property or establish ownership rights to property among the various entities. In one such instance, a number of community banks looking to share the benefits of a particular software created a separate non-profit that provided the operating systems to member-banks. The non-profit took the form of a licensor that provided member-banks the rights and licenses to use the software upon payment of a membership fee and an annual maintenance fee. To avoid property disputes, the agreement clearly indicated that member-banks' rights to the software was only valid as long as they were members in good standing with the non-profit.

Federal and State Employment Law Issues

A bank's legal obligations in a shared resource agreement should be clearly mapped out during contract negotiations. Employment law issues are just one type of legal concern banks sharing resources should consider. For example, a bank that utilizes an employee of another institution through a shared resource arrangement could be liable for employment claims even in instances where they merely reimburse another firm for borrowing its employee. Bank management should also consider the following legal questions: (1) whether a shared employee would be entitled to overtime; (2) which firm is responsible for compensating for overtime; and (3) how to best manage an employee benefit program.

Banks negotiating shared employee arrangements should discuss how they plan on sharing state and federal payroll responsibilities. The federal government generally allows one affiliated party of a shared resource arrangement – often called the "common paymaster" – to handle all federal payroll obligations on behalf of the arrangement. Some states allow similar arrangements for meeting state payroll obligations, while other states do not permit the practice.[15] For example, while Utah is one of many states that permits a "common paymaster" to compensate a worker on behalf of a shared resource arrangement, its neighboring state

Nevada does not permit this practice. In addition to payroll issues, there may be other state specific laws banks should consider before implementing shared resource arrangements.

Other Compliance Considerations

When reviewing shared resource arrangements among banks, the FDIC often looks to the OCC's rules on what activities and investments are permissible for national banks.[16] The FDIC's practice may have implications for banks acquiring interest in a separate entity established to conduct their shared resource arrangements. The OCC permits banks to make non-controlling investments in enterprises only when: (1) the enterprise's activities are limited to the business of banking; (2) investor-banks have the ability to prevent the enterprise from conducting activity outside of banking, or have the ability to withdraw their investments; (3) banks' loss exposures are limited; and (4) the investment is useful to the bank carrying out its business and is not a mere passive investment. In one known case, the FDIC found that the participating banks in a shared resource arrangement did not sufficiently map out in their operating agreement how they met the OCC's criteria and instructed the banks to clearly indicate how they plan to comply moving forward.

Furthermore, when it comes to shared resources, nearly all states allow banks to exercise the powers of national banks under the expectation that they comply with OCC regulations, including those on how to structure shared employee arrangements.[17] The OCC requires that each institution involved in a shared resource arrangement segregate their assets and records, and conduct business with each other at an arm's length when sharing either employees or space.[18]

Banks utilizing shared resource arrangements should ensure their activities comply with federal laws against anticompetitive practices. The Antitrust Division of the Department of Justice (DOJ) enforces antitrust policies in the banking industry, so bankers should familiarize themselves with the Federal Trade Commission (FTC) and the DOJ's joint *Antitrust Guidelines for Collaborations among Competitors*[19] when structuring shared resource arrangements.

Overall, the DOJ/FTC's joint guidance encourages collaboration between competitors since such arrangements are generally viewed as procompetitive when they allow consumers to benefit from lower prices, improved quality, and innovative products. However, there are cases where collaboration may depress competition. For example, if collaboration yields higher prices or reduced output, quality, service, or innovation below what would likely prevail in the absence of the relevant agreement, this obstructs competition. To avoid running afoul of antitrust law, banks constructing shared resource arrangements should consider the extent that their arrangements can be perceived as reducing competition in their markets.

IV. Conclusion

The establishment of a shared resource arrangement should be approached like other business decisions: with due diligence and thorough consideration of the risks and benefits. Shared resource arrangements may not be appropriate for all activities, markets, or institutions. However, when and where there are opportunities to gain efficiencies, improve compliance, or expand customers' access to services, sharing certain resources may be a means of achieving those opportunities. State regulators believe that with the proper controls and ongoing oversight, shared resources may be a viable component to a community bank's overall strategic objectives to remain an independent provider of financial services in the local market.

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[1] Defined by the FDIC as an insured depository institution that engages in traditional lending and

deposit gathering activities within a limited geographic area, *See* FEDERAL DEPOSIT INSURANCE CORPORATION, COMMUNITY BANKING STUDY 1 (2012).

[2] Julapa Jagitiani & Catherine Lemiux, *Lending on Main Street: Challenges and Opportunities for Community Banks – Before, During and After the Financial Crisis* 37 (2015) ("Nonbank lenders are subject to little or no regulatory oversight including disclosure requirements, and data reporting is therefore largely voluntary")

[3] SEAN M. HOSKINS, CONG. RESEARCH SERV., RL 7-5700, AN ANALYSIS OF THE REGULATORY BURDEN ON SMALL BANKS 28 (2015).

[4] *See* id.

[5] *See* id.

[6] Charles S. Morris & Kristen Regehr, *What Explains Low Net Interest Income at Community Banks?* 79 (2014) (arguing that community banks' that low net interest income among community banks can be attributed to "low interest rates, a flat yield curve, and weak lending activity").

[7] FEDERAL RESERVE & CONFERENCE OF STATE BANK SUPERVISORS, COMMUNITY BANKING IN THE 21ST CENTURY 22-23 (2015).

[8] Ruth Simons, *Big Banks Cut Back on Loans to Small Business*, WALL ST. J. (2015) (highlighting the difficulties a small business owner had securing a loan with a large lender compared to his experience receiving a Small Business Administration loan from a community bank).

[9] Federal Deposit Insurance Company, *Community Bank Study* 1 (2012).

[10] Harry Terris, *Banks to Spend More on Tech in 2016 – Especially Security*, AMERICAN BANKER, October 15, 2015.

[11] *See* Federal Deposit Insurance Act, 12 USC § 1831a (authorizing state banks to engage in a number of activities including those not permitted for national banks so long as approval is granted by the FDIC. Part 303, subpart G discusses, in part, the activities for which a bank must obtain the FDIC's prior written consent, as well as certain conditions that must be met in order to obtain consent.).

[12] *See* BASEL COMMITTEE ON BANK SUPERVISION, CONSULTATIVE DOCUMENT: OPERATIONAL RISK, 2 (2001).

[13] *See* Sharing Space and Employees, 12 CFR 7.3001

[14] See GUIDANCE ON MANAGING OUTSOURCING RISK, SR 13-19

[15] ABA SECTION ON TAXATION, SUMMARY OF ISSUES FOR AFFILIATED ORGANIZATIONS 4 (2010) ("In places where the common paymaster is not available, any affiliated organization which is a common law employer would separately be responsible for the payroll obligations for that portion of salary attributable to employment with each organization.").

[16] *See* FEDERAL DEPOSIT INSURANCE CORPORATION, FIL-54-2014, FILING AND DOCUMENTATION PROCEDURES FOR STATE BANKS ENGAGING, DIRECTLY OR INDIRECTLY, IN ACTIVITIES OR INVESTMENTS THAT ARE PERMISSIBLE FOR NATIONAL BANKS (2014) ("If a State bank's subsidiary engages in an Activity permissible for a national bank's subsidiary and the subsidiary is a limited liability company, limited partnership, or other similarly unincorporated entity, the documentation should indicate the subsidiary meets the requirements imposed by the OCC for similar business forms.").

[17] *See* John J. Schroeder, *Duel Banking System? State Bank Parity Laws: An Examination of Regulatory Practices, Constitutional Issues, and Philosophical Questions*, 36 IND. L. REV. 197, 205 (2002) ("Of the forty-eight states with parity laws, thirty-two require the state bank regulatory agency to approve the specific powers before the bank may engage in them. This authority is most commonly vested in the agency's chief executive, and less often, in the agency board. Another eight states, while not specifically requiring approval, provide for notification by the bank, and allow the banking agency to disapprove the practice within a short period of time—generally thirty to sixty days. While not technically an approval process, the effective results can be the same. In another seven states, the state banks may automatically exercise the power held by national banks within their states. In the remaining state (Kentucky), sometimes the power is automatically extended, based on the condition of the bank. Specifically Kentucky, banks with "CAMELS" ratings of 1 or 2 may exercise parity rights without seeking approval.").

[18] Sharing Space and Employees, 12 CFR 7.3001 (2015).

[19] FEDERAL TRADE COMMISSION & U.S. DEPARTMENT OF JUSTICE, ANTITRUST GUIDELINES FOR COLLABORATIONS AMONG COMPETITORS (2000).