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Competitive intelligence for bankers
March 2015
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The key to dealing with disruption, says TS Bank's Josh Guttau: Do some disrupting yourself

INSIDE EASTERN BANK'S "SKUNKWORKS"

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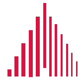

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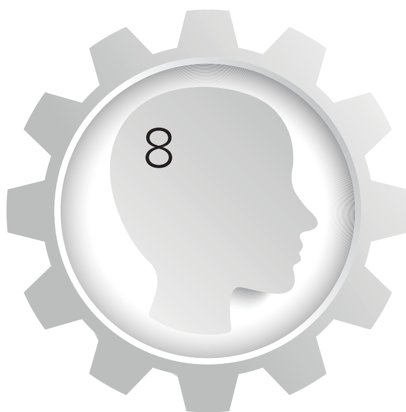

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Is the Efficiency Ratio still efficient?

"The efficiency ratio may be missing a vital part of a community bank's value," writes Jay Brew of Seifried & Brew LLC. "That value is cash type deposits." Also missing: tax efficiency. Brew says it's time to dig deeper. **Read more at http://tinyurl.com/brewratio**

"And it's too late, baby..." When mergers don't fly

Nearly every M&A deal has dark moments. But some fade to black. Jeff Gerrish examines why some deals die and what happens next. One of the latest in Gerrish's Community Banking Blogs. **Read more at http://tinyurl.com/gerrishdeal**

Young adults returning to credit card use ...

... and they are "more likely than average to keep credit cards issued by their primary financial institution top of wallet," a Mercator Advisory Group report finds. A new wrinkle for a credit-shy generation. **Read more at http://tinyurl.com/youngplastic**

Is your bank like "Downton Abbey"?

The popular PBS drama/soap opera covers broad subjects such as change, the past vs. the future, and differences between the classes. "While banks certainly don't have royalty—unless you count CEOs as kings and queens—there are similarities between the show and financial institutions," suggests consultant Mark Arnold. *May he suggest three lessons, m'lord?* **Read more http://tinyurl.com/downtonbank**

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Innovation Unleashed

Welcome to the inaugural issue of *Banking Exchange* magazine, the flagship offering under the Banking Exchange name. It complements our website, BankingExchange.com, and our weekly newsletters, *Editors Exchange* and *Tech Exchange*. The purpose and mission for all of these, plus our conferences, is to provide "Competitive Intelligence for Bankers."

That defines us and drives what our group of properties will be: an information resource focused on solutions, trends, and developments—forward-looking, while respecting the industry's varied and rich history.

In keeping with that, BankingExchange.com, launched last fall, is updated daily with solutions-oriented content—including posts by regular and guest bloggers—all organized by topic into seven "channels."

As some of you may already know, the Banking Exchange team—led by myself and Steve Cocheo, Executive Editor and Digital Content Manager, and aided by a dedicated and seasoned group of contributors—is the same team that produced ABA's flagship publication for 36 years, winning numerous awards in the process. *But this publication, and everything we do, is different in two key respects*:

1. No issue is off limits—we are completely independent.

2. We cover all banks and savings institutions, not just members of one group.

As our name suggests, Banking Exchange is a collaboration: a sharing of information and ideas and solutions among all industry players. In-person events, such as roundtables, seminars, conferences, and webcasts facilitate that exchange. So does our presence on Twitter. Join 8,400 followers of @BankingExchange, for frequent updates of what we, and others, are covering.

To jumpstart the exchange, this month's cover report, beginning on page 14, tackles the issue of disruptive competition head on. It seems like not a week goes by without the launch of a new, tech-based "neobank" like Moven, Prosper, GoBank, and Affirm.

Brett King, founder of Moven, and author of three books on the trend, urges banks to move quickly to adapt to the rapidly changing customer habits. Others echo that, including bankers.

Joshua Guttau, pictured on our cover, says the word "disruptors" is just a new term for what banks have been facing for many years from one quarter or another. Nevertheless he firmly believes banks have to reinvent themselves to meet new challenges, as Iowa-based TS Bank, which he heads, has done more than once.

Our first conference, InnoBank 2015/Disruptors, will delve into this same subject in depth over two days—May 27 and 28 in Atlanta. Brett King will kick things off with a keynote that will, we're sure, be provocative. But the conference, reflecting our mission, also explores how to meet the challenges, and will include bank speakers who have done just that. Click on "Conferences" on bankingexchange.com for a full list of speakers and the agenda.

This premiere issue has more than one theme. Check out other features and departments, plus "Threads," immediately following this page, which presents a variety of topics compactly, and, we hope, compellingly. You'll be the judge of that, of course.

This is important: If you like what you see and read, please confirm that you wish to continue receiving Banking Exchange at no cost (the bimonthly publication is offered free to qualified banking executives). Click the "Subscribe" link on BankingExchange.com.

We believe banks have a great future and are betting *our* future on it. Changes are coming much faster than they have before, but we also believe there is a great deal of innovation in the industry, some of it weighed down by regulatory overkill, some by habit. But it will show itself more and more.

So, come join the Exchange. Subscribe, browse our site, come to our conferences. We are committed to helping you and your institution succeed and grow.

Bill Streeter

BILL STREETER,
Editor & Publisher
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/THREADS

TOO MANY CHIEFS?

Answer is suite

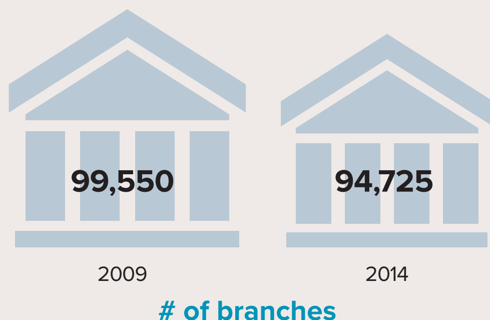
By Ashley Bray, contributing editor

The banking C-suite has grown a little more crowded recently. A club that traditionally included only the CEO, CFO, and the COO has now expanded to include many others. A few of variations include CIO, CRO, CDO, and CXO.

This proliferation of acronyms has been spurred in part by a rise in regulations. "I think in particular the chief risk officer (CRO) and the chief compliance officer (CCO) are generally direct outcomes of regulatory pressures," says Kenny Smith, vice-chairman and U.S. Banking and Securities Sector Leader at Deloitte.

The chief risk officer has been widely adopted by large banks over $50 billion in assets due to a Dodd-Frank rule requiring these institutions to form a board risk committee and designate a CRO. However the title has also been adopted by many small to mid-sized banks due to an industry-wide focus on enterprise risk.

The regulatory environment has also spurred the creation of the chief data



BRICKS VS. VISITS: FDIC'S VIEW...

FDIC's recent branch report paints an upbeat picture of the role of the branch. As of June 2014, some 6,669 banks and thrifts continued to operate 94,725 brick-and-mortar offices, versus 99,550 in June 2009, a decline of 4.8%, "providing testament to the enduring value of physical access to banking services."

—FDIC report, *Brick-and-Mortar Banking Remains Prevalent*

officer (CDO) in large institutions with complex organizational structures, which had a hard time providing regulators with a horizontal view of certain parts of their business.

The CDO has started to expand beyond regulations and risk and into profitability, customer experience, and other data-driven areas. The role marks a shift toward more information-driven positions, such as chief information security officer (CISO) to deal with concerns over hackings and cyber security. "The next couple of years is going to be a lot more driven around this whole data and information security space," says Smith.

A catalyst of a different sort is mergers and acquisitions. "If the newly combined entity wants to retain many of the existing officers, new titles have to be created," explains Carrie York, president of executive recruiting firm York & Associates. Two execs can't carry the same titles, so new ones are created, such as "enterprise CFO."

This type of C-suite expansion could be troublesome, however, as titles that are gifted often prove to hold no real value. "It all depends on whether the title was awarded in a 'proactive' or 'reactive' way," says York. "If the title is presented in a reactive way…it loses its meaning very quickly because it wasn't earned in a genuine way."

"Proactive" titles typically stem from an actual need. "Banks are essentially aligning resources with priorities that are coming from their agenda," says Smith. "They've empowered someone to resolve an issue or move the needle forward."

Sometimes moving that needle forward requires a special skill set, and other times it means an executive must take a big-picture approach.

This need to think bigger has led many banks to identify talent early. "They'll rotate people very actively from different positions in the bank to other areas that they may have very limited experience in," says Smith. "It's purely for the purpose of developing those young, aspiring executives, giving them more experience, and broadening their skill set."

This also occurs in the non-executive ranks. At $22.5 billion-assets Umpqua Bank in Roseburg, Ore., the teller position has been transformed into a "universal associate," who not only handles deposits and cashes checks, but also can assist with lending and whatever else a customer needs. This expanded approach to customer service has served as a great launching pad.

"I think what you look for at the executive level," observes Umpqua SVP Eve Callahan, "is people who have a breadth of understanding and have experience across a variety of different spaces."

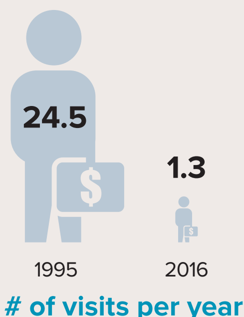
"Internal politics… in *your* bank?"

You may think your bank is free of internal politicking, but bank attorney Jeff Gerrish says politics is human. One example he recently blogged about on BankingExchange.com is when a potential merger or acquisition arises: internal bank politics impacts acquisitions, particularly when someone does not want an acquisition to be completed for some reason, such as potential loss of their job.

When such developments come, the party lines appear pretty quickly. And machinations happen.

For example, note that much of an acquisition consists of onsite due diligence. In the course of that, it is easy to put a bug in the buyer's ear about problems that may not be there, whether they be about asset quality, internal, or otherwise.

That is where politics rears its ugly head. Do all you can to manage these issues before they become "issues." **Read more at http://tinyurl.com/okltufb**



# of visits per year

… AND THE DISCONNECT

"There's only one metric that matters … the average number of visits to a branch per customer per year," says Moven's Brett King. FinansNorge (Finance Norway) data, he says, shows visits falling from 24.5 in 1995 to an estimated 1.3 in 2016. Two big U.S. banks peg it at 1.8-2.3 times this year.

Surging mobile use has amped the trend

RISING-RATE MANIA

in a low-rate environment *By Matt Pieniazek*

It seems like everyone has been calling for rising rates for a long time now, so it has to happen soon. The yield curve implies it. Even the Fed says so, considering hikes on a "meeting-by-meeting basis."

But what if rates don't rise soon or anywhere near as much as some predict?

The reality is that a sustained low or lower rate environment presents the greatest challenge to earnings for the majority of the banking industry. Yet, there seems to have been an obsession of sorts with rising rates over the last few years causing many banks to incur a substantial opportunity cost they could ill afford as they waited for that infamous rising rate environment to materialize.

Undeniably, rising rates present substantial risk to many banks—and too many have not planned appropriately.

However, it is important to understand that most astute banks have been preparing for rising rates at the same time they were exacting damage control against the ravages of this sustained low-rate environment.

Some defensive strategies

What can a bank do to guard against an extended low-rate environment without creating a problematic situation if interest rates increase substantially?

First, don't let good solid credits "get away" because of unnecessarily restrictive loan pricing and structure guidelines. A challenge most banks face is creating an appropriate context for examining loan pricing in an uber-competitive environment where traditional applications of loan pricing models are insufficient. Readily understandable techniques such as describing a fixed-rate commercial real estate loan as a spread to the Prime and/or Libor swap curves have proven invaluable for banks of all sizes.

Numerous banks "just say no" to fixed-rate loans, period. They won't entertain the use of programs such as back-to-back swaps. They pass on credits they would like to bank simply because of term, when many could readily support the loan with partial funding extensions and/or modified investment portfolio strategy.

Funding strategies are also important. For example, a key consideration for banks extending funding maturities is the use of callable structures where

OCC WORRIES ABOUT AUTO CREDIT

The math here is disquieting, to say the least *By Steve Cocheo, executive editor*

"It is not uncommon today for a family with subprime credit to take a loan at 110% of a used car's value that they will be paying off for seven years. That means if the family bought a used car on these terms when their daughter celebrates her ninth birthday, they will still be paying for it when she takes it for her first drive on her sixteenth birthday."

Darrin Benhart, deputy comptroller for supervision risk, cited this example recently in discussing risk that the Comptroller's Office worries about as banking continues its recovery from the recession. He pointed out that while auto lending has evolved significantly in the last few years, lenders have been expanding auto credit on the basis of historical patterns that may not play out in the same way.

Benhart used the auto lending situation as an example of the additional exposure banks face when they rely too strongly on historical performance data.

"The past, while providing us with good information, will not predict the future," said Benhart during a speech at the Annual Risk Management Conference of GARP—the Global Association of Risk Professionals—in late February. "This inherent limitation is where risk management needs to provide perspective by looking more broadly at how the environment has changed to protect against an overreliance on historical data."

Benhart noted that lenders have been stretching auto repayment terms to as long as 84 months on both new and used vehicles. Over the last two years, he said, the share of new car lending done at terms of 73-84 months has doubled to 24% of the total market. Likewise, longer-term lending for used vehicles has doubled over the same period to 14%. Benhart said

the bank owns the call option. These are readily available for a nominal incremental cost in the brokered CD markets, and are particularly applicable to banks with significant prepayment risk.

Don't overlook the use of barbell strategies for the investment portfolio rather than plowing everything into a particular area of the curve. Appropriately designed barbell strategies provide the same level of earnings with substantially more rising rate responsiveness.

Preparing for rising rates

Perhaps the biggest concern about rising rates is what bankers don't know. It is irrefutable that every bank has deposit monies that will leave them in the next rising rate cycle. The main issues are how much, when, how fast, and from where?

Thus, a key to preparing for rising rates may come down to how well your institution leverages existing customer and other data to create clearer pictures of its deposit base. A real challenge in assessing interest rate risk relates to analyzing the uncertainties/differences in customer behavior patterns and preferences that have been magnified because of the prolonged depressed economic and interest rate environment.

And, by the way, stress test your key assumptions. For example, regardless of how you arrive at deposit pricing betas—decay, potential surge, etc.—stress test them!

For liability sensitive banks it is important to quantify the degree of earnings exposure in the context of, "How much insurance do I need?" In other words, how much funding extension and/or asset shortening is required to neutralize net interest income exposure. Similarly, such banks should understand how much growth would be required to stay ahead of earnings pressure as rates rise.

ALCO in transition

Asset/Liability Committees are not about risk quantification and reporting. They are about strategy development.

Too many ALCOs continue to be long on reporting the past and focusing on interest rate risk, but short on liquidity, capital and even credit and operations risks discussion. The ALCO umbrella needs to expand and develop a more integrated risk management framework, especially if it is to become more strategy centric. There is an accelerating convergence of ALCO with strategic and capital planning.

The key for developing meaningful and focused strategies is a well-coordinated ALCO process that brings the relevant issues to the table. Assume away a sustained low/lower rate environment at your own peril.

@ **Matt Pieniazek is president of Darling Consulting Group, Newburyport, Mass. www.darlingconsulting.com**

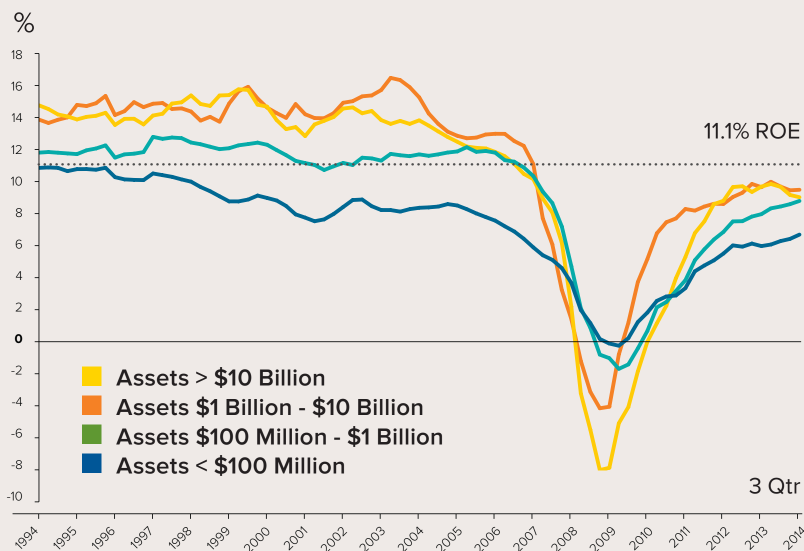
The share of new-car lending done at terms of 73-84 months has doubled to 24% of the total market

that lenders have also increased loan-to-value ratios on auto loans and are dipping lower on the credit scale.

"We are starting to observe deterioration in auto lending portfolios," Benhart said, "and banks are seeing the average dollar losses per vehicle rise. Sixty-day auto loan delinquencies rose 8.6% in the third quarter of 2014 compared with a year earlier, according to Experian."

Benhart acknowledged that significant growth in loan volume and low payments have offset the full effect of these risks. However, he pointed out that these factors have obscured delinquency and loss rates as a percentage of total volume.

@ **For full coverage of Benhart's wide-ranging speech on risk, http://tinyurl.com/occonrisk**



TRACKING THE SIMPLE MODEL

BBVA Compass' acquisition of Simple turned a few heads. Will other banks follow suit? *By Lisa Valentine, contributing editor*

It's been just over a year since BBVA Compass agreed to acquire digital-only alternative bank Simple for $117 million, surprising some industry watchers and reigniting the conversation among bankers about how to best approach the challenge of direct banking. Should a bank acquire a digital brand like Simple, or should it create a direct bank within the footprint of its existing brand?

Of course, for banks interested in acquisition, the pickings for a digital bank is slim. Among Simple's ilk are Moven, Green Dot's GoBank, and Bluebird from American Express.

"The Simple acquisition intensified the omnichannel discussion," says Jacob Jegher, research director, banking group, Celent. "Banks are trying to gain a better understanding of what it means to offer digital-only access if you already have a branch network."

The decision about how to extend their digital reach becomes more complex because many banks already offer mobile banking. A case could be made for creating a separate entity to function as the direct bank or expanding their mobile offerings into a true digital brand, says Ed O'Brien, director of banking channels advisory services at Mercator Advisory Group.

Jegher notes that the BBVA Compass/Simple acquisition has opened bankers' minds to new models. "Banks recognize that they don't necessarily have to build a

CFPB to banks: Let's keep it between us

How do you cope with the warning from the Consumer Financial Protection Bureau to keep "Confidential Supervisory Information" confidential? BankingExchange.com blogger Nancy Castiglione suggests taking a look at:

- Scope of "confidential supervisory information." (It is more than just examination reports and could include any information derived from those reports, as well as any communications between CFPB and the institution.)
- Your contracts with consultants that may need access to examination report information or any "confidential supervisory information."
- Controls over the security of Reports of Examination and related information: who in the institution maintains copies, where are they stored, how secure they are.
- Employee training surrounding confidentiality of supervisory information.
- Current access to information in the institution: who has that access now and should they have it?

Read more at http://tinyurl.com/m95lbzx

digital bank from scratch," he says. "They can partner or acquire a bank to get the higher-end digital tools they want."

The fight for millennials

The challenge for banks is how to leverage a no-frills digital deposit account into multiple products and services through multiple channels, says Jegher. For example, although millennial (also known as Gen Y) consumers largely prefer self-service banking, they want to speak with a live bank expert for more complicated transactions.

Says O'Brien, "Even with the increased use of self-service channels, branches are still relevant and important. The branch remains the center of the banking world for most consumers since they want to speak and interact with knowledgeable tellers and other personnel on important issues that can't easily be handled through self-service methods."

However, even a digital bank can make a play for more complex relationships with its customers. Joshua Reich, CEO of Simple, says that although Simple is currently focused on its retail checking account, "we're excited to expand into new product segments like savings and home lending in the coming years. Our work with BBVA provides Simple with more complete ownership of the customer experience," says Reich.

The strategic endgame

For BBVA, the acquisition of Simple is about much more than acquiring 100,000 millennial customers as was widely reported at the time of the acquisition. "BBVA did not buy Simple for its customer base," notes Jegher, "BBVA bought Simple for its vision, its people, and its technology."

Of course, the acquisition positions BBVA to capture more of the attractive younger demographic. The Millenials Paradox, a research report issued by BBVA in December, illustrates just how important this younger demographic is to banks. Today, about 75 million U.S. consumers are between the ages of 18 and 34 years old. More than 70% of millennials have used mobile services within the last 12 months compared to only 40% of all remaining consumers.

In addition, the acquisition fits with BBVA's plan to digitally transform banking, explains Enrique Gonzalez, BBVA Compass Senior Corporate Relationship Manager for Simple. "Simple will help us accelerate our vision for banking in the modern age."

BBVA Compass' digital strategy doesn't end with Simple. In December, BBVA acquired Spanish startup Madiva Soluciones for its big data and cloud computing services. In October, the bank announced that it had opened its technology platform to Iowa-based payments start-up Dwolla, allowing bank customers to make real-time network money transfers. And in August, BBVA Compass announced that it would use Zenmonics Inc.'s mobileBANKER to provide its sales force with sales, marketing, and account services information via tablets.

Gonzalez sums up how an old dog like BBVA, a bank with a history dating back to 1857, plans to learn new tricks. "As an industry, banking has been slow to adapt to digital, but that must change to be competitive in the 21st century. As an alternative to traditional banks, Simple has helped BBVA Compass better understand how to be a digital challenger.

Simply independent

BBVA Compass has said from the outset that Simple will remain a separate entity. Says BBVA's Gonzalez, "We intend to keep Simple independent, and to learn from them, and we see enormous potential for BBVA and Simple down the road."

From all indications, that promise has held fast and Simple remains an independent entity in the BBVA Compass family. Says Reich, "Culture is core to everything we do at Simple and remaining an independent entity allows us to stay focused on the pillars that guide our work: Listening to our customers, partnering in problem-solving innovation, and sharing clarity of purpose."

Is it ironic that Simple, which was created to be the kind of bank that doesn't "suck," is now owned by a large bank?

Not all, says Reich. "With our partnership with BBVA we are now able to do what we do on a larger scale. And nothing sucks about that."

LOOKING FOR LOST REVENUE?

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"GEO-BIGOTRY" AND OTHER TRAPS

Community bank investor Joshua Siegel takes aim at pundits and the "change of the minute"

By Steve Cocheo, executive editor

A flood of consultants, studies, and "facts" abound telling community banks how they must change, and why. Community bank investor Joshua Siegel is calling "time out."

Not that change isn't necessary. But much of the thinking on the future business models for banks—and coverage of same—comes from metropolitan centers, Siegel points out. He likes to call this effect "geo-bigotry."

"When I woke up this morning and somebody in rural Montana woke up, we both saw the world. Do you think we are seeing the world the same way?" says Siegel, based in New York. "Our perceptions depend on the values that we grew up with and how we think."

"The geo-bigot idea that young people everywhere don't need people to go face to face with ignores reality," Siegel says. "Go out and meet these young people outside of metro centers. They are not all leading-edge technophiles. They work at McDonalds, and they will go to work at a local factory. They won't all go work for a dot.com."

Siegel warns against letting the geo-bigotry of pundits completely dictate strategy. Yes, technology plays a critical, essential role in community banking, and Siegel doesn't think a bank has a future if it doesn't offer mobile banking, mobile remote capture, and an internet-based bank.

Siegel isn't recommending ignoring pundits, but he says their sweeping statements are just one view—just like, he points out with a grin, his own.

Q1. Josh, you are quite the skeptic, aren't you?

People often ask me how community banks still exist after all these years. I always say that it's not because they have better technology, a broader range of services, or better pricing. What they *do* have is customer service and that's why people come to them—the *relationship*.

Most Americans work paycheck to paycheck. The small accounts they have, they want to know the money is safe and in a place where they can get to it. They want someone who understands their place in the world, someone who will give them a loan to send their kid through school or to buy a used car.

It's a matter of "place." And for community banks, that is still defined by geography. If not literal geography, then by affinity, such as ethnic banking or a military connection, like USAA.

For most banks, the key remains having a CEO who is charismatic and possesses or employs good credit management. The CEO must represent the community almost like the mayor. You need someone who gives local customers confidence and comfort. Someone who has the discipline to protect local depositors and yet creativity enough to see opportunity in relationship lending.

Community banking is not going to be like "Moneyball," where some 26-year-old computer jock is going to come in and shift the bank to automated pricing models.

Q2. But such models are increasingly being used, aren't they?

One of the things we learned—let me restate that, one of the things I *hope* we learned—through the recent crisis is that loans that were made directly between a borrower and a lender had far better performance ratios than loans originated by some kind of broker or other third party and then resold and repackaged.

You can use statistical modeling and probability. But the reality is that there is a human component to making a loan that has an effect on results. It is important that a community banker can stare the customer in the eyes. It is important that borrowers can see the banker walking the streets in their community. Then they are less apt to assume, "It's no big deal if I default."

Statistical modelers try to fit their curve to reality, but reality has some unpredictability to it.

Q3. Yet people do a lot of business on the web now. Why not community banking?

In the virtual space, Zappos is considered to offer some of the best customer service that's out there. Guess what? They put a massive amount of time into *human* training. So, let's say our bank is now all-virtual—I don't think that will happen, but let's say it does and there is no physical location any more. You don't think that customer service and interpersonal relationships still matter?

If 6,000 banks all go algorithmic and digital, what will differentiate them from the next guy? How will they compete for customers? How will you win if you have one person facing the customer and 99 facing inward?

Guess what? You'll be out of business. Why? Because the bank next to you will put two people on the front end. And the next bank will put three people up front, and the next one four people.

Q4. Amid lots of talk about market disruption, there's regulatory disruption in the form of the Consumer Financial Protection Bureau. How has it moved the needle?

CFPB is a big stick stirring the pot. No one is quite sure what things are supposed to look like because things are entirely jumbled. I don't think anyone—except the director of CFPB—would say there's

“Zappos offers some of the best customer service out there. They put a massive amount of time into human training”

more or less consumer abuse. CFPB created enormous uncertainty, with all good intention. It assumes it is fixing problems, doing what it thinks is right.

But you may solve consumer abuse in the mortgage market by making sure that a bank never lends to a customer again. I don’t know if the Bureau’s “better” is really better. It may be worse. CFPB may protect six people, but it might prevent 10,000 who otherwise should have been fine getting a mortgage from getting one.

Q5. **You spoke about the need for tech essentials. What other essentials do you stress for community banks?**

Every bank leader has to be thinking about succession planning. Not just what happens when I retire or die, but what happens that you can’t predict, such as a tornado that kills the chief lending officer and the CFO. And investor succession—what happens if one of the bank’s big shareholder sells to someone who is not a friendly party? For a closely held bank, it can make a big difference.

Community bankers must consider not only this, but who the next set of board members will be. That, along with management succession, of course. If you don’t think of such things now, the world will pass you by.

When I ask many bankers about these things, I get a puppy dog look. They really have not thought about them.

Q6. **What are you seeing in recent deal trends?**

Many of the deals I’ve been seeing appear to be more sell-focused than buy-focused—buyers bought not because they were looking at a market but because somebody lowered their expectations and put their bank up for sale. They decide they would be better as part of something else, rather than remaining independent. They see that they can only take their stock so far. But if they can get on board with a leader who has a vision and a view and who can execute, they’d rather put their stock into that banker’s hands even if it means getting a lower transaction price.

This is sinking in. The expectation that we are going to bounce back and see two or two and a half times book fades more with each quarter.

Q7. **What should observers look at when evaluating community banks?**

Capital ratios—total capital, Tier 1, and Tier 1 common—will tell you a lot about a business. The efficiency ratio, combined with ROI, is going to prompt big questions about survivability. Not in terms of living or failing, but in terms of remaining independent.

Right now, interest rate exposure is very important. How negatively gapped is the bank? What’s the duration match between its liabilities and assets?

The bank’s funding cost is critical. A low cost of funds means there’s a likely buyer if the bank gets into trouble, but it also means a huge competitive advantage on the loan side. Lower funding cost allows you to underprice your competitors, to be able to win business away.

I think 30-to-90 day past dues are frequently overlooked. There are very few metrics on a bank’s balance sheet that are *predictive*. Past dues, however, say, where am I going? They give an immediate sense of people falling behind on their payments. Those numbers are maybe looking four feet in front of the car. But at least it’s in *front* of the car.

Joshua Siegel is CEO of StoneCastle Financial Corp., a closed-end investment company investing in community banks. He is also managing partner and CEO, StoneCastle Partners, LLC, which provides funding and lending aid.

Illustration © George Diebold/Blend

Dis

IT'S NOT SO BAD, ONCE YOU GET USED TO IT

But it's better to do the disrupting than the other way around. Learn how to survive and thrive in the new world of banking

By Steve Cocheo, executive editor & digital content manager

"Happily refusing takeovers since 1887," reads the banner on United Bank of Michigan's website. A second line: "Here to stay ... for good." Next to this is a photo of Art Johnson, chairman and CEO of $475.5 million-assets United for 31 years. Johnson means all that. The challenge is the "how."

Johnson is as thoughtful as he is resolved on independence, and what's made him more thoughtful than usual is the rapid pace of change in financial services, especially the "disruptions" that keep coming from without and from within banking. Twice in his career as CEO, Johnson has reinvented his bank to adapt to new conditions. He is on the cusp of more reinvention.

"We are not afraid of innovation," says Johnson. "We have reinvented the company before. Each time was a bit of an adventure, yet we did it. But each time, while our choice was new territory for us, it was not new territory for *banking*. This time, things seem different. And new answers for our bank are not immediately forthcoming."

Johnson remains convinced that community banks have a future, and that "the most adaptable will survive." To Johnson, "the biggest light bulb" right now is the balancing between what existing customers need and want and what future customers will need and want from a bank.

DISRUPTION, NEW COLOR OF CHANGE

"Disruption" is a simple label. Change is a constant in business and banks have faced plenty of it. Disruption, however, conveys a sharper break with the status quo—more like change on steroids.

"Disruption" covers so much. Technology drives much of it—think mobile devices, wearables, and the "Internet of Things," analytics, "big data." Startups introduce apps at a breakneck pace that facilitate many financial tasks. Generational change—what millennials supposedly want, for example—is part of it. So is the new face of competition—both existing players encroaching on banking, such as the Walmart/Amex Bluebird card, and newer players like Kabbage, Prosper, Moven, and Simple. Some of these compete with banks; some seek to make banking easier or better in some way. Some have joined with banks (Simple was acquired by BBVA/Compass last year) or partnered with them (as Lending Club does, plus its new BancAlliance deal). There's a lot going on.

Disruption also ropes in the long-running argument that the branch must evolve away from transactions, as increasingly sophisticated apps put everything into your handheld. And disruption goes on in banks themselves, in innovation workshops of organizations ranging from Wells Fargo to Eastern Bank, an $8.8 billion-assets mutual that recently set up Eastern Labs.

The dialogue segues from bankers such as Art Johnson, attempting to adapt at the local level, to fintech advocates such as Chris Skinner and Brett King forecasting complete shifts in what the "banking" industry will be.

For Skinner, author of the Finanser blog and head of consultancy Balatro, disruption is the struggle he sees between "suits" and "jeans"—traditional bankers versus the software/app developers that Skinner believes increasingly define financial services.

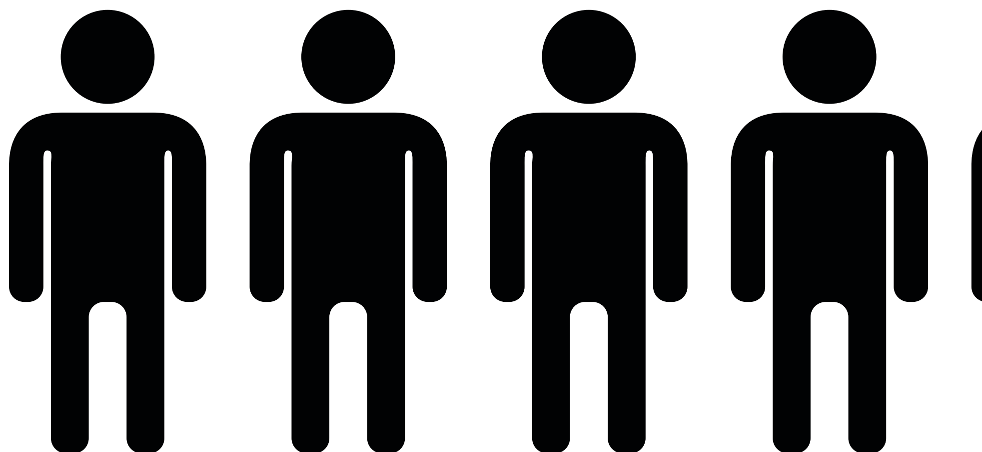
Skinner, based in the U.K., doubts that the job we call "banker" will exist much longer—he sees the advent of a fintech hybrid of old and new.

Bill Alatriste

ruption

Just as Wall Street is now home to more condos than banks and brokerages, disruptor Brett King sees bank branches as less relevant than ever. He says that banks that adapt can become relevant again.

> "Technology and analytics are what I'm betting the future of our bank on"



"Banking's no longer banking," says Skinner, author of *Digital Bank: Strategies to Launch or Become a Digital Bank*. "Banking used to be a lot of physical distribution of paper in a localized network that was branch focused. Now we're doing digital distribution in a globalized network."

"The new profession," says Skinner, "is far more a person who is a coder, a developer, a creative designer, someone who extends the user experience from a remote device. Someone who understands the desire for digital platforms for engagement with millennials and who sees those platforms as a culture rather than a channel."

"The new banking profession is far more about a person who is a coder, a developer," says Chris Skinner.

This picture doesn't sit well with some bankers, who see the essence of the business as relationships, particularly with credit customers. Others, however, see a shift is taking place. Joshua Guttau is one of them.

"Technology and analytics are what I'm betting the future of our bank on," says Guttau, CEO and CFO of TS Bank, Treynor, Iowa. Over time, Guttau suspects more community bank employees will be working behind the scenes to bring a premium experience to customers on the front end, whether they are working with the bank's technology or its humans. The days of a community banker managing by gut are over, for him. "You've got to work the numbers and know what they mean."

Guttau laughs at the term "disruptor," because he finds it a new label for what's been going on for decades—industry outsiders cherry picking mainstream banking. Still, Guttau recognizes that what the term represents is real. "We're not competing with other community banks," he says. He worries much more about nonbank players.

The $505 million-assets three-bank company has been bucking the status quo for decades, a tradition begun by Josh Guttau's father, Mick, now chairman.

"Mick knew we couldn't simply change the oil, but had to change the engine and chassis as well," says Josh.

The son has built on that to the point where, in answer to a question about the secret to a bank's future, he says: "*To not run it like a bank.*"

True to that description, Guttau describes TS Bank not as a community bank but as a "community hedge fund." While still in the business of ag and business lending, retail banking and wealth management, the bank brings in money from other parts of the country through Federal Home Loan Bank advances and internet CDs. It has spent years putting in place the necessary risk controls and managers to execute this strategy and satisfy the regulators, but at the same time strengthening its local ties to the community through service and giving.

DIGITAL CONNECTIONS

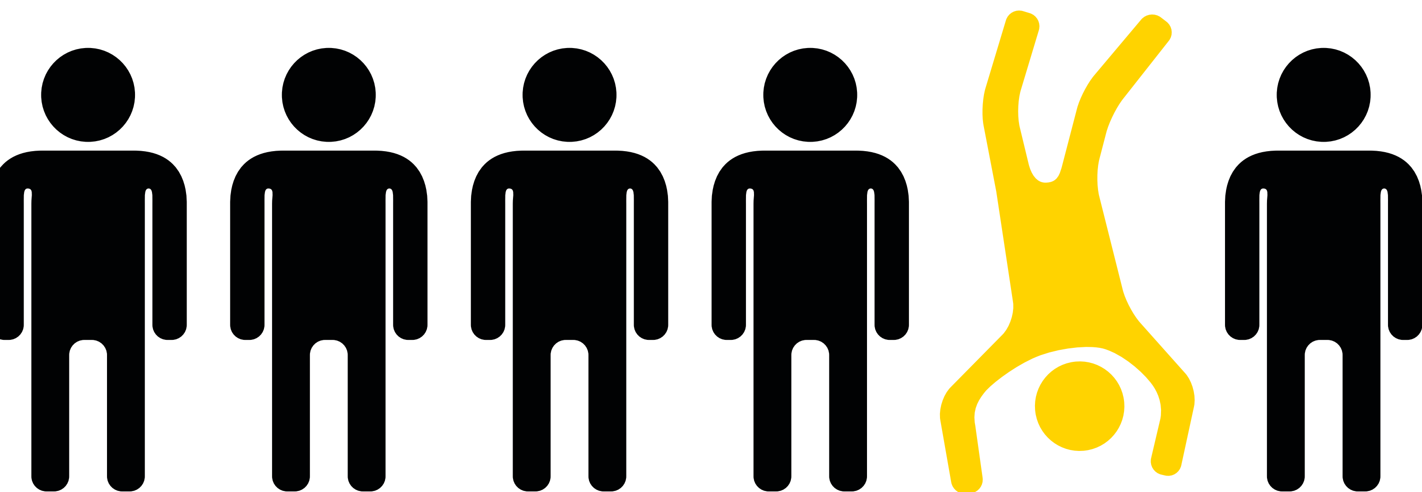
Josh Guttau grasps the need to continually change, but Brett King, the Australian consultant and change agent, who broke onto the American scene with his 2010 book *Bank 2.0*, finds many bankers have yet to better understand what disruption means to their business.

He says too many still look for the startup bank that is going to replicate what they do, but digitally.

"That's not the way it's going to work," says King. "Banks keep looking for this big competitor who is going to take them on end to end, and that's not going to happen. We'll see death by 1,000 cuts of the banking industry, a chipping away."

Kabbage has found a way to efficiently make small business loans, he says, and Walmart, through Bluebird debit and through the GoBank low-cost checking joint-venture with Green Dot Bank, are only two examples of competitive nonbanks knocking off a piece of mainstream banks' business. True, many newcomers have minuscule market shares, yet so did PayPal at one time.

How can community banks, in par-



ticular, begin to adapt to this world? Skinner believes they have to expand their conceptions of "relationship" and "community" beyond geography. "As a community banker, what I would focus upon is, 'How do I build community in those social networks where I am relevant'," says Skinner. "Community bankers need to think of how they can make a digital connection to their community through the new media. There's a huge opportunity there and it's not expensive. I mean, this stuff's *free*."

The biggest roadblocks are inertia, sometimes due to lack of familiarity, sometimes to an entrenched mindset, and not having the right people to get things moving—to push the envelope.

Ultimately, says Skinner, banks must give up the idea of having "control" and instead seek to convert customers into fans.

Not an easy migration for an industry regulated to the nth degree and accustomed to a rules-based MO. But some banks are well on their way.

TS Bank, for one, has had a Facebook presence since 2010, and is also on Twitter, Instagram, Pinterest, LinkedIn (for recruiting), and YouTube. Customer Experience Officer Kelsey Stupfell says the bank doesn't push product on social media, but community service, local events, and "behind-the-scenes" photos.

EVOLVE WITH CARE

Should a community bank set out to be a card-carrying disruptor? Much as innovation appeals to Trey Maust, he suspects smaller banks will find a downside to disruption.

"You have to ask about the ramifications, regulatorily," says Maust, co-president and CEO at $130 million-assets Lewis & Clark Bank, Portland, Ore. Innovation "makes you an outlier," he says, which can stifle innovation, especially given the general post-crisis "de-risking" attitude towards banks. (See "Regulatory Impediments," p. 22.)

Yet Maust sees opportunity in disruption for community banks in that they have the personal connection that many larger players and new tech-based entrants lack. From the customer's perspective, community banks offer access to bankers with much more experience than other players typically offer, a strength they should play to, he suggests.

"Small banks can move the needle," he says. "I'd love to be part of that movement." In time, he says, he can see an industry brand of sorts developing: "Powered by smaller banks."

The recent announcement that online consumer lender Lending Club will originate loans in cooperation with bank members of BancAlliance is a development along that line. It is also an example of how partnerships are one way banks can meet the challenge of market disruption.

Dan Schatt, who served as PayPal's general manager of financial innovations for six years, observes: "If you really peeled back the onion a few layers, what you would find is that co-opetition does exist for banks to partner with nontraditional players. Many of the new partnerships forming are blueprints that give a glimpse into future financial services innovation and some really compelling customer experiences to come."

Schatt resists the image played up of new players running rings around traditional banks.

"Innovation often comes from successful players," says Schatt. "Banks innovate just as much as private developers do, in my opinion."

But he does offer some advice to bankers considering how to stay abreast of changes in financial services: "Replace your concept of a product function with a platform function—the entire bank as a platform for other providers' products as well as some of its own." (Read Schatt's advice on partnering *http://tinyurl.com/disruptorpartnership)*

Dan O'Malley, head of Eastern Bank's

"We're not competing with other community banks," but with many kinds of nonbanks, says Josh Guttau.

Geoff Johnson

SQUARE 1 BANK: Branchless, not mobile

With so much talk of disruption, some bankers may think it's all about technology. Not Square 1 Bank.

While technically a "branchless bank," the $3.1 billion-asset North Carolina bank is far from being an internet or mobile bank. Square 1 builds its business on being a high-touch bank. It's specialty is servicing venture-capital-backed entrepreneurial businesses and the venture firms that fund them.

The bank has loan production offices in 12 cities, including New York, San Francisco, Silicon Valley, Los Angeles, Boston, Washington, D.C., and Seattle.

"We are very determined to offer white-glove service," says Doug Bowers, president and CEO. The bank hires for venture capital experience. Besides earning interest from loans, the bank also obtains warrants in borrower companies. Most of the banks deposits come from borrowers, rather than retail customers.

Bowers notes that Square 1's business model requires daily innovation. "Ours is a pretty creative lending process. We look at unique business models every day."

Square 1's competition is a select group of other institutions, including Silicon Valley Bank, widely recognized as the leading tech startup lender.

Square 1's success naturally has attracted attention. In early March, PacWest Bancorp, Los Angeles, and Square 1 announced an agreement to merge. It remains to be seen if the North Carolina bank's unique model and culture remain intact.

In a statement contained in the merger announcement, Bowers said, "As part of PacWest, we will maintain our steadfast commitment to the entrepreneurial and venture communities, [and] will be able to offer clients a wider array of products."

Eastern Labs, agrees partnerships are the way for smaller banks to go. But he doesn't see multibank consortia as the best choice. When everyone's in the same boat, O'Malley observes, there's no race.

"New things," the banker adds, "are made by highly motivated individuals."

THE MILLENNIAL EFFECT

Try to find one advertisement online promoting a new financial service that pictures anyone over 30. The disruptive contingent very much plays to the millennials. Asked what bankers should do to adapt, Chris Skinner's first suggestion is to change the demographics of the boardroom, with no one over the age of 35. That would be a huge change for probably 99% of banks.

Brett King believes publicly traded banks that leave too much of their investment in branches and that lag in mobile will be penalized by Wall Street.

Increasingly, he says, "If I as a banker want to have a relationship with you, the branch isn't going to be important. I'm go-ing to have to be on your phone. And if you haven't downloaded my app, I won't have any way of having a relationship with you." This, he insists, is how millennials live.

Among bankers—and bank observers—agreement with this view has become more common, but is far from unanimous.

"Millennials are very much into the 'buy local' scene," notes Jay Brew, a consultant at Seifried & Brew LLC, and a director at $717 million-assets Embassy Bank, Bethlehem, Pa. Likewise, in this issue's "7 Questions" department (p. 14), community bank investor Joshua Siegel offers a rebuttal to those who see millennials as a solid attitudinal bloc.

"Co-opetition *does* exist for banks to partner with nontraditional players," says PayPal veteran Dan Schatt

There's yet more to this debate. Dan O'Malley, profiled in a related article (p. 22), declares that in his experience, "generational differences are less stark than people usually think."

Prior to joining Eastern Bank, O'Malley founded and ran PerkStreet,a disruptive online bank. He says that the average age of a PerkStreet customer was 40. And he says he had many customers over 60. The common denominator wasn't age, he says—it was the desire for a better deal.

NOT JUST A RETAIL DEAL

Much of what gurus like Skinner and King speak of relates to retail banking, but business banking, still much more customized than retail in many ways, also increasingly comes in for disruption.

"We see it as a huge opportunity," says Steve Ellis, executive vice-president and head of the wholesale group at Wells Fargo. Ellis' group has launched Startup Accelerator, an incubator for companies developing fresh financial technologies. Wells invests in these companies, besides providing lab space.

Transformation is hard for banking, says Ellis, but far from impossible. (Ellis himself represents something of a transformation having owned and run a café in Portland, Ore., for almost ten years before shifting his career focus.)

"The industry has been through this before and it will do it again," Ellis says. Banks just have to recognize that disruption and transformation has become a persistent state of affairs.

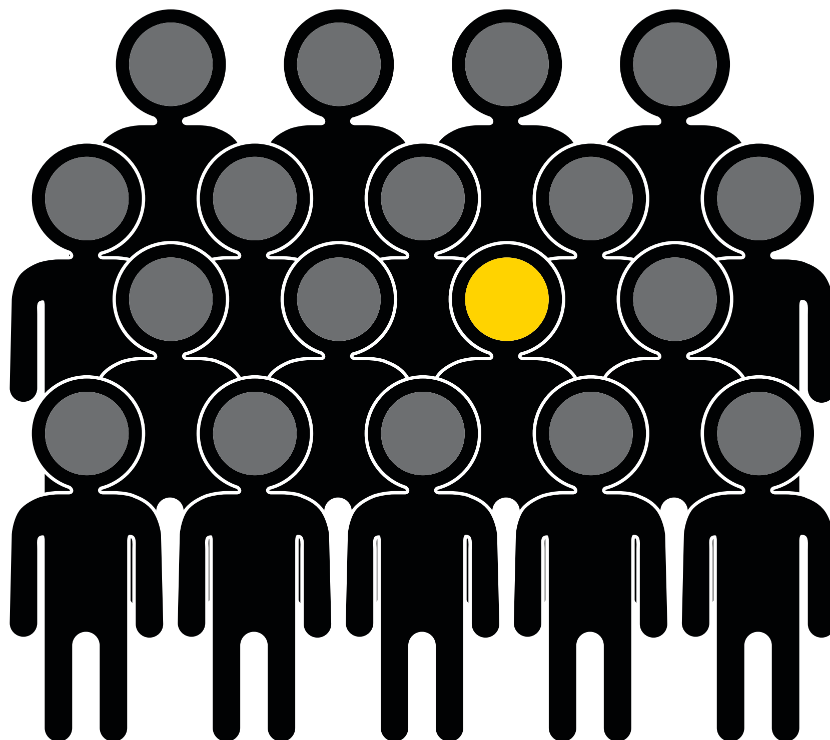
"One key necessity for us has been to get people inside our company looking outside," says Ellis.

The payoff is increased customer stickiness.

"If you can change and continue to be able to provide a better experience, why would they leave you?" says Ellis. "They wouldn't have a need to go, because you are giving them something that they want."

Ellis says the error of some visionaries is thinking that disruptive technologies will replace the business banker. He

> Generational differences are less stark than people usually think



believes change will enhance the business banking relationship.

"I have always considered banking a people business," says Ellis. He acknowledges that in time apps will provide advice, but only up to a point. "They won't replace the need for people talking to people."

DATA LARGE AND SMALL

Ultimately, the key to understanding disruption and finding opportunity seems to be looking past the devices and understanding that the real revolution lies in data: how it is generated, how it is organized, how it is moved, how it is applied, and how it can enhance the customer relationship.

Like Josh Guttau, Chris Nichols sees better use of data as the future. "I think you get more 'touchy feely' through technology than you can at a branch," says Nichols, who is chief strategy officer at $3.6 billion-assets CenterState Bank Central Florida, N.A. "I feel closer to Amazon, for instance, than I do to any local retailer. Amazon knows all about me. They suggest things for *me*."

When spoken of this way, "big data" sounds very pro-customer. Back pressure typically comes from concerns about confidentiality and security.

"Privacy is a really big deal," says Steve Ellis. "We've got to get this right." He sees the security and privacy protections built into Apple Pay as part of the trend that may make consumers feel more comfortable.

The other end of the data telescope is what Brett King calls "small data." He sees banks evolving from being "institutions" into "enablers" who are almost omnipresent in customers' lives. Rather than being a place one goes, through smart devices and geo-location technology, one's bank will always be in the background, ready to solve a problem or offer an opportunity.

"A key necessity has been to get people inside our company looking outside," says Wells Fargo's Steve Ellis.

Notifications sent right to your device will be how a bank "markets" to you, goes this school of thought. Though some may find this almost "creepy," the technology exists and is already beginning to be used, says Chris Skinner.

Banks and society have a learning curve here, he adds.

"Consumers will start becoming more aware of privacy settings and start tinkering with them to suit their lifestyles and preferences," he explains. "If you believe that the bank can give you value by giving you these great deals at the places where you shop, then you'll opt in. If there's no value exchange in the deal then you won't bother." ■

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DISRUPTOR PROFILE:

"ENTREPRENEUR. DATA NERD. BANKER."

Making money from innovation is the only point, says Dan O'Malley, head of Eastern Bank's "skunkworks"

Innovating in banking can be tricky, admits Dan O'Malley.

Inventors of all stripes generally believe that they learn more from failure than successes. "That couldn't be more true," says O'Malley, a veteran banking engineer. "But one of the hardest things for banks to do well is to build things that fail, because 'bank' and 'fail' really don't go together well in a sentence."

Yet as banks strive to remain competitive in the future with traditional rivals as well as disruptors from every direction, industry "grammar" might have to change.

"Anybody who thinks that they can build a new business or a new form of technology without failing first is wrong," says O'Malley.

O'Malley is executive vice-president and chief digital officer at $8.8 billion-assets Eastern Bank, in Boston, a post he took last spring. That's when O'Malley, former CEO of PerkStreet Financial, and several members of his team agreed to partner with the mutual savings bank to form Eastern Labs.

The lab was set up tapping both PerkStreet talent and over 80 Eastern Bank employees with a range of skills. The mission: Developing new technology and related innovations that can be applied, at a profit, both at Eastern Bank, and at institutions in the 48 states where it doesn't currently do business.

"If you want to really invest in new technology, you have to figure out how to make money from it," says O'Malley, who began his banking career at Capital One in payments. "We're *applied* technologists."

Finding right foundation

O'Malley and others who started PerkStreet—a branchless debit card company offering high rebates with banking partners—learned firsthand about the challenges of getting an idea off the ground and keeping it flying. O'Malley shut the company down when a supplemental capital raise didn't come off and promised rebates couldn't all be paid. Some customers were angry about the shutdown and consumer advocate/radio personality Dave Ramsey, a former fan, criticized the company in the wake of the termination.

At Eastern Bank and Eastern Labs, O'Malley believes he's found a platform

Regulatory impediments to SELF-disruption

When it comes to meeting the onslaught of nonbank disruptors, bankers often feel greatly constrained by the disparity of regulation.

"It's true that [nonbank] disruptors don't have that cradle-to-grave regulatory and supervision situation," says attorney Lynn Barr, head of Goodwin Procter's banking and consumer financial services practice. "However, many find that as they get deeper into providing financial services that they are triggering some of the regulatory burden." For example, they may have to become a licensed money services business under FinCEN regulations, and come under the eye of the Consumer Financial Protection Bureau.

Turning the matter around, "we have some banking clients who want to be disruptors, too," Barr says. "They have gone out and hired people from disruptive companies." This begets its own issues, she admits. "There is an internal tension between a highly regulated financial institution of any type and the kind of culture you see in a lot of the disruptive companies."

"All innovation is amoral," says consultant Jo Ann Barefoot. A former regulator herself and advisor to both banks and regulators, Barefoot doesn't think regulatory agencies get this distinction yet. They are interested in innovation and disruption, "but they move too slowly," she says. The very regulatory process of proposal, comment, reproposal,

Pat Greenhouse/Boston Globe/Getty Images

that he and his team can build from with both the aim of profit and the advantage of time.

"What got it done for us," says O'Malley, "is that there is a real commitment from the top of the house to take the long-term view on the future of banking. No one at Eastern thinks that banking is going to look the same in ten years."

While some see banking, as an industry, as stodgy, O'Malley says innovation typically starts inside a bank. Later, "when your technology platform is working really well, then you'll want to get it out of the bank, spun out into new companies," he explains.

A key advantage to being inside the bank for an inventive group like the labs staff is, in a word, data. Ask O'Malley exactly what people in his "lab" do all day and he says, "We write code. That's what we do." That code is applied to data, like a factory line uses raw materials and parts, to produce something.

And data is something that banks abound in. Where some see a pile of numbers, O'Malley and company see data that can be analyzed, and conclusions drawn from it. He explains that the financial technology creative process is "iterative." No blinding flash of innovation resulting in a finished product. You take an idea and prototype. Try it on a small sample of real, live customers, and see how it works. Tweak. Repeat.

In time, if the iterations continue in the right direction, the team will learn enough to produce a platform that can go commercial.

Something O'Malley's people are working at now, though he declines to drill down much, is a new view of how to find cross-selling opportunities with Eastern's customers. He says the lab's cross-selling concepts, under development, draw on how people actually spend their money, based on payment patterns.

> "No one at Eastern Bank thinks that banking is going to look the same in ten years"

"We'll be rolling it out as soon as we can," says O'Malley.

Regulatory shadows

Such research works well under a bank umbrella, O'Malley explains, because it avoids Gramm-Leach-Bliley third-party data privacy issues. In fact, O'Malley says that, as a developer, he finds his position "an incredible setup and an almost unfair advantage" compared to firms attempting to develop applications outside of a financial institution.

However, O'Malley has no illusions that he is working under the umbrella of a highly regulated institution in a highly regulated industry.

"We spend a lot of time on regulatory work," he says, and effort must go into finding ways, at times, to execute a simple idea in a way that will pass regulatory review.

"It may need to be done in a complicated way, and it can be hard," says O'Malley. He tries as much as possible to keep his developers and data scientists focused on innovation, and to take on the compliance tasks personally. "It's a key part of my job, as head of the group," he explains, and regulators' concerns can never be ignored.

Finding the right engine

Clearly O'Malley sees the need to strike a balance between getting a concept perfect and getting it out there so the labs' efforts will see some payoff.

One leg-up he feels he has at Eastern is its mutual structure. He believes the bank is about as small as an institution can be and still be able to support an R&D operation like his.

"Because Eastern is a mutual, we don't have public shareholder pressure," so there isn't the expectation of immediate payoff for the multi-millions that the bank has invested in this operation, he says. A public company, he adds, would probably have to be more in the range of $10 billion to be able to provide the resources, management bandwidth, and time that he enjoys at the labs.

—Steve Cocheo, executive editor and digital content manager

etc., doesn't synch with "Disruption Time." (Read Barefoot's take on how banks can use disruptive technology to improve compliance on p. 34.)

Author and futurist Brett King thinks regulators understand that traditional regulation is too slow and that something must change.

"Regulators know they must allow innovation for banking to remain competitive," he says. "They know that things are moving very rapidly and that they can't keep up with the rate of innovation. So regulation is going to have to become a much higher-level matter, and much less detailed to be effective."

What he envisions may look more like Yelp than traditional regulation, with the market thus causing those who don't measure up to lose business.

Author Chris Skinner thinks it is likely that the traditional bank charter may turn into a group of licenses, with each financial service being licensed separately. Deposit insurance will be sacrosanct, he believes, but otherwise "banks will face more new competition, from nimble component-based players."

Observes Dan Schatt, chief commercial officer at Stockpile, regulators find themselves in the position of being brakes because of their very mission: "Agencies generally want to do the right thing," he says. "But it's their neck on the line if they approve something that could potentially hurt customers."

SEVEN-YEAR ITCH

As commercial real estate bounces back, bankers and borrowers are eager to return to business as usual … sort of

By Melanie Scarborough, contributing editor

SIX TRENDS TO WATCH

When the economic tsunami hit seven years ago, commercial real estate lenders were pummeled hard by the waves of financial chaos. The recession eliminated more than seven million jobs, resulting in a high number of office vacancies and low rental rates. The noncurrent loan ratio in CRE quadrupled.

Community banks, in particular, were at risk from construction and other CRE loans, which made up more than 43% of their portfolios, with the average ratio of CRE loans to total capital above 280%. Many of the 414 bank failures from 2008-2011 were largely driven by credit losses on CRE loans, according to a 2013 GAO report. Not surprisingly, bankers became wary of commercial real estate lending and investors had no stomach for new projects.

But after seven years of improved benchmarks and regained confidence, FDIC reported last fall that banks' CRE lending had returned to levels not seen since 2007. That perhaps is not surprising considering today's very low loss rates. According to information from Sageworks, a financial analysis company headquartered in Raleigh, N.C., net charge-offs for CRE loans were 0.16% of average loan balances last year, down from a high of 0.9% at the end of 2009.

Moreover, the belief that improvement will continue seems universal. The CRE Finance Council's *2015 Outlook Survey* found that CRE lenders expect quite healthy market conditions. "Industry participants see another year of positive growth for commercial real estate debt markets as ample capital and credit should be available to meet borrower demand and pending loan maturities," says president and CEO Stephen M. Renna. "This is buoyed by stronger overall economic growth and a trend of improving property fundamentals."

The Mortgage Bankers Association found the same outlook among commercial lenders it surveyed: 100% said they expected CRE lending to increase in 2015. "Lenders' appetites for loans remain very strong," says Jamie Woodwell, MBA's vice-president for Commercial Real Estate Research, "and with the 10-year loans made during 2005, 2006 and 2007 maturing, lenders also anticipate growing demand from borrowers."

Within their broad expectations for CRE lending, bankers and other financial experts expect the continuation of six specific trends.

1 INTEREST RATES WILL STAY LOW WHILE CREDIT RISK WILL RISE

Prolonged low rates makes higher credit risk almost inevitable, says Stephen Wilson, president of $1.1 billion-asset LCNB National Bank, Lebanon, Ohio. "If you're awash in liquidity and need to make loans, and the supply of good loans is not out there, you have a tendency to reach a little further and take more risks," he says. That is not necessarily problematic. "Banks are better prepared to take risks because they've never been as liquid," Wilson notes.

H. K. Hatcher, president and CEO of $584 million-asset NBC Bank in Oklahoma City, points to another factor that drives the decision to take more risks. "You can't leave your money in Fed funds anymore and get a return," he says. With interest rates too low to generate significant profit, "you're almost forced to take more risk than you'd ordinarily want to."

Both Wilson and Hatcher rigorously monitor their banks' risk to keep it well within acceptable guidelines, but the Office of the Comptroller of the Currency fears that not all banks are as diligent. In December, in its *Annual Survey of Credit Underwriting*, the agency reported that underwriting standards have steadily loosened for the past three years.

The report noted increasing policy exceptions centered in commercial products. Among those surveyed by OCC, 34% of banks eased their underwriting

Impacted by e-commerce, thriving retail stores tend to be either very high-end or deep-discount.

standards in 2014, up from 28% in 2013 and 14% in 2012.

The rising numbers have raised the concern that banks might revert to the practices that led to the crisis of 2008. "This year's survey showed a continued easing in underwriting standards, with trends very similar to those seen from 2004 through 2006," said Jennifer Kelly, senior deputy comptroller for bank supervision policy and chief national bank examiner, in an OCC statement. "As banks continue to reach for volume and yield to improve margins and compete for limited loan demand, supervisors will focus on banks' efforts to maintain prudent underwriting standards, monitor portfolio credit risk, and reduce exceptions to policy," Kelly said.

Prudence already is a matter of policy at many banks, such as the $700 million-asset Bank of New Jersey that opened in 2006. "The lessons learned in 2008 remain within the core of our fundamentals, which are to keep an eye on loan-to-values and an eye on debt service coverage and repayment," says president and CEO Michael Lesler. "You won't see relaxed standards at our bank."

The Chicago market was "burned pretty badly" seven years ago, says Thomas Boyle, president and CEO of Chicago's $600 million-asset State Bank of Countryside, where underwriting standards are as strong or stronger than they were in 2008. "We analyze where all our loans are by geographical code, ZIP code, type of product and sales activity—and we do that monthly," says Boyle. Another precaution Countryside takes is to outsource its loan portfolio to be stress-tested on a quarterly basis, an almost unheard-of practice for a bank that size.

2 MULTIFAMILY HOUSING WILL BE IN HIGH DEMAND

Because of the constraints of the Dodd-Frank Act and the follow-up rules issued by the Consumer Financial Protection Bureau, many people who previously bought single-family homes no longer qualify for mortgages, an outcome that has produced a robust market for apartment complexes. "Large apartment houses are attractive [loans] because you have several revenue streams in terms of covering your debt service," says Lesler. "Take a 12- to 20-unit apartment building fully rented. The risk is that with a 10% increase in vacancies, you still have 18 rented out. As a borrower, you're comfortable that you can service that. As a bank, that's what you want to see."

In the area that State Bank of Countryside serves, Boyle says the multifamily housing market is "almost as strong as it was pre-recession, which is causing us to watch it closely." Contributing to the demand is the shift to urban areas. Not only do today's young adults want to live downtown, their baby boomer parents are following suit. The closer apartments are to downtown, Boyle says, the higher the rent they command.

Even in Oklahoma people are moving back into cities, Hatcher says, and many apartments are being built in those areas. In Wilson's Ohio market, multifamily housing is the most prominent segment of CRE lending. Indeed, multifamily transaction volume nationwide outranks loans for new office space for the first time in ten years.

3 RETAIL EXPANSION WILL BE AT THE VERY HIGH AND VERY LOW ENDS

In its latest "Beige Book" report on national economic conditions, the Federal Reserve noted a phenomenon in today's retail market: the most thriving stores tend to be either high-end or deep-discount. Certainly, the rise of e-commerce has changed the retail landscape. Writing in *The Investor's Guide to Commercial Real Estate*, economists Peter Burley and David Lynn argue that the market has been permanently redefined. "We are already beginning to see a deeply bifurcated mix of high-end urban retail destinations at one end of the spectrum with discounters at the other," they wrote. "The day of the suburban mall, anchored by a mid-market department store, has probably passed."

4 LOWER OIL PRICES HURT SOME STATES, BUT ARE A BOON FOR OTHERS

When the price of oil hovered at $100 per barrel, banks that finance energy production enjoyed soaring business. With oil prices now around $50 a barrel, the good times no longer roll. In Oklahoma, Hatcher says, "We just had a great shock to the system and everyone is readjusting their prices, wages and costs." He expects another jolt in this year's third and fourth quarters when capital expense budgets will change. "All the drilling companies are cutting those back—30, 40, 50%."

While that means a slowdown in business for the bank, it does not spell disaster because Hatcher is a proponent of managing concentrations and risks. Also, he is accustomed to Oklahoma's boom-or-bust economy. "We know how to make the adjustments in our business models and plans."

In the meantime, Hatcher predicts, other states' economies should benefit from lower oil prices that translate into more disposable income for consumers. Recent Fed "Beige Book" reports support his theory, indicating that tourism and travel businesses, in particular, are growing. While rates for new construction are still below historic averages, hotels and apartments are the exceptions.

5 BANKS MAY TRADE LOAN POOLS TO REDUCE CRE CONCENTRATIONS

Last year both the Federal Reserve and OCC warned bankers about having too much concentration in CRE, spurring some banks to trade loans. Although LCNB National Bank hasn't done it, Wilson says the practice makes sense in the right circumstances. "If your [market] area had a certain industry and a concentration was necessary to support what was going on in your area, [trading loans] would be a good thing to do."

One of the lessons learned from seven years ago is that such trades should take place only within local—or well-understood—markets, and bankers seem to be heeding that. Because State Bank of Countryside is known for its expertise in construction loans, the bank's CRE concentration is about 70%. Boyle says he traded $5 million of loans with another banker to hold down concentration, but the swap was "very local—an hour's drive away."

Another option is to use asset marketplaces such as Bank Assetpoint, a service run by Promontory Interfinancial Network, as well as those provided by some banker's banks.

6 POLITICAL UNCERTAINTY WILL CONTINUE TO HINDER CRE LENDING

President Obama has recently proposed new tax hikes; health care costs are rising; regulators continue to change the rules. Given all that, the true costs of a new project are unknowable. Wilson described a common scenario at LCNB National Bank. "People come to us and say they want to build plants, buy equipment. They're good customers, so we say, 'Let's go!' [But then] they say, 'Great, but let's wait a while.' They're not willing to pull the trigger right now because there's so much uncertainty."

Hatcher cites the chaos that ensues from a constantly changing tax code. For instance, last year's decision to extend the section accelerating equipment depreciation changed in mid-December. "People would have bought equipment all year long instead of waiting until year-end," Hatcher says.

"It would be much better if a tax code were simply enacted instead of passing them by continuing resolution."

Yet despite those hurdles and others, bankers and borrowers expect CRE business to continue improving—and most want to conduct it in ways that avert another crisis. It may not be easy: lenders say there aren't enough credit-worthy projects to go around. But the lessons of seven years ago still hold.

Prudent bankers seem to agree with CRE Finance Council President Stephen Renna, who warns, "It is critical that the industry demonstrate underwriting discipline in the face of abundant capital and heightened competition." ■

AVOIDING A REPEAT OF 2008: WHAT BANKERS RECOMMEND

"Require skin in the game. You definitely want the person you're lending to to bring personal guarantees. You don't want to be running a CRE project and taking 100% of the risk."
— ***Stephen Wilson, LCNB National Bank***

"As part of your underwriting, build in additional reserves to factor in rising costs of materials and salaries. It's also important to consider market fluctuations after the project is completed."
— ***Michael Lesler, Bank of New Jersey***

"Manage your CRE concentration. We actively monitor our CRE loans and shock the portfolio, and react accordingly."
— ***H.K. Hatcher, NBC Bank***

"Before financing an apartment development, look at the cash flow to be sure the project is viable and that they have the tenants lined up to make it successful."
— ***Stephen Wilson***

"Know your market; know what real estate values are; know your limitations. The key to CRE lending is to know what you do well and continue to do it."
— ***Michael Lesler***

HOW TO TALK TO REGULATORS

Hint: Show them how seriously your bank takes risk management

By Dan Rothstein, contributing editor

Your plans are really gaining traction. Three new loan offices you opened have handily exceeded profit and volume goals in their first year and are on track to do so again. The board congratulated you and the team.

Still, you know your shareholders want greater dividends or more growth in the next two to three years. You know that organic growth alone may not suffice. So you've been talking to a nearby bank about a possible combination. When you review the numbers, you see an acquisition would be immediately accretive to your shareholders—and theirs—and create a larger, more liquid market in your stock. You and the board are excited at the prospects.

Then comes your annual exam by your primary regulator.

As you reflect on how to discuss the state of your business with them, it is of course best to understand their perspective—how they see things and why they approach their jobs as they do.

In the abstract, your success in the long run is *theirs*—so long as there are no serious problems.

You are driving your bank to growth, increased profits, expanded job opportunities for employees, and positive returns for your shareholders.

The regulators simply don't want problems.

Examiners themselves need to be thorough and accurate. Their work is reviewed and they do not want to be the ones who miss an important matter that was within the scope of their exam.

And they also are interested in having bank management think favorably of them, and report to their supervisors that view. So they have an incentive to be knowledgeable about the bank and to work cooperatively with management.

Know this: Although individual examiners are typically not politically motivated, their agencies *are*. Leaders of bank regulatory agencies need to be responsive to legislative and executive concerns. No one wants to be brought to task, especially publicly, for problems

that are allowed to develop on their watch. And, if problems do happen, they want to be seen as tough and responsive.

If any of us had those jobs, we'd be that way too.

What's hot? Just ask

From being on the spot in this way, it's not surprising that agencies identify and focus on "hot spots." We've all seen it: mortgage servicing; commercial real estate concentrations; anti-money-laundering compliance; and even flood insurance compliance.

Examiners are guided to pay special attention to current items, so they are particularly sensitive to hot items at each exam. In fact, you can ask them what the hot items are now, and what is developing over the near-term. Experience tells me they'll give you direct answers. That's a good place to start in deciding how to portray your organization to them.

Next, it's helpful to analyze how your current situation and plans interact with examiners' pressures and incentives by asking such questions as:

- Has growth caused you to tilt towards a CRE concentration?
- Are you extending maturities in your investment portfolio just when agencies are publicly expressing concerns over interest rate risk?
- As capital continues to be the focus of safety in the banking system, how will your capital management policy withstand more stringent scrutiny?
- And what about your vendor management program?

These are examples. You can bet we will see some fade away while new ones arise, or re-arise. Staying current is key.

Examiners recognize your desire to grow and make more money. However, they expect—even *demand*—that risk management grows at least proportionately with growth and the demands of the times. Risk needs to be an integrated part of your strategic planning and business processes to meet expectations.

Communicating understanding of risk convincingly to examiners and their bosses is your goal. Do so, and you will be given leeway. Fail to do so, and you will be playing continuous defense.

Speak in their language

Prior to an exam, even last minute, it is worth taking the time to review your bank's position regarding current hot

items. Beef up areas that will be a focus, or get the process under way before the examiners arrive. *Voluntary attention and initiative earns far more credit than responsive behavior.*

Examiners are charged with assessing a bank's overall risk profile.

They use phrases like "Quantity of Risk," "Quality of Risk Management," "Residual Risk," and "Direction of Risk." Broadly, here's what they mean:

• *Quantity of Risk* is what we think of as inherent risk.

• *Quality of Risk Management* reflects the aggregate assessment of the effectiveness of management's control and risk mitigation activities.

• *Residual Risk* is what results after risk management activities are applied.

• *Direction of Risk* has its plain-English meaning.

Frame your remarks with terms that align well to their categories, which will help them write the exam report.

If your bank has an established enterprise risk management program in place, a well-organized report should exist that is structured along these lines. If there is a Risk Committee of the board, reports given to it should likewise be structured similarly.

And if not, that's okay, at least for a time. Demonstration of tangible steps in that direction are necessary to assure credibility, though.

So if formal reports are not where you'd like them to be, speak to examiners about incorporating their concepts in your communications. Have your key management staff do likewise. Consistency matters.

Talk about the risks first

First impressions also matter. If you've undertaken a new activity, it is best to lead with your analysis of the risks involved and the controls, resources, and reporting put in place to mitigate the risk. Then the profits or other positive outcomes that are expected can be discussed as the reason for taking on the risk and investing resources to manage it.

Leading with your understanding of risk and the structure to manage it ahead of the rewards will resonate with examiners. Better that than the other way around.

While you plan your communication to your examiners, it is possible that they may not give such attention to how they communicate to *you*. What they say can be just plain wrong, challenging, or worse.

Aggressive responses, even to ill-conceived comments, will be unproductive. Take these times as a chance to explain further what you are doing.

At other times, you will hear an insightful comment, perhaps pointing out a lapse. Be ready to admit you failed to consider something, or formed an improper judgment, if in fact that's the case.

Open-minded listening, investigation, and fact-based consideration win.

When M&A arises

Other than examinations and more routine interactions with your regulators, you may be approaching them with a potential merger or acquisition. You've focused on the benefits to your shareholders—regulators don't share that focus.

Today, it is commonplace to approach the regulators in advance of signing a merger agreement with a target company. The communication to the regulators prior to signing an agreement should be responsive to their concerns based on the same principles as during an examination.

Laying out the basics of the transaction comes first. This includes pro-forma financial statements depicting the assumed benefits of the transaction. Take time to lay out in clear terms the metrics that most concern regulators: resulting tangible capital levels; loan quality data; pro-forma allowance for loan and lease losses and credit marks assumed; loan concentrations; and similar matters.

Social issues in these transactions are of great significance. Regulators will, of course, want to know who will be in charge. But they will also want to understand the assumed cost savings, which are usually heavily weighted to staff cuts.

Be as clear as you can about your plans regarding the risk, credit, and audit areas. When you're not sure, a simple statement that you are committed to provide appropriate resources in these areas at the outset will be helpful.

If there are aspects of the transaction that reduce risk, make sure they are clearly communicated—for example, capital levels may be improved.

In the end, regulators will be more cooperative if they view the transaction as reducing risk. Help them come to that conclusion in a clear, factual manner.

"Baked-in" risk controls

Whatever the reason you are talking to the regulators, modulating your communication to address their concerns and pressures will yield improved results. Depict risk management as part of the way the bank runs.

Have direct, early, and consistent interaction about what risks you really worry about and what you're doing about them. If there are items that may appear to be a problem but you've determined are not, say so—and explain why.

> "From being on the spot as they are, it's not surprising that agencies identify and focus on 'hot spots.' We've all seen it"

Taking such efforts will demonstrate how you have in fact incorporated risk management into the company. Aim at winning examiners' confidence. If you do so, silently declare victory.

And congratulations, you win!

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CLOUD *MORE* SECURE?

More banks find it possible to get past security questions, where other factors come into play

By John Ginovsky, contributing editor

When the question first comes up around the boardroom table—"Should we move some of our core systems to the cloud?"—the instinctive response may be one of rejection.

The thought that the bank's confidential data entrusted to it by customers, the products and services it offers, and the proprietary work of the bank's staff could somehow lurk "out there," seems irresponsible. After all, news comes often enough of one breach after another of big companies. And regulators continually harp on the need to manage third-party risk.

What some bankers, cloud providers, and analysts are saying is that the concept of "banking in the cloud" may be either oversimplified or misunderstood.

Here are comments from two providers who offer cloud solutions as part of their product mix.

"The earliest discussions around cloud are, 'I don't want to do that. That's not very secure.' In fact it can be quite the opposite," says Scott Hansen, senior vice-president, D+H. "When you take a look at security breaches, often it happens with static data stored on machines. That's when breaches occur. The concept of a cloud environment is one where nothing is stored locally." In other words, data or the unauthorized access to data simply is not available on easily stolen or hacked user devices when the data resides with a cloud host.

More than a few banks appear to accept this view. D&H says its Compushare C3 cloud solution hosts the core banking systems of more than 700 banks.

CSI, which also provides cloud hosting to many banks, takes a somewhat different approach when prospective clients voice security concerns.

"The main thing I tell customers is you can outsource your IT systems. You can even outsource your IT management. But you can't outsource the responsibility of your data," says David Malcom, vice-president of managed services.

That means being able to go to a cloud provider's physical plant periodically to see how things are set up, how things are handled, what security layers and procedures are in place, and understanding the whole setup. The ability to do that is an important component of choosing a given partner.

Peter Graves, CIO, Independent Bank, $2.3 billion in assets, Ionia, Mich., is a strong proponent of outsourcing to cloud hosts, but remains wary.

"The only way to do this is by doing your homework," he says. "What you don't know *is* going to hurt you. That also pertains to the vendors you might partner with when you outsource. You really have to look at compartmentalizing that outsourcing and look at those pieces that make the most sense, and then try to find the right vendors that fit."

His bank relies on the cloud for its core systems, as well as some HR systems. Later this year they are looking to outsource their mortgage origination system.

Beyond security, what?

Once the security aspect of cloud hosting is at least held for further consideration, banks are acknowledging the positive aspects of cloud hosting—economics,

competitiveness, management, and more.

"It's not too many years ago that moving to the cloud meant getting rid of the racks and turning the old data center into an employee lounge, and you wouldn't need as many IT people. That's the hard-cost reduction," says Hansen. Now, he and others say, there are other aspects to consider:

• *"Customers like the transition from a capital expense type of expenditure* to an operational expense, where their IT management can move into a...monthly perspective instead of having capital expenditures that have to get depreciated over time," says Malcom.

• *Another driver is "the life cycle management* of all these systems and platforms and the maintenance, patching, and making sure they're secured and up-to-date. All of that life cycle management is a huge cost and burden and detracts from what you should be doing, which is making yourself more competitive," says Graves.

• *"It's a business continuity move,"* notes Hansen. "If there's nothing stored locally, and all your machines get destroyed, getting back up and running is nothing more than running down to Best Buy and buying some new PCs."

Security, though, is still what it often comes down to, and the two bank vendors we spoke with make two further points in that regard.

On the one hand, says Hansen, "If you're a $100 million bank, in essence you have to tackle the same in-house hardening and security as a $10 billion bank."

On the other, says CSI's Malcom, cloud hosts "have teams of people who are dedicated to security. Teams of people who are dedicated to compliance. And teams of people who are dedicated to internal auditing functions to make sure those other areas perform the way they are supposed to perform."

From bank CIO Graves' point of view, deciding to host systems in the cloud is something to seriously consider in an informed way.

"With the economies of scale that you can achieve through the right providers who do this day in and day out—if you find the right providers—it's not only economically going to make sense, but they are better at managing risk. They keep your systems more up to date. They're going to be able to keep the lights on and make sure things get done," says Graves.

Just as important, he adds, "it gives you an advantage over your competition."

The big decision

Deciding when and what to transition to the cloud may not be easy.

"There's a time and place for the transition," says Hansen. "It's not six months after you've just replaced all your PCs or reinvented your entire data center. But hardware has a shorter and shorter average depreciated life span. We're finding there are moments of opportunity in a three-to-five year cycle."

Also, says Malcom, "Some bank customers outsource to us just the core processor. Some outsource just IT management. Then there's a huge number of systems that can be outsourced. It's a pretty broad topic."

An important step, says Graves, is to develop a multiyear plan, based on a lot of research, testing, and consulting.

"If a bank is not looking at this and hasn't a plan out there, they are going to be at a disadvantage," says Graves, adding: "Those who don't look at this are missing the proverbial boat, and it's a lifeboat, not a cruise ship."

Cloud scrutiny

Regulators and other standards keepers have weighed in extensively regarding responsibilities and accreditation of cloud-hosting providers as they relate to their financial institution clients.

For example, the Federal Financial Institutions Examination Council requires that if the financial institution allows its data to be hosted in the cloud, the board of directors and management remain responsible to ensure that the third-party activity is conducted in a safe and sound manner and in

Clouds of confusion

Regarding cloud types, D+H's Shanon McLachlan, senior vice-president, provides this quick rundown, augmented by Techpedia, an online tech dictionary:

Public cloud is open to everybody and can be located anywhere in the world, offering some, but minimal, security.

Private cloud is roughly equivalent to one company paying to transfer its in-house data center into the facilities of the cloud host, to the exclusion of all other entities.

Hybrid cloud occurs when a company opts to outsource some functions to a public cloud, others to a private cloud.

Community cloud combines aspects of the other types of cloud. Techpedia says community clouds are "a hybrid form of private clouds built and operated specifically for a targeted group. These communities have similar cloud requirements and their ultimate goal is to work together to achieve their business objectives."

compliance with applicable laws and regulations. At the same time, FFIEC has statutory authority to supervise third-party services.

If any sort of credit card processing is included in the cloud services, the PCI data security standards come into play. As noted in the PCI DSS cloud guidelines, "Cloud security is a shared responsibility between the cloud service provider and its clients...PCI DSS will apply to that environment and will typically involve validation of both the CSP's infrastructure and the client's usage of that environment."

Added to this are audit requirements, known as service organization control (SOC) reports under guidelines set by the American Institute of Certified Public Accountants.

"At a minimum there should be an annual touch point between the [financial] organization and the cloud provider to review the SOC reports that the cloud provider have gone through and written up," says CSI's David Malcom. "They are a way to see what types of controls and procedures the cloud provider had tested and what their performance against those tests were."

"While these certifications provide a good starting point for banks and other financial institutions seeking to deploy their applications in a hybrid or public cloud," says Jim O'Neill, senior analyst with Celent, "the financial institution still needs to be vigilant in regard to the security of its own application environment. Best practices include rigorous access control policies, strong user authentication practices, and the use of encryption wherever customer data is concerned."

REGULATORY REFERENCES

- FFIEC Handbook on External Cloud Computing (ffiec.gov)
- FFIEC Handbook on Supervision of TSPs (ffiec.gov)
- PCI DSS Cloud Guidelines (pcisecuritystandards.org)
- AICPA on SOC reports (aicipa.org)
- AICPA on Cloud Controls (aicpa.org)

John Ginovsky cuts through the tech hype in his weekly blog "Making Sense of it All" in the free *Tech Exchange* newsletter. Sign up at "Newsletters" on www.bankingexchange.com

"Share-of-wrist" wars begin

Hard on the heels of the much-anticipated Apple Watch announcement, Citibank said it will launch a banking app for the watch once it hits the market April 24.

Called Citi Mobile Lite, it will enable Citi's U.S. debit and credit card customers to view account balances, review their five most recent transactions, and receive real-time notifications of credit card transactions on the Apple Watch.

Banking apps such as this could be as significant to the industry as the introduction of mobile banking.

"I see us rapidly moving in a world where we need to become hyper relevant in [the customer's] day-to-day life—where you are, what you're doing, any time you want," said Citi's Heather Cox in an interview with *Banking Exchange*. "Wearables take us one step closer to your individual life's experience. The mobile phone has opened that gateway, without question."

Cox is chief client experience, digital, and marketing officer for Global Consumer Banking at Citi. She indicated that this likely will be just the first iteration of this app.

The Citi Mobile Lite app will be enabled by the existing Citi Mobile Snapshot app, which resides on the iPhone and allows customers who opt in to the service to view certain account information without having to log into their accounts every time. The Citi Mobile Lite app—like all the many other apps that will show up on the Apple Watch—is tethered electronically to the user's iPhone.

What's in the watch

Among the technologies incorporated into the actual device, relevant to Citi's banking app, are:

- *Digital crown*, which allows the user to scroll, zoom, and navigate fluidly without obstructing the display.
- *Retina display*, which senses the difference between a "tap" and a "press," allowing the user to access relevant controls.
- *Taptic engine*, which discreetly delivers a gentle tap on the wrist whenever the user receives a notification or message.

Citi's Cox described several design features of the bank's new app. For example, the software will be able to sense that when the user's iPhone is in dark mode, it should automatically send notifications directly to the watch instead. Also, as users make credit card purchases, in addition to showing the balance in the account, a color-coded bar will tell them how close they are getting to their credit limit.

"It creates a very individualized, personalized experience," Cox said.

Domestic share of wrist

This union of technology and banking heavyweights—Apple and Citi—is likely to energize the recognition and acceptance of wearable banking apps. Again, said Cox, it gets back to the need for banks to become ever more meaningful in their customers' lives.

"It's certainly something that can keep you aware of and purposeful about how you spend your money," Cox said. "It's more about engaging our clients in their day-to-day lives."

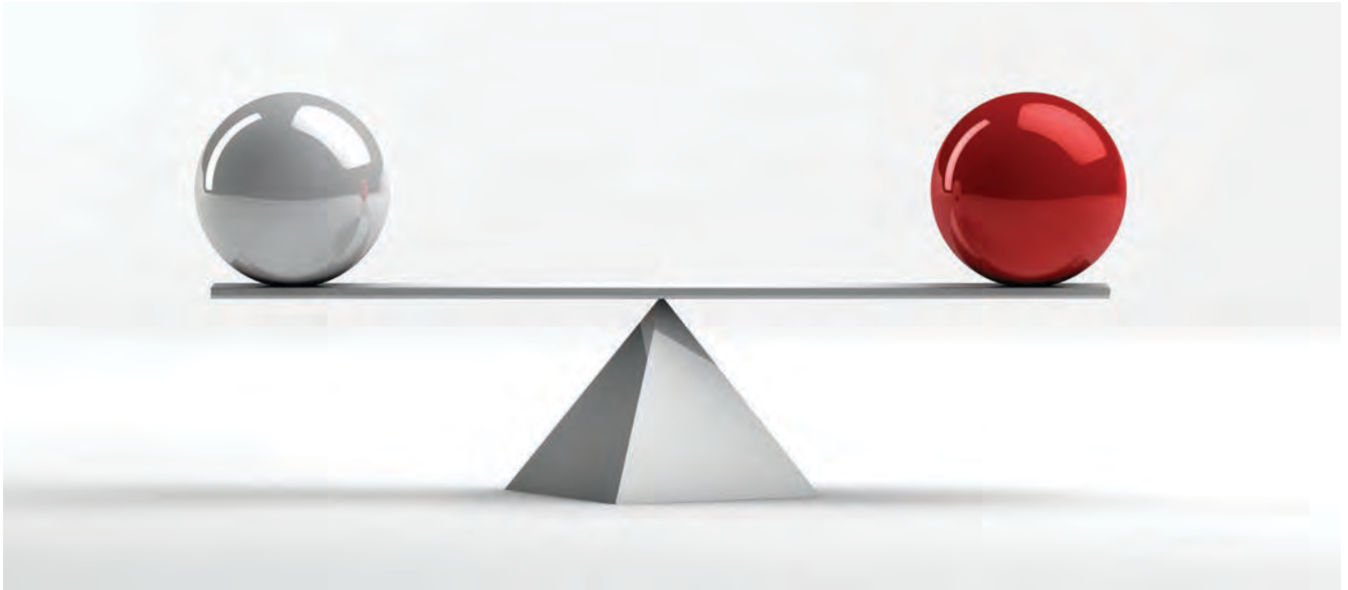
Regarding other smart watch brands, Cox said, "If this has the uptake that I hope it has, we will be looking at other operating systems as fast followers."

—John Ginovsky, contributing editor

FAIR-LENDING CHECKUP

Whatever the Supreme Court decides about disparate impact, the fair lending issue won't go away

By Lucy Griffin, contributing editor



Over the years, bankers have developed systems for managing risk. Some are elaborate, some are simple. But all are based on identifiable or predictable risk.

One example: Your bank runs the risk of technical regulatory errors, such as failing to correctly calculate loan disclosures or provide disclosures at the right time.

Because the possibility of error is predictable and measurable, compliance staff can design procedures and controls to minimize the risk that the errors will occur. Also, with these risks, we can predict the consequences of a violation.

With fair-lending compliance, assessing and managing risk has always been very different. There are no tricky or specific rules that can be identified, tested for, and monitored. There are no numbers to check or forms to issue. There are no underlying systems that can be examined for errors.

Fair lending is all about people, and how they treat customers. No risk management matrix can measure that risk.

But that doesn't mean you are helpless.

Assessing your exposure

Fair-lending programs are built on policies and procedures; product design and availability; lending authorities; product delivery; and training—lots of training. Banks can establish clear policies and provide procedures that guide lenders through all aspects of taking applications and making loans. Compliance can train lenders and other staff to understand fair-lending issues and act in ways that ensure fair lending.

However, the most careful and sincere management team cannot possibly predict everything that might happen—or how it will look in hindsight.

Fair lending's real risk challenge lies outside of the industry's control. As long as there are differences in how different groups of people are treated, the regulatory agencies are pressured to address the problem. Reviewing and evaluating a bank's policies and procedures is insufficient. It isn't enough to then evaluate performance by measuring lending results. If inequities exist, regulators must dig out the cause.

Even with all the policies, procedures, and training possible, it remains impossible to evaluate the risk that a regulatory agency will later consider that a practice violates fair-lending laws. As long as there is any unfairness in the world of credit, there will be fair-lending issues.

In this respect, fair lending is much like Community Reinvestment Act performance. No amount of effort seems to be enough. How many loans should a lender make? Until all low- and moderate-income consumers have their credit needs met and no one is treated differently, there is more to be done.

Looking back, and ahead

The challenge for risk management is that fair lending is evaluated after the loan decisions are made, with the advantage of hindsight.

Loan policies, products, and procedures are based on what is known at the time. How those will work out in the marketplace is educated guesswork, which makes it particularly difficult to anticipate risk. Some notable fair-lending actions brought by the Justice Department have involved banks that had been making pro-active efforts to *serve* protected groups—and at least one reflected obedience to a regulatory request that went wrong.

Managing fair-lending risk is fundamentally an exercise in predicting what an agency such as the Consumer Financial Protection Bureau or the Justice Department will develop as a theory for an enforcement action. In recent years

"Eliminate assumptions about what consumers want. They may want something entirely different"

the doctrine of disparate impact, while not synonymous with fair lending, has been the focus of many of the fair-lending actions brought against lenders. The doctrine holds that a lender can be charged with discriminatory practices—even if no intent to discriminate is found—if the effect of the lender's policies has a disproportionate effect on a protected class.

In January, a disparate impact case involving fair-housing law made it to the stage of oral arguments before the U.S. Supreme Court. News accounts indicate it was a spirited session where both sides took some hits from the Justices, and not just along their historic ideological lines. A decision in *Texas Department of Housing and Community Affairs* v. *The Inclusive Communities Project*, is expected in June or July.

The nature of the decision and its effect on disparate impact as it relates to lending remains uncertain. But fair lending as an issue won't go away in any event.

Here are four ways a financial institution can check itself to find if it has exposure to fair-lending violations:

1. EARLY INDICATORS. Pay close attention to news stories relating to credit discrimination. Many compliance issues are generated through consumer complaints. They don't just complain to you, however. They may contact a news channel or a website or write to their Congressman. Worse yet, they may contact your state Attorney General. As these problems become news stories, they are likely to become compliance problems. Watch them closely.

Next, take any statements or guidance from regulators seriously. This includes tracking what is said in speeches. Regulators use speeches as a means of advising the industry about pending concerns. Tracking regulators' speeches on a timely basis gives you an early warning to study the issue within your bank and get a head start.

Are apps the answer to banking's red-tape challenges?

Strip away the alphabet soup of regulations, and step behind the scenes of the massive industry-regulator compliance edifice, and what do you have?

The desire for the typical consumer to get a square deal. To give them financial services with something more to go on than "caveat emptor."

Jo Ann Barefoot's career has been devoted to compliance, from time as a regulator through several incarnations as a consultant, and, as well, a consumerist of sorts. In the course of researching a book about consumer protection and the financial crisis, and in surveying the growing role of disruptive technology in financial services, Barefoot draws two conclusions:

1. For all the massive regulatory burdens on banking, and the money spent on them, and the volumes of disclosure documents dumped on customers, many consumers still got hurt. She gives the whole regulatory/compliance effort "a C+, at best."

2. Increasingly, instead of seeking ways to impose compliance on disruptive new technology, "I felt that much of the solutions lay in the technology."

Too much effort currently goes into using new technology to automate existing processes, says Barefoot. She thinks more time should be put into using technology to produce processes that are friendlier to consumers.

"The industry is trying to become more consumer centric," Barefoot explains, "but it is still too *product* centric."

Barefoot says that the regulatory burden makes innovation and customer communication difficult. "The industry is really struggling to be able to provide clarity and clear choices to consumers," she explains.

The result: Products loaded with aspects consumers just don't understand.

In particular, whenever an agency such as the CFPB, DOJ, or the Federal Trade Commission says it is considering a fair-lending issue, take it as a warning and get to work.

These agencies are not going to communicate with banks in the ways prudential bank regulators do, so they require watching. When one of them mentions a new fair-lending theory, it is a safe bet that they are working on a case based on that theory.

Apply the theory to your bank and see what you look like.

2. SELF ASSESS. The only way to avoid being caught unawares is to be aware.

Know who the borrowers are, who the applicants were, and who is or is not your customer. Your CRA analysis of community credit needs is a useful foundation for fair-lending self-analysis.

Enforcement analyses have been based on who was included, who was excluded, and who was not even invited. Some agencies, such as DOJ, have made arguments of exclusion that seem to come from left field. For example, DOJ has stated that designating the bank's assessment area in a way that fails to include a minority area—*even if the designation complies fully with CRA requirements*—can violate the Fair Housing Act and the Equal Credit Opportunity Act.

3. THINK CREATIVELY. You must stay ahead of the curve.

Creditors must think creatively to anticipate ways in which regulators could approach fair-lending concerns.

Because fair-lending enforcement relies on hindsight, use you own version of hindsight. You actually have an advantage—because you are familiar with the inner workings of your bank. This renders a better view of cause and effect.

Base creative thinking on who doesn't have credit and why. This means a regular evaluation of all credit products together with analysis of approvals and denials based on demographics.

It also means eliminating assumptions about what consumers probably want—they may want something entirely different—and what is profitable for the bank.

But don't go overboard. After the burst of the housing bubble, lending policy must fall neatly between rock and hard place without hitting either one.

There is both need and desire out there that cannot be supported. Making a loan to a consumer who cannot afford it is just as bad as refusing to lend to a consumer because of the language that customer speaks.

4. UDAAP IS A GUIDE. Whether the topic is fair lending or unfair, deceptive, or abusive practices, the issues are strikingly similar.

Both fair-lending law and Unfair, Deceptive, Abusive Acts and Practices law represent "soft" rules in that there are no specific requirements to meet and no benchmarks to use. Both are based on perceived fairness and judged by results. Both are designed to protect consumers from decisions and actions over which they have no control.

A good test to subject your fair-lending program to: Run it through a UDAAP evaluation.

Scoring well on UDAAP is a good sign. Any indicators of possible unfairness or deception are bad signs and should be remedied.

The test must always be from the customer's perspective:

- Does the marketing program communicate to borrowers of every demographic?
- Do the loan products provide the right choices for consumers in your market?
- Is information about products clear and readily available?
- Are products designed to benefit the consumer as well as the bank?

How consumers understood and responded to the bank's offerings is the measure used in fair lending—*hindsight*. Risk management in the fair-lending program involves some creative work and always thinking about what things will look like later.

Lucy Griffin is president, Compliance Resources, and co-blogger, Common Sense Compliance, on BankingExchange.com @ http://tinyurl.com/p5xnlgs

The solution, says Barefoot: "The mobile revolution will be the catalyst that will get new things moving." She sees the instant availability of mobile financial tools, including personal financial management apps; increasingly sophisticated behavioral science; big data; artificial intelligence; and natural language interface—think "Siri" with a financial degree—will enable banks to turn the compliance page.

One element of this will be putting financial literacy into the mobile device. Barefoot believes customers will be more engaged when financial literacy assistance is presented as needed, in the moment, rather than in courses given long before the need that most consumers find boring and that they avail themselves of sporadically.

Jo Ann Barefoot believes banking still remains too product centric to have effective compliance.

A taste of the future, Barefoot says, may be seen in a company called Kenscho, backed by Goldman Sachs and Google Ventures. Founded out of MIT and Harvard, Kenscho has developed technology that allows computers to answer millions of investor questions. The technology has been likened to a Siri for investors, analysts, and traders.

Barefoot adds with a chuckle that another model might be along the lines of Carrot Fit, a mobile app described as "Your judgmental fitness overlord," which insults users to drive them to better fitness.

"SOCIAL" IN SHIRTSLEEVES

Camera friendly CEO delivers advice and life experiences online—minus the sales pitch

By Steve Cocheo, executive editor

"Everybody's trying to figure out social media," says Bob Mahoney, president and CEO at $1.4 billion Belmont Savings Bank, Belmont, Mass. "It's like finding a rifle in the woods and not knowing what it is. You fire it and you figure out how it works."

There are CEOs who write blogs, and there are CEOs who tweet, some quite regularly. There are even a few CEOs who know what Pinterest is. While Belmont Savings' marketing people do their share of such social media, Mahoney doesn't get into those platforms. What he prefers is video blogging, in a series called "Mahoney Money Minutes."

"I do them in batches, when I get inspired," says Mahoney. He's done about 25 spots over three years. (Google "Mahoney Money Minutes" to see some.)

Face-to-face on camera

"I like to inform and to educate," says Mahoney. "I thought being a smart friend would appeal to people." The bank's spots have had thousands of hits.

Mahoney's on-camera style is that of a slightly gravelly voiced, wise old uncle type, who has doffed his jacket and decided to impart his financial life experience in a no-nonsense, noncommercial way.

"If you do the banking business long enough," says Mahoney, "you learn a lot of stuff."

Mahoney has been in banking since 1971 and lived and worked through four or five recessions, depending on how you count them. He sees the videos as a chance to get his thoughts together—sometimes after researching a topic and sometimes off the top of his head—and share them with area consumers. Mahoney makes a point of expressing everything he covers in everyday language, avoiding anything that would put off a viewer.

In a way, Mahoney has simply taken a facility for explaining things and figured out a way to deliver it to many, instead of by ones and twos in person.

"I've talked friends through financial questions hundreds of times," says Mahoney. "I've been talking to people about such issues for 40 years." Doing it in front of a camera doesn't faze him in the least, it's the same material.

"I can usually do it on the first take," Mahoney says.

Recently Mahoney posted a trio of videos aimed at young people going out to job hunt for the first time. He broke the broad subject into how to pick a career; how to land an interview in that business; and how to have a successful interview.

This is just one set of a wide variety of videos, which have included buying versus leasing cars; renting or owning a home; handling marriage and finances; teaching kids to save; and financing a college education, among others.

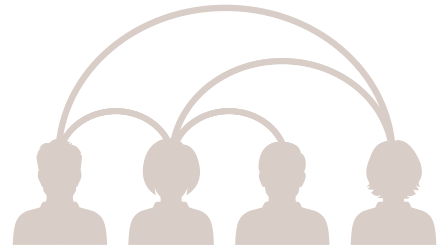
Bringing family into it

It's not uncommon for Mahoney to speak very much from personal experience. In a spot discussing how to set up an allowance, he opens by telling about how he tried a fixed allowance with his own three daughters and tried a variable one. He didn't like the way either one worked out.

So he invented the "declining allowance." Each daughter could draw on a pile of 20 singles stacked on the kitchen table during the week. However, if they talked back or otherwise misbehaved, Mahoney said, he'd reduce the allowance pile of the offender. They'd come to the kitchen expecting to go to the movies or buy a treat, only to discover Dad had levied a penalty.

Eventually, Mahoney says, his daughters got the message.

"This mixes the entitlement of an allowance with the behaviors you want to get," Mahoney explains in the video.



"I like to inform and to educate," says banker Bob Mahoney. "I've talked friends through financial questions hundreds of times." Doing it in front of a camera doesn't faze the savings bank chief. "I can usually do it on the first take," he says

Often, Mahoney says, he draws his subjects from a variety of published sources. Sometimes *The Wall Street Journal* Sunday supplement supplied to some city newspapers carries a story that gets him going. Other videos have been launched by stories in the *Journal's* daily Personal Journal section. Others have been suggested by the time of year—when April approaches, Mahoney says that's a natural point to discuss tax matters.

The week he was interviewed, Mahoney decided the topic of his next video blog would be about personal ethics.

Banker's friendly face

Clearly, Mahoney is more than a bit of a showman. Belmont Savings maintains some supermarket branches and the CEO has been known to give cooking demonstrations at the in-store locations. He's done egg nogs, soups, and more.

Key to all this is that "I'm not selling anything," says Mahoney. "There's no sales pitch at the end." He says this not only appeals to viewers, but helps the bank steer clear of compliance issues. Avoiding sales and sticking to general discussion and away from bank products keeps Mahoney Minutes from triggering disclosures and other requirements.

"That's the bright line," he explains.

Ultimately, says Mahoney, banking is a fundamental business to many people's lives, and "there are so many ways you can teach people things."

Producing his video spots is just one way Belmont Savings sets itself apart from the competition, says Mahoney, but it's an important way. "People like to see bankers being human," he adds. ■

NEW HIRES ARE "BORN"

Bank consultant Jay Brew of Seifried & Brew LLC was a founding director of $718.7 million-assets Embassy Bank and has watched its management work at building a culture founded on finding the best and brightest and keeping them sharp.

One element of this policy is that Embassy pays up for high-quality applicants. While this costs more up front, says Brew, the bank has found that such employees produce more and can handle a heavier workload. This enables the bank to run with a higher assets-to-staff ratio than comparable institutions.

"We get a lot more out of each employee," says Brew.

Something that sets the bank apart is no H.R. function, not in the sense of recruitment and hiring. In what he calls the " 'A Team' kind of approach," prospective hires are interviewed by fellow employees, not by H.R. professionals. Those who win positions with the bank get an Embassy Bank birth certificate, signifying their "birth" into the bank's culture. One of the pillars of that culture is to have high expectations ... of yourself.

Once aboard, an employee is assigned to a "pod." Brew explains that these groups meet to discuss issues and new ideas.

"The idea is to keep people innovating all the time," says Brew.

THINK WITH GOOGLE

Constraints and limitations are all around us: the need to be in more channels with the same budgets, the finite number of the most talented people, the little time we have to execute. The pressure is relentless: get more done with fewer resources in less time.

Sound familiar? In a recent blog on "Think with Google," Ben Malbon, Google's director of creative partnerships, spoke to the squeeze many businesses, including banks, face today. He drew his column from one of Google's "Firestarters" events, where marketing strategists and planners meet with Google thinkers. Some of the points from the event:

• *More than kid stuff.* Dr. Seuss launched his famous kids book career on the challenge from a publisher to write something first graders wouldn't put down—using only a 250-word vocabulary. This resulted in *The Cat In The Hat*.

• *Flip your thinking.* Ditch the word "can't." Turn "We can't do that because" into "We can do that *if* ..."

"An apparently slight change," Malbon writes, "it forces the conversation to focus on how an answer could be possible rather than allowing it to shift to whether the problem can be solved."

• *Focus on what you have.* Malbon wrote of a travel agency with a minimal marketing budget. What it did have was the endless visuals and stories that travelers generate. The agency sponsored an unusual contest that asked entrants for travel photos. They gained content for free. There was a twist. In exchange, the agency offered a prize, which rose in value as more photos were submitted.

Malbon quotes Porter Gale, advisor to startups: "Abundance isn't about the best idea; it's often about the people, the network that we can tap into. Winners look not for an abundance of resources but for one of relationships."

Read Malbon's entire blog at http://tinyurl.com/ndyrvj4

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EVERYBODY JUST RELAX

Why we shouldn't react to every new piece of information, advice, or criticism *By Brian Higgins*

Change isn't the only constant in banking—though it certainly can seem that way.

Each day brings articles, tweets, and research, plus advice to act now to avoid being left behind.

Demands on our attention grow greater than ever, as does the breadth of data. We feel pressure to make quicker decisions. We face not simply the pace of change, but also the multiple varying opinions on the nature of change, what it means, and how to respond.

Some headlines, on just one topic:
- "Rebooting the branch"
- "Banks can't close branches fast enough"
- "Bank branch of the future"
- "Bank branches are dead"

Yes, fundamental changes keep coming and, as is common during great change, defining what it all means and separating "noise from signal" is challenging. Banks can't afford to wait until the fog lifts. How should we respond?

Sit still and think

I would recommend one lesser-known industry voice. His advice? "Relax. Five letters here just for everybody out there in Banker-land: R-E-L-A-X. Relax. We're going to be OK."

Giver of that advice? Aaron Rodgers, Green Bay quarterback, during a media event when the Packers were way down. (OK, Rodgers really said "Packer-Land.")

Rodgers was suggesting that in times of change and adversity it is important to not react to every new piece of information, advice, set-back, or criticism. The potential cost of wrong decisions, made because you felt rushed or felt the need to react to every prediction, is too great.

You must keep confidence in your team and plan and remain committed. Adjustments will be made. Tactical changes too. What shouldn't change (at least not often nor without analysis) is strategy.

Banking isn't going away

Threats to traditional banks are real, but the fundamental need for banking services isn't going away. Who provides them and the channels through which they are purchased and consumed may evolve, but the fundamentals remain.

For consumers, that means access and convenience, security, availability of credit, and guidance.

Businesses have much the same needs. Banks have the added advantage with businesses in being well positioned to provide cash-flow management solutions that integrate with basic banking functions and enhanced payments fraud protection.

Banks have advantages

Banks' reputation may have taken a hit during the financial crisis, but banks remain trusted. (A recent BizRate survey placed banks—at 72%—as the provider trusted most with personal and payments information.) With strong distribution networks, convenient access, expertise, and a commitment to servicing all segments of our communities, banks enjoy strong advantages that will serve well as the future unfolds.

As you sift through the visions of the future and plan your bank's response, staying focused on the fundamental needs of your clients and being aware of your capabilities and strengths (and vulnerabilities) will go a long way towards removing uncertainty.

Rodgers also said, "We haven't made it easy on ourselves. We've dug ourselves a little bit of a hole. But we're a resilient bunch and we'll bounce back and we'll get better."

Truer words about our industry have never been spoken.

Brian Higgins is first vice-president, Product and e-Banking Director, First Financial Bank, Cincinnati, $7 billion assets. Brian.Higgins@bankatfirst.com

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