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Regulators Clarify Limits on Use of Supervisory Guidance

In four separate rulemakings, federal financial regulatory agencies have clarified that examiners cannot issue enforcement actions or supervisory criticisms against banks solely because they have not adhered to supervisory guidance.

The FDIC, OCC, Consumer Financial Protection Bureau and the National Credit Union Administration codified that guidance does not have the force and effect of law. "Rather, supervisory guidance outlines supervisory expectations and priorities, or articulates views regarding appropriate practices for a given subject area," they wrote. Unlike regulations, which do have the force and effect of law, guidance is not required to go through a notice and comment process.

At press time, the Federal Reserve was expected to finalize this proposed rulemaking as well.

The rulemakings do not mean regulators will no longer issue guidance, nor that banks should ignore guidance. In fact, guidance is often welcomed by bankers. However, the rules arm bankers with a defense against the improper use of guidance by clarifying that examiners cannot issue enforcement actions or supervisory criticism on guidance alone.

While supervisory guidance does not create binding legal obligations for regulated entities, "it does indicate supervisory expectations, advise the regulated entities of the manner in which an agency proposes to exercise a discretionary power, express a view regarding safe and sound practices on a particular subject, and may highlight areas of emerging risks," said Lynn Woosley, a senior director at the consulting firm Treliant.

As a result, Woosley added, "Directors should ensure that their institutions evaluate the applicability of guidance to the institution and ensure their institution prepares for supervisory scrutiny in the area covered by the guidance."

Directors may want to ask management whether there are any known disagreements with examiners on topics that may be covered by guidance. They may also want to ask whether a bank that is deviating from guidance has a good reason for doing so, and can do so while operating safely and soundly.

The clarification was sought by ABA and the Bank Policy Institute, which requested a formal rulemaking to ensure that banking organizations would not need to rely on a 2018 interagency statement to clarify the role of guidance. ABA has stated in comment letters that it believes the agencies should only base supervisory criticism on a violation of statute, regulation, order, or demonstrably unsafe and unsound practice.

FOCUS ON COMMITTEES

Digital Technology Has Secured Spot on Agenda

More discussion of digital technology can be expected in tech committees and bank boardrooms in 2021 as the COVID-19 pandemic alters and accelerates strategic priorities. A report by PYMNTS.com found that 46 percent of consumers increased their use of online and mobile banking during the spring and summer of 2020.

"You can't think about your future without thinking about your technology," said Mary Kay Bates, president

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In This Issue

Get Ready for Another Round Of Virtual Annual Meetings

The traditional April-through-June proxy season, when most corporations hold their annual shareholder meetings, is approaching. The lingering COVID-19 pandemic assures that most will be virtual for the second year in a row, says Lynn Casteel, a managing director at investor relations firm Lambert.

Casteel, a former investor relations officer for community and regional banks whose practice focuses on banking clients, offered some tips for effective virtual meetings.

Know the laws and bylaws. The state of incorporation and the corporate bylaws may have specific requirements for in-person meetings, or restrictions on virtual meetings, he noted. Companies need to know the framework in order to structure any necessary waivers correctly. The New York Stock Exchange and NASDAQ require that companies listed on their exchanges hold such meetings, but they don't prescribe the format.

Verify hosting capacity. Technology must be sufficient to manage attendance. Hosting-capacity snafus that were tolerated last year, when the switch to remote meetings was an emergency measure, won't be countenanced this year, Casteel said. "Technology providers have to step up. The hosting platform needs to be in place and seamless," he added. "Directors should be asking if management is comfortable that the technology is going to perform the way it's supposed to."

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Spell it out. Include clear instructions on the proxy statement on how to attend, vote and ask questions to ensure that shareholders won't have difficulty participating in the meeting. Also, establish a definite starting time that works across U.S. time zones, and stick to it. "Nine a.m. eastern is not going to make people on the West Coast very happy," Casteel said.

Provide help. A help-line phone number or chat feature should be available on the company website. "Bank investors of the non-institutional variety tend to be older and less technology savvy. Provide good support to help shareholders get into the meeting." Also, companies should consider providing a link to the list of shareholders of record, because registered shareholders have the right to inspect it.

Showcase your key people. It's important for shareholders to be able to see management and the board at the meeting. A two-camera setup may be helpful.

Share responses to questions. Most annual meetings are set up to allow shareholders to ask questions. Make sure shareholders feel their questions are respected by posting the answers on the website after the meeting, even if they weren't addressed during the live portion of the meeting.

FDIC Offers Insights On Community Banks

Community banks acquired more than two-thirds of the community banks that closed between year-end 2011 and year-end 2019, according to a large-scale Community Banking Study published by the FDIC. The number of community banks fell from 6,802 to 4,750 during the survey period, primarily driven by voluntary merger activity.

The study examines community bank financial performance and structural changes among community and non-community banks. It also reviewed the effects on community banks of demographic changes, technology and regulatory changes, and discussed future challenges and opportunities, including COVID-19's effect on community banks in these areas.

The report's definition of a "community bank" takes into account a bank's business plan, geographic footprint and number of branches.

DIRECTORS BRIEFING

Larry Price Publisher
Debra Cope Editor-in-Chief

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Spotlight: Iowa's Bank Midwest Blazes Trails in Pursuit of a More Effective Board

Bank Midwest, a $1 billion-asset bank in Spirit Lake, Iowa, that has been primarily family owned for five generations, has been moving intentionally toward strengthening board performance and improving board diversity for several years. Since 2018, the bank has expanded its board from nine to 12 members in order to infuse fresh blood. Then it consciously sought highly qualified women for board seats and leadership roles.

And just this year, the bank recruited three new directors who are millennials—part of the generation born between 1981 and 1996. Adam Pick works in farm management, Katie Cone in healthcare, and Amanda Shaffer is a corporate CFO.

"It's hard to find millennials who have the time to serve on the board," said Mary Kay Bates, the bank's president and CEO. "But when you find them, they can provide great value. They offer a wonderful new point of view on matters such as how they want to use their bank. They just came on the board January 1, and we're already getting questions that challenge our thinking."

Bates, who joined Bank Midwest in 1995, says diversity is not window dressing. It's vital for a dynamic financial institution to have varied perspectives on the board. She's proud to say that the Bank Midwest board has achieved gender balance, with six female and six male directors. Newly elected chair Becki Drahota has served on the board since 2012. And it has brought in expertise from various corners of the community.

One of those experts is Pam Rowland, who holds a doctorate in information systems and teaches cybersecurity at Dakota State University. "She works with our head of information security, and this year, at the end of every board meeting they will do a 10-minute education session on technology," aimed at helping directors keep pace with cybersecurity and build the knowledge they need to make sound decisions, Bates said.

Adding three millennials as directors has brought new points of view to board discussions.

"We had to really recruit to find our cybersecurity expert. This is an expertise that's in high demand," Bates said. She found that candidates were less motivated by compensation and more motivated by the opportunity to do interesting work. "They want to be engaged. You have to have a board that has their act together to recruit today."

Other board members have been recruited to reflect important aspects of the community. For example, one board member is a veterinarian who runs a large animal practice and provides a perspective on agricultural banking. One owns an oil business. One is a human resources executive at a large company.

The board meets 10 times a year, and four of those meetings are what Bates describes as "a deep dive." They begin with an afternoon of committee meetings and an evening get-together, which usually includes dinner and a speaker. The next morning, when the board meets, the emphasis of the deep-dive meetings is on strategic initiatives.

3 Three Questions for...

Jim McAlpin
Partner at Bryan Cave Leighton Paisner LLP, Atlanta

Why does board diversity matter?

Board diversity brings enhanced perspective and can result in more contact with a broader segment of the business community.

What do millennials bring to the board?

As millennials reach a stage of leadership in companies, they are becoming attractive board candidates. They bring a fresh perspective on doing business in a virtual world, and can also bring valuable perspective on the expectations of their generation in a banking relationship.

How do you find qualified millennials?

One way is to turn to professional advisers. Law firms and accounting firms put a lot of effort into developing relationships with strong growth companies, many of which are now led by millennials. Don't be shy—advisers can assist in identifying good millennial board recruits and facilitating introductions.

Start Framing Cybersecurity as a Business Issue

Cybersecurity isn't an information technology issue; it's a business issue, according to Steve Sanders, vice president of internal audit for core technology provider CSI. For directors, it is critically important to ask for training that is not too technical and that speaks the language of business, he said.

A recent survey conducted by CSI found that 34 percent of banking executives cited cybersecurity threats as the greatest challenge to the financial industry in 2021, ahead of meeting customer expectations (19 percent) and regulatory change (17 percent.) Ninety percent of the banks that participated in the survey had assets of less than $1 billion.

The survey also found that more than 80 percent of bankers said they expect some form of social engineering—including phishing scams targeting customers or bank employees—to be the top cybersecurity threat this year. Sanders noted that most bankers ranked scams targeting customers as a bigger concern than scams focused on employees. However, he stressed, "If a successful phishing attempt happens to their own employees, the whole institution can be compromised."

The second largest cybersecurity concern was seen as ransomware, with 9 percent saying they consider it to be a top threat. To improve cybersecurity, almost 85 percent of bankers said they plan to deploy employee, board and customer training and 47 percent said that they would be performing social engineering exercises.

Sanders urged boards to push for chief information security officers to come to board briefings with their business hats on. A CISO who can bridge the gap between business and technology can play a valuable role in keeping boards informed, he said.

COMMITTEE FOCUS

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and CEO of Bank Midwest, a $1 billion-asset bank in Spirit Lake, Iowa.

Bankers said it is important for boards to define the scope of their involvement with technology decisions. Approaches will vary from bank to bank.

"Our board looks to me and the rest of our management team to recommend technology initiatives and execute accordingly within the confines of our budget," said Luanne Cundiff, president and CEO of First State Bank of St. Charles, Mo., which has $452 million of assets.

It's important for boards to define the scope of their involvement with technology decisions.

First State's board focuses on high-level questions about technology initiatives, such as their impact on cybersecurity and the audit scope. "Those are important questions every director should ask," Cundiff said. The board views its role through the lens of reviewing the budget and financials and monitoring audits and exams.

Priorities include developing more robust online and mobile user experiences across the bank, Cundiff said. One initiative is the launch of a digital commercial loan platform.

Cundiff said her management team engages directors by demonstrating technology "so that they have an idea of what the end result of an expenditure looks like." In addition, she said, after the budget is approved, management develops a comprehensive list of strategies to present to the board, and most are technology-related.

At BankMidwest, several technology imperatives emerged from the board's strategic planning meeting last fall. Bates sees digital tools as key to achieving the bank's goal of delivering an exceptional customer experience that combines "useful, reliable technology" with the ability to access expertise and personal service.

Bates said it's important to give customers choices about how they want to interact with their banking professionals. "Look at the health care industry," she said. "Patients can go into the office, or speak to a healthcare provider using telehealth services. That transfers over to banking. Customers and their advisers are now much more comfortable with virtual meetings."

Before the pandemic, banks and their customers were aware of virtual technology, but customers tended to prefer in-person meetings, Bates said. Now, "you've got to offer both." She said smaller banks don't generally offer click-to-chat, but that could change.

During 2021, Bank Midwest is moving to an API, or application programming interface, platform, sometimes called an open banking system, which will enable the bank to plug in applications to increase its ability to deliver innovative solutions. "We hope to have it up and running by mid-year," Bates said.

Loan Review Emerging as Analytical Tool, Helping Boards Visualize Credit Quality and Identify Developing Trends

Historically, loan review has been a "sleepy little function" at community banks, with many viewing it as an extension of various audit functions, according to Giulio Camerini, a principal and credit practice leader at Crowe LLP. But reliance on loan review has accelerated over the past decade as banks have begun mining its potential to provide additional powerful analytics that can support credit oversight, he said.

"A lot of banks are looking to get more out of the loan review function, including help in spotting trends," Camerini said. "What used to be a matter of checking the accuracy of loan grades and files has become a dynamic function that can aggregate data and identify and report on systemic issues while fulfilling its core mission."

Loan review is particularly valuable given the rapid shift that has occurred in banking in the COVID-19 environment. After a five-year period in which the number of downgrades initiated in loan review was relatively low, different forces have weakened asset quality over the past year. The FDIC reported that the percentage of bank loans that were 90 days past due or in nonaccrual status rose in the second and third quarters of 2020, reaching 1.17 percent as of September 30.

Technology is changing the potential for loan review to play a bigger strategic role, Camerini said. He noted that until recently, it was not unusual for banks to use Excel spreadsheets and Word documents in their loan review process—tracking methods that were not designed for extracting information. "Technology is helping us extract and visualize loan review findings."

> 'What used to be a matter of checking the accuracy of loan files has become a dynamic function that can aggregate data and identify and report on systemic issues.'

Visual dashboards, including Crowe's, can help boards picture trends and help management spot loan officers with higher than average risk ratings and product categories with above-average past-due loans or other risk traits, he explained. Camerini said he has worked with several board committees that have added a data visualization session to their credit briefings.

Board members are asking how credit is being impacted by COVID-19, Camerini noted. It's appropriate to ask such questions even if the bank has fared well so far. For example, what potential credit quality issues could emerge as the economic cycle plays out? Are regulators and examiners satisfied with the bank's loan review efforts? "Examiners and auditors used to review heavier samples of loans, but now they are placing more reliance on the loan review function. They want to look at this function and see that it's effective," Camerini said.

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Diversity, Working through COVID-19 Cited as 2021 Priorities

How is board service changing in 2021? The National Association of Corporate Directors offers some answers in its American Board Practices and Oversight Report.

Published in late January, the report look at how directors and boards navigated challenges during 2020, including the COVID-19 pandemic. Among the key findings:

Diversity remains a high priority. The report found that 70 percent of boards discussed the organization's approach to diversity and inclusion during their 2020 meetings. More than one-quarter—27 percent—reported setting diversity goals, while 19 percent said their boards examined practices for possible racial bias and took steps to improve. NACD said the latter results leave clear room for improvement.

Sixty-three percent of directors said their time commitment to board service increased by 50 percent in the first nine months of 2020.

The pandemic jolted the operating environment. In the pandemic's wake, 63 percent said their time commitment to board service had increased by 50 percent in the first nine months of 2020. In shifting from in-person to remote board work, 72 percent of directors said the loss of nonverbal communication was their biggest challenge. Only 41 percent found virtual meetings as effective as in-person meetings. Yet two-thirds of directors predicted that at least 20 percent of board meetings would remain virtual after the pandemic has passed.

More adaptations are likely to come. Directors cited three top challenges in responding to the COVID-19 crisis. Sixty-one percent said scenario planning would require a new, broader set of risk factors; 59 percent said strategies would have to be recalibrated to fit new markets and environments; and 46 percent said ensuring the ongoing health and safety of employees was a priority.