

# COMMUNITY BANKING CONNECTIONS<sup>®</sup>

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## VIEW FROM THE DISTRICT

A Twelfth District Perspective — San Francisco

### Fintech: Balancing the Promise and Risks of Innovation

by Teresa Curran, Executive Vice President and Director, Financial Institution Supervision and Credit,  
Federal Reserve Bank of San Francisco

One of the hottest topics I am often asked about today is financial technology or fintech, as it is widely known. *Fintech* is a broad term, but at its core, it refers to the use of technology to better deliver banking products and services. These



Teresa Curran

services could be in the form of lending platforms, payment processes, investments and savings, block-chains, digital currencies, or a host of other areas. In all of these sectors, fintech has the potential to transform financial products and services for consumers and small businesses.

Think about it. Consumers can now use their smartphones and other mobile devices to manage their money, transfer funds, or obtain a loan. This type of accessibility has altered their expectations and demands about when and how they should be able to conduct financial transactions. In my view, the expectation for an on-demand experience is just one of the permanent changes driving today's innovation.

At the San Francisco Fed, with its proximity to Silicon Valley and the many new fintech firms nearby, the emergence of innovative technology has captured our attention. Some of the latest innovations offer consumers convenience, speed, and

reliability, and provide banks the ability to access and analyze big data quicker and sometimes cheaper than ever before. Other innovations can address some of the financial system's long-standing challenges, including the ability to facilitate direct payments between buyers and sellers and to direct households' and businesses' savings to their most productive uses, such as building homes, expanding businesses, or obtaining an education.<sup>1</sup>

<sup>1</sup> John C. Williams, "Fintech: The Power of the Possible and Potential Pitfalls," speech delivered at the LendIt USA 2016 conference, April 12, 2016, available at [tinyurl.com/j6roh7j](http://tinyurl.com/j6roh7j).

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# The Use of Evaluations in a Prudent Risk Management Framework for Real Estate Lending

by Carmen Holly, Senior Supervisory Financial Analyst, Board of Governors of the Federal Reserve System

Underwriting credit to finance real estate is a significant component of risk management activity at many financial institutions. Whether considering a loan request to finance residential property, owner-occupied commercial property, or income-producing commercial property, most lenders will at some point in their careers need to consider the value of real estate when making a decision to extend or not extend credit. Some lenders may be conservative and follow prudent risk management practices when obtaining property valuations by choosing to use appraisals for all real estate-related financial transactions, even those that would require only evaluations under the federal banking agencies' appraisal regulations.<sup>1</sup> This article discusses the appropriate use of evaluations as part of a prudent risk management program for an institution's real estate lending activity. It also addresses some of the reasons bankers may hesitate to use evaluations and shows how these hesitations can be overcome.<sup>2</sup> The agencies' appraisal regulations and the *Interagency Appraisal and*

*Evaluation Guidelines (IAEG)* address circumstances in which a bank must obtain an appraisal or may use an evaluation.<sup>3</sup>

Bankers should exercise prudent risk management by gaining a full understanding of all repayment sources prior to extending credit. Cash derived from the sale of collateral provides a secondary source of repayment in the event that a borrower's primary cash flow and liquidity are insufficient to make loan payments in accordance with the loan agreement. For a bank to understand the capacity of the real estate collateral that is to serve as a secondary source of repayment, a bank can use both appraisals and evaluations to provide an estimate of the market value of the property for which a credit extension is being secured.

## Connection to the Real Estate Lending Standards Regulations

The agencies' real estate lending standards regulations set forth the regulatory requirements for a bank's real estate lending activity.<sup>4</sup> These regulations and accompanying guidelines

<sup>1</sup> These agencies include the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the National Credit Union Administration.

<sup>2</sup> Institutions should also consider state regulations pertaining to certification and licensing requirements for individuals valuing real estate in federally related transactions.

<sup>3</sup> See 12 CFR part 208, subpart E, and 12 CFR part 225, subpart G. See also Supervision and Regulation (SR) letter 10-16, "Interagency Appraisal and Evaluation Guidelines," available at [www.federalreserve.gov/boarddocs/srletters/2010/sr1016.htm](http://www.federalreserve.gov/boarddocs/srletters/2010/sr1016.htm).

<sup>4</sup> See 12 CFR part 208, subpart E, and Appendix C.

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establish underwriting standards and supervisory loan-to-value (LTV) limits to address the risk of real estate lending. A bank is expected to comply with the regulations' supervisory LTV limits and to understand the value of a real estate loan's collateral. Bankers, therefore, need to obtain an estimate of the market value of a loan's collateral to determine its LTV ratio and whether the loan complies with the supervisory LTV limits and the institution's risk appetite. The agencies' guidelines define *value* as "an opinion or estimate set forth in an appraisal or evaluation, whichever may be appropriate, of the market value of real property, prepared in accordance with the agency's appraisal regulations and guidance. For loans to purchase an existing property, the term 'value' means the lesser of the actual acquisition cost or the estimate of value."<sup>5</sup>

### Requirements for Evaluations

The agencies' appraisal regulations and the IAEG provide guidance for determining market values, creating an effective real estate valuation program, and establishing the usage and content of evaluations. Institutions should establish policies and procedures to determine the appropriate valuation method for a given transaction, taking into consideration the associated risks. On a portfolio level, institutions should review their policies and practices related to real estate lending and should maintain risk management practices and capital levels commensurate with the level and nature of their real estate concentration risk while remaining in compliance with regulations and supervisory guidance.

When establishing a real estate valuation program, banks should keep in mind the following:

- One primary difference between appraisals and evaluations is who can perform them. While appraisals can be performed only by a state-certified or licensed appraiser, evaluations can be performed by a person who possesses appropriate appraisal or collateral valuation education. As such, banks can use internal qualified staff to prepare evaluations and comply with federal regulations. The IAEG discusses specific criteria that institutions should consider when selecting individuals to perform evaluations.
- Professional standards are another difference between appraisals and evaluations. The agencies' appraisal regulations require that appraisals must conform to generally accepted appraisal standards as evidenced by the

Uniform Standards of Professional Appraisal Practice (USPAP). While there are no professional standards listed for evaluations in the regulations or guidance, the IAEG provides supervisory expectations for the development and content of an evaluation.

- Reporting standards also differ between the valuation methods. USPAP provides various appraisal report options that appraisers may use to present an opinion of value. Reporting standards for evaluations are not specified.
- In regard to content, the agencies' appraisal regulations and guidance require both appraisals and evaluations to contain sufficient information to support the credit decision. However, USPAP also defines specific content standards for appraisals.

There are some similarities in the supervisory expectations for appraisals and evaluations. Both methods have an expectation of independence, meaning that the agencies expect the preparer of an evaluation not be a party to the transaction. The agencies also expect that an appraisal and an evaluation provide an estimate of the market value of the collateral and, equally important, provide sufficient information to support the bank's credit decision.

### Evaluations Versus Appraisals

Bankers have voiced concerns that they are hesitant to use evaluations even when the agencies' appraisal regulations permit the use of them. Bankers have also noted that examiners appear to favor appraisals over evaluations. The following discussion attempts to clarify the regulatory expectations for evaluations by highlighting common reasons why bankers may hesitate to use evaluations.

1. *We are not sure when we can use evaluations; examiners seem to favor appraisals and may be extra critical if we use evaluations.*

The agencies' appraisal regulations permit an evaluation instead of an appraisal for three transaction types:

- Transactions with a value equal to or less than \$250,000
- Real estate secured business loans with values equal to or less than \$1,000,000
- Renewals, refinancings, or other subsequent transactions when there has been no obvious or material change in market conditions or physical aspects of the property that threatens the adequacy of the institution's collateral

<sup>5</sup> See 12 CFR part 208 and Appendix C.

# Considerations for Banks Thinking About Migrating to a Dot-Bank Domain Name

by Kenneth J. Benton, Senior Consumer Regulations Specialist, Federal Reserve Bank of Philadelphia

As consumers and businesses increasingly conduct their financial transactions online, banks are paying more attention to their domain names, which are the portals to their browser-based banking platforms. When choosing a domain name, bankers should consider selecting a name that will enhance the security of the bank's website, appear in top search results, extend the bank's brand, avoid trademark infringement, and be easy for customers to key in and remember.

While banks have large latitude in selecting the portion of their domain name to the left of the dot, called the subdomain, their options have been limited until recently in selecting the domain extension at the end of their web address, or to the right of the dot, known as the top-level domain (TLD) (e.g., .com, .gov). As of 2012, only 21 TLDs were available, and some of these were available only to qualifying applicants (e.g., .edu is limited to U.S.-affiliated institutions of higher education). As a result, most banks have been using the dot-com TLD, which indicates a commercial organization.

In 2008, the Internet Corporation for Assigned Names and Numbers (ICANN), the governing body for Internet domain names, announced it was expanding the universe of TLDs by allowing applicants to self-select a new TLD.<sup>1</sup> In response to the change, fTLD Registry Services, LLC (fTLD), a financial services industry consortium, applied for a new TLD exclusively for banks and savings associations and related organizations such as banking trade groups. The new TLD, dot-bank, was approved by ICANN on September 25, 2014.<sup>2</sup> Effective May 2015, the dot-bank TLD became available to qualifying applicants that pass a screening process. Thus, a qualifying bank currently using the domain name www.bankname.com could migrate to www.bankname.bank. As of March 2017, more than 2,400 banks and savings associations in the United States registered nearly 4,900

dot-bank domain names, and more than 300 of these domain names are actively being used.<sup>3</sup> This article discusses some of the factors a community bank may want to consider when deciding whether to migrate to a dot-bank TLD.

## Enhanced Security

Security is perhaps the most important factor a community bank will consider when deciding whether to adopt a dot-bank TLD name.<sup>4</sup> As online security breaches continue to make headlines, concerns about website security are weighing heavily on banks and their customers. Customers want peace of mind that they can conduct financial transactions safely on a bank's website, while banks want to prevent financial losses and damage to their reputations as a result of fraud. Because no single magic bullet exists to protect against all threats, website security typically uses a multilayered approach. If one defense fails, other defense mechanisms can still detect and prevent an attack.

The dot-bank TLD uses the following enhanced security requirements:

- Eligibility is limited to:
  - banks and savings associations around the world that are chartered and supervised by a state or national government regulatory agency;
  - associations (such as trade groups) whose members are primarily composed of banks and savings associations;
  - service providers principally owned or supported by regulated entities; and
  - government regulators of chartered and supervised banks and savings associations and organizations

<sup>1</sup> See "Biggest Expansion in gTLDs Approved for Implementation," ICANN, June 26, 2008, available at [www.icann.org/news/announcement-4-2008-06-26-en](http://www.icann.org/news/announcement-4-2008-06-26-en).

<sup>2</sup> See ".bank Registry Agreement," ICANN, September 25, 2014, available at [www.icann.org/resources/agreement/bank-2014-09-25-en](http://www.icann.org/resources/agreement/bank-2014-09-25-en).

<sup>3</sup> Personal communication with Craig Schwartz, managing director, fTLD Registry Services, April 26, 2017.

<sup>4</sup> Paul Shukovsky, "Banks Flock to New.bank Domains for Security, Branding," Bloomberg BNA, August 16, 2016, available at [www.bna.com/banks-flock-newbank-n73014446420](http://www.bna.com/banks-flock-newbank-n73014446420).

whose members are primarily composed of such government regulators.<sup>5</sup>

- The software security company Symantec reviews all fTLD's applications worldwide and verifies an institution's eligibility, including a security check.
- Registrations must be re-verified by Symantec every two years to confirm an institution's continuing eligibility.
- Banks and savings associations must use domain name system security extensions, which verify that Internet users are reaching the web page of the institution and have not been taken to a fraudulent site.
- The dot-bank TLD must be hosted on dot-bank name servers to protect against manipulation of the domain name server, which has been used in the past to facilitate fraud.
- Banks and savings associations must employ e-mail authentication, a technology process used to protect against phishing and spoofing e-mails. Criminals frequently use forged e-mails to obtain information that can facilitate crimes. E-mail authentication technologies (e.g., DomainKeys Identified Mail, Sender ID, and Sender Policy Framework) verify the identity of the sender of an e-mail and can block e-mails that cannot be authenticated or notify the recipient that the identity of the sender could not be verified.
- Only Internet registrars (the companies that register an organization's domain name) approved by fTLD can conduct dot-bank registrations. The current list of approved dot-bank registrars is available at [www.register.bank/registrars](http://www.register.bank/registrars).
- Additional security requirements include, but are not limited to, using multifactor authentication for attempted changes to a bank's registration information, prohibiting registration through a third party (which hides information about the registrant), and implementing the encryption standards of the National Institute of Standards and Technology Special Publication 800-57.<sup>6</sup>

<sup>5</sup> The complete list of eligibility requirements is available at [www.ftld.com/docs/fTLD-Registrant-Eligibility-Policy-BANK-20170421.pdf](http://www.ftld.com/docs/fTLD-Registrant-Eligibility-Policy-BANK-20170421.pdf).

<sup>6</sup> Elaine Barker, "Recommendation for Key Management, Part 1: General," NIST Special Publication 800-57 Part 1, Revision 4, January 2016, available at [nvlpubs.nist.gov/nistpubs/SpecialPublications/NIST.SP.800-57pt1r4.pdf](http://nvlpubs.nist.gov/nistpubs/SpecialPublications/NIST.SP.800-57pt1r4.pdf).

Collectively, these and other dot-bank security requirements help mitigate the risk of fraud. For example, bank customers may receive phishing e-mails that contain malicious links to a spoofed website that appears to be a bank's website. If customers provide their log-in credentials on the spoofed website, criminals can capture the information, which allows them to initiate an account takeover. The malicious link will have a domain address very similar to the bank's actual website address to deceive the customer. For example, if a bank's web address were [www.bankname.com](http://www.bankname.com), the phishing link might contain a slight variation of the bank's web address, such as a hyphen ([www.bank-name.com](http://www.bank-name.com)).

Because eligibility for the dot-bank TLD is limited to the entities discussed previously, and only after they have been vetted by Symantec and approved by fTLD, it should be much more difficult for a criminal to establish a spoofed bank website with a dot-bank extension. The hope is that as customers begin to associate the dot-bank extension with a bank's website they will become skeptical of any website claiming to be the bank's website but lacking the dot-bank extension. Moreover, because of the e-mail authentication requirement, if a criminal attempts to send out a spoofing e-mail that appears to be from a bank, participating Internet service providers (ISPs) will recognize the discrepancy between the Internet protocol (IP) address of the sender of the phishing e-mail and the IP address of the bank on file. The ISP could then take steps to prevent the e-mail from being delivered.

Finally, because website security is an important concern for customers, banks adopting the dot-bank extension could use this as a selling point in their marketing materials to distinguish themselves from competitors that have not yet adopted the dot-bank TLD.

#### **Available Subdomain Names**

fTLD's subdomain name allocation policy prohibits the use of certain common banking names and generic names, such as "community," "national," "premier," and "first security." A complete list of unavailable fTLD names is available at [www.register.bank/reserved-names-list](http://www.register.bank/reserved-names-list).

Institutions that switch to the dot-bank TLD have the opportunity to change their subdomain name. The dot-bank TLD greatly expands the universe of available domain names

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# The Importance of Third-Party Vendor Risk Management Programs

by Tony DaSilva, S&R Subject Matter Expert, Federal Reserve Bank of Atlanta

Vendor management comprises all of the processes required to manage third-party vendors that deliver services and products to financial institutions. Significant effort is required from both the institution and the third-party vendor to maximize the benefits received from the relationship, service, or product, while simultaneously minimizing associated risks. As the scale, scope, and complexity of these relationships and services increase, the related risks and the importance of effective vendor management should proportionately increase. In addition to traditional core bank processing and information technology services, banks outsource operational activities such as accounting, appraisal management, internal audit, human resources, sales and marketing, loan review, asset and wealth management, procurement, and loan servicing. The increased use of outsourcing to third-party vendors and the importance of the relationships between banks and those vendors intensify the need for community banks to have highly effective third-party vendor risk management programs in place.

Over the past several years, managing third-party vendor risk has required greater attention from community bankers. On a daily basis, cyber-related incidents and contingency plan failures occur, involving serious to sometimes critical incidents that may have significant impact on community banks. As a result, bankers have devoted more resources to vendor risk management, integrating vendor management oversight into their critical processes. Therefore, it should be no surprise to anyone that the adequacy of vendor risk management is a top concern for community bankers and regulators.

Federal Reserve Supervision and Regulation (SR) letter 13-19, “Guidance on Managing Outsourcing Risk,” states that “a financial institution’s service provider risk management program should be risk-focused and provide oversight and controls commensurate with the level of risk presented by the outsourcing arrangements in which the financial institution is engaged. It should focus on outsourced activities that have a substantial impact on a financial institution’s financial

condition, are critical to the institution’s ongoing operations, involve sensitive customer information or new bank products or services, or pose material compliance risk.”<sup>1</sup>

Technological advances enable community banks to provide customers with an assortment of products, services, and delivery channels. As a result, community banks are increasingly relying on third-party vendors for a variety of technology-related services. Because the responsibility for properly overseeing these relationships remains with the institution’s board of directors and senior management, an effective vendor risk management program should provide the framework for management to identify, measure, monitor, and mitigate the risks associated with outsourcing arrangements. The bank’s senior management should develop and implement enterprisewide policies to consistently govern outsourcing processes. These policies should address third-party vendor relationships from an end-to-end perspective and should include procedures for establishing servicing requirements and strategies; selecting a third-party vendor; negotiating the contract; and monitoring, changing, and discontinuing the outsourced relationship.

While the components of an effective vendor risk management program may vary based on the scope and nature of an institution’s outsourced activities, effective programs usually include the following elements:

- Risk assessments, due diligence, and selection
- Contract provisions and considerations
- Incentive compensation review and service-level agreements (SLAs)
- Oversight and monitoring
- Business continuity and contingency plans

## **Risk Assessments, Due Diligence, and Selection**

When considering the outsourcing of significant bank functions to a third-party vendor, the bank’s board of directors

<sup>1</sup> See SR letter 13-19, “Guidance on Managing Outsourcing Risk,” available at [www.federalreserve.gov/bankinforeg/srletters/sr1319.htm](http://www.federalreserve.gov/bankinforeg/srletters/sr1319.htm).

and senior management should ensure that the outsourcing of a particular function is consistent with the institution's strategic plans and evaluate proposals against well-developed and specific criteria. Management should also establish and approve appropriate risk assessments and risk-based policies to govern the third-party vendor or outsourcing process. The risk assessments should be updated at appropriate intervals consistent with the institution's vendor risk management program. The policies should recognize the risk to the institution from outsourcing relationships and should be appropriate to its size and complexity. The degree of oversight and review of outsourced activities will depend on the criticality of the products and services, access to customer information by the third-party vendor, and any specific risks attributed to the selected third-party vendor.

Management should use due diligence as a validation and verification process to confirm that the third-party vendor meets the institution's needs. The amount and formality of the due diligence performed may vary according to the estimated risk of the outsourced relationship and the institution's familiarity with the prospective third-party vendor. A common weakness that examiners often see is an institution that relies on one core third-party vendor for most of the institution's products and services. While relying on one third-party vendor can result in operational, financial, and oversight benefits, diversification may be a more practical solution depending on the type of products or services offered by the financial institution. Also, the financial institution should be aware if the third-party vendor is further outsourcing all or part of its responsibilities to a subcontractor. If agreements allow for subcontracting, the institution should impose the same contract provisions on the subcontractor. Contract provisions should clearly state that the primary third-party vendor is overall accountable to the institution for all services the vendor provides as well as for services provided by its subcontractors.

### **Contract Provisions and Considerations**

Contracts should clearly specify the details of the third-party vendor business relationship. The contract needs to establish a common understanding between the institution and the third-party vendor as to what needs to be achieved and should (1) define all deliverables, service levels, and metrics; (2) define responsibilities and obligations; (3) define terms and conditions; (4) specify how risk will be allocated between parties; and (5) define legal counsel and jurisdiction stipulations.

Also, contracts should clearly define the rights and responsibilities of each party, including:<sup>2</sup>

- support, maintenance, and customer service;
- contract time frames;
- compliance with applicable laws, regulations, and regulatory guidance;
- training of financial institution employees;
- the ability to subcontract services;
- SLAs;
- information security and cybersecurity (including access controls);
- the distribution of any required statements or disclosures to the financial institution's customers;
- insurance coverage requirements; and
- terms governing the use of the financial institution's property, equipment, and staff.

In today's high-risk information security and cybersecurity environment, it is critical that contracts establish third-party vendors' responsibilities to meet or exceed specific cybersecurity standards or guidelines. SLAs can specify monitoring and audit processes, including performance measures for a financial institution to use to assess a third-party vendor's performance with respect to meeting cybersecurity and other performance expectations.

The institution's legal function has a critical role in defining its contractual requirements and writing and reviewing contracts. Compliance, audit, risk management, information security, and business continuity functions should also be involved in reviewing contracts. Unfortunately, examiners have seen contracts that have not been executed properly. This typically happens when an institution is under time constraints to change third-party vendors and needs to follow an aggressive conversion time frame to end the relationship with its previous vendor.

### **Incentive Compensation Review and Service-Level Agreements**

Institutions should consider if contract performance incentives might encourage third-party vendors to take imprudent risks. Inappropriately structured incentives may result in

<sup>2</sup> See SR letter 13-19.

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# Fintech: Balancing the Promise and Risks of Innovation

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But our excitement is tempered by our resolve to balance these promises by understanding and mitigating the risks of innovation. In certain terms, our goal is simple: to ensure that consumers are protected and that the safety and soundness of banks is maintained. Toward that end, the Federal Reserve System is fully analyzing fintech innovations and their impacts in different areas, including supervision, community development, financial stability, and payments. This effort aligns directly with our role in maintaining the stability of the financial system and containing systemic risk that may arise in financial markets.

In this article, I talk about these efforts and offer some thoughts about why bankers and supervisors should care about fintech.

## **Why Should Bankers Care About Fintech?**

The emergence of fintech has changed consumer expectations around the delivery and types of financial services. Consumers now expect to be able to complete a streamlined loan application online and receive a quick, if not almost immediate, response. They also appear to be embracing new ways to quickly transfer funds to other people, automatically move money to savings, and better manage their finances. As a result of these trends, banks are now feeling increased pressure to update and diversify their delivery mechanisms to stay competitive, particularly in the consumer and small business lending and payments channels.

A recent article in *Consumer Compliance Outlook* provides a good overview of four fintech market segments: credit; digital payments; savings, investments, and personal financial management; and distributed ledger technology.<sup>2</sup> These segments do not encompass the entire fintech landscape, but they are among the areas most likely to impact current banking practices.

In April 2016, I addressed a group of West Coast bankers and discussed many of the trends that we're seeing in fintech and

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<sup>2</sup> Tim Marder, "Fintech for the Consumer Market: An Overview," *Consumer Compliance Outlook*, Third Issue 2016, available at [consumercomplianceoutlook.org/assets/2016/third-issue/ccoi32016.pdf](http://consumercomplianceoutlook.org/assets/2016/third-issue/ccoi32016.pdf).

why bankers should take notice.<sup>3</sup> One rising trend is greater collaboration between banks and fintech firms, which can occur through investments, funding, or partnerships that range from loan originations to loan purchases to referral arrangements. We are also seeing bankers create fintech solutions or directly acquire fintech companies to complement their strategic goals.

We don't yet know which of the various efforts — acquisition, investment, or partnership models — will ultimately survive. But we do know that financial institutions and bankers collaborating with fintech firms must ensure they control for the risks associated with these new products, services, and third-party relationships. While incorporating innovation that is consistent with a bank's goals and risk tolerance, bankers will need to consider which model of engagement makes the most sense in light of their business model and risk management infrastructure, manage any outsourced relationships consistent with supervisory expectations,<sup>4</sup> and have strong fallback plans in place to limit the risks associated with products and partners that may not survive in this dynamic market.

Also, bankers should carefully consider timing issues when deciding to enter the fintech market. For example, early adoption carries the risk of committing to products and partners that may not survive, while waiting too long could mean losing customers and new business opportunities.

## **Why Do Bank Supervisors Care About Fintech?**

The discussions that I've had with my supervision colleagues across the Federal Reserve System reveal a strong interest in gaining a better understanding of fintech's potential and its related risks. For example, we see the opportunity to expand access to financial services, reach underserved customers, reduce transaction costs, provide greater transparency with

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<sup>3</sup> Teresa Curran, "Tailoring, Fintech, and Risk Culture: The Talk of the (Community Banking) Town," speech delivered to the Western Independent Bankers Annual Conference for Bank Presidents, Senior Officers & Directors, April 4, 2016, available at [tinyurl.com/zt4ve7g](http://tinyurl.com/zt4ve7g).

<sup>4</sup> See Supervision and Regulation letter 13-19/Consumer Affairs letter 13-21, "Guidance on Managing Outsourcing Risk," available at [www.federalreserve.gov/bankinforeg/srletters/sr1319.htm](http://www.federalreserve.gov/bankinforeg/srletters/sr1319.htm).

simpler products and clear cost disclosures, provide greater convenience and efficiency, and enable better control over spending and budgeting.

At the same time, we are concerned about the risks fintech may introduce to both financial institutions and their customers. Fintech has the ability to be a disruptive force, creating competitive pressures for banks in terms of speed, convenience, price, and maintaining customers. Also, fintech lending models raise several questions. How will the models perform over a full credit cycle? How are the requirements for the Bank Secrecy Act, information security, and customer privacy and data security managed, and by whom? And importantly, how is consumer protection ensured? It's conceivable that innovative algorithms, unintentionally or not, could enable new forms of discrimination or other unfair credit practices.

In the fintech speech I presented in April 2016, I told the bankers that our job, as supervisors, is to find an appropriate balance of oversight.<sup>5</sup> For example, as we develop relevant and applicable supervisory policies for fintech, we have to consider which existing regulations and guidance may be either appropriate or ill-suited to capture the set of risks that fintech poses to banks.

Bankers and supervisors alike need to learn more about fintech and develop appropriate strategies to capitalize on its benefits and mitigate its risks. Understanding and taking steps to ensure that a proper balance exists between the promise of innovation and the associated risks are key roles of bank supervisors, and we are committed to getting it right.

### What Are Bank Supervisors Doing About Fintech?

Most bank supervisors are taking a measured approach to consider the effect of supervision on fintech. Notable steps taken by other agencies to date include:

- The Consumer Financial Protection Bureau (CFPB) created Project Catalyst to facilitate consumer-friendly innovation;<sup>6</sup> it includes a “No-Action Letters” policy, finalized on February 18, 2016, to reduce regulatory

<sup>5</sup> See Curran, “Tailoring, Fintech, and Risk Culture: The Talk of the (Community Banking) Town.”

<sup>6</sup> Consumer Financial Protection Bureau, Project Catalyst, available at [www.consumerfinance.gov/about-us/project-catalyst](http://www.consumerfinance.gov/about-us/project-catalyst).

uncertainty for a new product or service that offers the potential for significant consumer-friendly innovation.<sup>7</sup>

- The Office of the Comptroller of the Currency (OCC) released the white paper “Recommendations and Decisions for Implementing a Responsible Innovation Framework” on October 26, 2016.<sup>8</sup>

*Editor’s note* — On December 2, 2016, the OCC announced a further step in its initiative to foster innovation by proposing to allow fintech companies to become chartered as special purpose national banks; see OCC, “OCC to Consider Fintech Charter Applications, Seeks Comment,” December 2, 2016, available at [tinyurl.com/ktd3huv](http://tinyurl.com/ktd3huv).

- The U.S. Department of the Treasury published the white paper “Opportunities and Challenges in Online Marketplace Lending” on May 10, 2016.<sup>9</sup>
- The U.S. Federal Trade Commission released the report *Big Data: A Tool for Inclusion or Exclusion? Understanding the Issues* on January 6, 2016.<sup>10</sup>
- The State of California’s Department of Business Oversight implemented the practice of offering prefiling meetings with its Money Transmitter Division staff to answer applicant questions with the goal of timely application processing.<sup>11</sup>
- The State of New York’s Department of Financial Services (NYDFS) created BitLicense for companies conducting virtual currency activities in June 2015.<sup>12</sup> The NYDFS has since issued four licenses.<sup>13</sup>

The Federal Reserve System is no different, and it has undertaken extensive efforts to study various technologies and their impact on financial services. Within the System, we have convened several high-level working groups that bring together the best thinkers across the Fed, including economists,

<sup>7</sup> Consumer Financial Protection Bureau, “CFPB Finalizes Policy to Facilitate Consumer-Friendly Innovation,” February 18, 2016, available at [tinyurl.com/zkd8px3](http://tinyurl.com/zkd8px3).

<sup>8</sup> Office of the Comptroller of the Currency, “Recommendations and Decisions for Implementing a Responsible Innovation Framework,” October 2016, available at [tinyurl.com/gwq8ck5](http://tinyurl.com/gwq8ck5).

<sup>9</sup> U.S. Department of the Treasury, “Opportunities and Challenges in Online Marketplace Lending,” May 10, 2016, available at [tinyurl.com/jezxwdn](http://tinyurl.com/jezxwdn).

<sup>10</sup> U.S. Federal Trade Commission, *Big Data: A Tool for Inclusion or Exclusion? Understanding the Issues*, January 2016, available at [tinyurl.com/zmjs3dg](http://tinyurl.com/zmjs3dg).

<sup>11</sup> California Department of Business Oversight, Money Transmitter Division, Money Transmission Act, available at [www.dbo.ca.gov/licenses/money\\_transmitters/default.asp](http://www.dbo.ca.gov/licenses/money_transmitters/default.asp).

<sup>12</sup> New York Department of Financial Services (NYDFS), Final BitLicense Regulatory Framework, available at [www.dfs.ny.gov/legal/regulations/bitlicense\\_reg\\_framework.htm](http://www.dfs.ny.gov/legal/regulations/bitlicense_reg_framework.htm).

<sup>13</sup> NYDFS, “DFS Grants Virtual Currency License to XRP II, LLC, an Affiliate of Ripple” (press release), June 13, 2016, available at [www.dfs.ny.gov/about/press/pr1606131.htm](http://www.dfs.ny.gov/about/press/pr1606131.htm).

payments specialists, supervisors, attorneys, and community development experts. These groups are tasked with understanding potential concerns and proposing solutions that support beneficial innovation.

The System is not alone in pursuing the goal of better understanding the implications of innovation in financial services. Supervisory agencies in other countries are grappling with the same issues, and we are monitoring developments abroad and considering potential best practices. Similarly, we are coordinating efforts with other domestic regulatory agencies to achieve consistency in our approaches.

Ultimately, our goal is to adopt an appropriate balance of oversight that acknowledges both the promise of innovation as well as its potential risks.

### What's Next?

The System intends to maintain an active dialogue with innovators, bankers, and other stakeholders to stay informed of developments in order to best fulfill its role of ensuring the safety and soundness of the nation's banking and financial system and protecting the rights of consumers. Part of that role is considering how to best mitigate risks to financial institutions' safety and soundness and ensure consumer protection. Since the stakes are generally higher in the area of financial services than in other areas of technological innovation, the System is working diligently to ensure transparency, create a strong compliance culture, and provide safeguards for consumers.

John Williams, the San Francisco Fed's president, expressed similar ideas in an April 2016 speech. He noted that "well-designed regulation that protects consumers, fosters inclusionary rather than exclusionary practices, and enhances the fairness and resilience of the financial system should help, rather than hinder fintech's contribution to creating a better financial system and economy."<sup>14</sup>

### Looking Forward

Given some of the lessons learned from the financial crisis about the importance of articulating a clear risk tolerance and the need for exercising sound management to limit risk, it is critical that financial institutions and fintech firms consider the long-term sustainability of the products and services they offer. This will come through continuous, thoughtful conversation on the right use of technology, its value to customers, and the relationships that are built along the way.

<sup>14</sup> See Williams, "Fintech."

Speaking of relationships, I am reminded about an article I wrote for *Community Banking Connections* in 2013,<sup>15</sup> in which I mention that community banks are most successful when they establish deep connections with their customers. The continued viability of the community banking model is in large measure dependent on these connections and the extraordinary service that community banks can offer their customers. Innovative use of technology to offer expanded and improved services is a natural development that we hope to see benefit both community bankers and their customers. It will be up to all of us — regulators and financial institutions alike — to do our respective parts to ensure that happens.

### Supporting media:

- Federal Reserve Bank of San Francisco 2015 Annual Report video, Transforming Financial Services, [www.frbsf.org/our-district/about/annual-report/annual-report-2015/transforming-financial-services](http://www.frbsf.org/our-district/about/annual-report/annual-report-2015/transforming-financial-services).

*The author would like to thank Tracy Basinger, Cynthia Course, Tim Marder, and Desmond Rice of the Federal Reserve Bank of San Francisco for their contributions to this article. ■*

### In Memoriam

**Teresa Curran, the author of this article, passed away in November after a heroic battle with a long illness. She served as executive vice president and director of the Financial Institution Supervision and Credit Division at the Federal Reserve Bank of San Francisco. Teresa was a highly respected leader who made significant contributions to the Federal Reserve System and its banking supervision function. She was passionate about the Federal Reserve's critical role in the economy, held strong regard for the importance of community banks, and was an expert on issues important to banking in Asia. Teresa is greatly missed by her many friends and colleagues throughout the Twelfth District and the Federal Reserve System.**

<sup>15</sup> Teresa Curran, "Considerations When Introducing a New Product or Service at a Community Bank," *Community Banking Connections*, First Quarter (2013), pp. 1, 8–11, available at [www.cbcsfs.org/articles/2013/Q1/Considerations-When-Introducing-A-New-Product](http://www.cbcsfs.org/articles/2013/Q1/Considerations-When-Introducing-A-New-Product).

# The Use of Evaluations in a Prudent Risk Management Framework for Real Estate Lending *continued from page 3*

protection (even with the advancement of new monies) or no advancement of new monies other than funds necessary to cover reasonable closing costs<sup>6</sup>

2. *Our bank does not have sufficient staff or does not have staff with the expertise to perform evaluations, so we just use appraisals.*

Bankers may feel that they are understaffed in the valuation function or that their employees do not have the level of expertise necessary to determine the value of the real estate. Community banks with limited staff resources may not be able to maintain a real estate valuation program that is independent from the lending function or the credit approval process. The bank personnel with the most knowledge about real estate are typically the bank's real estate lending officers. As such, a bank without sufficient internal expertise may need to hire an appraiser or another outside party to complete an evaluation and may not see much of a cost benefit between appraisal fees and the cost of an evaluation.

Although permitted, a state-certified or licensed appraiser is not required to prepare an evaluation. However, the important task of estimating collateral value should be given only to an individual with the knowledge, experience, or expertise relevant to the property being valued. The IAEG names several examples of individuals who may have the expertise to perform evaluations, including appraisers, real estate lending professionals, agricultural extension agents, and foresters (if applicable). In addition to these professionals, some institutions hire and train their own personnel to do evaluations or engage an appraisal management company or a third party to prepare evaluations. The use of a third party can address issues of cost and independence for some lenders.

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<sup>6</sup> As with any decision involving a credit extension, exemptions from the appraisal requirements should be applied appropriately based on the risk of the transaction. Policies and procedures developed by an institution should specify the conditions under which exemptions can be applied and should specify instances when it is more prudent to use an appraisal even if that may be over and above the regulatory requirements. The agencies reserve the right to require an institution to obtain an appraisal when safety and soundness concerns exist in regard to a particular transaction. Refer to 12 CFR part 225.63 (b). See also Appendix A, "Appraisal Exemptions," in SR letter 10-16, "Interagency Appraisal and Evaluation Guidelines."

3. *In the past, our bank used drive-by estimates or brokers' price opinions, but now we are unsure whether these estimates meet the agencies' requirements for an evaluation.*

Drive-by estimates or brokers' price opinions on their own do not meet the agencies' requirements for the content of an evaluation. The IAEG lists minimum content requirements for an evaluation; banks may establish criteria in addition to the requirements listed in the guidance. The most important concepts in evaluation development are that evaluations should be written, contain sufficient information to support the credit decision, and be developed in accordance with safe and sound banking practices.<sup>7</sup> There is no standard format or template for an evaluation as long as it contains the minimum content listed in the guidance. A second fundamental concept in evaluation development is that the institution understands the physical condition of the property. Institutions can develop their own criteria for achieving this level of understanding. Most often this comes in the form of a site visit and physical inspection. Banks may also use analytical methods or technological tools such as automated valuation models, brokers' price opinions, and perhaps one day even drones to assist in gaining an understanding of a property. These tools, however, do not stand on their own or replace the IAEG's content requirements for an evaluation.

4. *Our bank's personnel who perform evaluations often have problems finding recent comparable sales information; therefore, we just order appraisals.*

Valuation professional standards allow three approaches to valuing real estate: the sales comparison approach (compare the property with similar properties to determine the value), the cost approach (determine how much it would cost to rebuild the property after subtracting accrued depreciation), and the income approach (determine or calculate the market value of a property by the income it generates). Any of these methods can be used to estimate market value as part of an evaluation. An institution should use whatever method is

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<sup>7</sup> Refer to SR letter 10-16, "Interagency Appraisal and Evaluation Guidelines."

appropriate for the type of property being valued. For example, for new construction, the cost approach may be more appropriate than the sales comparison approach. Likewise, the income approach is more appropriate when estimating the value of income-producing properties. Individuals performing evaluations should be familiar with the approaches for valuing real estate and have experience using them. If the property being valued is so unique that suitable comparisons cannot be found, it may be more appropriate to engage an appraiser who has more comprehensive expertise or knowledge of alternative acceptable methods.

5. *We are not sure how long we can rely on an evaluation or when an appraisal is really needed.*

Monitoring collateral values over the life of a loan is one important element for controlling credit risk. Changes in market conditions can result in declines in the value of real estate collateral that jeopardize it as a source of loan repayment. Problems with collateral valuations can also result in an inadequate methodology for determining the allowance for loan and lease losses (ALLL) and the carrying value for other real estate owned (OREO). Examiners would question continued reliance on old appraisals or evaluations when there is inadequate support for the ALLL or the value of OREO.

Institutions should monitor changes in market conditions and test the validity of the evaluations used for subsequent transactions. The *IAEG* contains a list of factors to check when considering validity. Institutions should refresh values when the market conditions supporting appraisals or evaluations have changed or become volatile. A risk-focused approach to a particular transaction should determine if an appraisal is needed instead of an evaluation to address market volatility. Institutions that want to better utilize evaluations should have an overall real estate valuation program that encompasses standards and procedures for both appraisals and evaluations. Further, institutions should set clear expectations for valuations in their internal policies. A compliant real estate valuation program should address the following components of the *IAEG*:

- Maintain a system of adequate controls, verification, and testing to ensure that appraisals and evaluations provide credible market values

- Insulate the individuals responsible for ascertaining the compliance of the institution's appraisal and evaluation function from any influence by loan production staff
- Ensure the institution's practices result in the selection of appraisers and individuals who perform evaluations with the appropriate qualifications and demonstrate competency for the assignment
- Establish procedures to test the quality of the appraisal and evaluation review process
- Use, as appropriate, the results of the institution's review process and other relevant information as a basis for considering a person for a future appraisal or evaluation assignment
- Report appraisal and evaluation deficiencies to appropriate internal parties and, if applicable, to external authorities in a timely manner<sup>8</sup>

In addition to reviewing individual valuations during a loan review, examiners should also consider whether an institution's real estate valuation program complies with the agencies' appraisal regulations and the *IAEG*. Examiners commonly cite problems with both individual valuations and deficiencies in real estate valuation programs.

### Conclusion

An institution that wants to expand or underpin real estate lending activities with strong risk management should not move away from including evaluations. A bank should first consider the requirements of state appraisal laws that govern the use of a licensed or certified appraiser for estimating the market value of real property. A bank should also consider including experienced real estate valuation professionals on its real estate lending teams who understand lending and property values in the markets in which the bank does business. A bank may have personnel dedicated to completing evaluations or may use a third party. The process should also address the review of evaluations to promote compliance with the *IAEG*. If a real estate valuation program is managed properly and is compliant with the agencies' appraisal regulations and the *IAEG*, evaluations can contribute to the process of making sound credit decisions. Senior managers should consider incorporating evaluations into their bank's policies and procedures for real estate lending. ■

<sup>8</sup> Refer to SR letter 10-16, "Interagency Appraisal and Evaluation Guidelines."

# Considerations for Banks Thinking About Migrating to a Dot-Bank Domain Name *continued from page 5*

because names that might not have been available for a dot-com TLD could be available for a dot-bank TLD. If, for example, a bank's current web address is hard for customers to remember or is too similar to the web address of a competitor, the bank can change its subdomain name when it migrates to the dot-bank TLD.

## Costs

The fee to register for a dot-bank TLD varies among the short list of approved dot-bank registrars, but the average cost ranges between \$1,000 and \$2,000. Further, the enhanced security requirements for the dot-bank TLD will increase the operating costs for banks that are using that extension. Banks will also incur transitional costs, such as the cost to change the bank's URL wherever it appears (e.g., signage, documents, and marketing materials), the cost to notify and educate customers, and the cost to exhaustively test the new web address across all subdomains. Finally, banks will likely retain vendors in connection with the migration and operation of the dot-bank TLD. The time for completing the process on average takes approximately four to six months.

## Conclusion

The availability of the dot-bank TLD has prompted some banks to consider migrating their Internet addresses to this

TLD. As of March 2017, more than 40 percent of the banks and savings associations in the United States had completed registrations for the dot-bank TLD.

Banks should weigh the benefits (e.g., enhanced security and a broader choice of subdomain names) against the costs (e.g., fees for transitioning, testing, and maintaining the new domain name) before making any decision to migrate to the dot-bank TLD. ■

## Additional Resources fTLD Registry Services, LLC

- [www.register.bank](http://www.register.bank)  
This website offers a wealth of resources ranging from information about eligibility requirements to guides to leveraging a dot-bank domain to PR tools.
- [www.register.bank/faq](http://www.register.bank/faq)  
This web page addresses the most frequently asked questions about eligibility, registration requirements, costs, the verification process, security requirements, and more.



*FedLinks: Connecting Policy with Practice* is a single-topic bulletin prepared specifically for community banks and bank holding companies with total assets of \$10 billion or less. Each bulletin provides an overview of a key supervisory topic; explains how supervisory staff members typically address that topic; highlights related policies and guidance, if applicable; and discusses examination expectations as appropriate at community banks. *FedLinks* is not intended to establish new supervisory expectations beyond what is already set forth in existing policies or guidance, but rather to connect policy with practice.

By subscribing to *FedLinks* bulletins at [www.cbcrf.org/subscribe](http://www.cbcrf.org/subscribe), you will receive an e-mail notification when new bulletins become available.

# The Importance of Third-Party Vendor Risk Management Programs *continued from page 7*

reputational damage, increased litigation, or other risks to the financial institution.

An institution should include SLAs in its outsourcing contracts to specify and clarify performance expectations as well as to establish accountability. SLAs formalize the performance criteria that the institution will use to measure the quantity and quality of a third-party vendor's service. Management should closely monitor a third-party vendor's compliance with key SLAs.

## **Oversight and Monitoring**

An effective vendor oversight program can help ensure that third-party vendors deliver the quantity and quality of services required by the contract. The monitoring program should use effective techniques to target the key aspects of the outsourcing relationship. The institution's vendor oversight program should include a process for monitoring a third-party vendor's security control and financial strength as well as the potential impact of an external event on the third-party provider's ability to continue to fulfill its contractual obligations.

Because of the potential cybersecurity risk of external network connections, an institution should ensure that these connections are appropriately monitored and controlled. To improve and enhance monitoring effectiveness, management should periodically rank third-party vendor relationships according to their risk profile to determine which vendors require closer monitoring. Management should base the rankings on the residual risk of the relationship after analyzing the quantity of risk relative to the controls over those risks.

## **Business Continuity and Contingency Plans**

A financial institution's disaster recovery and business continuity plans should address critical outsourced services. In addressing outsourced services, an institution needs to assess the ability of these critical third-party vendors to implement their disaster recovery and business continuity plans as well as whether their recovery and business continuity plans align with the institution's plan. Therefore, an institution should understand all relevant third-party vendors' business conti-

nity requirements, incorporate those requirements within its own business continuity plan, and ensure that third-party vendors test their plans annually. Management should require third-party vendors to report all test results and to notify the institution after any business continuity plan modifications. The institution should integrate vendors' business continuity plans into its own plan, communicate roles and responsibilities to the appropriate personnel, and maintain and periodically review the combined plan.

Additionally, cyber resilience is crucial in today's high threat level environment because it reflects an institution's ability to prevent an impact from a cyberthreat or its ability to recover systems and processes following cyber-related incidents of all types and levels of impact. If cyber resilience is not properly managed, a financial institution's recovery from a cyber-related incident may be unnecessarily delayed, lead to financial and legal repercussions, or preclude an institution from recovering at all. This is why it is important to include a cyber event in business continuity training and testing, both with employees and an institution's third-party vendors.

## **Common Vendor Risk Management Program Weaknesses**

Examiners have observed the following weaknesses in institutions' vendor risk management programs:

- Insufficient oversight by the institution's board of directors
- Lack of a formal documented outsourcing policy
- Vague contract terms and requirements that lack specificity on a third-party vendor's performance or contract terms that favor the service provider or third-party vendor
- Third-party vendor performance reviews conducted by inexperienced institution personnel
- Inadequate disaster recovery tests between a third-party vendor and the institution as well as tests that do not address a possible cybersecurity event
- Information security and cybersecurity procedures of the third-party vendor that are not adequately reviewed and assessed by the institution
- Inappropriate risk rating by the institution of its critical third-party vendors

## Additional Considerations

The current regulatory guidance applies to outsourced activities beyond core bank processing and information technology-related services. Third-party vendors that an institution categorized as minor, lower-tier, lower-risk service providers several years ago may today pose greater risks similar to a major core processor. For example, an appraisal company or a loan collections recovery firm that has access to a financial institution's sensitive nonpublic data or networks can pose substantial risk if not properly managed. An effective vendor risk management program should be risk-focused and provide oversight and controls commensurate with the level of risk associated with the third-party vendor relationship.

surate with the level of risk associated with the third-party vendor relationship.

In summary, community banks should have a comprehensive outsourcing risk management process to govern their third-party vendor relationships. The process should include risk assessment, selection of third-party vendors, contract review, and monitoring of the performance of third-party vendors. Third-party vendors should be subject to the same risk management, security, privacy, and other policies that would be expected if an institution were conducting the activities in-house. ■

## Additional Resources

*Federal Financial Institutions Examination Council (FFIEC) IT Examination Handbook InfoBase*, available at [ithandbook.ffiec.gov/it-booklets.aspx](http://ithandbook.ffiec.gov/it-booklets.aspx).

*FFIEC IT Examination Handbook InfoBase: Outsourcing Technology Services*, June 2004, available at [ithandbook.ffiec.gov/it-booklets/outsourcing-technology-services.aspx](http://ithandbook.ffiec.gov/it-booklets/outsourcing-technology-services.aspx).

SR letter 16-14, "*FFIEC Information Technology Examination Handbook — Information Security Booklet*," September 19, 2016, available at [www.federalreserve.gov/bankinforeg/srletters/sr1614.htm](http://www.federalreserve.gov/bankinforeg/srletters/sr1614.htm).

SR letter 16-11, "*Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets Less Than \$50 Billion*," June 8, 2016, available at [www.federalreserve.gov/bankinforeg/srletters/sr1611.htm](http://www.federalreserve.gov/bankinforeg/srletters/sr1611.htm).

SR letter 13-19/Consumer Affairs (CA) letter 13-21, "*Guidance on Managing Outsourcing Risk*," December 5, 2013, available at [www.federalreserve.gov/bankinforeg/srletters/sr1319.htm](http://www.federalreserve.gov/bankinforeg/srletters/sr1319.htm).

SR letter 13-1/CA letter 13-1, "*Supplemental Policy Statement on the Internal Audit Function and Its Outsourcing*," January 23, 2013, available at [www.federalreserve.gov/bankinforeg/srletters/sr1301.htm](http://www.federalreserve.gov/bankinforeg/srletters/sr1301.htm).

SR letter 12-14, "*Revised Guidance on Supervision of Technology Service Providers*," October 31, 2012, available at [www.federalreserve.gov/bankinforeg/srletters/sr1214.htm](http://www.federalreserve.gov/bankinforeg/srletters/sr1214.htm).

SR letter 03-5, "*Amended Interagency Guidance on the Internal Audit Function and Its Outsourcing*," April 22, 2003, available at [www.federalreserve.gov/boarddocs/srletters/2003/sr0305.htm](http://www.federalreserve.gov/boarddocs/srletters/2003/sr0305.htm).

## Supervision & Regulation (SR) & Consumer Affairs (CA) Letters

The following SR and CA letters that have been published since the last issue (and are listed by most current) apply to community banking organizations. Letters that contain confidential supervisory information are not included. All SR letters are available by year at [www.federalreserve.gov/bankinforeg/srletters/srletters.htm](http://www.federalreserve.gov/bankinforeg/srletters/srletters.htm) and by topic at [www.federalreserve.gov/bankinforeg/topics/topics.htm](http://www.federalreserve.gov/bankinforeg/topics/topics.htm). A complete list of CA letters can be found at [www.federalreserve.gov/bankinforeg/caletters/caletters.htm](http://www.federalreserve.gov/bankinforeg/caletters/caletters.htm).

**SR Letter 17-2**, “Updates to the Expanded Examination Cycle for Certain State Member Banks and U.S. Branches and Agencies of Foreign Banking Organizations”

**SR Letter 16-19**, “Frequently Asked Questions on Current Expected Credit Losses Methodology (CECL)”

**SR Letter 16-18**, “Procedures for a Banking Entity to Request an Extended Transition Period for Illiquid Funds”

**SR Letter 16-17**, “Supervisory Expectations for Risk Management of Reserve-Based Energy Lending Risk”

**SR Letter 16-16/CA Letter 16-7**, “Special Post-Employment Restriction for Senior Examiners”

**SR Letter 16-15**, “Exception to Appraisal Regulation Requirements in Areas Affected by Flooding in Louisiana”

**SR Letter 16-14**, “*FFIEC Information Technology Examination Handbook* — Information Security Booklet”

**SR Letter 16-13**, “Imposition of Special Measures by the U.S. Department of the Treasury’s Financial Crimes Enforcement Network (FinCEN)”

**CA Letter 16-8**, “Uniform Interagency Consumer Compliance Rating System”

**CA Letter 16-6**, “Revised Interagency Military Lending Act Examination Procedures”

**Chair Janet L. Yellen gave her semiannual Monetary Policy Report to Congress before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, on February 14, 2017.** The report is available at [www.federalreserve.gov/newsevents/testimony/yellen20170214a.htm](http://www.federalreserve.gov/newsevents/testimony/yellen20170214a.htm).

**The Board of Governors of the Federal Reserve System (Board) finalized a rule adjusting the Board's maximum civil money penalties, as required by law.** In November 2015, a law was passed that requires all federal agencies to adjust their maximum civil money penalty limits annually rather than every four years as previously required. The final rule increases the maximum civil money penalty limits for 2017 by the amount required by law. The new penalty amounts apply as of January 15, 2017. The press release, which was issued on January 18, 2017, is available at [www.federalreserve.gov/newsevents/press/bcreg/20170118a.htm](http://www.federalreserve.gov/newsevents/press/bcreg/20170118a.htm).

**The federal banking agencies announced the annual adjustment to the asset-size thresholds used to define small bank, small savings association, intermediate small bank, and intermediate small savings association under the Community Reinvestment Act (CRA) regulations.** Financial institutions are evaluated under different CRA examination procedures based upon their asset-size classification. Those meeting the small and intermediate small institution asset-size thresholds are not subject to the reporting requirements applicable to large banks and savings associations unless they choose to be evaluated as a large institution. The press release, which was issued on December 29, 2016, is available at [www.federalreserve.gov/newsevents/press/bcreg/20161229a.htm](http://www.federalreserve.gov/newsevents/press/bcreg/20161229a.htm).

**The federal banking agencies finalized the rule expanding the number of banks and savings associations qualifying for an 18-month examination cycle.** The Federal Deposit Insurance Corporation, the Board, and the Office of the Comptroller of the Currency (OCC) issued interagency final rules that increase the number of small banks and savings associations eligible for an 18-month examination cycle rather than a 12-month cycle. The interagency rules are intended to reduce regulatory compliance costs for smaller institutions while maintaining safety and soundness protections. These rules have been in effect since February 29, 2016, pursuant to the interim final rules previously adopted by the agencies. The press release, which was issued on December 12, 2016,

is available at [www.federalreserve.gov/newsevents/press/bcreg/20161212a.htm](http://www.federalreserve.gov/newsevents/press/bcreg/20161212a.htm).

**The Board issued for comment a proposal to fully apply the Board's existing rating system for bank holding companies to savings and loan holding companies.** The press release, which was issued on December 9, 2016, is available at [www.federalreserve.gov/newsevents/press/bcreg/20161209a.htm](http://www.federalreserve.gov/newsevents/press/bcreg/20161209a.htm).

**Governor Lael Brainard gave a speech at the Conference on Financial Innovation in Washington, D.C., on December 2, 2016.** Her speech on "The Opportunities and Challenges of Fintech" is available at [www.federalreserve.gov/newsevents/speech/brainard20161202a.htm](http://www.federalreserve.gov/newsevents/speech/brainard20161202a.htm).

**Governor Daniel K. Tarullo gave a speech at the 2016 Financial Stability Conference, which was hosted by the Federal Reserve Bank of Cleveland and the Office of Financial Research.** The conference was held in Washington, D.C., on December 2, 2016. Governor Tarullo's speech on "Financial Regulation Since the Crisis" is available at [www.federalreserve.gov/newsevents/speech/tarullo20161202a.htm](http://www.federalreserve.gov/newsevents/speech/tarullo20161202a.htm).

**The Consumer Financial Protection Bureau (CFPB), the Board, and the OCC issued a final rule detailing the method that will be used to make annual inflation adjustments to the threshold for exempting small loans from special appraisal requirements.** The press release, which was issued on November 23, 2016, is available at [www.federalreserve.gov/newsevents/press/bcreg/20161123c.htm](http://www.federalreserve.gov/newsevents/press/bcreg/20161123c.htm).

**The Board and the CFPB issued a final rule detailing the method that will be used to adjust the thresholds for exempting certain consumer credit and lease transactions from the Truth in Lending Act and Consumer Leasing Act.** The press release, which was issued on November 23, 2016, is available at [www.federalreserve.gov/newsevents/press/bcreg/20161123b.htm](http://www.federalreserve.gov/newsevents/press/bcreg/20161123b.htm).

**The Board issued a final rule that amends Regulation I to implement provisions of the Fixing America's Surface Transportation Act, which reduces the dividend rate applicable to Reserve Bank depository institution stockholders with total assets of more than \$10 billion to the lesser of 6 percent or the most recent 10-year Treasury**

**auction rate prior to the dividend payment.** The press release, which was issued on November 23, 2016, is available at [www.federalreserve.gov/newsevents/press/bcreg/20161123a.htm](http://www.federalreserve.gov/newsevents/press/bcreg/20161123a.htm).

**Chair Janet L. Yellen appeared before the Joint Economic Committee, U.S. Congress, to testify on the economic outlook.** The hearing was held on November 17, 2016. Her testimony is available at [www.federalreserve.gov/newsevents/testimony/yellen20161117a.htm](http://www.federalreserve.gov/newsevents/testimony/yellen20161117a.htm).

**Five federal regulatory agencies had requested comment on a joint notice of proposed rulemaking to implement provisions of the Biggert–Waters Flood Insurance Reform Act that require regulated lending institutions to accept certain private flood insurance policies in addition to policies made available by the Federal Emergency Management Agency.** The agencies previously issued a proposal addressing private flood insurance (78 FR 65107). Based on comments received in response to that proposal, the agencies have decided to issue this second proposal for additional public comment. The press release for the second proposal, which was issued on October 31, 2016, is available at [www.federalreserve.gov/newsevents/press/bcreg/20161031a.htm](http://www.federalreserve.gov/newsevents/press/bcreg/20161031a.htm).

**The Board announced the annual indexing of two amounts used in determining reserve requirements of depository institutions: the reserve requirement exemption amount and the low reserve tranche.** The press release, which was issued on October 27, 2016, is available at [www.federalreserve.gov/newsevents/press/bcreg/20161027a.htm](http://www.federalreserve.gov/newsevents/press/bcreg/20161027a.htm).

**The Board approved the fee schedules, effective January 3, 2017, for payment services the Reserve Banks provide to depository institutions (priced services).** The press release, which was issued on October 25, 2016, is available at [www.federalreserve.gov/newsevents/press/other/20161025a.htm](http://www.federalreserve.gov/newsevents/press/other/20161025a.htm).

**Four federal financial institution regulatory agencies issued an exception from the appraisal requirements for real estate-related financial transactions in the parishes declared to be in a major disaster area due to the severe storms and flooding in Louisiana.** The agencies will not require financial institutions to obtain appraisals for affected

transactions for the time period specified if certain conditions are met. The press release, which was issued on October 24, 2016, is available at [www.federalreserve.gov/newsevents/press/bcreg/20161024b.htm](http://www.federalreserve.gov/newsevents/press/bcreg/20161024b.htm).

**Governor Jerome H. Powell gave a speech at the Community Banking in the 21st Century Fourth Annual Community Banking Research and Policy Conference.** The conference was sponsored by the Federal Reserve System and the Conference of State Bank Supervisors and was held in St. Louis, MO, on September 29, 2016. His speech on “Trends in Community Bank Performance over the Past 20 Years” is available at [www.federalreserve.gov/newsevents/speech/powell20160929a.htm](http://www.federalreserve.gov/newsevents/speech/powell20160929a.htm).

**Chair Janet L. Yellen gave brief remarks at Banking and the Economy: A Forum for Minority Bankers.** The forum was sponsored by the Federal Reserve Bank of Kansas City and was held in Kansas City, MO, on September 29, 2016. Chair Yellen’s remarks are available at [www.federalreserve.gov/newsevents/speech/yellen20160929a.htm](http://www.federalreserve.gov/newsevents/speech/yellen20160929a.htm).

**Chair Janet L. Yellen appeared before the Committee on Financial Services, U.S. House of Representatives, to testify on supervision and regulation.** The hearing was held on September 28, 2016. Chair Yellen’s testimony is available at [www.federalreserve.gov/newsevents/testimony/yellen20160928a.htm](http://www.federalreserve.gov/newsevents/testimony/yellen20160928a.htm).

**The Board announced the members of its Community Depository Institutions Advisory Council (CDIAC) and the president and vice president of the council for 2017.** CDIAC advises the Board on the economy, lending conditions, and other issues of interest to community depository institutions. Members are selected from representatives of commercial banks, thrift institutions, and credit unions serving on local advisory councils at the 12 Reserve Banks. One member of each of the Reserve Bank councils serves on CDIAC, which meets twice a year with the Board in Washington, D.C. Further information about CDIAC can be found at [www.federalreserve.gov/aboutthefed/cdiac.htm](http://www.federalreserve.gov/aboutthefed/cdiac.htm). The press release announcing the 2017 CDIAC members, which was issued on August 9, 2016, is available at [www.federalreserve.gov/newsevents/press/other/20160809a.htm](http://www.federalreserve.gov/newsevents/press/other/20160809a.htm).

The five federal agencies adopted a final rule exempting certain commercial and financial end users from margin requirements for certain swaps not cleared through a clearinghouse. The final rule exempts from the agencies' margin requirements the noncleared swaps of commercial end users, small banks, savings associations, Farm Credit System institutions, and credit unions with \$10 billion or less in total assets. The press release, which was issued on August 1, 2016, is available at [www.federalreserve.gov/newsevents/press/bcreg/20160801b.htm](http://www.federalreserve.gov/newsevents/press/bcreg/20160801b.htm).

The Board announced the adoption of changes to part II of the Federal Reserve Policy on Payment System Risk (PSR policy) to conform with enhancements to the Reserve Banks' same-day automated clearinghouse service previously announced by the Board on September 23, 2015. The Board's PSR policy establishes the procedures, referred to as posting rules, for the settlement of credits and debits to institutions' Federal Reserve accounts for different payment types. The press release, which was issued on July 21,

2016, is available at [www.federalreserve.gov/newsevents/press/other/20160721a.htm](http://www.federalreserve.gov/newsevents/press/other/20160721a.htm).

The federal bank regulatory agencies with responsibility for CRA rulemaking published final revisions to "Interagency Questions and Answers Regarding Community Reinvestment." The document provides additional guidance to financial institutions and the public on the agencies' CRA regulations. The press release, which was issued on July 15, 2016, is available at [www.federalreserve.gov/newsevents/press/bcreg/20160715a.htm](http://www.federalreserve.gov/newsevents/press/bcreg/20160715a.htm).

The Board extended until July 21, 2017, the conformance period for banking entities to divest ownership in certain legacy investment funds and terminate relationships with funds that are prohibited under section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, commonly known as the Volcker Rule. The press release, which was issued on July 7, 2016, is available at [www.federalreserve.gov/newsevents/press/bcreg/20160707a.htm](http://www.federalreserve.gov/newsevents/press/bcreg/20160707a.htm).

## Community Banking in the 21st Century

Research and  
Policy Conference



### Call for Papers

The Federal Reserve System and the Conference of State Bank Supervisors welcome submissions for the 2017 Community Banking in the 21st Century research and policy conference. The conference committee is seeking papers that explore all aspects of community banking, including but not limited to the role of community banks in the U.S. financial system, advantages and disadvantages of the community bank business model, the effects of government policy on community banks, significant challenges faced by community banks, and new opportunities for community banks. The conference will be held on October 4 and 5, 2017, at the Federal Reserve Bank of St. Louis. **The deadline is June 16. Papers should be submitted via e-mail to [conference@communitybanking.org](mailto:conference@communitybanking.org).**

For more information, visit [www.communitybanking.org](http://www.communitybanking.org).

# Connect with Us

What banking topics concern you most? What aspects of the supervisory process or the rules and guidance that apply to community banks would you like to see clarified? What topics would you like to see covered in upcoming issues of *Community Banking Connections*?

With each issue of *Community Banking Connections*, we aim to highlight the supervisory and regulatory matters that affect you and your banking institution the most, providing examples from the field, explanations of supervisory policies and guidance, and more. We encourage you to contact us with any ideas for articles so that we can continue to provide you with topical and valuable information.

Please direct any comments and suggestions to [www.cbfrs.org/feedback.cfm](http://www.cbfrs.org/feedback.cfm), or send an e-mail to [editor@communitybankingconnections.org](mailto:editor@communitybankingconnections.org).

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VIEW FROM THE DISTRICT  
A Twelfth District Perspective — San Francisco

**Fintech: Balancing the Promise and Risks of Innovation**  
by Teresa Curran, Executive Vice President and Director, Financial Institution Supervision and Credit, Federal Reserve Bank of San Francisco

One of the hottest topics I am often asked about today is financial technology or fintech, as it is widely known. Fintech is a broad term, but at its core, it refers to the use of technology to better deliver banking products and services. These services could be in the form of lending platforms, payment processes, investments and savings, block-chains, digital currencies, or a host of other areas. In all of these sectors, fintech has the potential to transform financial products and services for consumers and small businesses.



Teresa Curran

Think about it. Consumers can now use their smartphones and other mobile devices to manage their money, transfer funds, or obtain a loan. This type of accessibility has altered their expectations and demands about when and how they should be able to conduct financial transactions. In my view, the expectation for an on-demand experience is just one of the permanent changes driving today's innovation.

At the San Francisco Fed, with its proximity to Silicon Valley and the many new fintech firms nearby, the emergence of innovative technology has captured our attention. Some of the latest innovations offer consumers convenience, speed, and reliability, and provide banks the ability to access and analyze big data quicker and sometimes cheaper than ever before. Other innovations can address some of the financial system's long-standing challenges, including the ability to facilitate direct payments between buyers and sellers and to direct households' and businesses' savings to their most productive uses, such as building homes, expanding businesses, or obtaining an education.<sup>1</sup>

<sup>1</sup> John C. Williams, "Fintech: The Power of the Possible and Potential Pitfalls," speech delivered at the LendIt USA 2016 conference, April 12, 2016, available at [myurl.com/fintech/](http://myurl.com/fintech/).  
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