Ask The Fed®

Regional Banking: Beyond Examinations
Transitioning to Regional Bank Organization (RBO) Supervision

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Carl: Good afternoon, everyone, and welcome to Ask the Fed®. My name is Carl White. I am the senior vice president over Supervision at the St. Louis Reserve Bank. Today, we're joined by the Regional Banking Supervision Outreach Group for the first session of a new series that we're really excited about entitled "Regional Banking: Beyond Examinations."

So, before we get started, let's go over some logistics regarding today's call. So, on Slide 2, I just want to let you know that the best experience is if you're joining us through the webinar and then through the webinar audio. Some of you who—you may be calling in via phone and then maybe watching the webinar on a screen, you may notice just a slight delay, so one suggestion is to download the presentation and then go through it as you see the speakers advance the slides.

Also, please note that you can access the presentation slides right in the webinar tool under Materials or at our website, www.AskTheFed.org. As always, we do record every single Ask the Fed® call, and you can go back and listen to the recording at your convenience after the session at that same website. We have received a few questions already, but you can certainly still submit questions using either the Ask Question button also right there in the webinar, or you can send us an email at questions@AskTheFed.org.

This Ask the Fed® session is eligible for continuing professional education credits. So, during today's session, you're going to be required to participate in all three polling questions, and then you're going to need to complete the last section of the online survey, and we'll send that out right after the session's over. So, you do both those things, and you'll be eligible for CPEs.

And finally, a reminder: The opinions expressed in the presentations are statements of the speaker's opinion. They're intended only for informational purposes and are not formal opinions of—nor binding on—any Federal Reserve Bank or the Board of Governors of the Federal Reserve System.

Okay. So, let's get started. So, first of all, I'd like to welcome our presenters today. They're represented from a couple Reserve Banks. So, first from the East Coast and from the Richmond Fed, we have community and regional bank Safety and Soundness examiners Matt

Turner and also Elizabeth Keenan. And then from the West Coast, representing the San Francisco Fed, we have senior manager Richard Perisie. He's from the Supervision and Credit function, as I said, from the San Francisco Fed Supervision area. So, we're going to jump to Slide 3, and we're going to get started. I'm going to turn it over to Matt and let you take it from there.

Matt Turner: Great. Good afternoon and thank you to Carl. So, again, my name is Matt Turner. I'm a member of the regional bank supervision team at the Richmond Fed. On behalf of Regional Bank Supervision Outreach Group and my colleagues from around the Federal Reserve System, I want to welcome you to the launch of Regional Banking: Beyond Examinations, a brand-new industry outreach series which will primarily curate topics and programming for our regional-sized firms or as commonly referred to by us and in the industry as regional banking organizations, or RBOs.

At the Fed, supervised financial institutions with total assets between $10 and $100 billion are supervised as part of the RBO supervision program. Some of the nuances of the regional bank supervision approach are a key component of today's session, Transitioning to RBO Supervision. For today, we've extended the invitation to firms of all sizes through our friends at Ask the Fed® for a few reasons.

So, whether your firm is anticipating a transition to RBO supervision, in the midst of a transition, or has been supervised by the Fed within the RBO supervision program for a few years now, we do think that today's content will provide some value to you and your firm. You're also probably hearing more from the Fed about our commitment to provide technical assistance to our supervised firms. The Regional Banking: Beyond Examination series is one such effort in support of that commitment focusing specifically on RBOs.

We also hope you'll take a few minutes after the session today to provide us some feedback, including where else you'd like for us to invest in technical assistance resources, whether that be additional programming, learning content, or other needs. For supervised RBOs, please also be on the lookout for future communications from the Regional Bank Supervision Outreach Group. This is the primary way we plan to communicate important and relevant information to supervised firms, including alerts on future programming and resources for RBOs. Of course, all RBOs will continue to receive important information through their dedicated central point of contact and/or supervisory team within their local district.

Let's go to Slide 4, the discussion agenda. So, we're going to spend the next 40 minutes or so making sure that you can walk away from this presentation with some information that you can share with your management team, prepare you for some of the critical changes ahead as your firm approaches $10 billion in assets, and inform your discussions and plans to address the common challenges experienced when firms reach this size, of all the complexity of the business model, and start being supervised under the RBO supervision framework.

My colleagues and I are going to key in on the main things that firms will want to consider before and after becoming an RBO. They include changes to the regulatory framework and supervision model from that of a community bank organization—or CBO, as we call them, enhanced expectations with respect to internal audit, and maturation of risk management and corporate governance practices.

We're going to reference some critical supervisory guidance, but today's presentation is really about being transparent with common challenges and highlighting best practices and what my fellow presenters and I feel are keys to success. We'll also leave some time towards the end of this presentation to answer any questions you have for us.

So, joining me today are Liz Keenan from the Richmond Fed and Richard Perisie from the Federal Reserve Bank of San Francisco. Both Liz and Richard have many years of experience supervising both community and regional-size organizations, including serving as a dedicated central point of contact for firms in their respective districts.

With introductions out of the way, I think Carl's going to kick us off with our first polling question before we hand it off to Liz Keenan.

Carl White: Great. Thanks, Matt. So, yes, as Matt said, we do have our first polling question, so I'll go ahead and read it and give you the options. So, across the entire portfolio of financial institutions, which portfolio do you think has grown at the fastest rate in recent years? And your choices are:

A – community bank organizations, and just so you know, those are those under $10 billion in consolidated assets, otherwise known as CBOs;
B – RBOs, which is exactly what we're talking about today and why you're on the call;
C – the large banking organization portfolio, LBOs, and those are with greater than $100 billion in consolidated assets; or
D – unsure.

So, while we wait for the results, I do want to remind you all that if you want to earn those CPE credits, you need to answer all three of the polling questions. This is the first of three, and then you'll also need to complete the survey that we'll send out at the end of the presentation. So, as we wait for those results, go ahead and vote. Once again, A is CBO, B – RBO, C is the LBO portfolio, or D – unsure. So, we'll get those results here in just a second before we continue the presentation. I will say that I have several RBO institutions in my portfolio, so very interested in the results here.

So, here we go. So, for CBO, the smaller institutions, less than $10 billion, 18% thought that those grew at the fastest rate; 73% selected RBOs—very interesting; and then LBOs – 6%; Unsure – 3%. So, let me turn it over to Liz, and I don't know if you have any reaction to those results, Liz, but she's going to cover the next several slides. So, Liz, I'll turn it over to you.

Liz Keenan: Thanks, Carl. Yes. I think most of the audience maybe kind of guessed why we're doing this session today. So, I will cover Slide 6 to 11, which provide an overview of regional banking supervision and key differences from community banking supervision. As noted in the polling question, the regional bank portfolio includes financial institutions with assets of $10 to $100 billion, and yes, this is the fastest-growing portfolio supervised by the Federal Reserve System, which is a key reason for why we wanted to hold this session today.

Regional banks play a key role in serving the financial needs of local communities, which was especially evident during the coronavirus pandemic and implementation of the Paycheck Protection Program. Furthermore, regional banks provide a bridge to more complex services and lending arrangements and play a key role in supporting growing small businesses.

As of mid-April, the Federal Reserve supervises 102 regional banking organizations, with aggregate assets of approximately $2.6 trillion. Year to date, the RBO portfolio has experienced a net increase of 21 firms, largely due to the expiration of the Temporary Asset Threshold Relief at year-end 2021. For more context, the majority of RBOs are institutions with consolidated assets between $10 and $25 billion.

The slide provides a breakdown of the Federal Reserve's regional banking portfolio by the lead bank's charter. The Federal Reserve is the primary federal regulator for the 29 state member banks and also the primary federal regulator for all holding companies. As we'll discuss in more detail later, the Federal Reserve works closely with the FDIC and OCC when those agencies are the primary federal regulator of the subsidiary bank of an RBO holding company.

Turning to Slide 7: As a financial institution supervised by the Federal Reserve approaches the $10 billion asset threshold, the Federal Reserve will increase its engagement with firm management to prepare for the transition. While there is some flexibility for when the Federal Reserve officially considers an institution an RBO, generally, it occurs within six months of first reporting $10 billion or more in assets. This six-month timeframe is fitting, since the FDIC begins quarterly large insured depository insurance, or LIDI assessments, after a bank reports two consecutive quarters over $10 billion. LIDIs utilize those internal and regulatory reporting to support insurance assessments and determines the bank's insurance expense.

The Consumer Financial Protection Bureau, or the CFPB, gains statutory oversight of banks with assets of $10 billion and will assign a dedicated contact who performs routine monitoring. However, we've typically found that there is a transition period in oversight as the CFPB gets to know both the bank and primary regulators. Also, once an RBO is subject to CFPB supervision, then the CFPB receives a 30-day review period for all Federal Reserve-prepared reports that issue a supervisory rating.

Some additional regulatory requirements for management teams to factor include Regulation II, or the Durbin amendment, which limits debit interchange fees as well as expanded regulatory reporting line items on Call Reports and Y9s. The impact of these requirements varies by firm, though. In addition, Slide 7 highlights that many regulations apply to firms in all supervisory portfolios, such as the Bank Secrecy Act. It also notes, though, that the Dodd-Frank Act stress testing—or commonly referred to as DFAS—requirements were eliminated in 2019.

Slide 8 provides a visual of the Federal Reserve's and CFPB's consumer compliance authority for banks over $10 billion. The Federal Reserve and CFPB work together to regulate RBOs and coordinate efforts to the extent possible. It is important to note that while the CFPB gains oversight of some consumer compliance areas, the primary federal regulator retains oversight of several areas, including the Fair Housing Act, Flood, and Community Reinvestment Act.

Moving to Slide 9: The regulatory approaches for both regional and community bank organizations are risk focused, as both leverage financial reporting and existing knowledge of the institution. While there are similarities between community and regional bank supervision, it is implemented differently. Supervision of RBOs relies more heavily on a central point of contact as well as on more detailed risk assessments and tailored supervisory plans. These supervisory plans outline the annual objectives and schedules for targeted and full-scope events. In addition, regional supervision includes continuous monitoring throughout the annual supervisory cycle. In comparison, for community banks, risk assessments are updated less frequently, and our supervisory work generally centers around one point in time examination or inspection.

I'll begin with our approach to regional bank supervision, where the lead bank is not a state member bank. For these firms, the central point of contact coordinates with the primary regulator to leverage pertinent information in an effort to reduce regulatory burden. The supervisory plan will factor the complexity and financial condition of the institution as well as the primary regulator's bank examination schedule. Reserve Banks are required to perform one full-scope holding company inspection every 12 months, frequently referred to as the roll-up, and will often participate on a target event with the primary federal regulator for material areas related to the holding company, such as internal audit.

The central point of contact also performs continuous monitoring throughout the supervisory cycle, which includes reviewing internal MIS and packages, assessing regulatory and financial reporting, and conducting meetings with management and other regulators. I'll come back to that in a minute.

As you'd expect, when the subsidiary bank of an RBO is a state member bank, the Federal Reserve conducts additional events throughout the supervisory cycle. For instance, two asset quality targets are generally expected per supervisory cycle in addition to an annual roll-up event that issues supervisory ratings. Stand-alone specialty targets, such as information technology, will likely occur but vary based on the complexity and condition of the firm.

Advancing to Slide 10: As noted earlier, there is also continuous monitoring performed throughout the year, which enables increased interaction between management teams and the central point of contact. RBOs submit quarterly request items such as board and committee packages through the Federal Reserve's Supervision Central platform. Common examples of continuous monitoring activities include conducting quarterly meetings with management and other regulators, analyzing internal MIS on key risks, and reviewing audit committee packages and reports throughout the year. These activities may at times result in the identification and discussion of potential regulatory concerns outside of supervisory events, which actually some RBO management teams consider a benefit of the continuous supervision model.

We recognize that regional supervision is a change for management teams, and central points of contacts are a great resource to help along the way. A best practice is for the firm to either identify a process owner for continuous monitoring document submissions or develop and implement a coordinated process with all stakeholders. We also encourage management teams to ask questions throughout the transition phase and establish communication preferences with their central point of contact.

Turning to Slide 11: Another key difference between CBO and RBO exams is the loan coverage requirements for state member banks. For CBOs, examiner loan coverage is generally a statistical sample ranging from 20% to 40% coverage of total commercial and industrial and commercial real estate loans. Loan file review is generally performed at one full-scope event.

For state member bank RBOs, SR Letter 14-4 outlines expectations for two asset-quality targets per annual supervisory cycle. In addition, the loan sample will obtain at least 10% coverage of the four largest commercial loan segments. As a result, each credit target will often focus on one or two material commercial loan segments as well as a material retail loan segment or areas of emerging risk. Given the multiple credit targets in each supervisory cycle, expect that credit risk management practices and loan-review functions will be reviewed often.

Matt will discuss the importance of establishing strong first and second lines later, but I will highlight here that building a comprehensive internal loan-review program that assesses both credit risk rate accuracy and risk management practices definitely benefits growing RBO firms. For institutions with a satisfactory to strong internal loan-review function, central points of contacts will leverage internal loan-review work and conclusions when possible.

We hope this overview of RBO supervision was helpful in establishing a baseline understanding of the regulatory oversight for RBOs. My colleague Richard will discuss the increased internal audit expectations of an RBO, since this is a common area of focus for new RBOs. But before I hand it off to him, let's go to Carl for another polling question.

Carl White: Thanks, Liz, and yes, we're going to move to that second polling question, and given the next topic, it is going to be focused on audit.

So, the next question is: When firms conduct an audit gap assessment, which is referenced in SR Letter 13-1, where are the biggest gaps? Your choices are

A – risk assessment/audit planning,
B – audit staffing and leadership,
C – audit committee oversight,
D – all of the above, or
E – unsure.

And that SR letter—or Supervision and Regulation letter, you can see that referenced at the back of the presentation under additional resources. That's our policy statement specifically on internal audit and outsourcing. So, once again, your choices are A – risk assessment/audit planning, B – audit staffing and leadership, C – audit committee oversight, D – all of the above, or E – unsure. And we'll wait for those results, and those should be popping up any second. Don't forget, this is polling question number two out of three, so we have one more to go.

And here's the results. So, A – risk assessment and audit planning received 31% of the votes, audit staffing and leadership at 11%, audit committee oversight at 4%, and all of the above – 47%, while unsure is 6%. All right. So, I'm going to move it on to Richard, who's going to cover audit, and see if he has any reaction to these results. So, Richard, I'll turn it over to you.

Richard Perisie: Great. Thanks, Carl. I'm glad to see the 40% all of the above. I think these are all areas that I'm going to focus on over the next couple slides. So, Liz provided a great overview of the RBO supervisory framework. Here—we're now on Slide 13—I'm going to go into further detail on one specific area we evaluate, namely the internal audit function, sometimes referred to as the organization's third line of defense, as this is an area we have seen organizations experience some early challenges when transitioning to the RBO portfolio.

So, once an organization crosses over the $10 billion threshold, SR 13-1, "Supplemental Policy Statement on the Internal Audit Function and Its Outsourcing," becomes applicable. This policy statement includes a number of enhanced audit practices, as you can see on this slide. But before I delve in deeper into these enhanced audit practices, let me first emphasize the importance of the chief audit executive, or CAE.

Once an organization crosses the $10 billion mark, often times we observe the CAE role evolving during the transition from CBO to RBO. The CAE of a regional organization will no longer be conducting audit work but instead developing frameworks and processes that enable audit work to be delegated across the function. The CAE must give careful consideration to which audit work should be conducted in house versus co-sourced and balance the benefits and challenges with both approaches to identify the ideal model that works best for the organization. The audit committee should give careful consideration to ensure the CAE can think strategically in leading the internal audit function, and then we'll see the importance of the strategic CRE run through the enhanced audit practices that you see here on Slide 13.

So, the first enhanced audit practice is risk analysis. Internal audit should analyze the effectiveness of all critical risk management functions with respect to individual risk dimension and an institution's overall risk management function. Assessing the effectiveness of individual risk dimensions can be achieved through internal audit's review of risk management functions such as credit review, credit risk management, compliance management systems, and interest rate risk management. Some audit functions conduct periodic reviews of global or corporate risk management as part of the assessment of an institution's overall risk management function. Others complement corporate or global risk management audits with an annual written report that incorporates audit results throughout the year to support their conclusions on the effectiveness of the overall risk management function.

So now, I'm going to move on to the second enhanced audit practice, and that relates to thematic control issues. Internal audits should identify thematic macro control issues as part of its risk assessment process and determine the overall impact of such issues on the institution's risk profile. We found the most effective process considers thematic control issues from risk assessments and those identified through actual audit reviews. When the process is effective, thematic control issues identified are considered in individual risk assessments, engagement planning, and in testing procedures. The audit committee should be kept informed of thematic issues identified and how they're being remediated.

The third enhanced audit practice relates to challenging management and policy. Internal audit should challenge management to adopt appropriate policies and procedures and effective controls. We sometimes see where internal audit is simply evaluating compliance with the established policies and procedures. While this is necessary, it's not sufficient. Internal audit should also evaluate and opine on whether existing policies and procedures are designed effectively to mitigate an institution's risk or risks associated with its business activities and operations.

So now, I'll move on to the fourth enhanced audit practice, and that's infrastructure. Internal audit should review significant changes in infrastructure and report on internal control issues. Depending on the nature of the infrastructure project, some audit functions conduct periodic reviews during implementation so control issues can be timely identified and remediated. In all cases, conducting a post-implementation audit is critical to ensure conversion issues are appropriately remediated. For some complex system conversions, some firms will engage with third parties with expertise to conduct those post-implementation reviews.

The next enhanced audit practice relates to risk tolerance. Internal audit should understand the firm's risks and ensure that board and senior management are involved in setting and monitoring compliance with risk appetite and risk limits. Some audit functions review the firm's risk tolerance as part of the global risk management audit, the corporate risk management audit, or corporate governance reviews. Others might review risk tolerance and limits at the business-line level and then supplement those reviews with periodic review of the global risk management or corporate risk management function.

The final enhanced audit practice relates to governance and strategic objectives. Internal audits should understand the firm's business strategy, including how management executes the strategy and communicates issues to the board and senior management. Review can be conducted as part of a corporate governance or corporate risk management audit. Governance is also often reviewed as part of individual audit engagements or at the business-line level.

So, now that you have an outline on the enhanced audit practices, which are critical when becoming an RBO, I'm going to share some keys to successful transition as observed by peers across the Federal Reserve System on Slide 14.

So, here on Slide 14, the first key to a successful transition is that internal audit conducted an SR 13-1 gap assessment, conducted an objective and robust self-assessment of existing practices against the guidance, and developed remediation plans. For firms that have recently transitioned to the RBO portfolio or will be transitioning, it is critically useful to take the guidance and compare that to the audit function's current processes.

So, who should conduct the review? It is important that the individual conducting the assessment be objective and use a critical eye when reviewing policies and practices across the audit function. Examination teams across all 12 districts have yet to see a firm that has no gaps identified through the self-assessment process. Once the gaps have been identified, they should not be shelved. Instead, audit management should develop plans and timelines for addressing each of the gaps identified, share the remediation plans with the audit committee, and provide periodic progress updates.

The second key to successful transition is external quality assurance review. Consider it an external quality assurance review to assess conformance with the Institute of Internal Auditors' standards and to help identify other practice gaps. If a firm has not had an external quality assurance review, having one done prior to becoming an RBO or soon thereafter is a best practice and has been helpful to some firms. While the cost involved varies among third-party service providers, the primary focus during the due diligence process should be identifying a competent provider or reviewer with experience working with similarly sized firms or larger institutions that can provide meaningful horizontal perspectives and identify potential gaps.

In some cases, we have found that when the focus is unduly involved on the cost, the end prize often disappoints all stakeholders. As with any formal review, it is incumbent on audit management to share the results with the audit committee and develop implementation plans along with timelines for addressing key recommendations from the assessment.

The next key to successful transition relates to audit planning and risk assessment. Perform a thorough review of the firm's audit planning process. In our experience, both areas tend to have MRAs at many firms. Though the concept may seem simple enough, some firms end up with an audit universe that is incomplete, outdated, or lacking sufficient documentation. Firms should start with a thorough review of the audit universe as part of the audit planning process. The factors that are typically considered in the audit universe review include cost centers, general ledger, organization charts, major systems, significant laws and regulations, department listings, and products and services.

The audit universe should be reviewed at least annually and be updated when significant changes occur. It should be well documented, so a third party can review it and see the linkage between the audit universe and the auditable entities. The audit risk assessment is also critical for developing a meaningful audit plan. The risk assessment should be well documented and dynamic. The factors employed in the methodology and the overall composite residual risk score should be documented with written analysis.

The next key to successful transition relates to audit talent and independence review. Conduct skills gap assessment of current staffing against the audit plan. Focus on the key risks identified in the audit risk assessment to ensure that audit leadership and staff possess commensurate skills and experience to audit risk management and internal control processes mitigating those risks. Identify skill gaps—these could be technical areas such as information technology or compliance but also soft skills such as leadership and influence—and then develop strategies to address those gaps. This could take the form of recruiting efforts, both internally and externally; it could be development plans for current staff; or it could be co-sourcing or outsourcing relationships for some highly technical areas; or a combination of all those.

Then regarding independence, you know, a common issue that we've observed in ineffective audit functions is where internal audit was not providing an objective assessment of the institution's internal control processes. This can take the form of not reporting certain issues to management and the board. It could be watering down tough messages or not holding management accountable for addressing audit issues. It's important for the chief audit executive to have unimpeded access to the audit committee to report control weaknesses without fear of reprisal. With this in mind, many organizations revisit reporting structures along the way. We frequently see the chief audit executive reporting functionally to the audit committee and then administratively to the CEO.

Next, we have audit committee oversight. So, as an organization grows in size and complexity, so does the audit plan. It's important for internal audit to ensure the audit committee is receiving meaningful information to oversee the program. So, what exactly do we mean by "meaningful"? It's important for internal audit to connect the dots for the audit committee. Internal audit will be conducting more audits and more complex audits as the institution grows. Internal audit is expected to report thematic control concerns to the audit committee, taking the results from individual audits and identifying where there are themes for the organization to address.

So, one example of this would be tying the audit results back to the key risks and strategies of the company. Another example would be providing the audit committee with trend analysis over time regarding the audit results and past-due audit issues by business line or risk area so the audit committee can spot where control weaknesses are occurring and hold management accountable.

So finally, the last one I'll mention is engagement with regulators, and by now, you're probably sensing a theme regarding engaging with regulators. So, with respect to audit, though, hold ongoing dialogue with your Federal Reserve Bank central point of contact and the audit risk specialist regarding the internal audit's plans to address gaps identified in the SR 13-1 assessment. Successful audit functions have developed comprehensive action plans to address those gaps, track their ongoing status, and provided periodic updates to the supervisory team. The supervisory team can be a resource in providing a range of practice on SR 13-1 across many firms.

So, Matt will further discuss how risk management and corporate governance typically evolve in successful transitions. But first, let me turn it over to Carl for one final polling question.

Carl White: Great. Thanks, Richard. Appreciate that. So, as Richard said, this is our last polling question of the session. So: When firms cross the $10 billion in consolidated asset threshold and become an RBO, what are the biggest challenges that they face?

A –adjusting to different supervisory processes;
B – increased expectations for the audit function, which Richard just covered;
C – an expanding scope of risk management and governance considerations; or
D – all of the above; or
E – other or unsure.

So, once again, this is the last of three, so we'll wait for those results.

I did want to just mention, Matt, Elizabeth, and Richard did a great job of spelling out the acronyms that the Fed is so good at putting together, and at the end of the presentation, they put together a whole list of the acronyms that you can reference back to after the presentation. So, we'll wait for those results. Once again, what's the biggest challenges? A – adjusting to different supervisory processes, B – the audit function, C – expanding scope of risk management and governance, D – all of the above, or E – other or unsure.

And here's the results. So, very interesting. So, adjusting to different supervisory processes was just 1%. Increased expectations for the audit function was just 2%. Expanding scope of risk management and governance – 4%. And I don't think any of us are surprised, but all of the above – 93%, and 0% for other. So, I think our presenters will not be surprised by that, but I'll let them comment. So, I'm going to move it on to Matt, and he's going to cover our last slide of the presentation. Matt, back to you.

Matt Turner: Great. Thanks, Carl and no, not surprised one bit at those results. So, Liz did a great job covering the RBO regulatory framework and the continuous supervision model. I do think it's important to note that our supervisory approach does change as firms grow in size and complexity, so we expect larger community bank organizations and regional firms to have already established a sound framework within the organization to support the design and execution of risk management activities, and our supervisory focus generally shifts to reflect that. So, I think you'll find, moving into RBO supervision, that our examination work may focus more on the quality of risk management, control functions, and governance.

So, reviews of the audit program and the loan review function, you may find them to be more comprehensive, and we may spend more time evaluating BSA and IT to determine if those programs are keeping pace with the growth of the company.

I'm going to spend the next several minutes discussing a variety of governance and management topics that are important to keep in mind during the transition period into the regional portfolio and beyond. As has been previously mentioned, there is an understanding that these changes do not happen immediately, so consider these areas as points of evolution as size and/or complexity increases at your firm.

I'm first going to mention the organizational structure. So, your organization may have undergone significant changes in the past, or you may be operating under a legacy structure that has served you well as a smaller bank. Now is a good time to consider a number of questions. So, is the organization set up today optimally to achieve its strategic goals? Look at the roles that exist at peer banks or at banks of larger size that may add value to your structure. Also consider if there are silos or roadblocks to communication that have cropped up as the organization has grown. Think about how revenue and risk functions are organized and viewed within the company and what the communication looks like between them. If you've recently acquired or merged, consider how the integration of staff and culture is being handled.

As you work through this line of questioning, consider the corporate risk management program. Typically, the formalization of the risk management function begins fairly early to allow it time to mature alongside the rest of the organization. The distinction between first and second lines is often the most challenging to work out, with various risk management activities shifting between the two along the maturity curve. So, take time to consider how risk is assessed and monitored and how the first line receives effective challenge. Also consider how the organization will hold each layer accountable for upholding its risk management culture.

Next, we'll look at qualifications and skills of the board and management, when you'd holistically ask, does the board of directors have the appropriate representation to support the strategic goals of the company? So, if a new member were to join, what would be the ideal set of qualifications to bring to the table? Are there any gaps that exist now that the organization is becoming more complex? We encourage you to think about any new activities or markets that have come online as well as emerging trends in the wider banking sector. When opportunities arise to add to the board, these are the things that should be considered when making the selection.

With regard to management teams, as organizations grow, there is certainly less time and bandwidth for executive management to directly oversee certain elements of the bank's activities. Executives must be able to effectively develop the next layer of management, delegate responsibility, and manage accountability for corporate goals and effective risk management. Likewise, there are functions within larger organizations that simply just were not needed in a smaller company. Examples might include some structure around data governance, model risk management, and enterprise risk management. So, executives must carefully consider when these new functions may be needed and plan allocation resources accordingly.

In more complex organizations, we find that the strategic plan gains a greater level of importance as a steering tool. It helps to clearly define common objectives and align management expectations across business lines. So, if it's not already, the strategic plan should shift to be impactful across the organization. Tracking the strategic plan is an opportunity for the board to develop and communicate its risk appetite and integrate it into the action plans that business lines and support functions will take in achieving goals.

I'll say capital planning should certainly go hand in hand with the strategic planning process, especially for organizations intending to grow through acquisitions. There's an increased level of regulatory scrutiny as size increases, and management should be able to clearly demonstrate that capital levels are commensurate with risk and are sufficient to support future plans.

Next, we'd like to discuss data management. This is an area that we've noticed growing pains in institutions transitioning to the RBO portfolio. There is a critical mass of data that piles up, often with M&A activity complicating matters, and the task of maintaining well-organized, defined, and useful data can certainly get out of hand fairly quickly. So, consider the distinction between data owner—that is, who produces or collects the data, the data user who uses the data to perform tasks or analysis, and the responsibilities of each. Also, review how data quality and security are defined and maintained, current and potential uses for data, and consequences for mishandling data. Data-driven decision making becomes more relevant as banks grow, so it's important for management to have a clear plan for protecting the efficacy of this important resource. The consequences for mishandling data are certainly wide ranging, cross functional, and could have material cost implications.

Another area for discussion is vendor management. Use of third-party services and applications is increasingly relevant in banking generally and especially for organizations growing and stretching to achieve efficiencies. It can be helpful to consider the use of third parties holistically with a view into what benefits and risks are most pressing. So, consider what functional or back-office work is impacted by third parties, what customer-facing tools are used, and what are the risks and backstops if these products become unavailable?

Knowing about the interplay between systems provided by different vendors is also crucial. Due diligence is another critical step in determining what services or tools might be the best fit for the company. The cost of implementation and configuration generally rise as banks grow, so thorough vetting can help avoid the need to change course or duplicate efforts due to foreseeable factors. I would encourage you to consider what features will enhance current processes alongside a detailed understanding of what work will be needed to achieve that enhancement. So, consider: Does your organization have the expertise to get these new tools up and running internally, or will consultant hours be needed? Also consider what staff training will be needed and what gaps might remain once the new system or tool is in place.

Perhaps most important, a risk assessment should be performed and maintained throughout the life of a third-party relationship.

Lastly, I'll mention project management. More complex organizations often find themselves engaging in cross-functional work to implement a new process, product, or tool. A well-defined product management function can greatly assist in preventing various roadblocks by coordinating activities efficiently. So, this includes pulling together the necessary stakeholders and experts, defining the desired outcome, identifying constraints, and providing accountability. So, it may seem tempting to view the project management process as unnecessary bureaucracy, but we find it often leads to better outcomes and lower cost by preventing rework and keeping stakeholders on task.

So, you've heard from Liz, speaking on the changes to the regulatory framework and supervision model. You heard from Richard and I outlining some thematic observations and best practices with respect to internal audit, corporate governance, and risk management. Yeah. I'm curious now, what questions do you have for us? Carl, could you take a look at what we have in queue?

Carl White: Yeah. I sure will, Matt. Thanks. And on Slide 17, just a reminder on how you can submit questions. We have quite a few in already, but please send them in, and we'll make sure our presenters can at least get those and can review all the other questions that come in. So, you can just use the chat feature right there in the webinar. There's the Ask Question button that's right at the bottom of your screen. You can shoot us an email at questions@askthefed.org, or you can use the Ask a Question feature on our website.

So, as Matt said, we have received several questions, so we'll go ahead and jump in, and we'll cover as many as we can in the next ten minutes or so. So, the first question, actually, this is something I routinely ask my bankers, so I'm going to turn it to you guys. So, as financial institutions transition over to RBO supervision, what might be the two or three things that keep you as Federal Reserve regulators up at night? So, Liz, you want to try tackling that one?

Elizabeth Keenan: Yeah. I'm happy to start this one, and I appreciate the question. The first two things that came to my mind were that second- and third-line functions will not receive sufficient resources to elevate their existing programs and whether management has the comprehensive skill sets, necessary experience, and appropriate reporting structure just to effectively manage an RBO firm. So, I can elaborate a little bit on each.

The concerns about the second- and third-line functions is especially true for firms that become RBOs via acquisition, which honestly is most of our firms. So, we have noticed a clear trend that after either a large transformational merger or multiple acquisitions in a relatively short timeframe that the second and third lines often fall behind on review schedules, alerts, and then are always playing catch up. Therefore, the second and third lines do not have sufficient staff and resources to expand their programs like we really emphasized today is needed.

Regarding my management comments, Matt touched on a lot of them, so I might just kind of double down on some of the things that he said. But any growing firm, any firm that grows in size and complexity, it becomes more important to continually reassess staffing expertise for key roles, including the board of directors, and affirm the effectiveness of the organizational structure. We as regulators expect that a thorough assessment upon transitioning to RBO will identify knowledge gaps in several areas, which may result in the need for more external hires, changes in reporting lines to align with best practices, shuffling of responsibilities, or at the extreme, even departures of long-standing employees or directors.

While such changes should have long-term benefits, there can be short-term headwinds that are challenging to navigate and could ultimately result in and does at times and management teams punting some of these difficult decisions until eventually, unfortunately, supervisory issues arise. I think we can all agree that's not ideal for regulators to force management organizational structure changes, so we just really encourage firms to be proactive, and that's what worries me, if firms are not. So, I'll turn it over to Matt, because I'd like to hear his thoughts on this question.

Matt Turner: Yeah. Thanks, Liz. So, yeah. I would agree with your comments, Liz, ensuring that the second line or the risk control function and the audit program remain effective throughout the state is critical. Another area where we've seen firms struggle is with product due diligence and the use of service providers. Compliance risk can be significant, and that's why it's important to have representation from all areas of the bank when evaluating a new product, service, or bringing on a new vendor. In talking with CPCs across the system, I think that there's been numerous times where firms have run into compliance issues with a new service or a product, whether that be BSA/AML or something else, because of a miss during the due diligence process.

Also important, I just say that management needs to be realistic about the expertise of staff in managing projects. So, while up-front costs can be significant, bringing in outside resources to help with implementation of certain projects may be necessary and save time and money long term.

Carl White: Great. Thanks, Matt and Liz, for those answers. So, the next question has to do with audit. So, Richard, I know you covered a lot of material regarding internal audit, so this question reads: What's been the biggest challenges for banks and internal audit departments when they cross over the $10 billion threshold?

Richard Perisie: Thanks, Carl. I guess what comes to my mind in terms of a common challenge—and I covered this in the presentation, but let me emphasize—is really ensuring that the chief audit executive has the right strategic mindset to lead the audit function. The CAE, as I covered in the presentation, needs to be developing frameworks and processes that allows audit work to be delegated across the audit function. The audit work itself is going to becoming more and more complex as the organization grows in size and complexity. Matt covered a lot of risk management expectations for RBOs, and internal audit needs to in turn have the ability to audit those risk management processes, so they need to have sufficient skills and resources. So, we see that pop up in things like not completing the audit plan timely, having ineffective audit universe and risk assessment process, or lack of quality control issues. And quality assurance processes, I'll be kind of thematically theming back on the importance of a strategic chief audit executive.

Carl White: Great. Thanks, Richard. Okay. We have about five minutes to go. We're going to try to get through a few more here. So, Liz, you mentioned roll-up event as far as the exam process. Could you elaborate on exactly what we mean by—what a roll-up event entails?

Elizabeth Keenan: Yeah, sure. I field this question a lot internally as well. So, I always describe it as the roll-up event is essentially the event where all regulatory ratings are formally issued. So, for example, bank CAMELS ratings or holding company RFI ratings are issued in what we call a roll-up report. The term "roll-up" reflects that the information from targets, continuous monitoring that we discussed, are factored into the formal ratings and roll-up work papers. So, for instance, an internal audit target and separate letter may have occurred in the second quarter, but conclusions from that will roll into the management and risk management rating later in the year.

I will kind of say the distinction between maybe a roll-up and a full-scope event—because a lot of CBOs are used to that full-scope event term—the roll-up is more appropriate, because some areas, like information technology or Bank Secrecy Act or internal audit, may have been done at a separate event, and so technically, that roll-up event, while it is kind of the main event for an RBO, it's technically not always a full-scope event. So hopefully, that helps.

Carl White: Great. Thanks, Liz. This one has to do with dealing with the bank's primary federal regulator. So, Richard, how often do you engage and coordinate with the bank's primary federal regulator once the firm is in the RBO program?

Richard Perisie: Great. Thanks, Carl. So, the Federal Reserve has issued an SR letter regarding coordinating with the bank's primary federal regulator, namely SR 16-4. This SR letter states that taking into account a holding company's complexity, its risk profile, its condition, the Federal Reserve will rely to the fullest extent possible on the work of the insured depository institution, or sometimes we refer to as IDI, regulators to supplement its own supervisory work regarding the consolidated holding company and its nonbank subsidiaries. Through ongoing dialogue and exchange of supervisory documents and information, the Federal Reserve staff are expected to understand the IDI regulators' risk assessment, its supervisory plan, its examination scope, supervisory findings, and use all the information made available from the IDI regulators to reach conclusions regarding the consolidated holding company's overall condition as well as to assign appropriate supervisory ratings.

Carl White: Great. Thanks, Richard. Okay. A couple more I think we have time for. So, Matt, this is something that comes up a lot with us getting back to our normal exam processes, getting back to the field, and it has to do with outreach. So, what's the expectation from a Federal Reserve perspective as far as in-person outreach opportunities?

Matt Turner: Sure. So, in short, we expect to resume in-person outreach soon, but I'll add just a few additional thoughts. So, like many industries and businesses, the way we do business is evolving, and we expect to leverage technology to engage with the industry going forward. But engaging with the industry, whether it be a supervision event or conferences, other programming intended to support the exchange of thought, dialogue, it does benefit from some in-person engagement as well. To that end, you may already be hearing from some of your CPCs locally within your respective districts about opportunities for in-person engagement.

Also, I'll just put an early plug in for the 2023 Regional State Member Bank Conference, which is now in the planning stages. This is an annual event which features panels and speakers covering current activities and trends in supervision and regulation and regional banking overall. This conference is intended for senior management and directors of regional state member banking organizations across the country, and we're looking forward to holding that in person for 2023.

Carl White: Great. Thanks, Matt. All right. Last question. And, Matt, as I mentioned at the onset, you mentioned that this is an inaugural outreach event for regional firms. What can we expect from this series, this Ask the Fed® series in the future, and what would be the best avenue perhaps for our RBOs to suggest topics?

Matt Turner: Yeah. Another good question. So, you heard earlier in the presentation about our commitment to providing technical assistance to supervised firms. We're very interested in hearing from you about the types of learning content that would be most beneficial. So, this series, Regional Banking: Beyond Examinations, we're focused on delivering programming specifically for regional bank organizations, and there are several ways you can alert us to topics that you're interested in. Yeah. I would encourage you to include suggestions for future presentations in the feedback that you provide to this session. We're interested in hearing your ideas. So, whether that's programming, covering economic updates, training on new regulation, risk management expectations, compliance risk—we want to hear from you. So, please consider adding any suggestions you have in the feedback to this session.

I'll say, too, another good channel for communicating topics that you're interested in is your assigned CPC or supervisory team in your local district. The Regional Bank Supervision Outreach Group works closely with staff across the system, so the feedback you provide them will be passed along and considered as we build out future events.

Carl White: Great. Thanks, Matt. We are right at the top of the hour, so we're ready to wrap things up. So, just a few closing remarks before we end today's call. So, once again, thank you for all your questions. We didn't have time to get through them all, but we're really appreciative of those, and our speakers will take a look at those, and it might assist us, as Matt said, for our future sessions.

A quick couple of items before we wrap. On Slides 19 and 20, like I said earlier, you're going to find a list of acronyms and also a list of resources that were covered during this session. I'd like to thank all of you for joining us this afternoon and spending an hour with us. Special thanks to Matt, Liz, and Richard for all of their work getting ready for today's session and then presenting today. As I mentioned, this is the first of a new series focused on RBOs, and we look forward to future sessions with the Regional Banking Supervision Outreach Group.

So, just a few final logistical wrap-up comments: All sessions are recorded and archived on the Ask the Fed® site, so you can review the materials and listen to the sessions at your leisure. If you completed the three polling questions, this Ask the Fed® session is eligible for CEUs, but you're going to have to complete the last section of the online survey, which is going to be sent out literally any minute now.

And finally, Ask the Fed® is a program of the Federal Reserve Bank of St. Louis. It's intended only for informational purposes. The views are not formal opinions of—nor binding on—any Federal Reserve Bank or the Board of Governors of the Federal Reserve System. Thanks so much for joining us this afternoon, and we'll talk to you next time.

(END OF RECORDING)