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Technology and the Regulatory Agenda for Community Banking

Remarks by

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Thank you to the Independent Community Bankers of America (ICBA) for inviting me to address this year's policy summit. I am delighted to be speaking with you and especially pleased to see the summit's focus on innovation. The ThinkTech accelerator represents the type of resourcefulness necessary to help community banks tackle their greatest challenges, among them ensuring that banking services and credit support are available to customers in all communities, regardless of where they are located. Today, I will share my perspective that technological innovation is essential to the future of community banking in America, and reiterate my intent to elevate those issues related to innovation to the top of the regulatory agenda.

There are certain points in history when an event can fundamentally change how society and entire industries function. In addition to the other ways that COVID-19 has affected us, this could be one of those moments. The pandemic has demonstrated the importance and unique role of technology in responding effectively to new challenges. In this case, the challenge has been an unprecedented disruption in our lives. One year ago, it would have been difficult to imagine the extent to which we are now working and conducting routine aspects of our lives from home and online.

Take health care as an example. One recent report on telemedicine trends notes that the number of patients treated through video-enabled physician visits has increased between 50 percent and 175 percent compared to before the pandemic.¹ While virtual consultations with a health care professional haven't replaced physical examinations and medical procedures, they are serving a vital role in the industry's response to the

¹ McKinsey & Company, "Telehealth: A Quarter-Trillion-Dollar Post-COVID-19 Reality?" May 29, 2020, <https://www.mckinsey.com/industries/healthcare-systems-and-services/our-insights/telehealth-a-quarter-trillion-dollar-post-covid-19-reality>.

pandemic and they will likely play a significant role in how the health-care industry serves its customers in the future. When this health emergency has come to an end, I expect that telehealth, home grocery delivery, and a variety of online services and communications will continue at a higher frequency than before our recent experience.

In the financial sector, I believe we may be seeing a quantum leap in the use of digital deposit, digital payments and online lending. One large financial service provider reported a 200 percent increase in new mobile banking registrations during the early phases of the pandemic.² Customers who reacted to the physical limitation on visiting a bank branch or ATM are learning to bank using online banking or through an app on their smartphone may not be as willing to stand in line or wait for in-person service at their bank branch in the future. Recent surveys show that consumers with access to digital and mobile banking are more likely to continue using those convenience products and services in a post-pandemic world.³

The adoption of digital banking services can also be essential for historically underserved and disadvantaged communities, assuming they have bank accounts and access to internet-based tools like smartphones. In some cases, fintech can lower costs and improve services, particularly for small businesses or lower-income consumers who are less likely to have access to credit. While electronic banking certainly didn't start with the pandemic, acceleration of its adoption has undoubtedly led banks of all sizes to rethink how they will meet their customers' needs in the long term.

² CNBC, "Coronavirus Crisis Mobile Banking Surge Is a Shift That's Likely to Stick," May 27, 2020, <https://www.cnbc.com/2020/05/27/coronavirus-crisis-mobile-banking-surge-is-a-shift-likely-to-stick.html>.

³ American Banker, "Consumers Are Relying More on Finance Apps, Survey Finds," September 15, 2020, <https://www.americanbanker.com/news/consumer-reliance-on-finance-apps-spiked-because-of-coronavirus>.

I have noted on many occasions how vital community banks are to those they serve and to a strong and stable financial system. Successful innovation is not just about adopting the latest technologies. It involves aligning a bank's strategy with its innovation plans to clearly map a purpose and desired outcome for the adoption of new technology. The continued success of many community banks depends on their willingness to engage in strategy-based innovation-led growth. We have seen and are encouraged by many examples of entrepreneurial community banks embracing technological innovation. Developments such as digital deposit and lending products, regulatory technology solutions, and application program interfaces (APIs) have increasingly become more popular in the banking industry. When implemented effectively, they can result in greater efficiencies and effectiveness.

A number of community banks have already taken advantage of these opportunities. Still, perspectives on the need for change vary across the industry. I recognize that while it seems clear that the industry is changing, there remains a wide distance between fintech's promise of a future driven by technology and what many community bankers experience today. From my perspective, it is unlikely that fintech will ever completely eliminate what is the hallmark of community banking—personal interaction and building relationships with customers and communities.

One trend is clear, however: more and more community banks are expressing interest in fintech partners to help them open new lines of business, help with customer acquisition, enhance customer service, and improve operational functions. Through the Fed's engagement with fintech companies and small banks during our Innovation Office Hours, we learned that a wide range of partnership models are emerging, with varying

benefits and challenges. Some banks are engaged in customer-oriented partnerships, where a bank selects a fintech partner to improve the customer experience, develop new products or services, or acquire new customers. In one case, a bank partnered with a fintech company to centralize each customer's financial data and provide personal financial management tools. Other banks are engaging fintech partners to automate or improve the efficiency and effectiveness of compliance and regulatory processes, which is often referred to as "regtech." For example, a fintech partner automating the Bank Secrecy Act/anti-money-laundering process may be able to provide notable cost savings and enhance compliance, while freeing up resources for other areas. We have also seen instances where a bank offers its financial services to a fintech partner that, in turn, offers financial products or services to its customers. In this type of relationship, a bank plays an important part in the delivery of products and services. The list goes on. My point is there is great possibility and a wide variety of options for engagement. And everyone, from the banks to customers to the regulators, needs to be thinking about these changes and their implications.

With the emergence of additional core-service providers, we are also seeing more opportunities for community banks to access the technology infrastructure they need to improve basic banking activities. These basic banking activities include tasks like reconciling transactions to the general ledger or simply offering expanded digital services. Furthermore, there are new opportunities for integration of cloud-based platforms and APIs. Community banks should take advantage of the new technologies that make sense for their business and the communities they serve.

Still, even as community banks prepare for the future, there is the very real challenge of finding partners and knowing how to navigate the regulatory environment once an institution has identified a potential partnership arrangement. We certainly understand this concern. From the fintech perspective, one provider noted the challenges they face during the onboarding process with financial institutions, including struggles to navigate siloed compliance and risk-management functions. Participants in the Fed's Innovation Office Hours told us that they would benefit from the Fed broadly sharing information on the current landscape of such partnerships, on a range of practices, and on relevant guidance for banks to consider.

In response, early next year we plan to publish a white paper that documents examples of community bank partnerships with fintech companies and outlines effective practices for managing those arrangements. This white paper would describe a range of distinct options for such partnerships and seek to identify benefits and challenges of the different approaches. We are also continuing to pursue a range of community bank projects to provide pathways to innovation that I mentioned earlier this year.

While it is essential to safety and soundness that banks understand, monitor, and mitigate risks associated with their third parties, I am sensitive to the burden that due diligence can pose. Being unsure of the questions to ask a third-party vendor, or whether a response is sufficient, should not keep community banks from accessing innovation, yet we continue to hear that these are real challenges. To address this problem, I have directed Federal Reserve staff to work with their interagency colleagues to develop a vendor due diligence guide, aligned with existing supervisory expectations, which would include sample questions for vendors and guidance on appropriate responses. This guide

would also be specific about the documents and information that community banks need in order to successfully complete their due diligence.

In addition to the due diligence guide, I expect that Federal Reserve staff will work with our colleagues at the Office of the Comptroller of the Currency and Federal Deposit Insurance Corporation to enhance and align interagency guidance for third-party risk management. The guidance would eliminate the need for community banks to navigate multiple supervisory guidance documents on the same issue. It is my expectation that the combination of refreshed and aligned interagency guidance and the community bank due diligence guide will meaningfully enhance clarity on supervisory expectations for community bank partnerships with fintech companies.

There are also opportunities within our existing supervisory program to improve our regulatory response to innovation, without creating additional burden for community banks. The federal banking agencies' service provider supervision program plays an important role in assessing the rigor of risk management and controls at key service providers. It is important that reports of supervisory assessments be readily available to banks that rely on service providers so that banks can use the reports to support their third-party risk management. Since I last spoke about the program in February, the federal regulatory agencies have made notable progress in creating a process to automatically distribute those reports to all client banks. Proactively sending reports to community banks removes the inefficient step of each bank hunting for reports on their own. For banks supervised by the Fed, the aim is to begin automatic distribution in the first quarter of 2021.

Finally, I would note that as we consider the types of financial services technology that may be useful to the banks we supervise, our rules and guidance need to keep pace. The Federal Reserve is also considering whether the rise of artificial intelligence and machine learning in banking might require an adjustment in regulation and supervision. AI is becoming more prevalent in customer service and machine learning can offer real opportunities to assess risk and find new customers.

Community banks face limits on the resources they can dedicate to researching and evaluating third party providers of these new services. Regulators and supervisors should consider ways to encourage innovation by simplifying the process of third party selection, due diligence and monitoring.⁴ To that end, staff from the Federal Reserve and other agencies have been jointly conducting significant outreach to industry and other stakeholders over the past several months. We want to hear from you. In addition to this outreach, a conference planned for January, 2021 will include views from academic researchers on the potential benefits and risks posed by artificial intelligence for banks of all sizes.

Technological innovation holds great promise to help community banks compete and succeed in the evolving financial services landscape. I look forward to continuing to engage on these issues in 2021 and to work with the ICBA and other stakeholders to foster an environment where communities and the banks that serve them continue to thrive.

⁴ Michelle W. Bowman, "Empowering Community Banks," speech at the Conference for Community Bankers sponsored by The American Bankers Association, Orlando, Florida, February 10, 2020, <https://www.federalreserve.gov/newsevents/speech/bowman20200210a.htm>.