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An Opportunity for Community Banks: Working Together Collaboratively

Introduction

This paper presents the Office of the Comptroller of the Currency's (OCC) views on collaborative efforts by community-focused national banks and federal savings associations (FSA) (collectively, community banks or banks) to pool or share resources to reduce costs and leverage specialized expertise.

The OCC recognizes that many community banks are looking to lower expenses in response to reduced profit margins and limited strategic opportunities. In addition, community banks have expressed concerns about mounting regulatory compliance requirements that have increased the need for specialized expertise. Community banks also face challenges in providing the competitive products and services their customers expect, and as they develop these products and services, community banks try to achieve economies of scale while maintaining the advantages of being local banks.

In addition to their other challenges, community banks face competitive pressure from larger banks and credit unions, as well as from nonbank firms seeking to expand their banking activities. This paper examines the opportunities community banks have to collaborate as they seek ways to do more with less. In particular, the paper

- explores the potential benefits of collaboration.
- outlines the ways community banks can structure collaborative arrangements within their respective statutory frameworks.
- emphasizes the need for effective oversight, including appropriate risk management, and comprehensive strategic planning as prudent steps to increase the likelihood of a successful collaboration.

Background

Community banks face many challenges in the current operating environment. Community bankers have expressed concerns about regulatory requirements, competition, the sustained low-interest-rate environment, and the difficulty in finding qualified staff to execute bank functions. The banking industry has undergone significant regulatory change, and many believe that increasing regulatory requirements are an impetus for industry consolidation. The OCC is often asked questions such as "What can my bank do to sustain itself, be profitable, and fulfill its mission?" and "In the current economic environment, what is the right size and business model for sustainability?"

Community banks are important. While institutions face different challenges based on asset size, an institution does not need a certain asset size to succeed. Community banks are structured to meet the diverse needs of the local communities they serve. Regardless of size, community banks are important to the customers who rely on them as safe places for savings and needed sources of credit.

As diverse as community banks are, they share the same commitment to supporting the communities they serve. With this in mind, the OCC sees an opportunity for community banks to share resources and expertise to the mutual benefit of all involved. Some community banks may have excess capacity or may have developed platforms or expertise that enable them to provide shared services to other community banks that may not have sufficient resources or demand. Other community banks may look to collaborate with fellow community banks that share the same core values as a cost-effective way to meet growing demands while retaining their individual identities.

Community banks have asked the OCC whether they can share back-office operations, establish a compliance consortium, or collaborate to offer a new product. As a group of like-minded institutions, community banks may find the benefits of collaboration outweigh competitive challenges and could strengthen the future vitality of community banks. The OCC supports community banks in exploring opportunities to achieve economies of scale and the other potential benefits of collaboration. Any collaborative activities among banks, however, must comply with antitrust laws. Community banks should take appropriate steps to ensure that the activities do not violate antitrust laws.[1]

Collaboration Versus Outsourcing

Collaboration vs. outsourcing
Collaboration: A cooperative arrangement in which two or more parties work jointly toward a common goal while remaining separate organizations. **Outsourcing:** The obtaining of a service or product from an external provider.

Financial institutions can outsource many areas of operations, including all or part of any service, process, or system operation. There are many vendors, consultants, correspondent banks, and bankers' banks available to provide products and services to community banks. Community banks often belong to state and national trade associations and organizations that provide products and services or that endorse vendors that can meet community bank needs, including educational assistance and a collective voice on issues of concern. Nonetheless, the OCC sees an additional option, one in which community banks work together to support each other to tackle growing external pressures. Together, community bankers can be a "community" of organizations that look to each other, and thereby support each other, as they explore ways to face today's challenges.

Collaborative relationships are distinct from vendor relationships, which are usually viewed as outsourcing. Collaboration is not a new concept. As described in more detail later, Congress provided specific authorities to national banks and FSAs. For example, FSAs can

[1] The Federal Trade Commission and U.S. Department of Justice have produced a helpful resource, "Antitrust Guidelines for Collaborations Among Competitors."

jointly invest in service corporations. A consortium, which is a group of companies with the objective of participating in a common activity or pooling resources to achieve a common goal, is another example of a collaborative effort. In practice, management may use a combination of approaches.

Example 1: Loan documentation
Several community banks created a bank service company to prepare documents for one- to four-family mortgage loan applications.
Example 2: Contingency planning
Several community banks that have the same core data-processing hardware and software partnered to function as backup sites for one another.
Example 3: Loan participation alliance
Several community banks formed an alliance through a loan participation agreement to bid on larger loan projects in competition with larger banks.
Example 4: Multibank community development financing entities
Some bankers have chosen to pool their resources to finance community development activities by forming multi-bank community development corporations, loan pools, and loan consortiums.

Community banks already collaborate in many ways. The most informal level is networking, or exchanging information and ideas. Other collaborative examples include

- jointly purchasing materials or services.
- sharing back-office or other services.
- sharing of a specialized staff member or team.
- jointly owning a service organization.
- participating in disaster mitigation agreements.
- jointly providing or developing products and services.

This is not an exhaustive list. Rather, it demonstrates a few ways community banks have collaborated in the past or are currently considering. The focus of this paper is on collaboration that involves a relationship with another banking institution. That institution could be a competitor, and might not be in the business of providing services to other banks. The entity may be regulated by another state or federal banking regulator.

There are risks to collaborative relationships, but there are also risks to doing something alone without the proper expertise or in an inefficient or ineffective manner. Ultimately, the risks of any endeavor must be identified, measured, monitored, and controlled.

Benefits of collaboration

Management may choose to explore collaborative options for various reasons. Community banks working collaboratively may improve quality, reduce costs, strengthen controls, and achieve many of the following objectives:

- Gain operational or financial efficiencies.
- Pool resources and spread costs for capital-intensive products and services.
- Increase ability to acquire and support current technology and avoid obsolescence.
- Conserve capital for other strategic business opportunities.
- Increase management focus on core business functions.
- Refocus limited internal resources on core functions.
- Obtain or share specialized expertise.
- Increase reach and availability of services.

- Accelerate delivery of products or services through new channels.
- Earn greater credibility.

Opportunities to explore collaborative benefits may be found across various operational and functional areas of the bank, as illustrated in table 1.

Table 1: Areas of Opportunity for Collaboration

Administrative and back-office operations	• Accounting • Advertising • Clerical support • Data processing • Internal audit • Marketing • Procurement (office supplies, furniture, equipment) • Records management and data storage • Research studies and surveys
Human resources management	• Employee benefit development and administration • Health insurance • Payroll processing • Recruiting • Training and education
Regulatory compliance	• Bank Secrecy Act and Anti-Money Laundering • Mortgage rules

In exploring opportunities, banks should consider factors that can enhance compatibility. For example, community banks that have a core operating system in common or that use the same data servicer may find more efficiencies exist, and banks with similar risk profiles may have more closely aligned expectations for risk management. Banks that do not directly compete may find it easier to collaborate. Those that do compete may choose to exclude activities or services that differentiate the banks from one another (for example, advertising and marketing). Similarly, collaborative relationships raise issues and challenges that differ from outsourcing. Competition and priority of interests may be concerns.

Example 5:
Appraisal joint venture

As an example of the challenges in establishing collaborative relationships with competitors, one community bank tried to create a joint venture to do appraisal review for a collective of community banks. The initiative did not proceed because of issues surrounding the priority of review and the handling of an expedited review.

Community banks must address cultural, legal, and corporate governance matters upfront and perform due diligence before collaborating with another entity and be diligent in their ongoing oversight. Proper oversight and the keys to prudent collaborative relationships are described later in this paper.

Community banks have the authority to engage in various collaborative relationships. The authorities are outlined by charter type below:

National Bank Authority

In addition to fee-for-service arrangements, OCC regulations authorize national banks to establish and invest in various subsidiaries and other business entities, giving national banks options in structuring their operations to provide a wide range of permissible banking products and services. These subsidiaries and business entities include operating subsidiaries, bank service companies, and noncontrolling investments in such entities. Each option described below has distinct provisions governing ownership, investment, and permissible activities.

Operating Subsidiaries

An operating subsidiary of a national bank is a corporation, limited liability company (LLC), or similar entity a bank owns or controls. An operating subsidiary may only conduct activities that are permissible for the bank to engage in directly, either as part of or incidental to the business of banking. A national bank may invest in the operating subsidiary if the bank owns and maintains more than 50 percent of the operating subsidiary's voting interest or otherwise controls the entity. The bank may own 50 percent or less of the operating subsidiary if it otherwise controls the entity and no other party controls more than 50 percent of the voting interest or a percentage greater than the bank's interest.

Bank Service Companies

A bank service company is a corporation whose capital stock is owned by one or more insured depository institutions or an LLC whose members are insured depository institutions. National banks are authorized to invest in bank service companies and to provide services authorized by the Bank Service Company Act (12 USC 1861 et seq). A national bank may not invest more than 10 percent of its capital and surplus in a bank service company. In addition, a national bank's total investments in all bank service companies may not exceed 5 percent of its total assets.

A bank service company may perform the following services only for depository institutions: check and deposit sorting and posting, computation and posting of interest and other credits and charges, preparation and mailing of checks, statements, notices, and similar items, other clerical, bookkeeping, accounting, statistical, or similar functions performed for a depository institution.

A bank service company may provide to any other person any service authorized under the Bank Service Company Act (subject to certain geographic location and other restrictions), except that the bank service company shall not take deposits.

Noncontrolling Investments

National banks may make noncontrolling equity investments, directly or through an operating subsidiary, in an enterprise that engages in activities that are part of or incidental to the business of banking as described at 12 CFR 5.34(e)(5)(v). In addition, national banks may make noncontrolling equity investments in entities engaged in activities substantially similar to those previously approved by the OCC, such as providing management, consulting, and operational advice and services for other financial institutions. Before making a noncontrolling investment, the bank must be able to demonstrate, among other requirements, that it can ensure the enterprise will only engage in permissible activities and that it otherwise has the ability to withdraw its investment. When making noncontrolling investments, the national bank must comply with the statutes and regulations that would apply if it were engaging in the activity directly.

FSA Authority

In addition to fee-for-service arrangements, OCC regulations authorize FSAs to invest in operating subsidiaries, service corporations (including their subsidiaries or joint ventures), bank service companies, and pass-through investments as other options to structure their operations. Each option has distinct provisions governing ownership, investment, and permissible activities.

Operating Subsidiaries

FSAs are authorized to establish or acquire one or more operating subsidiaries with the OCC's prior approval. An FSA operating subsidiary can be organized as a corporation, LLC, or similar entity. An operating subsidiary may engage only in activities that an FSA is permitted to engage in directly. In addition, the parent FSA must own, directly or indirectly, more than 50 percent of the subsidiary's voting stock, and no person or entity other than the parent FSA may exercise effective operating control over the subsidiary.

Service Corporations

FSAs may organize service corporations that engage in activities that are permissible for the FSA, as well as other activities that the OCC has determined to be reasonably related to the activities of financial institutions. OCC regulations permit service corporations to engage in, among other things,

- accounting and internal audit.
- data processing.
- data-processing storage facilities.
- remote service unit operations, leasing, ownership, or establishment.
- credit-related activities such as credit analysis and appraising.

A first-tier service corporation must be organized under the laws of the state in which the FSA's home office is located, and its capital stock must be available for purchase only by that state's savings associations and FSAs with home offices in the state. Lower-tier service corporations, however, are not subject to these limitations. Service corporations enable FSAs to participate with other financial institutions in systems or services to allocate costs among participants.

An FSA is limited in the amount it may invest in service corporations. An FSA may invest up to an aggregate of 3 percent of its assets in service corporations. Aggregate investments in excess of 2 percent must primarily serve community, inner-city, or community development purposes.

Bank Service Companies

FSAs are authorized to invest in bank service companies and to provide services authorized by the Bank Service Company Act. This authority is identical to that discussed above for national banks.

Pass-Through Investments

FSAs may make, directly or through an operating subsidiary, noncontrolling or pass-through investments in certain entities that hold only assets and engage only in activities permissible for FSAs. When making the pass-through investment, an FSA must comply with all the statutes and regulations that would apply if it were engaging in the activity directly. For example, an FSA must aggregate a proportionate share of its pass-through investment in an entity with the assets the FSA holds directly in calculating its investment limits. Subject to OCC regulations, certain qualifying pass-through investments may be made without prior notice.

Oversight

Broadly defined, a third-party relationship is any business relationship between a bank and another entity, by contract or otherwise. This generally does not include customer relationships. Regardless of how a collaborative arrangement is structured, it involves having a relationship with a third party. The OCC expects a bank to practice effective risk management whether the bank performs the activity internally or through a third party, including another OCC-supervised bank.

As outlined in OCC Bulletin 2013-29, “Third-Party Relationships: Risk Management Guidance,” the OCC expects banks to recognize that third-party relationships pose significant risks. Any institution that supplements its own resources with those of outside providers needs to have risk management practices in place that are commensurate with that risk. A bank’s use of third parties does not diminish the responsibility of its board and senior management to ensure that the activity is performed in a safe and sound manner and in compliance with applicable law.

Strategic Planning

Sound strategic decisions are essential for any bank to compete and be profitable. The OCC expects all community banks to conduct strategic planning to identify priorities, goals, and objectives; strengths and weaknesses; realistic measures; and what success should look like. Carefully thought-out planning of proposed activities or products and services is critical to ensuring a bank’s competitiveness.

Strategic planning helps a community bank decide how to position its business and service activities, identify its best opportunities, and provide guidance in making hard choices about the unknown and uncontrollable. The future is always uncertain, but strategic planning can provide criteria and context for making decisions. Community banks need to formulate strategic plans that incorporate managing risk on a prudent basis.

Definition: Strategic risk
The risk to current or anticipated earnings, capital, or franchise value arising from adverse business decisions, poor implementation of decisions, or lack of responsiveness to changes in the industry or operating environment.

Examiners focus on evaluating the quantity and direction of the bank's risks and assessing the quality of risk management to identify, measure, monitor, and control risk. The OCC's risk assessment system establishes a common framework to evaluate eight categories of risk. OCC supervisory employees assess risk from banks' contemplated changes to business models and responses to strategic opportunities, such as the introduction of new or revised products, processes, or delivery channels. In considering collaborative activities, strategic and reputation risk deserve special mention because they typically permeate all of a bank's activities and products.

Strategic risk considerations include whether the board has adopted policies that are consistent with the bank's business strategies, whether initiatives are supported by sufficient capital, and whether there is effective communication in articulating goals. The OCC's assessment of strategic risk also incorporates how management analyzes external factors that affect the bank's strategic direction. Entering new lines of business or relationships without a well-defined strategy, thorough due diligence, appropriate risk controls, or sufficient capital are common pitfalls. All institutions need strategic planning; the form and approach depends on their size and complexity.

Definition: Reputation risk
The risk to current or anticipated earnings, capital, or franchise value arising from negative public opinion.

Reputation risk is present throughout all organizations, and it affects a bank's ability to establish new relationships or services or to continue servicing existing relationships, directly affecting current and future revenue. Strategic planning is critical to managing reputation risk.

There are many approaches to effective strategic planning. In its simplest form, the strategic planning process and execution should help find answers to the following questions: "Where are we now? Where do we want to be? How do we get there? How do we measure our progress? What adjustments are necessary to meet our goals?"

For collaboration to succeed it must be strategic. The collaboration should be consistent with the board's vision, mission, and strategic plan. Table 2 outlines prudent measures and attributes that increase the likelihood of a successful collaboration to emphasize that collaborative activities must line up with strategic objectives. The OCC's "A Common Sense Approach to Community Banking" booklet provides additional insight into the strategic planning process. That booklet also addresses equally important topics of capital planning and risk management.

Conclusion

There are some basic operational requirements for community banks that lend themselves to more cost-efficient execution, such as compliance, audit, and appraisal reviews. Rethinking past operating paradigms can lead to creative solutions, such as cost sharing. The OCC is open to ideas about collaborative approaches for sharing operations, and the OCC has seen that such consortiums already exist among credit unions and small business enterprises.

Collaboration is an opportunity for a community bank to take advantage of core efficiencies. If a community bank has the expertise to provide quality services in one area, it has an opportunity to provide these services to other community banks. Where a community bank may have less-developed staff expertise, it could partner with more experienced staff at another bank. Through collaboration, community banks can potentially achieve better outcomes of less costly services, greater range of services, and increased expertise. The OCC believes that when conducted with appropriate strategic planning, strong risk management, and effective oversight, collaboration can help community banks thrive.

Table 2: Successful Collaboration Lines Up With Strategic Objectives

S	**Successful**	
T	Trust	**Trust** is a key element in a successful collaboration. Consider other community banks that share your common goals and objectives. Do they have a shared vision of the outcome of the partnership? Even the most successful collaborations will face challenges. Management should recognize this in advance and remain flexible.
R	Realistic	Successful collaboration has clear strategic objectives and should be viewed as a means to achieve a strategic end. Look for opportunities to collaborate in areas where there is a **realistic** chance the initiative will be supported and implemented. Conduct due diligence and confirm compatibility with potential partners.
A	Agreement	Successful collaboration should be documented in writing in an **agreement** or memorandum of understanding that memorializes commitments and outlines the guiding principles, activities, responsibilities, and prioritization.
T	Talk	Communication is vital to any successful collaboration. **Talk** with OCC staff, partners, and prospective partners; ask questions, voice concerns, and resolve differences of opinion.
E	Expectations	Successful collaborations define **expectations** and responsibilities and establish clear goals and objectives. Make sure your bank knows and acknowledges what your partner expects to get out of the relationship. How will you evaluate success? If partners have divergent expectations, it limits the chance of success.
G	Governance	For collaboration to be successful, community banks must ensure they have an adequate **governance** structure. Community banks should have policies and procedures designed to identify, measure, monitor, and control risks related to their relationships with third parties.
I	Innovation	Successful collaborations often embody **innovation** and creativity to find the best solutions and a competitive advantage, possibly one in unchartered territory. When exploring new options, community banks should communicate with supervisory staff.
C	**Collaboration**	