

Michelle W Bowman: Community bank access to innovation

Speech by Ms Michelle W Bowman, Member of the Board of Governors of the Federal Reserve System, at the Government Relations Council (GRC) meeting sponsored by The American Bankers Association (virtual conference), Washington, D.C., 9 September 2021.

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Introduction

Thank you to the American Bankers Association for inviting me to address this year's Government Relations Council meeting. Although we had all hoped that this meeting would be in person, we will have to settle for the opportunity to convene virtually once again. As we do so, I continue to reflect on the way the pandemic has transformed businesses and sectors of the economy, much as it has changed life for all of us. Unfortunately, some aspects of the way we live and interact may be significantly altered for some time. But focusing on today, I will share some of my perspectives about the impact of the pandemic on the community bank sector and the potential of technology to help meet the challenges of this new environment.

The financial services industry has experienced rapid technological change over the past few years, and there is no sign that this change will slow any time soon. Innovative technologies were already driving greater efficiency and creating opportunities for banks and their customers before the onset of the pandemic. In the past year and a half, these trends have accelerated, and I expect this level of performance to establish a new threshold of industry expectation. Let's look at education as another example of an industry that has been transformed. We saw schools throughout the country quickly leverage technology to shift to online learning last year. Schools implemented innovative technology solutions to continue curriculum, and to creatively engage students and build virtual student-teacher relationships. While the implications of a period of prolonged online learning are not yet clear, technology enabled the expansion of the range of learning alternatives and essentially prevented the American education system from grinding to a halt. Some of these new tools will likely continue to be used even as in-person instruction returned this fall. We are seeing service providers in a variety of industries leverage technology to engage with their customers—from education, to retail shopping, to fitness training and beyond.

In the banking industry, technology continues to encourage new ways of interacting with and serving customers that can help banks meet the needs and preferences of their customers and communities. Such innovation creates important opportunities for banks of all sizes and business models. As regulators, it is also important that we monitor how banks are adapting and evolving in response to these changes, and that we offer insights and clear expectations to help banks manage associated challenges.

Broad Innovation Considerations

Community banks continue to play a vital role in supporting local communities. Their ability to thrive in an increasingly digital landscape is critical to the economic well-being of those communities. Through my regular engagement with community bank leaders, I do see innovation thriving. When banks can be agile in developing relationships with third-party providers to meet unique customer needs, they can find their own paths to innovation. For example, community banks approach the evolving payment needs of tech savvy customers from many different angles. Their solutions include partnering with financial technology (or fintech) companies, developing peer-to-peer payment solutions with their core providers, and even hiring outside developers to create their own apps that will best serve customers' needs.

While positive trends in community bank innovation are encouraging, I am also attuned to the challenges community banks face when seeking to innovate. I have heard from many community

bankers about the constraints they face in taking advantage of new technologies—both in terms of the resources and the expertise required to adopt innovative technologies in a responsible manner. The cost of conducting due diligence on prospective partners can be high for community banks already facing capacity constraints. Seeking a partnership with a newly established fintech company may introduce additional complications. For example, a less experienced partner may be able to offer a product that fits a community bank’s needs but may not understand the bank’s regulatory obligations or have fully developed operational or compliance frameworks. Gaps in the ability to demonstrate or guarantee compliance can introduce risk that a community bank will need to fully understand and ultimately to manage.

In December 2020, I spoke about several initiatives being pursued by the Federal Reserve targeted at promoting access to innovation for community banks and overcoming related challenges. Today I am happy to provide updates and announcements about those initiatives. I hope that each provides additional clarity and serves as a valuable resource to community banks as they pursue their own innovation strategies.

Community Bank/Fintech Partnership Paper

The first initiative is the publication of a paper highlighting some of the promising ways that community banks are partnering with fintech companies. It lays out some important issues that banks must consider to maximize the effectiveness of the partnership. This paper is the product of an extensive outreach effort with community banks, fintechs, and industry stakeholders. It involved discussions focused on the strategic and tactical decisions that support effective partnerships in a responsible manner.

Community banks engage in a range of partnerships with fintechs, each pursued for different reasons, with varying levels of investment of time and resources. The paper describes key partnership types and the associated benefits, risks, and challenges that community banks experience with each type. The paper also identifies fundamental considerations for effective partnerships as described by community bankers.

Some valuable insights emerged from our outreach, which may benefit community banks at various stages of the innovation process. Two important themes stood out: the first is establishing trust and aligning with fintech partners, and second, building a long-term culture committed to innovation. Let me elaborate on each of these themes.

In our outreach, bankers noted that it is critical for partnerships to be built upon a foundation of mutual trust and alignment of values. In some cases, due diligence efforts reveal that potential partners do not share the banks’ values or objectives. One bank, for example, began discussions with a fintech company that could assist it with the bank’s Paycheck Protection Program loan originations by providing a customer-facing application portal. After learning that this partner intended to sell the small business customer information it would obtain, the bank opted out of the partnership. Instead, the bank looked to other fintech partners with values more closely aligned with its own.

Harnessing the full potential of technology innovation also requires a long-term, strategic commitment to innovation. Many bankers spoke of the importance of knowing exactly what new technology is solving for, building a team they trust, and securing buy-in from both senior management and the staff responsible for implementation. Bankers who have forged successful partnerships don’t innovate for the sake of being innovative but instead have a clear vision of their goals. For example, one bank partnered with a fintech company to roll out limited banking services to teenagers. Its intention was to promote financial literacy among young people in the community and to prepare the bank to accommodate the preferences of a new generation. The bank also hired local college students to work with staff, combining the technological expertise of these more recent hires with the deep compliance background of the bank’s long-standing employees.

Interagency Fintech Due Diligence Guide

In addition to the paper, the Federal Reserve, Office of the Comptroller of the Currency (OCC), and Federal Deposit Insurance Corporation (FDIC) have recently published a vendor due diligence guide to assist community banks with their risk assessment when considering a new relationship with a fintech. I have often heard from community bankers that the manpower and other costs related to due diligence are formidable barriers for banks seeking to establish new third-party relationships. A recent survey of community banks confirms that burdens related to due diligence are indeed an impediment to new third-party relationships, including those with fintechs.¹ This guide was developed to help reduce these burdens by providing a practical resource for community banks when assessing the risks of potential fintech partnerships.

This optional and customizable resource does not establish new regulatory expectations but it can serve as a starting point for banks in their due diligence process. A community bank can tailor how it uses the guide to meet its unique circumstances and the specific risk-management needs posed by each fintech relationship. A community bank can also share the guide with potential partners to help them understand the bank's risk-management requirements. Specifically, the guide contains relevant considerations, sources of information, and illustrative examples within six key areas of due diligence. These include, but, of course, are not limited to, business experience and qualifications, financial condition, and legal and regulatory compliance. I hope this guide will encourage responsible innovation that takes into account the range of potential risks of a partnership in addition to its potential benefits.

Request for Comment on Interagency Third-Party Risk Management Guidance

While the Federal Reserve will continue to focus on developing resources for the community bank sector, it is also important to ensure that guidance is up to date, it supports the evolving range of partnerships, and it is consistent across all banking agencies. In July, the Federal Reserve, the OCC, and the FDIC published for comment proposed guidance for banks managing the risks of third-party relationships, including those with fintechs. This guidance should reduce unnecessary burden by eliminating variation in supervisory views. It is also my hope that this guidance will better address the landscape of the third-party relationships that exist today. I am particularly interested in hearing from a wide range of community banks on whether the guidance is clear, helpful, and appropriately calibrated to address the risks associated with these arrangements.

Use of Artificial Intelligence

The final topic for my remarks today is the use of artificial intelligence (AI). Through clear, consistent supervisory guidance combined with useful tools and resources, supervisors can continue to support community banks in their efforts to navigate an increasingly complex world. In pursuit of this goal, in March of this year, the agencies published a request for information on financial institutions' use of artificial intelligence. As part of this request for information, the agencies sought details about banks' challenges in developing, adopting, and using this technology, including those challenges related to third-party services.

While we are still reviewing and processing the feedback, initial reactions from Federal Reserve staff indicate that these responses are very helpful in our consideration of next steps. So, I would like to thank those who provided comments in response to the agencies' request, especially those pertaining to the use of artificial intelligence by community banks. Comment letters confirmed our understanding that at times community banks choose to engage with fintech partners and their models to tap into the benefits of AI. We have also heard loud and clear that acting on an interagency basis to ensure regulatory consistency is very important. As we consider the information collected and the potential next steps, I will encourage Federal Reserve staff to continue exploring opportunities to provide supervisory clarity on this topic and more

generally to consider ways to help community banks innovate in the application of new technologies.

Conclusion

In conclusion, I welcome comments and feedback not only on the resources the Federal Reserve and other agencies have published recently but also regarding additional resources that may be helpful for community banks as they continue to pursue access to innovation. And in the coming weeks, I look forward to participating in two upcoming innovation-focused programs oriented toward community banks. The Federal Reserve will host an “Ask the Fed” program later this fall focused on community banks and service providers, and the Board and the Kansas City Reserve Bank will jointly host an Innovation Office Hours event later this month.

Frequent and continued engagement with bankers, fintechs, and other third parties has demonstrated the nuance, complexity, and many considerations involved in promoting community bank access to innovation. It is my sincere intention that the community bank/fintech partnership paper, the vendor due diligence guide, and proposed third-party, risk-management guidance serve as a foundation upon which the Federal Reserve will continue to build.

¹ Conference of State Bank Supervisors, [2020 CSBS National Survey of Community Banks \(PDF\)](#), 2020 Research and Policy Conference. [Return to text](#)