EXCLUSIVE INTERVIEW TRANSCRIPT

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EM: I want to get a feel, in the early stages of 2019, what the top risk areas are essentially that you're concerned about at this stage.

PK: Sure, and I think it's a fair question. At Bryn Mawr Trust, I'm sure it's probably consistent with other institutions. We measure risk through major categories, and our major categories align with a regulatory perspective as well. So, in our case, we evaluate strategic risk, credit risk, what we'll call financial risk and within the financial risk bucket, it's interest rate sensitivity, as well as liquidity risk. We've got operational risk, as you might imagine. Legal and regulatory. And reputational risk as well. And those are really the major buckets that we really apply our lens to.

And, if I had to say, one of our top risks that we're currently managing to in this environment, it's really the rising rate environment and what that's doing in terms of driving deposit competition within the Philadelphia market in particular. And really ensuring that we remain relevant to our customers, both existing and those that are prospects, and that we can compete with the larger institutions in the markets that we serve. So that's certainly one of our top risks.

And when you take a look at where we are in the economic cycle, and I'll categorize this as partially strategic and partially credit, but when we look at competition within the markets that we serve, we're really—and I think institutions from Bryn Mawr [Pennsylvania] are probably in the same boat—reevaluating terms and pricing in the loan market, as well. So, in the lending arena, what we're seeing is a slackening in our competitors. And I'm sure everyone's saying that about everyone else, but in our competitor's pricing and in our competitor's deal structure.

[Editor's note: For more about loan competition, check out the April 2019 Senior Loan Officer Survey from the Board of Governors of the Federal Reserve System.]

And one of the things—we are a community bank, we have significant concentrations in commercial real estate, as you will see if you take a look at our financials and our call reports. And we've got specific metrics that we manage to on that front, to ensure that we understand from a risk perspective whether or not we're really loosening our credit criteria and what I mean by loosening, we may be approving deals that are still within the confines of our credit policy, but you might start to see a trend where leverage may change over time or the debt service coverage [ratio] may change over time.

And we take these measures very seriously … and these are part of our key risk indicators to make sure that we know where we are on the risk spectrum. We will evaluate the totality of our quarterly underwriting to make a determination as to whether the needle is moving positively or negatively when it comes to debt service coverage [ratios], when it comes to loan to value [ratios], when it comes to term and amortization. So, these are metrics that we follow very specifically, and they're bellwethers for whether our underwriting's consistent quarter over quarter. And that helps us as a management team to understand where we are. And it also helps to provide information as to whether or not we as a management team decide that we want to loosen our credit standards.

And to date I would argue that we have not. But when you don't, you can expect stiff competition that you're going up against, and you're going to lose some deals. So, there's a reaction for every action, and not all of them are going to be beneficial to us so. If we're not growing our loan book quarter over quarter, what kind of an impact is that going to have on returns at the end of the day? And driving shareholder return in particular.

So those are the immediate two things that I think we're currently managing to. From a regulatory perspective, I had some folks inquire the other day, "What do think about the Dodd-Frank reform?" And I've got to be honest with you, from our perspective as a Main Street bank, not as a CCAR [Comprehensive Capital Analysis and Review] or DFAST [Dodd-Frank Act Stress Test] bank, but really as a Main Street bank, we've not felt any meaningful relief from our perspective, with regard to the regulatory reform that was passed last May.

And from our perspective, we're managing our regulatory affairs and our compliance risk in a manner that is commensurate with how we have in past years. And there's a significant expectation, and there should be, on financial institutions to comply with laws and regulations. Obviously, a part of that is to ensure safety and soundness, and part of that is to ensure that there's fair treatment of our consumers, so we understand the need to be compliant.

But we haven't really ... your Main Street banks, I would argue, have not seen the same level of benefit from that reform. But our larger brethren have. And a lot of that has to do with compliance costs around stress testing and being designated as a systematically important financial institution, or not. So, these changes did have more of a direct effect on larger institutions.

EM: In bringing that up, and I know you guys are just a hair below $5 billion [in assets], so you're still a bit away from that $10 billion barrier. And [regulators] moved some of the risk practices on stress testing and having a risk committee, [so] that $10 billion barrier's not what it once was. Was that something you guys were preparing for? I'm just wondering if it changed how you looked to that $10 billion mark.

PK: We have aspirations to become a larger institution, and we are prepared to accept a higher level of regulatory expectations from our primary functional regulator. And many of us have been in $10 billion, or larger than $50 billion, institutions on the executive team. So, over the course of last year—year and a half in particular—the board and the CEO, Frank Leto, really went out of their way to invest in talent that will better prepare Bryn Mawr Trust to make those hurdles, if you will. And specifically bringing in leadership, from BB&T [Corp.] in the way of our chief technology officer. From PNC [Financial Services Group] in the way of our president of wealth [management]. From Key[Corp.], most recently, ensuring that we bring on board a chief credit officer [who] has larger financial institution experience. Our CFO has already had larger experience with both Susquehanna Bancshares and First Niagara [Financial Group, which was acquired by KeyCorp in 2015]. Myself, as the chief risk officer, I'm in the same boat. I had been up at First Niagara. I had been down at Susquehanna as well and more recently, I was down at Bank of the Ozarks, or Bank OZK as they've been rebranded.

So, we have the ability, the luxury to have a number of executive leaders who have been in larger organizations, who understand what the governance expectations are, what the regulatory expectations are. And it's really about evidence in the process and making sure that the right leaders have a seat at the table, and that decision making is transparent and well understood. So, participation is key here. And I think the group that we have around our table, our leadership table, understands that. So, we are prepared when the time is right. And that time needs to be determined by the board, by the CEO, and certainly collectively with that executive team's input. But we feel confident that as we broach the $10 billion mark, we will be prepared to move forward—and that's going to include additional investment in people, in process and in technology, and I think that's fairly well understood at this point.

EM: One of the questions we asked in [Bank Director's 2019 Risk Survey] was to get a feel for the role of the board in loan approvals. So, I wanted to know how your board's involved in this area. Are they approving specific loans, or is it more on the credit policy side? How are you guys involving the board here?

PK: We establish certain thresholds by category, and if a deal is approaching or breaching a particular threshold, we will bring it to the board for their review and approval. But the goal here is really to manage as many of the deals as we can under existing credit policy. What we consider to be an enhanced risk management perspective—where certain construction deals may be involved or certain commercial real estate deals may be involved—we will bring select deals that meet certain criteria to the board.

EM: It sounds like this is a pretty rare instance.

PK: Yeah, it's not business as usual, that is correct.

EM: Okay.

PK: The majority of our decisions, we would not in the ordinary course of business bring any large volume of loans to the board for their approval. And if we look at what the board's responsibility really is, it's really that of oversight, and not necessarily stepping into the shoes of management. They're directing us to ensure that we have policies and limits in place as a management team. That we have appropriate management information reported. That we're transparent in that reporting up to and through the board of directors, and that we maintain a system of control within the organization, and that we can evidence the effectiveness of that control over time, whether that's a first line of defense, a second line of defense or ultimately the third line of defense.

And we really account for those lines as follows. Anybody who owns process in terms of sales and operations is really on that first line of defense, and they own their process, their risks and their controls. Risk management is there to perform monitoring, testing, risk aggregation, reporting, facilitation around risk assessment and generally, understanding the risk landscape across the organization, and reporting against our risk appetite to the risk committee and with the board of directors. And then you've got audit sitting there in that third line of defense, and internal audit's testing effectiveness of our second line of defense programs as well as the internal control environment within the first line of defense. So, I think the long and the short of it is: The board is there to provide guidance and oversight, and management is tasked with truly managing the business and evidencing the same.

EM: Okay. So, something else I wanted to ask you about—we found that a lot of banks below that $10 billion barrier are conducting stress [tests]. Is that something you guys are doing? And could you share with me the benefits you're seeing from that?

PK: Sure. So, we do stress tests, and [regulators expect] that as we hit certain thresholds, particularly in the commercial real estate and construction arenas, that we deploy a level of enhanced risk management over the origination and management of said portfolio.

In our case, what we've chosen to do is to stress test the commercial real estate portfolio on a quarterly basis. And one of the things that we've done over the course of the last couple of years is really evolve that methodology. At one point several years ago, it might've been a coverage methodology where we ensured that we're stressing ... let's say, some percentage of the portfolio. At this juncture, we stress the entire commercial real estate portfolio. And we go so far as to feed the results in a stream, if you will, into our capital modeling exercise for capital management purposes to ensure that as we're modeling our capital needs on a go-forward basis, we're taking into consideration how our own stress results—and we look at stress through three different lenses, very similar to the way that you would do it in a DFAST [Dodd-Frank Act stress test] environment.

We have a budgeted, or “business as usual,” environment. We have an adverse environment, and we have a severely adverse environment. We keep it simple. The Federal Reserve publishes their scenarios on an annual basis, and we key off of those scenarios, and those scenarios are what drive management's assumptions as to the performance of the portfolio. We're not doing a nine-quarter test, we're doing an eight-quarter test. And we're not obligated, obviously—not being a DFAST bank—to do a nine-quarter review. So, we take it over a two-year period, and we roll it forward and refresh it on a quarterly basis as we see our own portfolio evolving, because business either rolls off or is booked.

And we incorporate management's views, not just on the commercial real estate portfolio, but as we do our annual assessment and testing from a capital management perspective, we'll take into consideration impact on our noninterest earning streams as well. So, any of our business models that are predicated upon driving fee revenue, such as our wealth management business, such as our mortgage business, we will actually sit down with management and ascertain their perspectives around how the changing economic environment—as articulated within adverse or severely adverse scenarios—would have a potential impact on those fee businesses. And we incorporate those results into our ultimate outcome.

EM: Okay. So, it sounds like you're getting a good feel for not just its impact on the loan portfolio but different lines of business.

PK: We are, and what we have found ... and I think this is one of your questions, you know, how do we respond to what we see?

We incur stress as we go through these exercises—I wouldn't sit here and say that we don't exhibit some form of stress. We do. However, is what we are observing, in terms of our results, currently changing the way that we will do business? I would say the answer is no. And I'll give you some examples, some what-ifs.

EM: Okay.

PK: If the results were to be indicative of outsized losses, and let's just say for the sake of arguing in our commercial real estate business or in a certain type, you know, subtype or subcategory within our commercial real estate business—that may give you pause for concern. And you may adjust your origination and underwriting risk appetite accordingly, in other words, "Hey, we think we have too much of this category. Based upon the results that we saw in stress testing, we may be loss adverse from a default perspective, and really make a determination, you know what, this is no longer fitting within our risk appetite, let's back off."

We really haven't seen loss results that are currently indicating to us that we should adjust our overall profile, our overall credit risk profile. Now, I will say this, our gut reaction as to where we are in the credit cycle does inform our credit risk perspectives. And we do make certain decisions based upon what we're actually seeing locally in the market, not necessarily through a stressed environment, but actual conditions on the street coupled with where we believe we are in the economic cycle. And that does inform certain adjustments that we make to our credit risk profile. And that's real-time information as opposed to the hypothetically stressed outcomes.

EM: Now I wanted to quickly shift gears a little bit, and I know I've taken up a good chunk of your time, but I did want to get a feel for how you guys are overseeing cybersecurity. Particularly at an executive level, a management level—whether you guys have a [chief information security officer], to be specific—but also how that's addressed at the board level.

PK: Sure. So, a number of years ago we bifurcated the roles and responsibilities, and it actually pre-dates my involvement with Bryn Mawr Trust. So, Bryn Mawr separated the information security role from the information technology role … the information security officer does in fact roll into the chief risk officer, and what we do is maintain an information security program for the organization. So, our responsibility as that second line of defense is really to design policy and program, and that's in conjunction with our IT and operations brethren.

We don't do these things unilaterally, but we do take ownership of the policy and of the program. And then we really work with the IT folks to establish standards, and we monitor against those standards. Those standards may entail firewall settings, they may entail to what degree we go through vulnerability assessments and penetration testing, and how we respond to the same. We established key risk indicators in the information security realm as well.

We look to ensure that we have an understanding around critical patches that are required to be made, and that we can confirm that management is in fact acting on this information, and updating our applications and our systems as warranted to make them as defensible as possible. We do report, we have governance in place where management gets together from the information security, information technology, IT and risk worlds on a monthly basis. And we do summarize results and report up to the board of directors, as well—and/or the risk committee.

We do conduct annual information security risk assessments, and we do participate—being in the financial services industry obviously—in the FFIEC's cybersecurity assessment, as well. And we conduct each of those on an annual basis, and they're not conducted in a vacuum. They are conducted by interacting with and operating with those owners in the first line of defense who actually again, own their process, they own their risk, and they own their controls. So, those initiatives and assessments are joint in nature. Observations that are derived may drive or cause management action. If we happen to see, there's a gap that we need to act on as an organization, that too is escalated and shared with the board, and then management acts on those gaps accordingly.

The system seems to work pretty well. We do have a highly engaged chief technology officer in Adam Bonanno, who recently joined the organization. And he's every bit as strong in information security as he is in information technology. So, I'd say we've got a very, very good partner in place, and our groups work in tandem with one another, so it's truly a joint partnership that we deploy in terms of our business model to manage our cybersecurity threat.

Separately, the information technology group is reporting cybersecurity initiatives and the threat landscape, as well, up to and through the board's information technology steering committee.

EM: It sounds like on the board level—you've mentioned the risk committee, as well as the IT steering committee—in terms of, at the board level and making sure the board has a handle on their oversight of that risk, it sounds like there are a couple of committees involved in that.

PK: There are. And I think that goes back to ensuring that we're getting the right information up to the board, so that they're in a position to discharge their oversight of management accordingly.

EM: Okay. Well, the last thing I wanted to ask you about was toward the regtech area. There's a joint statement by the federal regulators [offering] some guidance regarding innovative technology [Bank Secrecy Act/anti-money laundering compliance]. In terms of solutions and providers, there's been a lot of growth in this area, so I wanted to get a feel for where you're seeing opportunities to deploy regtech in your own organization, and whether you're feeling some regulatory pressure or a need to heed that guidance and make some enhancements there.

PK: First and foremost, we want to ensure that we comply with the applicable laws and regulations, so whether they be the U.S. Patriot Act, various anti-money laundering statutes, or the Bank Secrecy Act, as well as OFAC [Office of Foreign Assets Control] requirements themselves. We take an approach where we want to make sure we understand what the law is, and what the regulations are that have been promulgated by the laws. Then, we want to make sure that we're designing work flows that actually meet the requirements of the same. And it's critical ... you know, I always look at business process first, and then I look at technology as a way to achieve an economy of scale. Technology for the sake of technology is not the right answer for financial institutions. I see too often in my career where people see the greatest thing, and they just say, "Well, let's go do it," and they take their old process, they jam it into the new technology, and they fail. And they fail because they really fail to take into consideration what their current environment is and really doing an effective gap assessment as to what it should be. And then designing business requirements before we even look at the new technology, you say, “Look, what do we really need to do, as an organization? So, from a process perspective, from a conceptual design perspective, have we appropriately nailed those requirements?” Then let's go out and vet the technologies that can best render the results that we're looking for, to actually comply with those requirements, which are obviously mapped back to the various regulations and laws themselves.

In that regard, what we seek to do first and foremost [is ask], “Do we have the right process? Do we have the right people?” And then let's take a look at where we are in technology. I will say that we've enhanced our own surveillance technology over the course of the last couple of years, and we continue to broaden our view of customer activity. So, it's not just what would've been 20 years ago, where you say, "Oh well, I've got my retail and my commercial customers covered." Well, what other products and services do you sell to them, and how can you ensure that you're integrating the totality of your surveillance over all products and services? You know, I would be a liar if I said that we were surveilling 360 percent of our product and service offerings in a single surveillance system, but we are capturing most. Overwhelmingly.

We've got a couple of enhancements that we need to continue to focus on, in terms of getting some additional transactional streams into our surveillance and monitoring system. But those are teed up to happen in due course. So, I think we're doing the right things to exploit technology to evaluate and surveil what I'll call anomalies of customer behavior. I think everyone's greatest challenge is understanding, what is that anomaly going to be? And if I were to say that there [was] an opportunity for us to improve in the technology perspective and in the innovative technology perspective, it's really to get the best understanding that you can of what you're expecting customer activity's going to be, so that you can systemically identify anomalies with that static risk profile.

That would be ideal. And that's probably tough. That's really being done in your customer due diligence work flows today. And I think deploying technology might get you partially there, but the technology itself won't be enough. You're really dependent upon how you're reaching out to your customers, how you're acquiring information about what products and services they're going to be using, how they expect to use those products and services, what ancillary services do they anticipate tagging on. Things of that nature. You know, that's probably what we're all after, so that we can make sure that we're surveilling the right activity and acting on that activity as opposed to surveilling all activity, which is an ineffective use of everybody's time.

EM: Patrick, thank you so much for taking the time with me this morning. I really do appreciate it.

PK: Not a problem, Emily. It was a pleasure.