Record of Meeting

Community Depository Institutions Advisory Council
and the Board of Governors

Friday, November 6, 2015

1. **Current Banking Conditions:** *What is the Council's view of the current condition of, and the outlook for, loan markets and financial markets generally? Please describe any significant changes in the creditworthiness of applicants for loans, loan demand, and lending standards in general.*

   a. ***Small Business Lending*****:** *Has credit availability for, and demand for credit from, small businesses changed significantly? Have lending standards for these borrowers changed?*

   Credit remains freely available at low interest rates, and supply continues to outweigh demand. Metropolitan areas in particular have seen an increase in lending, while rural areas remain steady or more stagnant. Many stronger businesses are continuing to de-risk by reducing leverage, and in some cases, business capital needs are being met by equity investors' internal cash flow rather than through bank lending.

   Small business borrowers have ample ways to secure financing, including directly from banks of all sizes, through Small Business Administration guarantee programs, and, more recently, from marketplace lenders. As a result, there has been pressure to lower underwriting standards, resulting in lower spreads, erosion of covenants, lengthened maturities for unsecured tranches in buyouts and acquisitions, pre-revenue or bridge loans, or similar accommodations. Large banks have recently re-committed to the small business lending market using propriety platforms that streamline the lending process, ostensibly lowering costs and giving the appearance of chasing yield. Pricing is thin and provides little risk premium for some loans.

   Community banks remain apprehensive about the sustainability of some competitors, especially marketplace lenders that have only recently entered the market and have not experienced downturns or full market cycles.

   Note: The Council members addressed questions 1.b. and 1.c. together, as construction lending is a subset of commercial real estate lending.

   b. ***Commercial Real Estate Lending*****:** *Have there been any changes in the Council's view of challenges in the commercial real estate market since the beginning of the year? How are commercial real estate loans performing compared to the Council's expectations?*

c. **Construction Lending**: *What is the Council's view of the availability of credit for construction and development projects? Have Council members seen any changes in the demand for construction loans since the beginning of the year?*

Demand for CRE and construction loans remains robust – especially in urban areas. Not surprisingly, gateway cities have seen an influx of foreign capital investors. Multifamily, senior, and student housing have been the most appealing asset class as of late. Conversely, the hospitality industry is saturated and could see a decline. Property values continue to increase, with many being at pre-recession levels, and Council members report concern about asset values supported by historically low cap rates in appraisals.

Council members are concerned about pressures to ease underwriting standards as a result of increased credit competition. In addition to competition from banks, insurance companies, and GSEs, Council members are seeing the entrance of nonbanks and REITs. The decline of cap rates continues to be a worry, especially when combined with the prospects of increasing interest rates. Some believe this might contribute to another real estate bubble, as some market factors appear similar to those of 2006 and 2007.

Given the availability of credit, borrowers know they can leverage their lenders and push for competitive rates and nonrecourse loans. Additionally, borrowers are often pre-paying and selling or refinancing their equity interests early in the development of projects before stabilization. Council members are hesitant to meet these borrower demands in order to maintain prudential standards. Several Council members report that loans previously held in their portfolios have been taken out by aggressive competitors because members were unwilling to cut underwriting standards, and some report substandard-rated CRE loans being taken out by competitors.

Currently, loans are performing well, but there is a concern of market nonperformance in the next few years if the trend to originate lower-quality loans continues.

With regards to construction lending, more clarity is needed surrounding the High Volatility Commercial Real Estate regulation. The rule will likely cause certain loans to be priced differently, but as of now its final impact remains to be seen as the market digests the implementation of the rule and lenders seek further clarification regarding its application.

d. **Home Mortgage Lending**: *What changes has the Council seen in the mortgage market since the beginning of the year? Is a trend developing among community banks to increase, decrease, or cease home mortgage originations, and if so, what are the likely causes for and effects of this trend?*

Many Council members are experiencing high demand for home-purchase mortgages, more so than for mortgage refinancing. Overall mortgage portfolios have increased, especially in the case of jumbo loans. Jumbo loans tend to have high-quality borrowers and have resulted in low delinquencies or defaults. Overall delinquencies are in line with those from last year.

The increase in compliance costs associated with the home mortgage business has made the business unprofitable for some banks, resulting in many banks with noncore commitments leaving the business. This is particularly true for smaller and marginal lenders. Implementation of new or expanded regulatory rules, such as the TILA-RESPA Integrated Disclosure (TRID) and HMDA, continue to pose challenges and, in some cases, are directly impacting the home mortgage lending market. For example, under the new TRID rules, banks are being forced to lengthen the amount of time that lapses between the application and the closing, which is forcing consumers into longer, higher-cost rate locks. Furthermore, due to the lack of competition in smaller and rural areas, regulatory burden is having a disproportionate impact, despite regulatory accommodations aimed at these areas.

The TRID rule continues to be an area of concern for Council members; however, potential market impact remains to be seen, as the implementation date was only a month ago. The TRID vendor performance, in particular, has been problematic and will likely remain a challenge in the near term. The Council is also concerned about the education of nonlending real estate professions, as well as consumers as they transition to a new set of disclosure documents. Lastly, qualified mortgage (QM) loans remain the business of choice for many community institutions, while others originate both QM and non-QM loans.

e. ***Consumer Lending*****:** *What changes have Council members seen in consumer lending?*

Consumer loan demand is relatively stable. Auto loan demand has increased, and there has been an increase in auto loan volume. However, low rates and longer terms on these loans often make them marginally profitable. Demand for HELOC loans has also increased, but the Council has concerns that prospective increases in HMDA reporting may increase compliance costs sufficiently to affect the business. Student loans are becoming more difficult to underwrite due to the extreme regulatory risk.

Banks that are not primarily consumer lenders are increasingly exiting the market due to increased regulatory and compliance costs. It has become increasingly expensive to keep up with regulations for multiple products, leading banks to specialize in a few select products. The movement of consumer lending to the mostly unregulated nonbank sector is increasingly worrisome.

f. ***Agricultural Lending*****:** *Have there been any changes in agricultural lending?*

Areas with high concentrations of agricultural businesses note that there has been a decrease in agriculture lending largely due to falling commodity prices. Farming equipment has seen a significant decrease in demand, resulting in lower loan demand for equipment and declining value for existing equipment. Weather remains a concern as the drought continues to be problematic.

Though production remains good in most areas, land prices are falling at a lagging rate compared to commodity and equipment prices. Agriculture loans of all types tend to have balloon-payment features as a matter of practices, and a normal part of the cycle for such loans is to have increases in carry-over debt in conditions such as those currently existing. The Council recommends that supervisory policy avoid any precipitous response to this trend, which might serve as a market disruptor.

g. ***Deposits*****:** *Have Council members seen any changes in local deposit markets?*

Deposit availability remains stable. The cost of funding has been low, but many Council members are waiting for the anticipated federal funds rate increase. Some are concerned that the stability of their balance sheets will be threatened by the possible volatility in rates. The Council has seen increased competition from online and large banks, especially in markets where banks are trying to gain access and grow market share.

2. **Economic Discussion:**

a. ***Overall Economic Conditions*****:** *How do Council members assess overall economic conditions in their regions?*

Economic expansion has steadily increased across the Districts. Inflation has been low, housing is strengthening, and consumer confidence has continued to improve. However, Council members are concerned with certain dichotomies that have been observed.

One dichotomy concerns the "urban versus rural regions." Urban centers are seeing the majority of economic growth, while rural regions are being left behind and experiencing more struggles. Another dichotomy is the contrast between weakening energy sectors and a booming tech industry. Lastly, there is a marked contrast between the healthy employment prospects of skilled laborers and the displacement of low-skilled positions.

b. ***Particular Indicators*****:**

i. <u>*Inflation*</u>: *Are the prices of products and services rising more or less quickly (or declining more) than in the recent past? Are the prices for the* *products and services Council members purchase rising more or less quickly?*

Inflationary pressures are generally low. However, most Districts have observed inflation in health care and higher education costs. Low interest rates have also contributed to real estate inflation in urban centers, especially related to rental housing.

Some Council members believe surplus labor demand will result in wage inflation in the near future, although this trend has not been observed yet, except in skilled roles.

The Council also believes inflation has more upside than downside potential.

ii. <u>Housing</u>: *How have house prices changed in recent months? Have there been any changes in housing activity overall in Council members' regions?*

In general, the Districts are experiencing fairly stable housing prices with values at pre-recession levels. Both domestic and foreign investors have increased investments in housing development. However, the dichotomy continues between urban centers and rural regions. A drop in rural employment opportunities has resulted in fewer first-time homebuyers in rural areas, and in a net increase in demand for metro area housing.

Housing demand in urban centers has led to steadily increasing home and rental prices. In contrast, rural regions are seeing stable housing and rent prices, or in some cases, declines in these prices. The Council predicts that homeownership will become more attractive as rent prices continue to rise.

iii. <u>Labor Markets</u>: *How have the labor markets in which Council members operate changed in recent months? In particular, assess the degree of job loss or gain (how much and in which industries). What changes to wages have Council members observed in the past year?*

Labor conditions have continued to improve over time, and unemployment continues to decrease. The energy sector is struggling, as oil and gas prices remain low. However, some Council members predict employment growth in the considerably healthier technology industry.

The residual effects of labor disputes at West Coast ports have caused shipping activity to move to alternative routes. Council members whose Districts have been affected by these changes believe they represent a permanent shift. Increased port activity on the East Coast and the widening of the Panama Canal have increased the demand for construction as these ports become more heavily used. This shift has caused employment in the construction sector to grow.

The supply of skilled laborers has been tightening, and position postings appear to be on the rise, causing Council members to anticipate wage inflation. Several Districts are observing job cuts at universities, while others are seeing evidence of low-skilled labor displacement as a result of new technology.

iv. <u>Consumer Confidence</u>: *Is the Council seeing signs of improved consumer confidence? What is the outlook for consumer credit losses?*

The Council indicates that consumer confidence has continued to improve, but consumers are still hesitant in some regards.

Improved consumer confidence can be observed in the auto lending sector, which has increased considerably. Also, consumers have become more confident as home equity borrowing increases. Consumer credit losses are at unprecedented lows, and delinquencies have continued to decline.

However, some Council members believe consumer confidence is being restrained by the belief that the business cycle is at an advanced stage. For example, small businesses are using cash to fuel expansions in place of getting loans in order to avoid taking on additional debt.

In addition, consumer confidence is being constrained as consumers are faced with higher health care and education costs.

3. **Trends in Financial Services:** *How is technology affecting (1) credit and financial services products and (2) access to those products in the communities you serve, including low- and moderate-income communities? Has technology expanded access for underserved populations or acted as a barrier to access in some cases? What has been the effect of the changing landscape of branch banking and the increasing availability of digital banking channels on the communities you serve, including low- and moderate-income communities?*

Technology has had a limited impact on access to bank products, both deposit and credit. For example, the primary reasons people do not have bank accounts are not addressed through technology. Various studies, including those from the FDIC and Federal Reserve System, show that the primary reasons for not having an account are a lack of money or consumers simply do not want or need a bank account. Few consumers do not have an account because of prior mismanagement. Community banks find that many without bank accounts may not trust technology or institutions, including banks. They are also concerned about who (including the government) can access their bank account information and obtain information about their income and assets.

In addition, the process of opening an account, due to regulatory requirements, may be discouraging, especially to those without bank accounts who are already distrustful of institutions generally and of banks in particular. For example, many find the "know your customer" procedures to be intrusive and unwelcoming, including requirements for identification documentation and identifying the source of the deposits. While the process is applied uniformly for all customers, those without accounts may be more put-off and sensitive to the intrusive process. Technology does not solve this discomfort and distrust. The complexity of the reasons some choose not to have bank accounts was illustrated by a Council member's institution that had opened branches in low-income areas, hired staff from the community, and offered free/low-cost accounts and quick availability of or access to deposits but that nonetheless met with limited success. Some potential alternatives, like prepaid cards that offer a simple, safe account, may be thwarted by pending regulations.

Community institutions find that technology does allow customers more ways to interact with the bank and manage their finances. However, those expanded opportunities may not be attractive or usable to those without bank accounts. For example, low- and moderate-income people may have broad access to smart phones, but it is not clear that their habits and familiarity with navigating websites on a smart phone or tablet translate into comfort with applying for or managing a bank account.

The limitations of technology apply equally to credit products, in particular to small-dollar loans. Moreover and importantly, technology does not change the obstacles that regulatory pressures impose on developing and offering affordable small-dollar loans. For example, the OCC and FDIC Guidance on Supervisory Concerns and Expectations Regarding Deposit Advance Products complicates efforts to develop small-dollar products. Similarly, the small-dollar loan proposal recently released by the Consumer Financial Protection Bureau sends the message that banks should avoid making small-dollar loans. Small institutions also expressed concern about their ability to offer accommodation small-dollar loans due to potential disparate-impact challenges.

Finally, technology does not necessarily make the business of banking less expensive. There are costs to develop, build, maintain, and protect technology and databases. While technology can replace less efficient systems, it often adds to rather than substitutes for existing systems. Moreover, the technology can exacerbate the supervision of small banks when regulators develop sophisticated regulation matrixes based on their experience with larger institutions in metropolitan areas. These systems may not be appropriate for evaluating small institutions, especially institutions in rural areas.

4. **Examination Practices:** *Have Council members experienced problems with recent examinations? In particular, have examination practices constrained access to credit by creditworthy borrowers? What steps can be taken to address the Council's concerns?*

Satisfaction with examination practices generally has improved. The Council continues to find no process issues in safety and soundness examinations and an improved environment for compliance examinations. Council members continue to view increases in the complexity and costs of regulatory compliance as posing a major burden on insured depository institutions. Compliance has increased costs to consumers and affected business strategies.

The examination environment has improved in two areas where the Council has previously raised concerns. First, examiners have been clearer in their instructions to delineate between suggestions and required changes. Second, examiners are less likely to suggest best practices that may be appropriate for larger, more-complex institutions but are inappropriate for community institutions. Overall, the examination process has become more collaborative, to the benefit of the banks being examined as well as examination staff. While the examination environment has improved, however, the burden of complex compliance regulations has become greater as the number of regulations continues to grow.

The Council is encouraged that regulators in leadership positions frequently have called for supervision that is tailored to the complexity and business risks of the institutions being examined. However, the Council members remain uncertain that adequate plans are being made to tailor supervision to achieve this objective. It is essential to establish and execute such plans so that smaller banks can better serve the communities in which they operate. The Council members estimate that they spend three to four times as much of their week on compliance management as they do on developing and executing business strategy. The relative burden of compliance is reducing innovation and flexibility in delivering community financial services.

5. **Regulatory Matters and the Future of Banking:** *How are recent changes in the regulatory landscape affecting community depository institutions' ability to continue to provide services to their customers? What has been the effect on the industry generally?*

The regulatory landscape continues to hinder community institutions' ability to meet the needs of their customers. Historically, community banks made loans to consumers who larger banks did not know as well, who required more personalized service, or who were otherwise unattractive or unprofitable for large banks. However, community banks now find themselves increasingly encumbered by regulation that is not tailored to their missions and purposes, and they are accordingly less able to compete and offer community-based, value-added services. A poignant example mentioned by one Council member involved the financing of startup businesses. Many community institutions from his District have curtailed making loans to startups because the regulatory risk was too much of a concern. But if community institutions cannot offer such financing, what types of institutions are providing it? What other market opportunities might smaller institutions be forgoing because of the associated regulatory burden? The Council continues to urge the Board to consider tailoring regulatory standards across different institutions based on their risk, business model, and other factors to permit community institutions to better serve their markets.

Furthermore, many Districts have also found that their institutions have been forced to exit other business lines or not offer certain products because of high regulatory costs or compliance risks (or both). As previously stated, many of the business lines being exited are related to consumer lending. However, residential lending has also seen a trend of banks exiting that business, especially when it is not a core business for the bank or when achieving the necessary operational scale was difficult for the bank to achieve. Ultimately, institutional departures from certain business lines or products have an adverse effect on the consumer, as credit becomes harder to obtain and product diversity is reduced. The consumer is also losing a degree of service that has been unique to community banking.