

RECORD OF MEETING

Federal Advisory Council and Board of Governors

Friday, December 4, 2015

Item 1: Current Financial and Economic Conditions

What is the Council's view of the current condition of, and the outlook for, loan markets and financial markets generally? Are there any notable developments in loans for (a) small and medium-size enterprises, (b) commercial real estate, (c) construction, (d) corporations, (e) agriculture, (f) consumers, or (g) homes? Do Council members see economic developments in their regions that may not be apparent from the reported data or that may be early indications of trends that may not yet have become apparent in aggregated data?

General Outlook:

- The availability of credit in all asset classes remains abundant. Intense competition for the most creditworthy customers has resulted in continued margin compression and the loosening of credit terms. Banks continue to look for loan growth, expense reductions, and productivity enhancements to offset margin compression.
- Loan demand has generally increased during 2015 but remains tepid compared to this stage of past economic recoveries.
- Momentum and confidence has been building within the small and medium-size enterprises segment as we close out 2015. While there has not been a broad-based return of small business owners seeking new credit, confidence is improving and banks remain positive with their outlook going into 2016. New business formation remains very low.
- Commercial real estate fundamentals continue to improve for most major property types, with some Districts reporting moderately increasing project flow and stronger demand compared to earlier in 2015. Near-term outlook for this sector is strong, as property performance metrics are at all-time highs. Potential overdevelopment poses the greatest threat over the longer term.
- Increases in land costs and the overall higher cost of new construction are making new projects more difficult to justify. Increased costs require that projects obtain high rental rates compared to the broader market. Construction demand is slowing as fewer new projects are coming into the market.
- Large corporate borrowers continue to have ample access to bank lending and funding via the capital markets. Corporate lending is expected to continue its moderate growth with several macro themes helping propel demand for debt, including the large number of M&A transactions, continued low level of interest rates, and cheap cost of debt relative to the cost of equity.
- After several strong years, farm revenues are declining. As prices for agricultural commodities continue to decline, loan demand from weaker producers for interim borrowings may increase, and the overall reduction of debt may slow as farmers change their spending patterns.

- Given the continuation of low commodity prices, energy and related industries continue to be monitored closely. In particular, smaller oil-field-services companies are showing considerable weakness with losses expected. The continued uncertainty has resulted in a halting of growth in this market.
- Consumer loan demand is growing as a result of improved confidence by consumers to spend and finance part of their purchases by taking on more debt. While improving, consumer attitudes and spending are not at prerecession levels. Stable borrowing and default rates for auto loans and credit cards contributed to strong overall performance in consumer credit markets.
- Mortgage loan demand is strong, fueled by purchase volumes despite low levels of home inventories. There is expected to be continued strength in purchase volumes and a downward trend in refinance volumes with the anticipated rise of long-term interest rates.
- With the rollout of the TILA-RESPA Integrated Disclosure Rule in October, there are many unclear interpretations of and questions regarding the regulation. The timing that this regulation adds to a mortgage loan will push most mortgage transactions from 30 days to 45 days. Real estate agents in the markets have a varying level of knowledge of the new regulation.

(a) Small and Medium-Size Enterprises

- There are no observable changes since the September 2015 FAC meeting in the availability of credit for small and medium-size enterprises, which remains abundant. Intense competition for the most creditworthy customers has resulted in continued margin compression and the loosening of credit terms.
- The current environment for the creation and growth of small businesses is favorable, with positive economic activity in sectors other than energy. Borrowing has continued to improve and loan demand is increasing in certain markets, although at a relatively slow rate. Small businesses are beginning to make and/or plan capital expenditures, but not nearly at historical levels.
- The Small Business Association (SBA) program continues to be a bright spot in this sector and a strong focal point for both borrowers and lenders.
- Lower commodity prices have impacted businesses with energy- and agriculture-related activities. While most districts are well diversified, the energy and agriculture sectors continue to play a prominent role in certain Districts.
- In general, credit quality remains strong; however, as we approach the bottom of the cycle, past-due levels and charge-offs may increase.
- While banks continue to be the primary source of funding for small business owners, nonbank lenders are becoming an increasingly strong force in the market.

New Observations since the September 2015 FAC Meeting

- Small and medium-size enterprises are generally stronger in Q4 2015 than Q3 2015. Momentum and confidence has been building within this segment as we close out 2015, but in general business owners remain relatively cautious. While there has not been a broad-based return of small business customers seeking new credit, confidence is improving and banks remain positive with their outlook going into 2016.

(b) Commercial Real Estate

- Commercial real estate fundamentals continue to improve for most major property types, with some Districts reporting moderately increasing project flow and stronger demand compared to earlier in 2015. While the recovery in commercial real estate over the last years has been strong, it has been somewhat uneven. Major markets have recovered much better than nonmajor markets and, across submarkets, apartment prices have recovered the most since the crisis.
- Multifamily developments continue to perform at very high levels and trade at very low cap rates. The loan market remains robust; however, lending supply continues to exceed demand, so competition among lenders is fierce. The rapid growth is driven by demand from millennials, low interest rates, rising (but slowing) rental rates, and low cap rates.
- The office market has experienced a slow recovery. Office vacancies rates have improved only marginally over the last several years. More recently, some submarkets have noted that rent concessions are appearing and vacancies are increasing.
- The retail-center submarket continues to perform well in the occupancy area, but new development has slowed. Overall, this sector is still experiencing a very tepid recovery. Vacancy levels have only modestly declined from their recessionary peak. Growing e-commerce will remain a headwind for this submarket.
- Industrial assets have experienced a moderate recovery to this point, but investors and lenders are increasingly optimistic about this sector. Secondary and support markets are beginning to build momentum.
- The hotel industry has continued its strong fundamentals recovery. Full-service properties continue to lead, with select- and limited-service assets posting slower gains.
- The cost of new construction continues to increase. Rehabilitating and/or refurbishing existing properties to compete with recent new product have been prevalent in 2015.
- Credit from the banking community continues to be readily available for quality construction and development projects.

New Observations Since the September 2015 FAC Meeting

- Property supply and demand have come closer into balance during the second half of 2015. In some markets, demand is now slowing, as occupancy levels are beginning to reach historical averages and lease-up times for new properties are increasing. In the strongest markets, we are seeing some discounting and incentives to boost occupancy. Office and retail space vacancies have risen, and rent concessions are appearing in some submarkets.
- Near-term outlook for this sector is strong, as property performance metrics are at all-time highs. Potential overdevelopment poses the greatest threat over the longer term.
- A survey completed by the Federal Reserve showed that loan standards on net tightened in Q4 2015, while demand rose for multifamily and construction loans. Loan standards on net tightened for both multifamily and nonfarm nonresidential. This is the first time we've seen net tightening for nonfarm nonresidential since the Federal Reserve modified its survey in 2013.
- Anticipating higher interest rates, clients are becoming more aware of interest-rate risk exposure and management for commercial real estate properties.

(c) Construction

- Overall, lender demand has increased for various asset classes within commercial real estate, including construction and development as well as term debt. The supply and availability of credit for commercial real estate construction projects remains ample but varies by both property type and location. Increased competition has resulted in continued pricing pressure and the loosening of credit terms.
- Construction of new retail and office developments continues to be tenant-driven, with very little speculative activity in the marketplace. The retail sector experienced an increase in construction activity and completion from last quarter, although a slight one and on a low base.
- Office acquisition and repositioning are expected to offer more opportunity as the economy continues to recover. Select markets with strong occupancy and diverse demand drivers are beginning to show new development/construction.
- Residential activity is accelerating and forms the core of forecasts calling for housing markets to drive the next U.S. construction boom. Many markets report record low supplies of finished new housing, as well as lot shortages in prime locations. The largest single segment of growth has been development and redevelopment of rental housing stock. This sector continues to benefit from the lack of new rental housing created during the for-sale housing expansion of 2000-2008, as well as the increasing demand for rental housing.

New Observations Since the September 2015 FAC Meeting

- District 9 reports that multifamily construction has curtailed significantly, a sign that the market in certain regions is firming. Completions in the apartment sector declined in Q3 2015. Nonetheless, new multifamily construction remains substantial.
- Increases in land costs and the overall cost of new construction are making new projects more difficult to justify. Increased costs require that projects obtain high rental rates compared to the broader market. Construction demand is slowing as fewer new projects are coming into the market.
- Recent reports suggest banks are tightening some lending standards after years of easing terms.

(d) Corporations

- Corporate lending is expected to continue its moderate growth. Several macro themes helped propel demand for debt, including the large number of M&A transactions, continued low level of interest rates, and cheap cost of debt relative to the cost of equity.
- Many middle-market and large corporate businesses continue to watch efficiency closely, while expanding sales opportunities. Industries showing modest relative strength include some segments of healthcare, suppliers and manufacturers that touch automotive segments, segments within tech and defense, and some consumer/service segments that benefit from lower gas prices and relative housing strength for remodeling/single family/multi-family.
- This sector continues to be highly competitive resulting in pressure on both spreads and structure. There is some evidence recently that suggests pricing is “bottoming.”
- Underwriting has remained consistent, with a slight easing of lending standards for medium-size businesses.

New Observations Since the September 2015 FAC Meeting

- There has been a significant recent rise in requests, driven by companies' concerns about the impact of credit availability after the supplementary leverage ratio (SLR) requirement begins to affect lenders from a capital perspective.
- Loan structures continue to be aggressive, with some recent signs that the decline in loan pricing and fees is slowing in certain segments.
- Chief financial officers are beginning to increase their demand to restructure credit ahead of a perceived interest rate hike. Refinancing into current market pricing is another factor driving down interest margins.

(e) Agriculture

- Grain prices have remained low through the year as a result of favorable growing conditions and high acreage planted. This has continued to enable protein producers, who use grain as feedstock, to generate solid profits. Grain processors benefitted from greater demand for storage and transportation as inventories built up.
- The continued low grain prices have reduced farm profits and land rents, tempering what had been a rapid run-up in farmland values and related fears of a price bubble. However, in some areas, land prices and land rents are continuing to hold.
- Recent declines in oil prices will provide a small improvement in farmer economics as fuel is a material cost for most farms and many of the agricultural products are petroleum based.
- Capital spending is expected to be muted given the returns, which will affect equipment dealers and continue to pressure land prices.
- Implement dealers have seen a decline in new sales, but some seem to be holding on to profitability through parts and service revenues.
- The strength of the U.S. dollar and the impact of High Path Avian Influenza also continue to impair export volume and lead to growing inventories.
- Domestic agricultural industries continue to evolve into ones increasingly impacted by the global supply and demand for key commodities, unpredictable weather patterns, and geopolitical factors. The industry is subject to global markets, which require capital flexibility and highly honed management techniques to navigate thin commodity margins, forcing smaller operators out of business due to their inability to gain the scale necessary for profitable operations.

New Observations Since the September 2015 FAC Meeting

- Many producers were able to liquidate their 2014 crop during a short market rally in July 2015; however, many have stored their 2015 crop to wait for better prices. For the weaker producers, this will increase demand for credit in the form of inventory notes as they also prepare for 2016 input financing.
- Commodity-price volatility and pressures are the biggest challenges for the 2015 crop operating cycle, as the price of many food commodities has declined significantly. While protein producers have enjoyed reduced feed costs, year-over-year sales prices have declined by 37% for pork, 32% for raw milk, 29% for poultry, and 25% for cattle.

- Production agriculture is reporting very strong yields with minimal need for natural gas drying. Higher yields and lower drying expenses will help, but not completely offset, lower commodity prices.
- Most agricultural economists are projecting continued weakness for the 2016 crop year.

(f) Consumers

- Consumer loan demand is growing, but some borrowers remain cautious due to the uncertainty in the economy. While consumer attitudes and willingness to spend are improving, they are still not at prerecession levels.
- Consumers' finances are in the best shape in years. Household balance sheets are repaired, the debt-to-disposable income ratio is at a thirteen-year low, and wealth is above the prerecession peak.
- Consumer loan delinquencies have remained consistently low over the last year, and FICO scores for the average consumer have improved.
- Growth of government-backed student lending continues to be an economic concern. The long-term economic impact of the \$500 billion debt increase in this sector is still to be seen. It appears that the first-time homebuyer age has moved from the middle 20s to early 30s for the average consumer.
- To entice movement of assets held at other institutions, advance rates on loans secured by marketable securities are becoming more aggressive, despite recent volatility.

New Observations Since the September 2015 FAC Meeting

- Consumer credit increased at a rapid pace (\$28.9 billion) in September, driven by auto and student loans. This followed a gain of \$16 billion in August and pushed total consumer borrowing to an all-time high of \$3.5 trillion. A healthy labor market is giving some consumers the confidence to spend and finance part of their purchases by taking on more debt.
- Demand is increasing for home equity lending, attributed to improved home values and economic conditions, as well as an increase in renovation/home repair/maintenance projects that were previously postponed due to the recession. HELOC originations have increased 14.6% from a year ago and have reached their highest level since 2008. The \$82.7 billion in originations year-to-date through September is 23.3% higher than the same time last year.
- Stable default rates for auto loans and credit cards contributed to strong overall performance in the third quarter. Delinquencies for mortgages continued to drop, while both auto and credit card default rates remained near all-time lows.
- Auto lending continues to grow despite used car values having begun a moderate decline. This is due to an increased supply of three-year-old vehicles.
- TILA/RESPA Integrated Disclosure Rule changes effective October 3 have created additional overhead and longer client wait times for mortgage term loans.
- There is increased demand for unsecured and deposit-secured lending, most likely due to the easier process for obtaining these loans compared to the requirements and length of time to close a home equity loan.
- Peer-to-peer based lending inquiries have risen. Clients may turn to those less regulated and faster channels for their loan needs.

(g) Homes

- Mortgage rates remain low and are expected to increase in 2016. New construction is increasing slightly. The cost to build in some markets remains higher than the outcome of the values.
- Existing home sales have improved, and with interest rates remaining low, there are more buyers than sellers. Many homeowners are proceeding with remodeling projects vs. selling their homes. This is adding to lower inventory in some markets.
- The Mortgage Bankers Association (MBA) forecasts mortgage originations will decrease to \$1.32 trillion in 2016 from \$1.45 trillion in 2015. The business mix reflects a 10% increase in purchase originations and a 33% decrease in refinance originations. The purchase share is projected to represent 68.6% of originations.
- Large balances on student loans continue to result in many borrowers struggling to qualify for mortgages, and when interest rates rise, the qualifying will be even harder for first-time homebuyers. The balances on student loans are now also contributing to lower credit scores which affect many buyers.

New Observations Since the September FAC Meeting

- For the third quarter, MBA expects originations of \$381 billion, while Freddie Mac is more optimistic with an estimated \$400 billion in production. The MBA is expecting a larger increase in purchase production share, growing from 57% in the second quarter to 63% in the third quarter. Freddie Mac, however, is expecting the number to remain relatively flat at 55%.
- Both entities are forecasting total home sales to come in slightly under 6 million units, which is a slight improvement of ~2% over the prior quarter. The MBA is reporting an 8% share of the originations to be new-home sales and is expecting this number to increase in the fourth quarter to just over 9%. They also agree on the estimated increase in the home price index of approximately 5% year over year, but this increase is expected to slow in 2015 to between 3.5% and 4.5% over the course of the year.
- During the second half of 2015, housing prices continued to be supported by tight inventories of new and existing homes for sale, though the rate of appreciation has moderated as compared to the past several years.
- The Texas housing market was particularly robust, and 2015 is forecast to be a record year for home sales in the state. As of the third quarter, housing inventory was four months, and homes sold spent an average of 51 days on the market. In general, six months of housing inventory is considered to be the equilibrium in the market. New-home construction in Dallas was constrained by labor shortages.

Do Council members see economic development in their regions that may not be apparent from the reported data or that may be early indications of trends that may not yet have become apparent in aggregated data?

Though there is considerable variation across states, developments across Districts remain broadly consistent with trends in the aggregated economic data.

Item 2: Regulatory Capital Requirements and CRE Lending

Earlier this year, certain CRE loans were classified as “high volatility commercial real estate” (HVCRE) loans and have become subject to heightened capital requirements under regulatory capital rules. What have been the effects of these changes on (a) individual banks, (b) CRE practices by all types of lending institutions, and (c) observable behavior in the market for CRE loans?

Under Basel III, the risk weighting for CRE loans remains unchanged at 100%, except for high-volatility commercial real estate (HVCRE) loans, which are defined as loans that finance the acquisition, development, or construction (ADC) of real property prior to permanent financing, except for 1- to 4-family residential properties, community development investments, or loans for purchase and development of agricultural land. Under Basel III, the risk weighting of HVCRE loans will increase to 150% from 100%. A higher risk-based capital (RBC) ratio on HVCRE loans requires banks to hold more tier 1 capital, which effectively lowers their ROE. As a result, banks must either decrease their exposure to this type of lending or charge more for HVCRE loans in order to maintain returns.

Exempt from the rule are CRE loans that meet certain criteria, including the following: (1) the loan must have an LTV of no greater than 80%; (2) the borrower must contribute equity to the project of at least 15% of the appraised “as completed” value; and (3) the equity contributed must be before the bank funds any amount of the loan and must remain in the project for the life of the project, which concludes when the loan is paid in full or the project receives permanent financing.

(a) Individual Banks

The Interagency FAQs issued in April 2015 have resulted in some confusion as to what constitutes an HVCRE, such that there is an inconsistent approach among the banking community. Banks appear to be interpreting the regulations differently, as seen in Q1 call reports in which some banks had very small numbers of HCRVE classified loans, while similar banks showed 80%-90% of ADC loans classified as HVCRE. Some smaller banks, in particular, have anecdotally been reported as either not understanding or not being focused on the new rules. The impact on credit appetite, pricing, and credit terms therefore varies widely by bank. Some banks are unwilling to do HVCRE loans, particularly if their capital levels are strained. Others will do HVCRE loans for strong relationships only, others require a higher spread, and some have not changed their lending practices.

(b) CRE Practices

When understood, the need to hold more capital has caused some banks to require 50 to 150 basis points more spread to book an HVCRE loan. These higher interest rates have driven some borrowers to alternative lenders, both within and outside of the banking system, and could, if followed more universally, lead to higher cap rates, lower values, and less credit availability. Larger banks that are financing larger projects, especially syndicated deals, are more likely to include a capital premium. Smaller banks tend to ignore the impact of the new regulations on their pricing and underwriting of smaller projects.

The requirement for the borrower to inject at least 15% equity up front is problematic, especially when the equity is in the form of land. Land purchased years earlier must be reported on an original-cost basis. When the appreciation of the land is a major factor in the overall “as completed” valuation of the deal, there could be a need for the borrower to add additional cash (which is trapped until completion and permanent financing is obtained) beyond what a traditional lender would have required. Borrowers naturally balk at this, requiring banks to decide between accepting the negative capital implications of an HVCRE loan or turning down the deal.

(c) Behavior in the Market for CRE Loans

The overall impact of the new regulations has yet to be felt, primarily because there is little consistency in the approach by various banks. Council members report that the appetite for larger construction projects has diminished, particularly if a loan would be classified as HVCRE. There do seem to be increased pricing requirements on HVCRE loans by banks that are aware of and understand the impact of the regulations. Borrowers continue to be educated about the impact of the rule. In competitive environments, they will look for lenders that are less likely to ask for higher spreads or that will allow for cash-out during the development process, based on milestones that have been traditionally available.

The Council believes that additional clarity and guidance on the final rule would be very useful. The Council also believes the implications of the rule, in its current form, and if understood and followed by all banks equally might include:

- (1) Higher pricing from banks on most ADC loans
- (2) Increased growth opportunities for nonbank lenders
- (3) Higher cap rates, lower LTVs, and less credit availability for borrowers
- (4) Increased capital allocation to the multifamily sector because multifamily loans remain eligible for the RBC ratio reduction to 50% from 100%

Item 3: Basel III Countercyclical Capital Buffers

Basel III capital requirements include a countercyclical feature for global systemically important banks (G-SIB) that adds to capital buffers when credit growth is strong and releases capital from the buffers when credit growth is weak. What are the likely effects of these countercyclical buffers and how should regulators use them?

The countercyclical capital buffer satisfies an explicit requirement of Basel III and the Dodd-Frank Act mandate that banking agencies must consider the use of countercyclical aspects of capital regulation.¹ The buffer is, in theory, a simple measure that gives regulators flexibility to respond to market trends and credit exposures; it represents another arrow in the quiver that is available when others are ineffective. Time-varying measures such as these buffers could potentially ease restrictions on economic activity imposed by through-the-cycle constraints and act as an industry-wide complement to more targeted actions to combat systemic risk.

¹ Sections 616(a), (b), and (c) of the Dodd-Frank Act, codified at 12 U.S.C. 1844(b), 1464a(g)(1), and 3907(a)(1).

Notwithstanding the buffer's potential benefits, Council members are strongly consistent in their view that the same objectives can be achieved through the existing supervisory process, which may employ a targeted approach to curb excessive leverage or credit growth. In particular, the use of specific stress scenarios under CCAR, such as those that incorporate asset growth and severe global market shocks, are well suited to capture the same risks that the countercyclical capital buffer seeks to mitigate. Moreover, the countercyclical capital buffer is likely to create certain unintended and sufficiently worrying consequences – and may well stunt sensible economic growth – that its proposed implementation demands significant further attention. Among these are:

- **Reliability of measures of excess credit or systemic risk.** The Basel Committee recognized that identifying periods of excessive credit growth that lead to systemic risk is a difficult analytical task and proposed a methodology to do so that charts the gap between the historical and actual ratio of aggregate private-sector credit to GDP. However, this credit-to-GDP ratio gap may be subject to substantial revisions. Federal Reserve Board economists have found that such revisions have been on the same order of magnitude as the gap itself and that application of the buffer based on this metric could incorrectly curtail significant volumes of lending.²
- **Lack of transparency on circumstances that would drive initiation of the buffer.** A lack of transparency on the circumstances driving initiation of the buffer hinders a bank's ability to effectively manage and forecast its capital needs, thereby introducing additional operational complexity in capital planning and capital management to account for fluctuating buffer requirements.
- **Speed of implementation and effectiveness.** Generally speaking, there is a one-year time lag between the setting of a countercyclical capital buffer in the United States and its required effectiveness. The one-year notice period is necessary to allow banks to build capital to meet the buffer requirement, but the time lag adds complexity to implementation of the buffer and its ultimate effectiveness.
- **Calibration of measures to effectively damp excesses while not curtailing healthy credit growth in the economy.** The countercyclical capital buffer is a relatively blunt tool; when turned on, it applies to all Advanced Approaches banks and across all asset classes. By raising capital requirements across the board, it impacts both “overheated” sectors as well as less-frothy sectors. This could complicate incentives for banks by encouraging lending in lucrative sectors that are more prone to excess credit growth, as all areas will be impacted by the increased costs of additional capital.
- **Unintended consequences in its implementation.** If enacted for the U.S. Advanced Approaches banks with respect to their U.S. exposures, the buffer could curtail lending across all products, resulting in a slowdown of the U.S. and international economies. Moreover, the effect of enacting a buffer would signal that there is more data around the

² *The unreliability of credit-to-GDP ratio gaps in real-time: Implications for countercyclical capital buffers*, Rochelle Edge and Ralf Meisenzahl, August 21, 2011.

health of the economy than might be intended, potentially causing investors to be more averse to bank exposures.

- **Difficulty of achieving the cycle-moderating benefits of releasing the buffer in times of stress.** Relaxation of regulatory requirements on the downside may be difficult, as market discipline tends to increase when conditions deteriorate. Investors and counterparties may react unfavorably to reductions in capital levels at any one firm, regardless of the potential systemic benefits to the economy from all large firms following suit. This may impact the flexibility of firms' senior management to reduce capital buffers.

If the regulators believe the countercyclical capital buffer is an important and necessary tool for macroprudential regulation, the Council would strongly recommend that, at a minimum, the following steps be taken to ensure its effective implementation:

- **Conduct additional research on potential indicators of excessive credit growth,** possibly by conducting an industry-wide quantitative impact study drawing on data from Advanced Approaches banking organizations; and
- **Develop a robust, transparent framework** that establishes a more comprehensive list of indicators, clear roles and responsibilities for decisionmaking parties, and an estimation of the potential economic drag, and that identifies alternatives to buffer implementation.

Pursuing these actions would help to maximize the countercyclical capital buffer's usefulness while minimizing the drag on the broader economy that could be created by its misapplication. In any case, regulators have a number of tools currently at their disposal designed to reduce uncertainty, increase transparency, and preserve systemic health. The Council believes that including another tool has significantly more negative than positive repercussions and the tool should not be implemented.

Item 4: Cybersecurity

Banks are taking action to protect financial information amid evolving types of cyberattacks. Where are banks presently focusing their cybersecurity efforts? What is the impact of the recent cybersecurity legislation and how should it be implemented? What additional types of legislative or regulatory actions would help support cybersecurity efforts?

Where are banks presently focusing their cybersecurity efforts?

- At a time when cyberattacks are increasing in frequency and severity, organizations need to prioritize improving their cybersecurity frameworks and foundational capabilities. Strong cybersecurity programs help us protect customers, shareholders, confidential information, and our reputation. We need to focus on the current state of risk and the impact that the evolving risk landscape, new technologies, and business processes present. We know business growth drives more systems in the environment, and

complexity is a significant challenge to effective cybersecurity. It is critical for organizations to understand the complexity and to mitigate the risks.

- The growing adoption of ever-more connected technology continues to expand the attack surface. Mobile, cloud, and wireless computing are some of the contributing factors to further disruptive technologies that ultimately lead to the “Internet of Things.” These new attack surfaces require more complex and connected applications and system development. To meet these emerging risks, a continued focus on a defense-in-depth strategy is critical. No one control will suffice. This includes good security hygiene (both system and human risk factors); strengthening culture (security starts with each and every team member); and proactive engagement (early involvement and partnering with all areas of an organization to anticipate next threats).
- It is important to focus on the basics that form the critical foundation of strong cyberprotection: discovery, assessment, and remediation. Key day-to-day activities include continuous monitoring, integrated risk management, situational awareness, and effective measurement and reporting. The protection of infrastructure, corporate data, and assets is imperative to ensure alignment with applicable regulations and laws. Investing on the front-end and focusing efforts on the evolving risk landscape, new technologies, and business processes can help companies be prepared for possible attacks.
- Generally, effective cybersecurity programs include the following top 10 components:
 - (1) Insider threat**
 - Insider threat can sometimes be a more dangerous organizational issue than external threat. Rogue employees or contractors who intentionally or unintentionally perform unauthorized actions can result in service outages, fraud, and theft or exposure of intellectual property.
 - (2) Vulnerability, patch, and asset management**
 - Foundational to vulnerability management are asset and configuration management.
 - You first have to know what you have (asset management) and what state it is in (patch/configuration management) before you can perform effective vulnerability management.
 - Ability to identify and fully recover the backup system.
 - (3) Third-party legal-entity and vendor risk**
 - Third-party legal entities must be held to the same standards as the parent company, especially if resources, data, or systems are shared. Even if they are not shared, the same standards still need to apply due to the reputational risk.
 - Vendors and other business partners that process data or host services for a company must be held to the same cybersecurity standards as well.
 - (4) Access control & identity management, especially privileged access control**
 - Privileged access must be accounted for and controlled, given only to those who need it and only for when they need it.
 - Persistent administrative access to resources and systems should be monitored closely for abuse.
 - Having many disparate access-control systems is a huge risk, and these must be combined into a few federated systems to be manageable.

(5) Simulation of advanced cyber incidents (cyber war games/cyber range)

- Cyber war games improve team processes and reaction times and responses by using simulated attacks emulating external adversaries and insider threats.

(6) Maturing monitoring and discovery controls

- Deploying monitoring and discovery controls with threat-intelligence integration and automation to create mature fusion center capabilities.

(7) End-user device control

- PC and mobile device management, especially off network, is very important to protect the network as a whole. These are the machines that are targeted by adversaries due to the ease of intrusion and the susceptibility of the end-users.

(8) Log management

- Correlation and availability of logs for critical resources, making these available for your cyber teams to perform analysis and use for incident response is critical and foundational for good cyberdefense and monitoring.

(9) Threat intelligence

- Integration of threat intelligence into controls, programs, and strategies.
- Controls: automation of threat-intelligence data making our existing investments more mature and robust.
- Programs and strategies: Threat intelligence is used to make better tactical and strategic investments in carrying out a cyberdefense program.

(10) Employee & customer skill-building

- Our most valuable investment.
- Training and skill development makes our cyberdefense teams more prepared and keeps them engaged, sharp, and ready to respond to incidents.
- Employees who understand the threats are able to design and build robust security controls that are effective.
- The “human factor” is another risk that is always present and can create significant risk for companies. Whether it is human error on the technology side or a lapse in judgment by an employee on the frontline, strong education and awareness programs are key to risk mitigation. These programs can help empower employees to understand how and why they are critical in preventing an attack, as well as best practices to adopt in their work environment. Additionally, customers should be given the knowledge and tools they need to help protect their sensitive information from cyberthieves. Operating securely must be an easy experience for employees and customers. Hard-to-use security measures often drive users to attempt to bypass controls.
- Finally, the right talent is imperative. Currently, there is a war for talent, and retaining top information security professionals is difficult and costly. These professionals often choose organizations based on their security reputation. The better the security reputation, the easier it is to attract and retain topflight security talent.

What is the impact of the recent cybersecurity legislation and how should it be implemented?

- Congress has passed comprehensive cybersecurity information-sharing legislation. The House passed two strong industry-supported cyber information-sharing bills earlier this year. A few weeks ago, the Senate passed S. 754, the Cybersecurity Information Sharing

Act (CISA). The House and Senate legislation still must be reconciled through conference before the President can sign it into law.

- Industry strongly supports cyber legislation because it provides voluntary incentives for threat information-sharing between the private sector and the government and between various industry sectors. The legislation also provides strong privacy protections for consumer information and provides liability protections for companies. However, several Council members expressed concerns that the protections are not comprehensive and that “best efforts” are not defined. In the congressional debate, many privacy advocates pushed for even stronger privacy protections, which were considered and rejected by the Senate.
- For the upcoming House-Senate conference, the financial trades and a multi-industry group have written letters to House and Senate leadership, urging the removal of CISA section 407, which would give an outsized and inappropriate role to the Department of Homeland Security in requiring de facto regulatory mandates for critical infrastructure reporting. This could lead to burdensome regulation and undermine the core voluntary nature of CISA.
- While regulators and Congress discuss various policy options, the security communities in both industry and government have to continue collaborating on cyber-incident exercises and other cross-sector information sharing and coordination programs. We have to continue to improve our privacy networks and take customer data seriously.

What additional types of legislative or regulatory actions would help support cybersecurity efforts?

- Cybersecurity has become a cross-cutting policy issue involving much more than a traditional data breach of personal information. A transition to better global cooperation by government, especially on the attribution front, and better defense strategies are necessities.
- We must work together so information-sharing between the public and private sectors can allow alignment of threat intelligence. This intelligence must be as specific and actionable as possible to enable organizations to proactively defend against the latest threats.
- The financial sector will be working through the fall and into next year with regulators that make up the Federal Financial Institutions Examination Council (FFIEC) to improve its Cybersecurity Assessment Tool released last June. The Financial Services Sector Coordinating Council (FSSCC) has urged that the tool remain voluntary and that it map more closely to the NIST framework, among other technical recommendations. Some Council members believe the FFIEC assessment tool conflicts with regulatory guidelines and that clarification is needed.
- The Council believes regulators should support the adoption of .bank domain names supported by well-defined and strict protocols that would provide increased protections to participating banks and enhance the public’s sense of security when working through such domains.
- Some believe ecosystem-wide investments and collaboration in new solutions will significantly help combat cyber threats in a cost-effective manner. For example, tokenization of the payments ecosystem does improve safety and soundness in a cost-effective manner.

- Council members also expressed concerns that the CISA fails to address underlying root causes of most cyberattacks—outdated software, malware, and unencrypted files. They believe effective legislation should focus on these root causes and solutions, which include enforced patching routines and compliance monitoring.

Item 5: Fannie Mae and Freddie Mac

What is the Council’s view on the best way to resolve Fannie Mae and Freddie Mac? Specifically, should these government-sponsored enterprises be recapitalized and brought out of conservatorship? What is the outlook for a legislative resolution?

The resolution of the two mortgage GSEs, and the restructuring of the secondary mortgage market, is the largest piece of unfinished business remaining in the aftermath of the 2008 financial crisis.

The current financial arrangement between Treasury and Fannie/Freddie is a stop-gap and ultimately unsustainable. At present, Treasury takes, as dividends, all GSE profits, aside from minimum capital buffers. As of September 2015, the enterprises will have paid \$239 billion in dividends to the Treasury, far greater than the \$187.4 billion capital injection to date. Since these payments are considered dividends, they have not reduced the outstanding \$187.4 billion principal balance. Freddie Mac reported a \$475 million loss in Q3 2015, prompting concerns that the GSEs’ current funding model does not provide for sufficient capital reserves to sustain their activities indefinitely.

The Council believes that a recapitalization of the two GSEs, absent a fundamental restructuring and resolution of the essential issues of ownership and risk retention, is not advisable. This is also the stated policy of the White House, the ABA, and the MBA. Dr. Michael Stegman with the National Economic Council was very direct at the MBA Conference on October 19, 2015, as he described the administration’s position:

“Recapitalizing the GSEs with taxpayer funds and administratively—or legislatively—releasing them from conservatorship with a business model that conflicts with their public mission—in essence turning back the clock to the run up to the crisis—would be both an exercise of bad policy judgment, and poor stewardship of the taxpayers’ interest; willfully recreating the very system that helped do this nation so much harm.”

There is concern that the longer Fannie and Freddie stay in government hands, the more lawmakers will use them for purposes unrelated to housing. An example is the 2012 payroll tax holiday, which was partially paid for by raising the premiums Fannie and Freddie charge homebuyers for providing insurance. One year ago, the Federal Housing Finance Agency directed Fannie and Freddie to begin setting aside and allocating funds from their guarantee-fee revenues to the Housing Trust Fund and the Capital Magnet Fund for affordable rental housing programs. During the current session, Congress has considered using an increase in these

premiums to offset spending for the surface transportation bill, which is wholly unrelated to housing finance.

It might also be noted here that as part of its open market operations, the Federal Reserve continues to be among the largest investors in mortgage securities. In addition to its investment of \$2.5 trillion in U.S. Treasuries, the Federal Reserve currently owns \$1.8 trillion in mortgage-backed securities and agency debt.

Proposed future structures need to address the four primary functions the GSEs have traditionally performed: Securitization, Credit Enhancement, Portfolio Investment, and Housing Goals. The general outline of the goals of reform should therefore include:

- Development of the new “Government Guarantor” entity as the ultimate backstop for investors in mortgage-backed securities.
- Definition of the role(s) and structure of private capital participants to assume the primary risk of default of the underlying mortgages. There was mention of concern as to the level of risk exposure to a GSE for “remote risks,” such as loans with below 60% LTVs and 15-year fixed rate mortgages.
- Development of a transition plan which will wind down or transform the current GSEs without disruption to the current flow of credit to housing and of liquidity for investors and for lenders of all sizes.
- Accommodate a clear and sustainable approach to affordable housing that encompasses both the single- and multifamily markets to ensure safe and affordable alternatives for those where homeownership is not practical.
- Resolution of issues of residual private-sector ownership of the existing GSEs’ common and preferred stock.
- Ensure the “to-be-announced” markets continue to provide a highly liquid, forward market for mortgage origination, especially to support the conventional 30-year, fixed rate residential mortgage.

A transition plan is critically important, especially for preserving current capacities and assuring access to smaller lenders that don’t have the scale, expertise, or infrastructure to securitize on their own. Currently, the Fannie/Freddie “cash window” provides liquidity for lenders. To fulfill this function in a reformed structure, one legislative proposal (“Johnson-Crapo”) included creation of a lender-owned co-op to facilitate the purchasing and securitization of loans for smaller lenders.

Fannie and Freddie should be liquidated, and certain functions removed to a new “government guarantor” agency. In addition to the final “backstop” guarantee, the guarantor would be responsible to both set all standards and provide administration for the originators, insurance, securities, and underwriting associated with these securities. However, many parts of the end-state of this restructuring are not yet clearly defined. For example, there appears to be some substantial current overlap between Fannie, Freddie, the FHA, VA, and the Federal Home Loan Banks, which could be rationalized relative to explicit federal housing policy goals.

Legislation is required to achieve any substantive reform. There appears to be no opportunity in the legislative calendar in the next 18 months, with most commenters looking for the first action to be taken up in 2017. Any complete resolution is likely to be a long-term (5- to 10-year) effort.

Council members offered these recommendations as desirable interim steps. Some of these are already underway, championed by the FHFA under the leadership of Director Melvin Watt:

- Construct “back-end” private risk-sharing initiatives, such as Freddie’s STACR and Fannie’s CAS initiatives.
- Pilot programs for up-front risk-sharing – such as the proposal by mortgage insurance companies to provide “deeper” upfront mortgage insurance on loans purchased by the GSEs.
- Initiating a Common Securitization Platform (CSP) now being developed by the GSEs that supports the vision of a single security.
- Clarification of the GSE representations and warranties policies.

These steps are positive but not a substitute for the fundamentally stronger reform described earlier.

Item 6: Unbanked & Underbanked

There remains a relatively large population of unbanked and underbanked households in the United States. How can commercial banks do more to meet the deposit, payment, and credit needs of these consumers? What are the barriers to making banking services more accessible to this population and are there opportunities for addressing these barriers?

How can commercial banks do more to meet the deposit, payment, and credit needs of these consumers?

- According to the 2013 FDIC National Survey of Unbanked and Underbanked Households, there are over 34 million households that are financially underserved.
- According to the Center for Financial Services Innovation’s research, the most commonly cited reasons for not having a traditional bank account are the high costs and lack of utility.
- The level of regulatory compliance is limiting innovation and risk appetite for offering affordable financial solutions that meet customer needs.
- Many underserved consumers are utilizing alternative financial products to conduct their various transactions in a potentially high cost, less convenient, and often less regulated environment.
- Major themes related to the underserved consumer:
 - Need access to affordable financial services that provide control security and convenience.
 - Living paycheck to paycheck often creates a need for high-quality, short-term liquidity options
 - Mobile technology is prevalent from an access and convenience aspect

- Commercial banks have the opportunity and the obligation to provide products and services directed at improving financial access and health. By understanding the behaviors of the underserved and by leveraging distribution networks and mobile technologies, commercial banks can design products to help consumers track, plan, and execute transactions, while providing a pathway to credit and more traditional banking products when these consumers are ready for them:
 - Develop affordable and accessible prepaid cards and/or “safe accounts” that provide access to funds, control, the ability to make deposits and payments, and a way to help consumers enter or re-enter the financial mainstream.
 - Provide greater funds availability through check-cashing and payment-processing services.
 - Introduce vehicles for short-term saving and access to small-dollar secured credit to help consumers manage uneven cash flows and improve their credit history.
 - Develop or partner with financial technology businesses (fintechs) to provide mobile financial services, providing consumers with greater access to financial management tools and a better understanding of their cash flows.
 - Play a leadership role in the community, encouraging financial education for the long term.
- Innovation from multiple providers (including retailers, convenience stores, and online providers) is creating an increase in options and a highly competitive environment.
- Commercial banks are best positioned to provide a pathway to financial health through relationships and financial advice, guidance, and education. Banks are also best equipped to provide a greater array of financial products and services with a fair and transparent fee structure all in one safe and secure environment.

What are the barriers to making banking services more accessible to this population and are there opportunities for addressing these barriers?

- Building trust through financial awareness and education:
 - The very nature of offering products and services to address the financial needs of the underserved, in a fair and transparent way, will help banks become trusted advisers to this segment.
 - Bank associates can be involved in the community (in schools, at work, and through faith-based and multicultural institutions) to provide education on how the financial system works and to help improve trust in the banking system as well.
 - There is a need for commercial banks to build trust with consumers. Today, commercial banks are making a credible effort to provide products, services, and advice to improve the financial lives of customers.
 - Consumer financial outreach and education is key to breaking down barriers with this segment. Many consumers in the unbanked segment feel they do not belong in a bank or they are unwelcome. Furthermore, they believe a bank cannot offer the products and services they need.
 - Commercial banks have the advantage of their bankers and leaders in the community (people) as well as their locations in the community (branches) to inform and provide guidance where consumers need it most.

- Product development and innovation while meeting regulatory compliance obligations:
 - There are in place or proposed regulations where the intent is to protect the consumer. In some instances, these regulations inhibit the ability of financial institutions to profitably provide the products and services that are needed (examples: savings account limitations, small dollar credit, interchange limits, prepaid card rules). This regulatory environment creates uncertainty in regards to innovation and the extent to which commercial banks are able to provide innovative products and services.
 - It is important for banks to work closely with regulatory supervisors, sharing consumer research, product development, and results in a way that builds confidence in innovation and its outcomes.

Item 7: Monetary Policy

How would the Council assess the current stance of monetary policy?

- The Council sees the current stance of monetary policy in the U.S. as highly accommodative.
- Members believe that the broad-based strength from the October 2015 employment report and recent signs of resilient core inflation indicate that both labor market conditions and the outlook for inflation in the medium term warrant increasing the target range for the federal funds rate.
- Substantial progress has been made toward full employment.
 - Job creation rebounded strongly in October, and the unemployment rate is now at 5%, half its post-crisis peak.
 - The broader U-6 measure of unemployment stands below 10% for the first time in this cycle.
 - Hourly wage growth, which has been stable at near 2% for most of the expansion, is now 2.5% over the last 12 months.
- Prospects for reaching the 2% inflation target have improved. Headline inflation should accelerate at a gradual pace.
 - Current low rates of headline inflation are mainly the result of the precipitous decline in energy prices and lower commodity prices. These are, to a large extent, reflections of a weak global demand environment and that is likely to improve at a gradual pace.
 - Oil prices have firmed, and the downward pressure they exerted on the price level is dissipating.
 - The dollar's strength and its impact on import prices stand as a modest dampener to the outlook for inflation.
 - Meanwhile, domestic wage growth will add to the inflationary momentum in the U.S.
- Meanwhile, the Council is concerned that this prolonged period of extraordinarily low interest rates is fostering imbalances in capital allocation and asset prices, and that risks to financial stability will continue to build even after the FOMC begins the process of normalizing interest rates, particularly if the process continues at a very gradual pace.
- Financial market participants have priced in more than one 25-basis point hike in the fed funds rate target range. Therefore, setting a sustained course of normalizing interest rates

- need not have destabilizing effects on the financial markets. Moreover, domestic economic conditions are sufficiently strong to withstand such a course of normalization.
- An increase of 25 basis points in the FOMC's fed funds target range would be a modest first step in the long process of normalizing interest rates.
 - Accompanying this increase with a statement from the FOMC suggesting that further tightening would occur only very gradually would minimize the potential for market dislocations.
 - The increase might even be viewed as an expression of confidence in the health of the U.S. economy and the sustainability of the expansion.
 - Equity markets and other risk assets will adjust to subsequent increases, as long as the pace of increase is generally in line with market expectations.
 - Economic developments and the effectiveness of the FOMC's communication policy will heavily influence the impact of the eventual rate increases on financial markets.
 - Given the lack of history with the Fed's use of unconventional policy tools and the unwinding of their use, there remains considerable uncertainty as to how the normalization process will impact financial markets and the economy. This uncertainty reinforces the need for the FOMC to effectively use forward guidance to influence market expectations of future monetary policy changes.
 - In the September Survey of Economic Projections (SEP), FOMC participants foresaw a modest trajectory for the federal funds rate, with their median projection of a fed funds rate at slightly less than 1.5% at the end of 2016 and between 2.5% and 2.75% by the end of 2017. However, market pricing suggests an even flatter trajectory for rate hikes over the next few years.
 - International risks warrant consideration, but should not derail a gradual normalization of U.S. monetary policy.
 - Normalization of U.S. monetary policy, particularly if it diverges from the policy paths of other central banks, may further strengthen the dollar in the near term, thereby softening the expansion in the US and inducing potentially destabilizing capital flows to the U.S. from emerging market economies.
 - On the other hand, if more stimulative monetary policies overseas foster a stronger global economy, the U.S. economy will benefit.
 - Chinese equity markets have stabilized, and the People's Bank of China announced another round of reductions to interest rates and reserve requirements.
 - The European Central Bank has signaled that it is considering extending its quantitative easing program, which would reduce downside risks for the Eurozone economy.
 - Longer-term, stronger economic growth and lessened risk aversion overseas, with the attendant shifts in monetary policy by foreign central banks, will support higher long-term U.S. interest rates.

12:00 pm – Luncheon for Council and Board members in the Board Room