Record of Meeting

Federal Advisory Council and Board of Governors

Thursday, December 1, 2022

Item 1: Economic Activity

How do Council members see business activity among their clients and other contacts trending since the September meeting? Are Council members, clients, or contacts seeing any new areas of strength or weakness? Are there industries or geographic areas in which significant supply-side constraints persist? What is the Council's prognosis for the pace of economic activity across sectors during the remainder of this year?

How do Council members see business activity among their clients and other contacts trending since the September meeting?

Business activity remained relatively robust since the September meeting. Consumers remained generally on solid footing, with nominal consumer spending above pre-pandemic levels and up year-over-year across income levels—and across all major categories and geographies. However, inflation has cut into real spending increases over the last year, and growth has slowed. Retail spending in general and furniture and home improvement spending in particular are trending softer. These are watch items through the holiday season. Meanwhile, travel spending looks like it still has room to grow.

U.S. consumer cash balances and credit metrics similarly remained strong, although both continued along the path of slow normalization, with lower income groups normalizing faster. Small business and middle market balance sheets also remained durable, with most sectors being able to pass through increased costs to customers. However, more recently, smaller clients—especially those in consumer retail—are experiencing some margin pressure due to inflation and because they are operating with excess inventory. Small business clients generally cited reduced profitability as a key challenge and noted that (1) reducing expenses, (2) accepting lower margins, and (3) increasing cash on hand were some of the top actions planned.

Several Council members noted that commercial clients generally characterized business activity positively, with many feeling more optimistic about their business than expected given the uncertainty looking forward.

Are Council members, clients, or contacts seeing any new areas of strength or weakness?

The housing market continued to be an area of weakness, with related industries, such as building products and services, also slowing. Additionally, there is increased evidence of pressures in industries feeling the effects of inflation, particularly food services, retail, and transportation, where excess liquidity is coming down the fastest. One member noted hospital clients have begun to be affected by rising costs and labor shortages. Some members reported biotech and technology clients announcing or contemplating layoffs.

On the positive side, manufacturers reported that inflation in the prices paid for inputs is slowing. Corporate and leisure travel have rebounded strongly, with high occupancy in the lodging sector and rising airfares not affecting consumer demand. There are signs of improvement in the automobile industry, with inventory levels gradually replenishing, but demand is shifting to higher-income bands.

Are there industries or geographic areas in which significant supply-side constraints persist?

Supply-side constraints have improved but are not back to normal. Shipping costs and the backlog of ships have improved at the major West Coast ports, and logistics companies are seeing cost improvements as freight rates are steadily declining. Supply shortages still impact certain sectors, such as automobiles. In the auto sector, companies have optimized their component inventory toward higher-demand models where they have pricing power. Supply chain impacts are especially acute in aerospace, where engine production is constrained by the unavailability of highly engineered parts, and defense manufacturers are citing semiconductor shortages as a headwind.

What is the Council's prognosis for the pace of economic activity across sectors during the remainder of this year?

Council members agreed that the probability of a recession is elevated and added that if you panel economists across the industry, the majority expect a recession. The general consensus is that if there is a recession or contraction in 2023, it will likely be relatively modest or short lived. Those calling for a contraction estimate that the unemployment rate will peak at about 5 percent.

Item 2: Labor Markets

Based on Council members' own experience and that of their clients and contacts, how would Council members describe the overall state of the labor market? Has there been any significant shift in the size, composition, or qualifications of the available labor pool in recent months? In sectors where product demand is slowing or falling, are businesses cutting back on hiring, increasing separations, or pursuing other strategies to reduce labor costs? In sectors where product demand is still growing apace, are businesses still pursuing aggressive hiring and retention strategies? Are businesses pursuing productivity-enhancing changes to the workplace as well or instead?

Based on Council members' own experience and that of their clients and contacts, how would Council members describe the overall state of the labor market?

The overall state of the labor market is improving, moving into better balance between demand and supply, although the former still exceeds the latter. Upward pressure on compensation levels remains strong. Most Council members mentioned that there is less voluntary turnover than earlier in the year, although it remains above pre-pandemic levels. Quit rates are down overall, most notably within industries previously trending high such as transportation, leisure, and hospitality. Strong demand is observed by Council members in certain areas such as data science, process engineering, audit, and skilled trade labor. Council members also noted increasing competitiveness in lower-level hourly positions after months of improved talent availability. Softening demand is noted in the technology, mortgage banking, and home construction industries. Council members have observed that certain businesses are actively managing labor costs through workforce reduction and hiring freezes. While the demand/supply trends in the labor market are improving, there is a universal view among Council members that the long-term labor supply issues will negatively impact the current favorable trends. Demographic issues relating to the aging population, lower birth rates, and a lack of immigration reform will continue to weigh on the supply side of the labor market.

Has there been any significant shift in the size, composition, or qualifications of the available labor pool in recent months?

Most Council members and their customers are experiencing an increase in applications for work, with minimal changes in the proportion of "quality" applicants. Some Council members referenced seasonal hiring patterns influencing reduced recruitment efforts leading into the holidays. Businesses are continuing to widen their pool of candidates by considering adjacent skills and experiences. More reliance is being placed on internal training to close the skills gap for both new hires and existing employees.

In sectors where product demand is slowing or falling, are businesses cutting back on hiring, increasing separations, or pursuing other strategies to reduce labor costs?

Broadly, Council members noted that hiring activity is intentionally slow as businesses brace for weaker economic conditions. There is a consensus among Council members and their customers that overall labor demand will decrease next year and expedite a more balanced labor market. Council members noted a reduced sense of urgency to fill open positions; however, filling these positions is still problematic given the constrained pool of available workers. In the short term, year-end merit decisions are being heavily debated.

In sectors where product demand is still growing apace, are businesses still pursuing aggressive hiring and retention strategies?

Businesses continued to hire and compete for top talent where product and demand remain strong. A majority of the Council members continued to attract and retain talent with competitive wages, remote-work flexibility, well-being and health programs, and value alignment. Many businesses are finding solutions within their existing employee base by increasing re-skilling and internal mobility opportunities.

Are businesses pursuing productivity-enhancing changes to the workplace as well or instead?

Council members noted that technology is viewed both as a substitute for and a complement to labor. Technology is currently observed by Council members as primarily being leveraged to boost productivity, facilitate collaboration, and support the mental health of their employees operating in a hybrid work environment. The timeline to implement and adopt technology solutions is identified as a primary deterrent.

Item 3: Loan Markets

What is the Council's view of the current condition of loan markets and financial markets generally? Are there other conditions or developments that are particularly noteworthy in lending categories such as consumer, commercial real estate, residential real estate, construction, small and medium-size business, or corporate?

Summary

While lending activity has been strong with noncurrent and nonaccrual loans, modifications, and charge-offs remaining low across all major loan types, Council members have noticed widespread tightening of lending conditions, heightened risk aversion, and slower deal volumes as investors and borrowers are re-evaluating portfolios due to tighter macro conditions. Higher interest rates and tighter lending standards are now having a visible impact on loan demand, and members generally anticipate this trend continuing into the fourth quarter as borrowers are becoming a little less bullish on the economic outlook.

Consumer

The consumer credit market is seeing growth, but the pace of growth is beginning to decelerate, as a result of higher interest rates and slowing economic growth. The growth in consumer loans was nearly entirely owed to growth in credit card balances, which increased 3.9 percent over the quarter and 18.1 percent year-over-year. The growth in credit card balances is most likely attributable to continued inflationary headwinds for households. Headline inflation increased at an annual pace of 8.3 percent in September, driven largely by higher prices for food, shelter, and medical care. Consumers' balance sheets see elevated (although decreasing) deposit pools and modestly increasing credit outstanding with minor deterioration in quality. Year-to-date consumer loan applications have been stable, with typical seasonality.

Consumer loan markets are currently functioning well. Banks have returned to pre-pandemic lending standards, and the supply of credit is robust. Demand for secured credit (such as houses and cars) has leveled off as borrowing costs have increased. Demand for unsecured credit has rebounded as stimulus funds decline and inflation increases. Credit card growth continues to be muted, driven by still elevated payment rates/low utilization levels in the business. Albeit small, the other asset class that has continued to grow and increase in risk is the "buy now, pay later" (BNPL) loan, mostly driven by fintechs. BNPL lending continues to present risks to legacy unsecured loan and credit card revolving balances. Given the reduced consumer protections and visibility for lenders, this lending in its current form is creating risks that could result in increased pricing and decreased credit availability from bank lenders.

In the auto finance sector, although credit standards have tightened to reduce exposure to the sub-prime market, members have seen lenders and consumers stretching from a credit and an ability to pay standpoint. With elevated used car prices and the average loan amount up significantly, Council members see consumers and lenders stretching into longer term (for example, terms that are 84 months or longer) auto loans and originating 125% or higher LTV loans.

Commercial Real Estate

While the pace of recovery has varied and certain subsegments continue to lag, overall CRE performance has improved to the point that pandemic impacts are no longer the primary concern. The primary exception and largest property type concern is the secular change for office demand driven by remote-work alternatives and technological advances. While uncertainty remains around the overall impact, expectations continue for a persistent decline in office demand over the coming two to three years.

The increasing interest rate environment presents challenges for all CRE. The higher rates translate to both higher financing costs and declining valuations. Shorter-term rate increases are affecting financing costs. While most products will be able to handle the additional costs, the rapid pace of increase presents short-term challenges for most, and more material hurdles for the products lacking pricing power. As with many valuations, CRE multiples had moved to record highs in the low-rate environment. Recent increases in long-term interest rates have challenged these levels, pulling valuations back 10–15 percent over the past three months. Additional increases will likely outweigh income gains and further degrade values.

High inflation presents additional headwinds. Historically, CRE has been viewed as a hedge against inflation, as rent levels are generally able to grow with the increasing cost structure. While the multifamily and industrial segments should be better positioned to respond in the current environment, there are concerns related to office and non-essential retail, as they are unlikely to have the pricing power to move rents in concert with increasing inflation levels. Impacts from rate movements on the multifamily segment should be partially mitigated by continuing affordability concerns in the single-family housing market driven by those same rate increases. That should help support rental demand and rates.

Recent activity has seen lower levels of liquidity, as many large banks have curtailed their lending activity in CRE overall, and particularly in the office segment. Notably, equity providers have also pulled back as project returns are being impacted by higher rates. Additionally, increasing concern and oversight around CRE is expected to moderate lending and tighten underwriting.

Residential Real Estate

Generally, the market is still unstable. Inflation is not yet dropping, causing continued affordability challenges and leading to a third month of decline in the national average home price. As rates continue upward, this trend is likely to continue. Single-family residential real estate lending will remain seasonal but is unlikely to see much further decline—or increase—in volume during the current cycle. Members expect current loan origination volume to remain seasonally consistent during the next quarter and beyond. Lenders are exiting business more heavily in the niche or non-qualified-mortgage spaces, while others are downsizing and still trying to adjust their go-forward strategies.

Higher interest rates have slowed mortgage refinance origination volumes and have caused prepay speeds to slow for existing mortgages. Higher home prices, along with higher mortgage rates, have caused some potential home buyers to delay their home purchase. Housing price increases have started to decelerate year over year due to higher mortgage rates and housing affordability concerns. Home equity lending has caught up with the first mortgage market as homeowners cash in on the increase in house prices over the last two years.

Construction

CRE construction has been measured and primarily focused on growth segments, such as multifamily and industrial. Multifamily growth has been in response to the continued demand in the segment, assisted by the shortage of single-family alternatives and the pricing growth in the for-sale markets. While the pipeline will add supply for two to three years, members expect to see this expansion slow and be more prevalent in the moderately priced secondary markets rather than elevated gateway markets. Industrial expansion has been in response to changing retail distribution channels, and Council members similarly expect the development pace to soften in the coming year as primary demand drivers reevaluate requirements.

Labor and supply chain issues are considerations for construction of all property types. These constraints should keep new construction at lower levels and may even assist in repurposing existing underutilized properties. Additionally, interest rates and inflation are contributing to higher costs and higher return expectations, which is limiting the economic viability for many projects. Increasing concern and oversight around CRE is expected to further moderate lending and tighten underwriting, particularly for construction loans. Additionally, as larger banks limit appetite, liquidity levels for construction will decline and limit the level of new product delivered in the current environment.

Small and Medium-Sized Business

Commercial loan origination activity moderated in the fourth quarter. Near-term pipelines are solid but are softening for the first quarter of 2023. Borrower demand is starting to wane, and application volumes in the third quarter of 2022 are down compared to the previous quarter—but they were up compared to the same period the previous year and higher than they were in 2021. With lighter demand, the market is becoming more competitive around pricing and terms, particularly for higher credit quality sectors such as healthcare. Given the increasing rate environment, refinancing volumes are down. In addition, members see non-bank lenders increasingly playing in the small business space, adding further pressure to the market. On the existing line of credit portfolio, utilization remains significantly lower than pre-pandemic levels and has been holding flat all through 2022. Likely driving this are elevated deposit balances, which remain much higher than before the pandemic. Council members expect that utilization levels may increase if members see small business owners starting to make investments to hire and expand inventory. Small business owners have cited labor shortages and inflation as their top two concerns.

Corporate

Given the pullback in the debt capital markets (investment grade issuance is down 17 percent year over year; leveraged lending is down 37 percent and high yield is down 78 percent, with spreads wider across the board), the bank market has seen strong corporate loan growth year-to-date 2022 especially for general C&I loans. Defaults and losses continue to run near historical lows, and for much of 2022, banks continued to operate with excess liquidity. With these underlying conditions, banks largely stepped in to replace the capital markets at still-friendly borrower spreads.

Over the last few months, liquidity has left the system at an increasing rate, and the macroeconomic outlook for 2023 has deteriorated. As a result, lending conditions have tightened.

In addition, the corporate lending market is currently in transition. While corporate clients continue to seek liquidity as they prepare for a recession and replace capital markets financing, Council members are starting to see a pullback from banks as pricing and terms have not widened/adjusted commensurate with the pricing changes that Council members have seen in the debt capital markets and the economic outlook. This is not unusual for the bank market, as pricing and terms do not tend to change materially until defaults happen. In the meantime, there is higher risk in completing syndicated deals based on individual bank appetite as members are making more thoughtful decisions around more limited liquidity and a higher risk of loss.

In terms of credit quality, current metrics remain strong. While there was a small uptick in nonperforming loans in the third quarter, the balances remain historically low. Members are seeing increased margin pressures as clients are less capable of passing on higher prices and are facing higher borrowing costs. Some banks have reported increasing rates of credit downgrades versus upgrades. Banks cited various industries they are more closely monitoring, including healthcare, transportation, and anything housing related. Based on early signals from a few clients, one Council member expects to see an increase in amendments and covenant relief requests in 2023 resulting from inflation, some margin compression, selective waning customer demand, and other macroeconomic pressures.

In equipment financing, loan and lease demand is softer than it was in early 2022 and late 2021, but it is still holding steady.

Item #4: Inflation

Based on Council members' own experience and the experience of their clients and contacts, are the prices of various products and services rising more quickly or less quickly than they were at the time of the September meeting? Has the recent pace and pattern of price increases changed the expectations of consumers and businesses about overall inflation?

Based on Council members' own experience and the experience of their clients and contacts, are the prices of various products and services rising more quickly or less quickly than they were at the time of the September meeting?

In general, goods price inflation appears to be rising less quickly but pent-up demand has kept services rising at the same—or even higher—rates in recent months. Disinflationary signals have started to emerge in goods markets; however, the deceleration taking place in many price categories is obscured in aggregate measures. The chronic undersupply of housing continues to present substantial rent increases that are projected to be a long-term problem. Fundamental shifts in the world economy and geopolitical relationships have negated previous deflationary pressures. Information about inflation has a significant lag between real-time changes and observed changes. For example, the Manheim auction price measure shows that used car prices are now down 10 percent year over year, but used car price inflation in the CPI report is still up 7.2 percent year over year. As a result, traditional indicators may not accurately reflect price changes or stability in the dynamic environment.

On the demand side, financial conditions have tightened with the sell-off in risk assets leading to a higher cost of capital as well as higher mortgage rates, and the appreciation of the dollar. Demand may be starting to dry up in some areas, but it has remained surprisingly strong in the face of tightening. Businesses have largely been able to pass increasing costs on to customers without experiencing decreases in demand; however, customer pushback on higher prices may be mounting.

One of the most stubborn drivers of inflation continues to be high wage pressures and labor costs across industries. Slack in the labor market has been slow to appear, and structural changes resulting from COVID-19—such as reduced labor force participation in dual-worker families and decreased immigration—have kept the market tight. Council members observed layoffs in higher-wage positions; however, the availability of lower-wage labor remains scarce. In the third quarter, the MetLife & U.S. Chamber of Commerce Small Business Index experienced the largest drop since the start of the pandemic. Inflation was the top concern for businesses, which expected higher future inflation and were less comfortable with their current cash flows. Many expressed concerns about an economic downturn, and the smallest businesses reported plans to reduce hiring in the new year.

A survey of independent retailers found that expenses have risen by 19.7 percent in 2022, and many shops reported increasing their prices to maintain margins. The most significant cost increases came from labor, freight, and packing supplies, although some owners reported a recent slowdown in the rate of these price increases. Most shops reported slightly higher sales for October than in 2021, but it remains to be seen how economic conditions will impact aggregate demand and holiday spending.

Has the recent pace and pattern of price increases changed the expectations of consumers and businesses about overall inflation?

In the short term, inflation expectations remain high. Customers expect to continue to see inflation pressures, particularly around wages. Higher inflation has, in turn, contributed to wage increase expectations, although it is unclear if this will be an ongoing phenomenon. Futures commodity prices have turned more mixed after sharp declines in August, and, in general, commercial clients continued to report no change in their expectations of elevated inflation. Energy, labor, and material input prices appear to be driving these currently high expectations. To avoid further price increases, retailers have implemented strategies such as additional service and payment convenience fees.

In the long term, businesses and consumers seem to believe that the impact of increased rates will slowly work its way through the economy, and they anticipate moderate inflation in 2023. These expectations appear to remain anchored and have settled after the initial increase of the rates. Real income is expected to play a role in long-term expectations: if it were to deteriorate consistently, long-term expectations could increase quickly and remain high. The limitations of affordable housing and labor supply are not expected to improve. As a result, Council members projected continued price pressure in shelter and wages for the longer term. Council members expect inflation to decrease and stabilize at a level slightly higher than the target rate in the next twelve months.

Item #5: Impact of a Strong Dollar

The strong dollar is contractionary in that it weakens demand for exports from the US and strengthens demand for imports into the US. It also creates fragility globally, particularly in emerging markets, thereby potentially affecting US and global growth. Have Council members or any of their clients or contacts seen evidence of the strong dollar's impact thus far?

The dollar is at its highest level since 2000, having appreciated 12 percent this year against major trading partners in advanced economies. The appreciation of the dollar this year has been one of the fastest in several decades, partly driven by the rapid hiking path of the Federal Reserve leading to wide interest rate differentials between the U.S. and other counties. The appreciation has been sharper against advanced economies compared to emerging market economies, which started the hiking cycle earlier thus reducing the differential. The unprecedented depreciation of local currencies has resulted in foreign exchange (FX) intervention by many countries including Japan, India, and Brazil.

The sharp strengthening of the dollar has sizeable macroeconomic implications globally due to the hegemonic status of the USD in trade invoicing, as a credit channel, and as a reserve currency. Approximately half of all cross-border loans and international securities are denominated in USD, raising concerns for coverage ratios and solvency due to USD strength. Export prices from the U.S. have historically risen by about 3.8 percent every year but have gone up 11.8 percent this year, with the majority (58%) of the increase attributable to FX effects, according to recent research from the Kansas City Federal Reserve Bank.[1]

Council members noted that they have seen muted impact of USD strength on the business activity of their clients. However, those with FX exposure have seen heightened volatility in their books of business. Part of the reason for the observed muted impact is the initiation of domestic projects by clients, post-COVID, as part of their "on-shoring" activity. However, Council members with clients that have export exposure have seen increased requests for price renegotiation from clients exposed to the appreciation of the USD. Given the elevated FX effects and uncertainty of the timing of reversal, manufacturers have seen slowdown in new export orders, particularly in the healthcare, technology, industrial, and consumer sectors. Partially offsetting this slowdown is a meaningful pickup in international travel demand due to dollar strength.

[1] Johannes Matschke and Sai A. Sattiraju, "Price Pressures for U.S. Exporters and a Strong Dollar Have Increased Inflation in Foreign Countries," August 31, 2022, KC Fed Economic Bulletin.

Broadly speaking, Council members noted that the effects of the strong dollar have been muted thus far but are beginning to become a cause for worry in 2023. This concern is being reflected in earnings calls and corporate preannouncements. A large number of companies in the S&P 500 have noted FX headwinds, with technology, chemicals, and auto-related sectors leading the negative calls.

Given the hawkish stance of the Federal Reserve amidst stubborn inflationary impulses, the relevant questions for policy setting include the following: (1) Is the continued USD strength likely to greatly crimp U.S growth and tighten financial conditions, thus accelerating recessionary concerns? and (2) Will the fragility of emerging markets from FX depreciation and domestic inflation exacerbate systemic risk? While the timing of the reversal of dollar strength depends on the timing of the pivot in FOMC policy, the question here is on the magnitude of the impact during the period of USD strength.

There are three channels by which risk can escalate from USD strength:

(1) Impact of USD strength on GDP growth
(2) Impact on inflation
(3) Impact on financial conditions

On the first channel, as noted by one Council member, the U.S. does not import economic slowdown from abroad. As cited by another Council member, academic research and the Federal Reserve's FRB/US model note that 10 percent appreciation in trade-weighted dollar should subtract about 40 bps from U.S GDP. The effect on GDP comes from reduced exports. This effect on GDP is not excessive because exports are a relatively small share (12%) of the US GDP.

On the second channel, USD strength contributes to lower inflation from reduced import prices. According to the FRB model, the effect on inflation from reduced imports prices is approximately 12 bps, whereas research from the Federal Reserve Bank of Kansas City[2] notes this to be 16 bps. Non-petroleum prices, for example, are down 5.6 percent year over year. Thus, USD strength contributes, at the margin, to reduce domestic inflation, but this effect is not material.

The third channel is the impact on financial conditions. Higher USD tightens financial conditions in the U.S. via what is termed "U.S. dollar credit channel," as credit spreads widen for companies with export exposure. Research shows that there is a strong negative correlation between originations of C&I loans and the dollar index reflecting tighter lending standards, and an increase in the broad dollar index by one standard deviation reduces U.S. banks' corporate loan originations by 10 percent. This effect is not excessive at this point, as higher lending standards are predominantly driven by uncertainty of future growth prospects, but it is not immaterial. This channel bears watching as it can escalate in certain sectors where export revenues are material such as technology, chemicals, and autos.

On the issue of impact of USD on other geographies, continuation of USD strength can create fragility issues for emerging market economies due to the hegemonic role of USD. Those with weaker currencies, high dependence on trade with the U.S. (exports and imports), and higher share of dollar-denominated debt are particularly vulnerable.[3] Fortunately, many emerging market central banks have stockpiled dollar reserves in recent years, reflecting lessons learned from earlier crises, but these buffers are limited and should be used prudently. Having said that, the impact of the dollar's appreciation on some emerging markets economies has been acute, particularly coming on the heels of the pandemic and inflation. Sri Lanka, Pakistan, Bangladesh, and Nepal are clear examples of highly troubled countries with large populations where the rise of the dollar has been particularly punishing.

In summary, the risks to the U.S. economy primarily from strength of USD are not material at this time. There are two future developments to consider that may change the dynamics as it relates to USD strength: (1) continuation of the war and propagation of energy price shocks into other parts of the economy, which

[2] Johannes Matschke and Sai A. Sattiraju, "Recent Appreciation in the U.S. Dollar Unlikely to Have Large Effect on Domestic Inflation," August 17, 2022, KC Fed Economic Bulletin.

[3] Some frontier market countries, such as Sri Lanka, Pakistan, and Bangladesh, have been impacted materially.

can spur domestic inflation and weaken public finances; and (2) a longer-than-expected lag in the development of slack in labor markets and other sticky components, such as the operating expense ratio, requiring the continuation of hawkishness and a longer time to pivot. Both developments, which have been highlighted in the Federal Reserve's recent Financial Stability Report,[4] could result in rising hedging premium and higher local financing risk premia. The negative feedback effects to U.S. GDP growth could also escalate. These can potentially cause disruption in some financial markets, particularly the funding markets, which are already stretched from stress to growth and confidence from prolonged and sustained inflationary impulses.

Item #6: Federal Reserve Policy

What are the Council's views on the stance of monetary policy, including portfolio activities?

Throughout 2022 the Council has consistently increased its Federal Reserve rate hike expectations as high inflation has proven to be more persistent than initial forecasts. As the Council members look to close out the year, they are unanimous in their view that the Federal Reserve's aggressive rate hikes to date have been appropriate and are already beginning to yield some positive results, though more evidence is needed to provide reassurance that inflation is on a convincing path toward the Federal Reserve's medium-term inflation goal.

Council members recommend that going forward, the Federal Reserve be prepared to moderate the pace of future rate hikes but hold its policy rate at a restrictive level for a prolonged period to ensure inflation is on a sustained path. The many steps the Federal Open Market Committee has already taken to slow price inflation will take several more months to be fully realized in the economy. Several Council members have observed initial indicators that the tighter monetary policy stance has been having its intended effect and that the banking system is starting to see signs of declining liquidity, in terms of the run-off of excess deposits. Council members also noted that clients have been moving into nonbanking alternatives, such as money market funds, short-term Treasury securities, and insurance products--and some Council members observed that the trend has been more impactful among regional banks.

Council members reinforced the need for the Federal Reserve to assess structural shifts in inflation and remain vigilant, given the labor supply challenges in the post-COVID environment and the continued supply chain disruptions. These factors continue to work against the Federal Reserve's goal of bringing consumer inflation swiftly back down, and instead raise the risk of the economy entering a more prolonged period of elevated inflation.

Finally, similar to the last meeting, the Council observed that not much has changed with regard to the Federal Reserve's quantitative tightening (QT) activities, though this continues to require close monitoring and may necessitate a moderation or pause in the pace of QT, should conditions warrant.

Item #7: Capital Requirements

How should a regulator determine a bank's capital requirements? What is the role of capital in supporting bank lending, and how should that role be reflected in regulatory capital requirements? Given that additional capital can lower the risks faced by debt holders, and that capital can be used to finance profitable projects, how expensive is "too much" required capital?

How should a regulator determine a bank's capital requirements?

Council members noted that the goal of any capital regulation should be to ensure there is an appropriate cushion to absorb systemic and idiosyncratic stress, without disrupting the safety and soundness of the financial system and without unnecessarily limiting bank activity. Regulators should determine a bank's

[4] Financial Stability Report, November 2022 (federalreserve.gov).

capital requirements commensurate with the level of inherent risk in its business activities, such as credit and market, which is accomplished by tailoring regulatory capital levels based on the complexity and business model of the institution. To that end, Council members said that the use of a risk-based capital framework and a leverage ratio as a backstop are the most effective mechanisms for determining capital requirements. Council members stated that having a stable, simple, and transparent framework for measuring capital is as important as how a bank's capital is measured. Additionally, the use of asset thresholds, which may not be indicative of risk-taking activities or of the complexity of an entity's operations, may impose unnecessary regulatory burdens on institutions.

Council members reported that regular and well-designed stress tests can be important tools in assessing the adequacy of capital to absorb losses. Stress tests also remain important for maintaining confidence in the banking industry, but they should be predictive of stress behaviors and not targeted toward over-conservatism. Finally, bank capital buffers should be considered usable or releasable in stress.

Council members believe the debate about capital requirements should take into consideration the disparate impact between primary regulators' capital rules and the rules applicable to Federal Housing Finance Agency (FHFA) lending. A bank that may have been considered adequately capitalized by its primary regulators could have a negative tangible capital position under FHFA regulations. For instance, in the case of community banks, as one Council member noted, banks that fall below 5 percent book capital could face operational risks that include (1) reduced access to wholesale funding sources and public fund deposits, (2) a reduction in uncollateralized funding sources for correspondent banks, and (3) potential restrictions on dividend payments. Without additional capital issuance, a bank's ability to grow would be further limited.

What is the role of capital in supporting banklending, and how should that role be reflected in regulatory capital requirements?

Council members agreed that setting the appropriate amount of required capital is critical to maintaining economic growth via the availability of credit while providing a cushion for unexpected losses. "Too much" required capital unnecessarily limits economic growth, and, generally, an increase in the amount of capital required to support a loan will increase the cost of a loan. The expense of capital requirements may prohibit banks from engaging in certain lending activity. Setting the appropriate amount of required capital is the desired outcome, rather than a capital requirement that is overstated or disconnected from the actual risk. Council members said that disincentivizing banks from lending in certain areas would be unnecessarily detrimental to business activity and the economy. Similarly, higher capital requirements have already driven certain activities, such as mortgage banking and servicing, away from banks and into nonbanks, which are more costly and less resilient channels. This kind of activity often leaves some industry segments disfavored, from a capital perspective, and unserved. In addition, overly onerous capital requirements could lead to increased systemic risk, as credit markets are forced to move outside the regulated banking industry and into less regulated industries.

Given that additional capital can lower the risks faced by debt holders, and that capital can be used to finance profitable projects, how expensive is "too much" required capital?

Capital at its core is used to make investments that create value for an institution and ultimately benefit the communities it serves. Holding capital that is significantly in excess of that which is required to absorb potential losses limits the ability of any institution to make those value-creating investments, which in turn stifles economic growth. This often happens at a point in the economic cycle when banks should serve as a source of strength in their communities. Council members also stated that holding excess capital is quite costly, given that the relative cost of capital far exceeds the cost of debt, and that any marginal cost reduction in debt due to excess capital is far less than the actual cost of capital. Council members believe that the amount of capital necessary to finance projects should be proportionate to the risk. If capital levels are disproportionally higher than the risk, a bank's lending will be curtailed.

Item #8: Bank Merger Policy

What are the key strategic drivers behind bank merger activity? What are the implications of these mergers for the structure, stability, and capabilities of the banking sector and the financial services industry more broadly? How does the current regulatory framework shape these outcomes? How might the regulatory framework be reformed to improve outcomes for consumers, businesses, low-income communities, and the economy?

Regulations pertaining to interstate banking changed significantly in the 1980s, triggering a multi-decade wave of bank consolidation, which reduced the number of banks from about 25,000 to under 5,000. While the pace of consolidation has somewhat slowed in the last decade, there is still an expectation of continued and significant merger and acquisition (M&A) activity in the years to come.

What are the key strategic drivers behind bank merger activity?

The following themes contribute to the core strategic rationale for bank mergers:

- Rising expense bases to support traditional banking activities benefit from economies of scale, including ongoing technology investments (which can be customer driven as well as infrastructure related), higher costs of compliance and cybersecurity, investments in innovation, marketing initiatives, and data and analytics capabilities. These costs often have large, upfront fixed components, which are harder to commit to without meaningful scale.
- Diversifying sources of revenue, product offerings, customer segments, and its geographic footprint to better manage a bank's risk profile.
- General consolidation in most industries has created larger corporate customers with greater capital needs. Banks need to scale their balance sheet commensurately to meet their customers' growing needs.
- Keeping up with increased competition from banks and nonbanks. Customer expectations have changed significantly, and larger banks, fintechs, and nonbanks are able to invest heavily in infrastructure and technology to enhance key parts of the user experience. The cost to deliver more personalized digitalization in order to compete has caused many banks to consider reworking their technology strategy, which has led to discussions on M&A to stay relevant.

While these factors have remained fairly consistent over the past few decades, the pace of change—especially with the introduction of more fintechs and nonbanks that aim to disintermediate the financial industry—has accelerated significantly. As a result, bank management teams are more seriously considering M&A as a core strategic priority.

What are the implications of these mergers for the structure, stability, and capabilities of the banking sector and the financial services industry more broadly?

Banking in the U.S. is highly competitive, and the industry remains relatively fragmented compared to other large, developed economies. Banking products and services are not just provided by traditional banks, but also by an ever-growing number of nonbank participants, such as mortgage companies, private equity firms, debt funds, and business development companies. In certain sectors, such as mortgage banking and commercial lending, nonbanks are already dominant and have collectively built a majority market share.

Merger activity in the banking sector will create a healthier, more robust industry, and will allow for continued investment in technology, innovation, customer experience, and overall safety and soundness. Shareholders often demand that sub-performing banks sell to better-performing and better-managed banks. Such consolidation creates stronger institutions that improve the delivery of products and services for clients and the community, and ultimately benefit the broader economy.

While the merger process creates short-term operating risk as platforms are integrated, in the long term, M&A create more diverse and resilient institutions, are important for a healthy banking industry, and support positive economic growth.

How does the current regulatory framework shape these outcomes? How might the regulatory framework be reformed to improve outcomes for consumers, businesses, low-income communities, and the economy?

Council members noted that the current regulatory framework for bank M&A, which has been in place since the 1990s, is robust and has worked well. Though the framework has not been fundamentally altered, the regulatory approval process has changed from time to time, which is evident by the resulting expedited or extended timelines for merger approvals over the years.

When there is a high level of uncertainty in the process, such as there is today, the industry tends to see meaningfully less merger activity (and the opposite also holds true). While the regulatory framework has worked well, the banking landscape has changed, including the emergence of less-regulated fintechs and nonbanks. Therefore, Council members deem that it would be appropriate for regulators to review the framework to see if any changes are warranted to make it more relevant to address the current landscape and emerging risks that did not exist when the framework was originally designed.

A new or revised framework should aim to promote transparency, fairness, and efficiency. Processes that create uncertainty will dampen not only the success of announced mergers but could also narrow the pipeline of rational M&A activity. Council members noted that regulatory agencies should examine how the review process could be executed in a shorter timeframe, which would ultimately benefit all stakeholders, including communities, customers, employees, and shareholders. Drawn-out approval processes generally lead to a deterioration of business value, create safety and soundness issues, and put the strategic rationale for the business combination at risk (for example, loss of customers due to market disruption and confusion, loss of employees due to extended or burdensome retention strategies, and loss of opportunity to deploy capital into the community). Furthermore, institutional investors with capital in these transactions want to have confidence that approvals are not being tied to factors outside of what is required in the regulatory diligence process.

The merger framework should also take into consideration the consolidation trend occurring in the credit union space. With credit unions having a more advantageous tax status and a different set of regulatory expectations than banks, there is an inherently uneven playing field favoring credit union acquirors, and this could potentially have negative impacts on communities. This advantage should be examined when looking at revising the current framework.

Overall, Council members concluded that a more efficient and transparent process would ultimately allow for a greater ability to deploy capital more expeditiously toward innovation and invest in communities, customers, and employees.

Item #9: Central Bank Digital Currency (CBDC)

What does the Council think are the risks to the economy and to the financial sector if the Federal Reserve does, or does not, issue a CBDC? Does a CBDC raise the possibility of disintermediating banks? Will a CBDC be able to coexist with stablecoins and commercial bank money by providing a safe central bank liability in the digital financial ecosystem? How does the potential absence or presence of a U.S. central bank digital dollar affect the use of the dollar in global payments? Other countries including, but not limited to, China, South Korea, Japan, India, and Russia, are developing a CBDC. Is this a concern? And a CBDC would be attractive to risk-averse users during times of stress. Is this a problem?

Overview

Prior to the development of a CBDC, Council members believes that there should be close examination of alternative solutions and improvements to existing platforms to achieve the benefits potentially attributed to a CBDC, so as not to unnecessarily introduce new risks and complexity to the financial system. Council members referred to recent network innovations such as The Clearing House's (TCH) RTP network and FedNow, the Federal Reserve's anticipated real-time payments system, as well as increased access to financial services and client experience through digital offerings, as examples of improvements that address a number of "pain points" that CBDC is intended to address. Given payments modernization efforts in the private and public sectors, the incremental value of a CBDC is unclear, while the potential risks are well documented and potentially significant.

What does the Council think are the risks to the economy and to the financial sector if the Federal Reserve does, or does not, issue a CBDC?

If the Federal Reserve does issue a CBDC, Council members emphasized that the risks posed to banks, the economy, and the financial sector would depend heavily on the CBDC's architecture and design choices. In the case of a retail CBDC, the migration of bank deposits to CBDC would negatively impact banks, U.S. consumers, and the financial system. Decreased bank deposits would, in turn, reduce banks' ability to lend and could ultimately result in higher interest rates and reduced credit availability. These impacts would likely be amplified in times of economic stress. Because of the added stress on deposits and lending, the Federal Reserve may be required to step in to address shortfalls, and to provide market stabilization through the provision of credit to the public, the banking system, or both.

Council members also believe that the concentration of the asset and network associated with CBDC issuance is also likely to increase cyber risks. Cyber criminals may see a single target in the form of widely held liabilities of a single central bank, instead of commercial bank liabilities distributed across the thousands of financial institutions in the U.S. The network used for CBDC-based transactions would also introduce risk and resiliency concerns if there is not an alternative way to settle transactions in the event of a network outage or failure. This is in opposition to existing financial market infrastructure, which offers many ways to settle transactions based in commercial bank money.

While there is certainly value in continuing to research CBDC issuance, Council members noted that there is no immediate risk associated with the Federal Reserve **not** issuing a CBDC.

Does a CBDC raise the possibility of disintermediating banks?

The foundational characteristic of a CBDC—that it is a liability of the Federal Reserve—means that it would exist only on the Federal Reserve's balance sheet as a liability and on the holder's balance sheet as an asset. In the case of a retail CBDC model, financial institutions would simply either provide bank customers a view of their CBDC balances held on the Federal Reserve's balance sheet or act as a custodian for the customers' CBDC "wallet." As previously mentioned, a retail CBDC would likely reduce commercial bank money balances, forcing banks to either curtail lending or seek funding from alternative sources, likely increasing the cost of credit for consumers. Even in an intermediated model where a CBDC would be distributed through depository financial institutions, the CBDC would remain a liability of the Federal Reserve and would not benefit banks' lending activity. Council members agreed that this would reduce the role of the bank and may disintermediate banks' relationships with consumers.

In a wholesale CBDC model, the risk of bank disintermediation is much lower in that the CBDC would largely replicate the Federal Reserve master account model, just with different technology. This would allow banks to continue relationships with clients in line with today's operations. The wholesale model is fundamentally a change in ledger technology at the Federal Reserve as opposed to a new form of central bank liability. The benefits of a wholesale CBDC are often associated with settlement, primarily in cross-border transactions, though several Council members noted that many of the challenges associated with cross-border payments result from a misalignment of laws, rules, regulations, and scheme interoperability. As has been noted by industry groups, most of those challenges could be addressed without a CBDC.

Will a CBDC be able to coexist with stablecoins and commercial bank money by providing a safe central bank liability in the digital financial ecosystem?

Theoretically, a CBDC could coexist with stablecoins and commercial bank money; however, it's unlikely that this coexistence would occur without adversely impacting the broader financial system. A retail CDBC would likely be regarded as a safe and desirable form of money, relative to commercial bank money or any stablecoin, potentially driving a downward trend in usage of stablecoins and commercial bank money. Council members stressed that bank-issued stablecoins, in most circumstances, are effectively tokenized commercial bank deposits. If issued by a nonbank intermediary, stablecoins represent an indirect interest in a pool of commercial bank money and equivalents, such as Treasury bills, held on behalf of the intermediary. In an ecosystem with multiple forms of money, market participants are likely to make choices based on perceptions of relative utility and risk, and having multiple forms of money could lead to increased costs and inefficiencies resulting from fragmentation. In short, Council members questioned whether the result might be an unnecessarily complex solution much more easily handled by innovations currently in use or scheduled, such as 24X7 Fedwirre and FedNow.

How does the potential absence or presence of a U.S. central bank digital dollar affect the use of the dollar in global payments?

Some Council members suggested that a foreign CBDC could threaten the dollar's status as the global reserve currency and as the currency of choice for international trade and finance. Council members cited positions from an industry study that was conducted in response to the Federal Reserve's CBDC discussion paper, and they noted that it is important to remember that the dollar and its prominent role in the global economy rests on several foundations, including the following:

- The strength and size of the U.S. economy
- Extensive trade linkages between the United States and the rest of the world
- Deep financial markets, including U.S. Treasury securities, and the stable value of the dollar over time
- The ease of converting U.S. dollars into foreign currencies
- The rule of law and strong property rights in the United States
- Credible U.S. monetary policy

These characteristics remain unchanged regardless of whether a U.S. CBDC is issued. Several Council members cited potential risks that a U.S. CBDC could introduce, such as (1) privacy concerns, which are not present in today's system, (2) lower friction when freezing assets of foreign parties, and (3) being subjected to extra-judicial political pressure to exercise intervention. International individuals, companies, and jurisdictions may see this as a reason to further diversify the currency they hold and use for international trade to avoid political interference. Similarly, if a U.S. CBDC were to become politicized or perceived as risky, foreign entities may be reluctant to adopt it. This is in line with the way U.S. corporations have exhibited reluctance to participate in the Chinese financial product marketplace.

Some Council members suggested that CBDCs may provide greater speed for cross-border payments, thus increasing the desirability of CBDCs over existing payment systems that move commercial bank money for international payments. However, CBDC is just one approach to improve global payments, and it introduces added complexity over today's infrastructure (for example, those associated with international participants in the U.S. CBDC system and vice versa). Other initiatives are under way to improve upon existing infrastructure and capabilities, while minimizing additional risk and complexity to the system—for example, TCH's immediate cross-border payments initiative, which seeks to connect instant payment systems around the world.

Other countries including, but not limited to, China, South Korea, Japan, India, and Russia, are developing a CBDC. Is this a concern?

Many countries globally are developing CBDCs for reasons that are not aligned with U.S. policies and values, but for purposes of control and potential coercion. In addition, CBDCs raise concerns around consumer privacy, as some design considerations could enable governments to monitor, surveil, and directly influence consumer behavior. Council members agreed that a framework around data collection, storage, protection, and usage would need to be thoughtfully designed and implemented.

A CBDC would be attractive to risk-averse users during times of stress. Is this a problem?

As Council members mentioned, in times of stress, depositors may choose the structural safety of a CBDC over commercial bank money, as a central bank liability carries with it guaranteed, immediate liquidity, whereas a claim for deposit insurance does not and is subject to insurance caps. Currently this security/confidence need is met with deposit insurance, which has the benefit of maintaining liquidity in the banking system, which is critical, particularly in times of stress. An uncapped CBDC could have a detrimental effect on lending and the cost of credit as banks lose deposits to CBDC, facilitating and accelerating "run on the bank" risk.