Record of Meeting

Federal Advisory Council and Board of Governors

Thursday, February 9, 2023

Item 1: Economic Activity

What trends in business activity do Council members see among their clients and other contacts? 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 for 2023?

What trends in business activity do Council members see among their clients and other contacts?
Overall business activity remained relatively strong, especially compared to the same period in 2021. However, across most sectors, signs of slowing and weakening have started to show. In some sectors this has signified a return to normalization, and in others the slowdown has appeared more severe—particularly in higher growth and interest rate sensitive industries such as technology, construction, and real estate. Geographically, the underlying trend remains distinctly uneven as business activity appears to be slowing down nationally yet holding steady in certain parts of the country. Going forward, the mixed outlook is likely to continue and to be heavily dependent on local factors. While both consumers and businesses have remained on solid footing, their level of confidence reflects recessionary concerns. Businesses have limited their investments as they prepare for a slowing economy, the probability of higher interest rates for a longer period, and the uncertainty of the demand outlook for 2023. Many businesses have started to report margin pressure due to continued inflation and rising input prices, in addition to their declining ability to pass on increased costs to consumers.

Council members reported that consumer cash balances and credit metrics have remained strong, and that consumer spending has continued to grow at a modest pace. A robust labor market and accumulated savings during the pandemic have continued to support these trends. However, there are signs of consumers switching to lower-priced goods and services and a continued increase in revolving credit card balances. Several Council members highlighted the acute impact of inflation on low- and moderate-income households, as real income has deteriorated and consumer checking accounts in the lower-balance quartile have seen steady declines.

Are Council members, clients, or contacts seeing any new areas of strength or weakness?
The housing market has continued to be an area of weakness and has recently spilled into adjacent areas such as home remodeling and contractors, appliance sales, and furnishings. Affordable housing construction continues to be in high demand, yet it has become more difficult to execute. The combination of higher interest rates and higher construction costs have impaired the capacity of the Low-Income Housing Tax Credit program to facilitate construction. In general, almost all property type transactions have decreased due to rising rates and pricing. Activity in general manufacturing and service portfolios have slowed, and both industries have reported continued difficulties with labor, higher costs, and the ability to pass cost increases on to the consumer. Lower-than-anticipated demand in areas such as retail, trade, warehousing/distribution, and technology has led many firms to lay off workers and trim their capital budgets. However, Council members noted that (1) layoffs are not expected to be as profound as they have been described in the media and (2) many firms are returning to pre-COVID employment levels as the demand normalizes. The labor market remains strong, and wage inflation has continued to affect all businesses—including hospitals and other healthcare-related businesses, food services, retail, and transportation. Additionally, the agricultural industry has experienced a doubling of input costs over the past two years, and those costs are expected to rise into the high single digits in 2023.

On a positive note, areas of strength include multifamily residential housing, energy, media and entertainment, consumer services, defense, and infrastructure spending. Additionally, there has been consumer strength in tourism, corporate travel, restaurants, grocery stores, and hospitality. More broadly, manufacturers have started to report a decline in prices paid for inputs, which could help offset some of the headwinds mentioned above.

Are there industries or geographic areas in which significant supply-side constraints persist?
Consistent with the previous FAC meeting, Council members reported that supply chain disruptions have continued to ease, although there are still challenges. Shipping costs and backlogs have continued to improve but have not yet reached normalized levels and can be industry specific. Even though the semiconductor shortage has started to wane, it continues to be one of the largest supply-side constraints affecting all things digital. The auto industry remains constrained, but a softening in demand could help bring the industry back into balance. Medical supplies, drug sourcing, and pharmacy supply conditions continue to suffer. Lastly, the labor supply has improved marginally, but continues to affect all industries, and businesses continue to cite concerns with persistent high labor costs and shortages.

What is the Council's prognosis for the pace of economic activity across sectors for 2023?
Council members agreed that the risk of a recession in 2023 continues to increase, albeit a recession could be mild and is not completely inevitable. Overall, economic activity is expected to decrease in 2023 compared to 2022, and many small and mid-size business leaders are preparing for a recession—even if they remain optimistic about their own company's performance. Employment has remained solid across most industries, which has led to continued optimism about the possibility of a "soft landing," characterized by relatively mild and short-term recessionary conditions.

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? Will businesses be increasing or decreasing their employment levels in the year ahead, and in what categories? Has there been any significant shift in the size, composition, or qualifications of the available labor pool in recent months? What does the Council foresee in terms of the balance between job openings and available workers over the course of the year? What kinds of compensation increases are being planned for 2023?

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?
Overall, Council members said that the labor market remains tight and competitive for talent, especially for skilled workers, manufacturing employees, and office staff. However, there has been some improvement as the economy slows, with application volume up and turnover down. For example, in the global services industry, expected slowdowns in production due to recession planning have started to ease the significant strain caused by the labor shortage. Council members said that the same was true for supply chain-related issues, and they added that labor challenges have been somewhat mitigated by slower production and transportation demands. Hourly and entry-level roles continue to be the most difficult to fill for retail and service industries. Council members have started to see improvement in the hospitality and leisure industries, although labor shortages remain, and many employers raised hourly wages significantly to try to attract and retain staff in 2022. Council members said employees continue to demand flexibility, increased wages, and remote work, and are using those as bargaining chips when considering new roles or departing their current employers. All that said, Council members reported that recessionary concerns have started to slow the number of people voluntarily leaving their jobs for new opportunities.

Fears of inflation, pressure on retirement accounts, and anything that may increase instability in personal finances may cause workers to delay retiring or leaving their jobs.

Will businesses be increasing or decreasing their employment levels in the year ahead, and in what categories?

Given continued economic uncertainty and inflationary challenges, most businesses will maintain or decrease their labor force sizes in 2023. Council members pointed to recently announced layoffs in the technology and media spaces as examples of this trend. The need for staffing is expected to remain relatively flat in 2023 in the hospitality and leisure sectors, as store traffic and hotel occupancy have nearly returned to pre-pandemic levels. Areas such as construction, which experienced strong employment throughout 2022, could see declines this year as the housing market cools. One Council member mentioned that some areas (such as environmental, cybersecurity, digital, and innovation) are seeing an increased demand in scope and a surge in headcount levels.

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

Given the tight labor market and high turnover rates, companies have reported paying higher salaries to less qualified employees, and there is concern that this may be exacerbated by retirement rates. It also is expected that as the fast-food industry wage minimums increase in states like California, candidates for entry-level roles in other industries (such as automotive service technicians) may migrate. Council members noted that some of their business banking clients have reported a slight improvement in the labor pool, although an increase in demand for restaurant delivery service drivers remains. Council members also said there has been an increase in the willingness of companies to pay to upskill their current workforce as a retention tool for qualified labor in targeted jobs.

What does the Council foresee in terms of the balance between job openings and available workers over the course of the year?

Council members said they expect the labor market to normalize a bit this year--moving closer toward pre-pandemic levels, with fewer job openings, less hiring, and less turnover. Unemployment is expected to increase but should remain relatively low when compared to historical rates. Council members said business banking, specialized industries, and public sector clients are anticipating continued imbalance between the number of openings and the quantity and quality of available candidates. This labor imbalance is pronounced where efforts to return to the office have caused retention concerns and increased the pressure on the labor situation. Additionally, difficulties continue in the transportation and manufacturing segments, where planned slowdowns have started to mitigate the need for labor, yet labor shortages persist. One Council member noted that the end of 2022 brought an increase in the number of applications per job—reaching the highest number of applicants per open role since June 2020.

What kinds of compensation increases are being planned for 2023?

Council members generally said that given labor market pressures, companies are doing everything they can to enhance competitiveness in terms of total compensation. Many clients are reporting modest increases in compensation for 2023 beyond current levels—typically in the range of 3–5 percent. Wage inflation overall is a concern for the first half of the year, especially in specialized industries. Council members expect there will be continued movement toward wage increases, flexible scheduling, and other perks to attract and retain staff throughout 2023—particularly in service industries. In healthcare, a high number of physicians are quitting or reducing their hours, and skilled nursing companies are hiring nursing students and paying their tuition or renegotiating payor contracts at every opportunity. One Council member said that some employers are offering bonuses to retain current staff who may otherwise be lured away by offers from new companies.

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, residential real estate, construction, small and medium-size business, or corporate?

Summary

Overall borrower demand is moderating across sectors because of higher interest rates and increased economic uncertainty. Underwriting standards and deal structures are beginning to tighten across asset classes. Nevertheless, credit quality broadly remains strong, although it is continuing to normalize and is receiving a high level of diligence.

Consumer and small business (including residential real estate)

Since the Council's last meeting in December 2022, consumer lending trends remained reasonably consistent. In the credit card market, demand and spend levels remained strong. Continued re-leveraging and grow-over from the pandemic is expected, supporting strong credit card outstanding growth in 2023.

In auto and home lending, asset values are rolling over on both higher interest rates and supply challenges. Demand is solid but at a lower level One Council member noted some regional strength in residential real estate purchase volume due to continued migration and real estate values. Another Council member noted a slight rebound as rates have slightly decreased. Council members reported stronger demand for home equity lending. And there was consensus among Council members that lenders are continuing to tighten credit standards at the margin.

Small business demand for credit remains benign, and deposit balances and cash buffers remain elevated when compared to pre-pandemic levels. Surveys indicate that clients are being more cautious at the margin and conserving liquidity in preparation of a recessionary environment. Some Council members noted that businesses are more inclined to borrow for operating expenses than for expansion.

Middle market and corporates

Credit demand and utilization have stayed reasonably consistent, and underwriting standards and structures have remained largely unchanged, with some tightening that is not yet broad based. Some clients are putting projects and capital expenditure (capex) on hold, given higher interest rates, inflation, and concerns of an economic slowdown. Nevertheless, capex is still expected to be overall positive. Additionally, clients are expressing a desire to increase revolver capacity to manage liquidity through uncertainty in 2023.

Council members reported they are beginning to see margin compression as a broader story in larger consumer and retail names. Downgrades have been largely concentrated in the middle market; however, increased softness was seen across small and larger clients in the fourth quarter, concentrated in the consumer and retail, industrial, and healthcare sectors. One Council member noted that agricultural loan performance and farm financing remain strong, despite the impacts of high rates, lower real estate values, and drought conditions. Some banks are being more selective on deals or when signing up new clients—reflecting the effects of capital scarcity and higher costs of liquidity—but existing clients continue to be supported.

Leveraged lending activity, although still somewhat challenged, showed signs of reopening in January. The high yield market has improved, funds have cash to be deployed, and investor demand is strong. The investment grade market is stable, with January activity showing clients with permanent capital needs locking in lower 10-year interest rates.

Overall, refinancing risk is expected to be manageable and well-contained through 2024.

Commercial real estate (including construction)

Commercial real estate (CRE) saw demand slow due to higher interest rates, increased construction costs, and continued uncertainty around office demand. Higher rates resulted in reduced cash flow and declining property valuations.

Construction demand has decreased because of higher interest rates and higher construction costs (due to inflation), but deals are still getting done, primarily focused on growth segments, such as the multi-family and industrial segments. Construction deals in the current market are on more favorable terms for lenders and have more equity. Although they are easing, labor and supply chain headwinds remain present for construction of all property types.

CRE fundamentals vary based on property type. The multi-family and industrial segments are positioned to perform in the current market, but fundamentals have started to moderate, and new project demand has begun to slow.

Office fundamentals remain weak as a result of decreased demand—with national vacancy rates forecasted to exceed the GFC peak by the fourth quarter of 2023. Within the office sector there is bifurcation: New assets are seeing stronger demand and record rents, while older assets are impacted by lower demand, falling rents, and increased capex, as well as higher financing costs.

The market for retail space continues to benefit from an extended period of limited construction, and vacancies are forecasted to remain flat this year. This, too, is a bifurcated market with stronger performance in neighborhood and grocery retail centers and softer performance in office-dependent and older malls given reduced foot traffic.

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 December meeting? To what extent, and in what sectors, are businesses able to pass along price increases? 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 December meeting?

Inflationary pressures have eased somewhat as prices are increasing less quickly now than they were at the time of the December meeting. Concerns about high price inflation, rising inputs costs, and high transportation costs have dissipated notably since June 2022. Price pressures have lessened, with slower growth in labor costs and price declines for some non-labor inputs. Supply chains and port backlogs have improved, and oil and gas prices have declined. Rising labor costs remain a concern, as labor supply remains short in some sectors and wage inflation continues to be the stickiest form of inflation. Council members noted that the healthcare industry is a significant concern given that it has little opportunity to pass along cost increases from significant and permanent wage inflation.

Most of the slowdown in consumer inflation appears to be coming from the goods sector as transportation costs, energy costs, and commodity price inflation subside, and goods demand growth softens. Prices for consumer goods, excluding food and energy, have been under downward pressure in recent months. Many retailers have found themselves with unwanted inventory builds and have resorted to aggressive discounting to clear these unwanted stocks. Services inflation will be slower to soften as labor costs remain high and services demand remains relatively more stable.

To what extent, and in what sectors, are businesses able to pass along price increases?

The ability to pass along higher prices is mixed. Some of the Council members' clients reported a lessened ability to pass along input cost increases, and others reported no change. With inflation appearing to show signs of moderating, businesses are anticipating a slowdown in the level of price increases being passed on to their clients throughout 2023. Some corporate clients were pessimistic about their ability to pass on any pricing increases to their end users and hence are facing greater margin pressure (albeit off very strong historical margin levels).

Since the last FAC meeting, a higher number of corporate sectors have shown shrinking margins. This signals that the ability to pass costs through has been reduced since the last quarter. The sectors where the ability to pass through costs is more challenging are consumer (non-discretionary), retail, and auto industry.

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

There seems to be a growing sense that the worst of the high inflation is over, and clients generally expect slower, yet still elevated, inflation in 2023. Corporate clients were generally more upbeat on inflation in the fourth quarter, reporting better supply chains, less labor pressure, and lower energy prices. Consumers and businesses are expecting inflation to remain elevated, while growing at slower rates, and are concerned about the overall state of the economy and the higher cost of goods and services. Consumers cut back on purchases in the second half of 2022, indicating they had reached a limit on what they are willing to pay for certain items.

The sharp drop in oil and gasoline prices since last summer has helped temper short-term consumer inflation expectations and anchor longer-term inflation expectations. In addition, aggressive action by the Federal Reserve has tightened financial conditions and slowed private sector demand growth. The decline in services and housing inflation components will take longer to feed into the overall consumer inflation rate and the inflation outlook. The pandemic and the war in Ukraine remain upside risks for energy and food inflation as well as for continued supply chain disruptions.

Item #5: Federal Reserve Policy

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

The Council believes the pace and magnitude of policy tightening to date has been appropriate given the level of inflation and questions around the durability of price pressures. The pursuit of this policy has contributed to a tightening in financial conditions with substantial increases in both nominal and real Treasury yields, widening credit spreads, and recent declines in asset prices, including broad equity market and housing indices. The economy has absorbed the shift in policy stance from the accommodation of the pandemic era to the current levels; yet recent data suggests a shift may be occurring that would be supportive of a change in the pace and magnitude of the hiking cycle on a go-forward basis. In addition to economic indicators such as ISM Services and Manufacturing, which have fallen below 50 in recent months for the first time since May 2020, loan demand has fallen in general and specifically in interest-rate sensitive areas such as both auto and mortgage loans, which have been impacted by higher rates. Additionally, inflation metrics are now declining. The impact of the rate hikes is beginning to lead to (1) a slowdown in economic activity and (2) signs of cooling in inflationary pressures, especially goods inflation. Most Council members believe that some further tightening in monetary policy remains necessary to bring inflation down to target levels. However, now that policy is in restrictive territory, the Council members believe that the FOMC can moderate the pace of future hikes but hold their policy rate at a restrictive level for a prolonged period to ensure disinflation is on a sustained path and to take the lagged effect of monetary policy into account. Council members noted that elevated wage inflation, which is expected to continue for a prolonged period, and the war in Ukraine could continue to keep upward pressure on prices.

Regarding quantitative tightening, the impact of the continued drain on liquidity is easily observed by declines in deposit balances, which appear to be manifesting in higher utilization of wholesale borrowing across the industry. The increased attractiveness, availability, and awareness of higher yielding alternatives to bank deposits has placed significant pressure on liquidity, especially at regional and community banks. This pressure has been exacerbated by a constrained ability to reduce securities and loan portfolios without recognizing significant losses that would put pressure on capital levels. Additionally, reverse repo utilization has been significantly elevated, increasing over $400 billion, which has led to a significant and rapid drawdown of reserves in the banking system of nearly $1 trillion since year-end 2021. For now, reserves in the banking system remain ample, and Council members believe further balance sheet normalization at the current rate remains appropriate; however, Council members noted that the level of reverse repo balances and reserves should continue to be monitored.

Item #6: The Outlook for Banking in 2023

What is the outlook for Council members' institutions and other banks in their Districts:

a. **What is the outlook for loan volumes and deposit flows in 2023?**
b. **What will be the primary drivers of revenues, costs, and profitability?**
c. **What sorts of risks and contingencies warrant particular attention?**

Loan Volumes

Compared to elevated levels in 2022, loan volumes are expected to pull back to historical norms in 2023, continuing the trend of slowing loan growth from the fourth quarter of 2022. Borrower demand is expected to continue to moderate in response to the significantly higher interest rate environment, inflationary pressures, and an anticipated slowdown in economic activity. Banks are also expected to slow lending as a result of capital constraints, funding gaps, and changes in credit quality. Overall, the possibility of a recession in 2023 is expected to have the biggest impact on loan volumes.

Deposit Flows

Council members expect that the trend of decreasing deposits from the fourth quarter of 2022 will continue into 2023. Excess savings are being depleted, and higher prices have expedited this shrinkage. Additionally, quantitative tightening continues to remove liquidity from the system. Customers have become more rate sensitive in light of the current environment, and have moved to Treasuries, money market funds, and other more attractive return instruments. Online and non-traditional banks are also offering highly competitive deposit products, leading to deposit migration. Overall, deposit pricing pressure is expected to become increasingly intense. Given the higher rate environment, banks can expect to focus on balancing deposit betas and deposit balances throughout 2023.

Primary Drivers of Revenues

Council members reported that net interest income would be the primary driver of revenue in the early months of 2023. Strong loan growth from 2022, coupled with higher rates, is expected to lead to increased revenues that will peak in the first half of the year. The magnitude of this overall revenue increase is expected to depend on the Federal Reserve's rate policy, deposit beta performance, and the extent to which a potential recession affects loan growth.

Non-interest revenue and fee income is expected to depend heavily on the continued volatility of markets caused by heightened macroeconomic uncertainty. Mortgage-related revenue is expected to be low because of decreased origination and refinancing volumes. Apart from that sector, predictions regarding fee income remain uncertain after revenue was suppressed in 2022 in mortgage, wealth, trading, asset management, investment banking, and capital markets.

Primary Drivers of Costs

A myriad of unique cost drivers is anticipated to have significant impacts in 2023. Increased deposit costs resulting from deposit beta pressures will be a serious consideration, and the cost of borrowing will also be elevated throughout the year. Across the industry, the average rate on one-year CDs rose 106 basis points to 1.31 percent between January 7, 2022, and January 6, 2023. Many banks, including larger institutions with assets greater than $250 billion, are marketing one-year CDS with rates higher than 4 percent. The FDIC's increased insurance assessment rate, along with other regulatory and compliance costs, will have a meaningful impact in 2023. Credit conditions are seen as benign at present, but macroeconomic environmental pressures are likely to cause stress. As credit conditions shift, charge-offs are expected to rise toward pre-pandemic levels, which will necessitate an increase in provisions for loan losses. Banks also expect to make substantial investments in technology upgrades, digital product development, cyber security, and fraud mitigation to remain competitive and resilient in 2023. General expenses, and labor expenses in particular, are expected to increase in response to inflation and wage pressures from the tight labor market.

Primary Drivers of Profitability

Banking profitability in 2023 is expected to depend on the effective management of the above-mentioned drivers of revenues and costs, rather than significant growth as was seen in 2022.

Risks and Contingencies

Bankers are looking out for a number of risks in 2023. Credit quality will continue to be a focus throughout the year. Although conditions are currently benign, the outlook is largely uncertain, and risk will depend heavily on the economic environment. The potential range of outcomes over the course of the year is large and will diverge even more in the case of a recession.

Capital allocation and liquidity management will be much more important issues for banks in 2023. Several banks reported growth in CDs and borrowings in the fourth quarter of 2022. Large banks' fourth quarter results are showing a significant increase in CDs and FHLB advances, by 12.5 percent and 36.5 percent respectively, compared to the previous quarter. Demand for FHLB advances and other liquidity sources is expected to increase. FHLB restrictions related to tangible equity for bank borrowers is an immediate issue for hundreds of community banks.

Although Council members indicated that net interest margin would be the main source of revenues in early 2023, in a recent survey, net interest margin was named by more than 85 percent of community banks as the top risk in 2023. This is likely due to possible compression in margins as the sensitivity of liabilities on balance sheets intensifies. The survey included 498 banks with $10 billion or less in assets across 40 states. Survey respondents also listed economic conditions and risk of slowing loan demand as top external risks for community banks. As a result of higher rates, banks currently face constraints in their ability to reduce securities portfolios without recognizing losses, which then puts pressure on capital levels.

Cybersecurity is a top challenge for bankers across the country and throughout the industry. In a national survey, nearly 96 percent of bankers listed cybersecurity as the top internal risk. Mitigating cybersecurity risk requires significant investment, particularly considering geopolitical tensions. Global conflict is a concern because of its possible effect on general economic stability, oil supply, and food prices. Finally, bankers are concerned with the overall performance of the economy and are aware of the risks associated with an economic downturn in 2023.

<u>Item #7: Long-run Outlook for Office Space</u>

In light of the changes in in the nature of work in an office setting in the aftermath of the pandemic, have Council members seen evidence of firms changing their long-term plans with regard to their use of commercial real estate? In the Council's view, what shifts in the demand for commercial real

estate appear to reflect permanent adjustments to work environment in response to the pandemic? Are firms planning on reducing their total office space needs, or shifting their demand towards more suburban satellite locations to better complement employees' hybrid work schedules?

In light of the changes in in the nature of work in an office setting in the aftermath of the pandemic, have Council members seen evidence of firms changing their long-term plans with regard to their use of commercial real estate?

Overall, Council members agreed that hybrid working is here to stay and may become a permanent feature for companies across the U.S., though the final form it will take remains unclear. As a result of this uncertainty, many companies continue to experiment with return-to-office strategies, such as the number of days in the office and unassigned seating. One item that has become clear, however, is that most institutions today have more square footage of office than they will likely require on a permanent basis.

One reason the market has not seen significant changes thus far is likely tied to the long-term nature of the leases themselves (historically 5-10 years), which also carry heavy breakage fees. For organizations whose leases are up for renewal, however, companies are opting for less square footage and Class A office space.

In the Council's view, what shifts in the demand for commercial real estate appear to reflect permanent adjustments to work environment in response to the pandemic?

Historically, office space demand was tied to employment levels. This correlation appears to have changed, however, as the country reports record low unemployment at the same time that office utilization is 30-40 percent below pre-COVID levels.

Council members noted that the decrease in office utilization is primarily driven by the shift to hybrid and remote work, adding that with the increase of technological solutions, many roles that were once viewed as only able to be completed on-site—such as call centers—can now be managed remotely.

The increased demand for a hybrid work environment has also been driven by employee preferences in a tight labor market. Council members observed that this was particularly true in sectors such as technology, finance, and professional and business services, which currently have the highest levels of hybrid and work-from-home employees.

Because of these factors, many industry experts and Council members believe such work schedules may lead to a 15-25 percent permanent reduction in the demand for office space. This impact is compounded by the fact that many companies who are in the market for new space are becoming more discerning and focusing almost exclusively on Class A properties with employee-friendly amenities, such as flexible layouts, and features—including outside air and natural light—that promote health and wellness.

Are firms planning on reducing their total office space needs, or shifting their demand towards more suburban satellite locations to better complement employees' hybrid work schedules?

As discussed above, most companies report having more office space than will be required on a permanent basis, though how much more remains unclear and plans to reduce physical footprints will take time to enact due to the long-term nature of leases.

The magnitude of any shift in demand toward suburban markets over the long term also remains uncertain. Council members' observations varied, with some reporting increased interest, while others noting the reverse, commenting that employees preferred to work from home instead of driving into any location. As with other trends in the sector, the outlook for office space demand in suburban versus major metropolitan areas remains unclear.

Item #8: Impact of Interest Rates on the Financial Condition of Banks

What is the impact of higher interest rates on banks' investment portfolios and fixed-rate loans? To what extent are banks' deposit-taking activities offsetting these impacts? How, if at all, do unrealized losses weigh on bank behavior? Do unrealized losses in banks' portfolios inhibit bank lending?

What is the impact of higher interest rates on banks' investment portfolios and fixed-rate loans?

Most Council members noted that higher interest rates, coupled with the drastic rate increases over the last year, negatively impacted the bank's investment portfolio and fixed-rate loans. Banks have been experiencing margin compression on fixed-rate loans given the rapid increase of rates.

Almost unanimously, Council members projected bank investment portfolios sustained unrealized losses because of higher interest rates. The extent of a bank's unrealized losses would be dependent on their balance sheet management practices. If, for example, a bank had initially invested the excess deposit balances in high-quality short-term government bonds, then the bank would have an ability to reinvest at higher rates. However, if the bank maintained a large percentage of its portfolio in extended duration investments, the bank would sustain larger unrealized losses and most likely hold those investments until maturity. The unrealized losses would reduce accumulated other comprehensive income (AOCI) and are reflected in tangible common equity (TCE). Some Council members expressed awareness and sensitivity toward how AOCI and TCE may alter investor perceptions and valuation. Council members observed a decrease in demand for securities purchases and anticipated that demand would remain low in the first half of 2023.

To what extent are banks' deposit-taking activities offsetting these impacts?

Several Council members indicated that banks have been able to use their excess liquidity, partially derived by high deposit balances during the pandemic, to offset the drop in securities market value. However, Council members added that deposit balances have not kept up with loan growth, noting declines in 2022. As deposit betas increase, the margin on fixed-rate loans and investment decreases, thus impacting profitability.

Given the expectation of a continued reduction in deposit levels partially driven by the Fed's quantitative tightening program, banks are attempting to retain and grow deposits by offering promotional rates to attract new deposit balances while maintaining core relationship deposit accounts. The erosion of cash balances and added pressure on liquidity has banks potentially considering expensive wholesale borrowings and other activities to fund their balance sheets, which could squeeze net interest margins.

How, if at all, do unrealized losses weigh on bank behavior?

Most of the Council members expressed that unrealized losses alone will not affect bank behavior. Instead, behavior would be impacted if there was an expectation that the losses would be realized, or if the regulatory capital guidelines relating to unrealized losses were to change. Banks that are below Category II are not required to include AOCI in their regulatory capital calculation and will generally remain unaffected by unrealized losses. To the extent there are market confidence concerns, banks have the option to deploy capital more conservatively to combat volatility in unrealized losses.

Do unrealized losses in banks' portfolios inhibit bank lending?

Most Council members agreed that unrealized losses do not generally inhibit lending as long as there are no regulatory capital implications that would potentially spur a bank toward capital preservation mode. Council members observed banks mitigating their risk by moving securities to held-to-maturity positions, engaging in hedging programs, and tapping into other liquidity channels such as the Federal Home Loan Bank and repurchase markets. Unrealized losses alone would not likely change a bank's lending appetite meaningfully, although a bank's access to liquidity could potentially inhibit the bank's lending.