Record of Meeting

Community Depository Institutions Advisory Council
and the Board of Governors

Friday, April 4, 2014

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

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

Generally, small business loan demand slowed over recent months. Most believe this to be due to the cold weather, with many expecting a pickup as temperatures rise. Larger urban areas are generally seeing the strongest loan demand. Any area outside of an urban center has tended to be much less positive.

Small businesses have been hesitant to borrow in the face of tremendous uncertainty associated with their future costs and the economic environment. Health care and tax policy has limited small businesses' ability to predict their staffing costs, resulting in delay or cancelation of many plans to expand.

Competition for qualified borrowers remains strong. Larger banks are beginning to "reach down" and offer loans to smaller businesses that they had not serviced in the past. This competition has pushed pricing down, squeezing interest margins.

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

Commercial real estate lending seems to have leveled off after improving as reported at previous meetings. Competition for quality borrowers remains fierce, and community institutions face slim margins.

With rising interest rates, refinancing activity has fallen significantly, with little new lending taking its place. Competition has increased from large institutions, insurance companies, and REITs.

Multifamily, medical facility, and in some Districts, hospitality have been bright points for CRE lending. Though a number of regions reported seeing strengthening multifamily demand, some regions see supply beginning to outstrip demand. Where hospitality has been strong, new construction is likely increasing credit risk for existing loans on older properties.

Competition for CRE loans remains strong, and aggressive lenders, particularly non-banks, are offering low-rate, long-term loans. In an unexpected trend, businesses are tapping cash reserves to pay down loans early. This is an indicator that businesses are too uncertain to expand and would rather use available cash to de-lever.

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

The Council has seen gradual improvements in construction lending, particularly in more urban areas and high-growth "hot pockets." In some areas, the cranes are back. In other areas, construction financing is strong for college-town, multifamily housing, or energy exploration and production infrastructure.

New buildings are selling out or leasing quickly in some areas. This is expanding other construction financing demand, but there is no evidence of speculative development at this point. Similarly, demand for new housing stock in some areas has increased for acquisition, development, and construction (ADC) lending opportunities, though new housing construction frequently is for "tear-down" construction.

Several District councils reported increasing attractive opportunities to finance "strip commercial real estate centers."

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

Home mortgage lending has fallen off dramatically since interest rates began rising. This has hit refinancing particularly hard, with the majority of bankers reporting strong declines. Competition for good loans remains strong.

There was significant concern regarding mortgage regulations. The majority of the group noted that they planned to remain within the Qualified Mortgage definition (QM or Qualified Mortgage) for almost all of their loans. Despite this, some noted there are community institutions – particularly in rural areas – that elect to make non-QM loans due to their customer base and market and to maintain targeted long-term customer relationships. For urban community institutions, the choice to stay within the QM box was stronger. The most common exception was for higher-LTV jumbo loans in high-cost areas. Several Council members noted that a few community institutions have chosen to stop mortgage lending altogether.

Council members also reported that a reduction in product variety and the use of credit overlays were common among community institutions to ensure that loans remained within intended regulatory definitions. Use of similar overlays that differ by investors often results in decisions by community institutions to limit the number of investors used in secondary market channels to reduce the risk of loans sold being "put back" to originators in the event of delinquency or default risk. Each of these decisions tends to reduce credit availability.

There is also concern that following a QM-only lending policy will lead to an increase in fair lending risk. Despite assurances from regulators that this will not be the case, the risk of a fair lending violation is real and will have an impact. The "zero-tolerance" approach from examiners and the impact of a statistical disparate-impact analysis have created a dilemma for many community institutions.

Having sufficient documentation to prove ability to repay in a court case was a concern.

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

Consumer lending levels remain depressed with the exception of a few categories. Auto lending has been particularly weak since the last meeting, perhaps due primarily to the cold weather. Margins on auto loans remain extremely thin, with many community institutions offering loans purely to meet the demands of existing customers.

Some areas were seeing increasing home equity loan activity, although this was not widespread. This improvement was seen to be driven by both improving sentiment and appreciating home values.

Many smaller community institutions are concerned about being priced out of consumer lending by large banks and nondepositories. Many of the Council members noted that community institutions in their areas were exiting the consumer lending business altogether. Members noted that the demand for consumer loans at community institutions is primarily from less-qualified borrowers due to the low rates offered to qualified borrowers by larger institutions and to the growth of captive finance companies that blended credit rate and product pricing in a manner not readily transparent to consumers.

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

Agricultural lending has slowed somewhat in certain regions as lower commodity prices for some crops drag on sentiment. In many cases, lower commodity prices are calling into question the current the high valuations seen on agricultural land. Despite this, there has been little evidence of falling land prices, especially for high-quality agricultural land.

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

Community institutions remain flush with deposits; however, the rate at which the deposits are coming in has leveled off in recent months for many regions. Many are currently evaluating the impact rising interest rates are likely to have on deposits.

Many of the community institutions noted that although they are flush with deposits, they have seen significant consolidation of deposits at larger institutions. Larger banks seem to be putting more focus into holding onto deposits, which could lead to increased deposit competition in the future.

2. Economic Discussion:

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

The Council noted that while general economic conditions remain strong, there has been a mild slowing due to the severe winter. In addition, there remains a large degree of uncertainty that continues to restrain growth across the country.

The Council noted that conditions vary dramatically from region to region. Conditions in many metropolitan areas seem to be strong; however, the more rural areas are often left behind.

Most Council members were concerned about the effects health care reform would have on the overall economy. Many medium and small businesses face tremendous uncertainty regarding the upcoming costs associated with the reform and have delayed major business decisions or hiring until there is more clarity.

Uncertainty also has resulted in many businesses shifting to strategies to invest in new technologies, rather than hiring new employees, to increase capacity when necessary. The strategic shift is partially responsible for weaker labor markets.

b. ***Particular Indicators:***

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

Although inflation as reflected by standard indices remains at quite modest levels, some Council members continue to report the impression that customers feel "street inflation" is higher. This phenomenon is perhaps a reflection of very visible and publicized increases in health care costs. The impression that living costs are higher also may be affected by the fact that employment and income levels have not fully recovered from the recession, which has the effect of reducing consumer purchasing power even if inflation is stable.

There is also concern that food prices will begin to rise as the full effects of the droughts in key agricultural areas begin to be felt.

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

Housing remains a relatively bright spot in the economy. Nearly all of the Council members noted improvement in housing markets. Many noted that demand is picking up, which has surpassed market supply and is pushing home prices up.

Many committee members noted a continuing strong demand for multifamily housing, as younger generations seem more inclined to rent than to buy homes. Part of this decision is the result of uncertainty, job growth, the debt burden of younger Americans, and delays in household formation. For these reasons and perhaps others, today's younger workforce also seems to place a high value on mobility, discouraging their home purchases.

Home prices have appreciated notably over the past year, particularly in some of the hardest-hit markets. Although it is encouraging that these markets are beginning to recover, it may be a "catch-up" effect rather than a true improvement in housing conditions.

There remains significant concern that regulatory changes – particularly application of the QM regulation – could restrict credit to a number of creditworthy borrowers.

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

Overall, labor markets continue to be a weak point in the economic recovery. Many noted that although there are jobs available, there are significant skills mismatches. Many open positions required skilled labor that is not available in local areas. Many attribute this labor shortage to still-depressed housing prices, which are restricting labor mobility. Wage inflation is becoming more problematic for positions in demand. The new "hot positions" in banking are for BSA and mortgage compliance staff.

The job market remains particularly tough for recent graduates. Many in the workforce have delayed retirement due to the still-weak value of their investments. This delay, when combined with efficiency gains made after 2009, means that there are fewer entry-level jobs available.

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

Consumer confidence took a hit as cold temperatures hit the wallets of consumers through higher-than-expected heating costs. There is a general feeling that underlying economic trends are improving, but this has not yet been manifested in tangible improvements for consumers.

Although the broad economy has begun improving, wage growth has been largely stagnant, except where skilled employees are in short supply. As a result, consumers have seen little improvement.

The cost of education remained a key concern, dragging on confidence.

3. **Payment Systems:** *How have consumers and business practices and preferences for making payments been changing? Have community depository institutions been able to meet the changing needs of their customers? Are there significant impediments to meeting customers' needs for payments services, and if so, how should these impediments best be addressed?*

Consumers are demanding payment products that rely on improved technologies. These products include online banking, mobile banking, remote-deposit capture, and text messaging. Providing these additional services can be challenging when there is little opportunity to generate revenues to absorb the costs of implementing the service. These products serve as a customer-retention tool because without offering them, the customers would move to an institution with a broader product mix.

Community depository institutions have been able to meet the changing needs of customers so far.

Given the number of unregulated nonbank entities entering the payments space, there is concern that products will be created with which financial institutions will not be able to compete due to regulatory obligations and costs. Council members believe that this presents a real risk to consumers who may not understand that they will not have the same protections if they are not dealing with regulated institutions. The Council recommends that the Board consider how to improve the regulation of standards for all participants in the payments market, including nonbanks, in order to protect consumers and the integrity of the payments system.

Recent data breaches at nonregulated entities have negatively affected financial institutions. Council members have absorbed the cost of fraud, card reissuance, and expanded customer service expenses in response to the most recent and egregious card data breach. The Council believes that all confidential payments-related data must be protected against breaches with the same standards for protection, whether the data are being held at a financial institution or not. The Council recommends that the Board consider how to improve data security of payment-related information held or processed by nonfinancial institutions.

There is a consumer demand for faster payments. The Council recognizes the contributions that Board has made in this area through its industry outreach and proposals. The Council recommends that the Board continue to play an active role in this effort to lead the industry to a faster payments solution that allows equal access by all institutions.

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

Council members continued to note a decline in examination problems and complaints with respect to matters related to safety and soundness. However, community institutions are seeing continued heightened expectations and stringent approaches in compliance, vendor management, flood insurance, and AML/BSA and CRA examinations. Council members reported examiners requiring many community institutions to meet "best-practice" standards and noted the "trickle down" of large bank regulatory rules. Although community institutions are not required to comply with such rules, this "trickle down" seems to be particularly true of capital and credit stress-testing requirements.

Of great concern are the inconsistencies community institutions are seeing from examination to examination and from examiner to examiner. For example, different examiners may rate or view the same area of the bank differently. This was particularly noted in the AML/BSA area, where a bank's program may be acceptable one year but highly criticized the next, even though the institution's only program changes represented a net improvement in capability. Inconsistencies are leading to uncertainty for community institutions.

Council members are concerned with the number of internal and outside audit requirements placed on community institutions. The size of the examination teams for community institutions has also increased significantly over the last several years, with many Council members noting that examination teams have doubled in size over the last year, in part due to the specialization of examiners and the fact that strong community banks are a training ground for new examiners.

While Council members noted that safety and soundness examinations have become more risk based, members also noted that the tone of examinations has become much less collaborative. Examiners appear more focused on identifying unwritten "best practices."

The increase of regulatory requirements and intensity of examinations have placed a great deal of stress on bank personnel and resources. Community institutions are investing significant amounts of time and money in compliance and AML/BSA areas and have had to pay higher salaries for compliance personnel in order to attract qualified individuals.

Council members also noted that the increased demands on directors and the de facto shift of management responsibilities to the board have stressed boards, making it more difficult for community institutions to attract qualified directors.

Council members offer two recommendations for improving the examination process. First, rather than requiring institutions to copy and provide massive amounts of documents, such as board reports, minutes, and packets to examiners in formats specified by examiners, regulators could reduce this burden by simply permitting examiners to access requested materials through secured portals that institutions already have in place. Second, rather than examining every institution separately on matters that are controlled by technology companies servicing numerous institutions, regulators could reduce the burden on community institutions by examining the technology company and requiring changes be made at the source. Such an approach would be more efficient and change could be effectuated much more quickly.

Overall, bankers believe that suggestions from examiners, even those not based on guidance or regulation, must be implemented to avoid scrutiny and criticism the following year. In this regard, examiners drive institution behavior beyond the scope of regulation and guidance. This maxim applies even for comments that centered on "best practices" that often seem inappropriate with the businesses and risk profile of the bank.

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

The year-over-year increase in regulatory burden – stemming from not only the Dodd – Frank Act but also Basel III and proposed changes to the FASB accounting rules – calls into question the future of community banking institutions and their role in the communities they serve. In District council meetings, industry sentiment is trending strongly negative about the impact of recent regulatory changes on community institutions.

As mentioned above, Council members are increasing compliance staff and external audits to keep up with new compliance rules and examination requirements. The increasing compliance requirements are hampering the ability of some community institutions to focus on the needs of their customers. Most institutions are only offering Qualified Mortgage loans given the uncertainty and potential liability. This is resulting in some otherwise creditworthy customers being unable to access credit.

In response to these regulatory stresses, community institutions are curtailing or exiting some traditional products lines. The new Qualified Mortgage and ability to repay (ATR) regulations have reduced mortgage credit availability and product diversity. Council members also report that some community institutions are curtailing or exiting consumer lending and terminating long-standing relationships with money service businesses (MSBs) and third-party providers of credit cards. These decisions are being made because regulatory obligations to monitor and inspect are too costly and time-consuming or because the business lines do not provide adequate return to cover new compliance risks. As a result, the community suffers because it has fewer product options and fewer sources of banking products. In rural areas or communities with large numbers of people who are unbanked or under-banked, MSBs have been an important alternate provider of consumer liquidity. However, without a stable banking relationship, an MSB may restrict product lines or exit the market. The bank also suffers from reduced revenue, which when considered in the aggregate with a low-rate environment and high regulatory costs, hinders the long-term viability of community institutions.

In January 2014, the implementation of the QM rules introduced more than 4,000 pages of new banking rules in one month. As a result of the heavy regulatory burden, banks continue to report a significant level of stress on staff and bank resources. Some senior experienced staff are opting to retire early or find less-stressful positions in less-regulated industries rather than tackle the burden of implementing new regulations. Bank resources are focused by necessity on compliance – a nonrevenue producer – rather than on growing the business, serving the customer, expanding products, and being active in the community. High compliance costs are reflected in the bank's performance metrics: increasing efficiency ratios and lower ROAs. Investors now inquire about a bank's ability to respond to future regulations. The Council noted that cost savings, not revenue growth, were the common impetus for consolidation.

In addition to the new mortgage rules and increasing scrutiny of third-party relationships, the Council observed the conflicting interplay between the Basel III capital rules and the anticipated FASB impairment standards for expected loss. These rules need to operate in concert, not independently. Implementation of capital rules must occur in the context of accounting rules that are expected to change the buffers required for allowances for loan and lease losses and other significant supervisory changes in a post-Basel III environment.

The imposition of overly standardized rules for all banking products undermines the individuation that is essential for community institutions to meet the needs of a diverse public with diverse credit needs. Moreover, the universal application of rules and "best practices" intended for large, systemically important financial institutions is an unnecessary burden and fails to recognize the differing risk profile of community institutions.

6. **Additional Matters:** *Have any other matters affecting community depository institutions emerged from meetings of the Reserve Banks' advisory councils that Council members want to present at this time?*

BSA Compliance Issues

All District councils have been aware of the expanded and intense scrutiny of BSA/AML compliance. While this may be due to increased congressional interest in the subject, institutions report examiners are spending more time and resources reviewing BSA compliance. At the same time, examiners are expecting policies, procedures, and efforts that are not spelled out in regulation or agency guidance.

Examination Issues

Several common themes emerge from recent examinations. First, there is an expanded expectation for application of technological solutions, especially to monitor transactions. Examiners are imposing these expectations even though the FFIEC BSA/AML examination manual clearly says automation is not required and is a business decision for the bank. Related to the expectation for expanded and mandatory use of technology for BSA compliance is an expectation that systems be validated and alerts regularly tested, although the source for this expectation is unclear. The guidance from regulators on these expectations needs to be more clearly articulated, possibly in the examination manual. However, the lack of guidance is creating confusion, as evidenced by misconceptions on the part of bankers, consultants, and auditors on the use of default settings for compliance software. Finally, the expectations for validation need to be thoroughly discussed and understood by all parties, especially since the costs for validation by outside consultants can be extremely high.

Another theme is the confusion surrounding risk assessments and controls. While examiners may be good at assessing absolute risks, they also must recognize that steps to mitigate and control risks have to be factored into the equation. Examiners should not question a bank’s decision to follow a line of business as long as appropriate controls are in place to address risks. Examiner "recommendations" to count the cars going in and out of a money services business or monitor each and every transaction at a nonbank ATM are far beyond what is needed to control risks. These types of questions and expectations are causing banks to eliminate products, services, and customers to the disservice of the public. And as transactions are driven away from mainstream banking, it causes transactions to go underground to the detriment of efforts by law enforcement to detect and prosecute criminal activity.

Finally, examiners and regulators place expanded expectations on the board and senior management to be actively engaged. While it is appropriate and to be expected that the board and senior management oversee the BSA compliance function and should ensure adequate resources are made available, all too frequently the line is crossed if this expectation places on the board and senior management the responsibility for day-to-day management of the BSA program.

Better Feedback Needed

The banking industry has long asked for better feedback from law enforcement. Section 314 of the USA PATRIOT Act was intended to address the issue, but even before that, information was requested from law enforcement about the success of the information being reported and the utility of the data provided. At the same time, requests for information about elements to monitor, or "red flags," have long been discussed with minimal results. In 2013, nearly 1 million SARs were filed by the industry and yet little-to-no information has been provided by regulators or law enforcement about the use of that data, other than generalized comments that the information is helpful.

Negative Environment
Separately, recent remarks by government officials, particularly those from law enforcement and senior regulators, are creating a negative environment. The constant message that banking institutions will be prosecuted for any missteps produces an environment where risk avoidance becomes risk management. Therefore, it should be no surprise to government authorities when institutions manage risk by eliminating products and services, including MSBs, embassy and consulate accounts, and marijuana businesses. When costs and risks outweigh any benefits from an account relationship, that is a logical and, one might almost say, the safe and sound solution.

The government has been sending out mixed messages, which only adds to the burden. For example, while bankers are encouraged to reach out to the unbanked and under-banked, mandates for compliance, particularly BSA compliance, often make it too costly or difficult to serve these markets. Similarly, while stating that it is understandable for banks, particularly community banks, to rely on outside consultants and vendors to support operations, the expectations to micromanage these relationships make it extremely inefficient.

Steps Needed
Two critical steps are needed. First, when examiners expect institutions to take steps, the requirements underlying those expectations should be clearly spelled out in advance and publicly available. When examiners are uncertain about something, they should be encouraged to contact their regional office for appropriate guidance. Examiners should also be willing to answer questions from bankers when an area is unclear. Second, and more important, examiners should be thoroughly trained in BSA compliance and the requirements of the FFIEC BSA/AML examination manual. As the new manual is introduced, it would be an ideal time for interagency training of examiners and bankers, as was done so successfully in 2005 when the manual was introduced.