

Record of Meeting

Community Depository Institutions Advisory Council
and the Board of Governors

Friday, April 13, 2018

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.*

Overall, the condition of, and outlook for, loan and financial markets is generally stable. Changes in creditworthiness, loan demand, and lending standards were not significant, and where they occurred, were specific to certain market segments or geographies.

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

The majority of Council members reported that after a slowdown late last year over uncertainty due to possible tax changes, demand for small business loans is strong, particularly among new start-ups. New businesses are opening and optimistic, as younger entrepreneurs are excited to have access to funds. Existing firms are expanding, but at a more cautious pace. However, one Council member reported that increased productivity at small businesses has led to weaker-than-expected demand for loans.

While loan demand is strong on the whole, it is particularly elevated for businesses operating in certain sectors of the economy. A few Council members reported a large pickup in loan demand from businesses operating in the shale, fracking, and natural gas industries. Many of these businesses are export focused and want to be ready to ship their product overseas. Additionally, small business lending has been strong to service businesses, such as ones operating in the health-care field.

Several Council members reported that the major concerns for small businesses are the availability and quality of labor and the uncertainty about recently proposed tariffs. The tight labor market has led some businesses to ease their standards for job applicants.

- 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?*

Council members reported mostly stable demand for commercial real estate (CRE) but that demand is stronger in some areas than others. The First and Seventh Districts noted that CRE demand is high and that it is easy for banks to find business. However, the Third and Fourth Districts reported that there are signs of a marginal decline in certain sectors of CRE, especially multifamily, signaling the possibility that some loan markets are reaching capacity. The slowing demand for multifamily lending is characterized by differences in the absorption of multifamily inventory across urban markets, which are increasingly neighborhood specific.

One pressing issue related to CRE lending is the quality and availability of appraisers, especially in rural areas. Most Council members reported that the current crop of appraisers is aging and that it has become hard to attract new ones. There has been a need to resort to appraisers who are unfamiliar with the areas where the work is being done in order to complete required appraisals. Moreover, the blending of the comparable-property and income-analysis approaches has led to some issues. Some appraisers appear to be reluctant to perform necessary income analysis on CRE properties because of liability concerns.

- 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?*

Many Districts reported that construction lending demand has been mixed on the whole. Three Council members have observed that industrial properties and warehouses are completely full, which has led to new demand for warehouse space. With questions looming over trade policy, there is a concern that a slowdown in trade could leave many warehouses empty. Numerous Districts reported that the retail sector has experienced a decrease in demand for loans.

Council members reported that construction of new housing is at very low levels. There is an extreme shortage of entry-level homes, which has suppressed loan demand for this purpose. As the millennial generation ages and starts families, this shortage could become a concern. Additionally, builders are facing labor constraints, which has in part led to a larger focus on building fewer, more expensive homes instead of starter homes.

- 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?*

Mortgage lending demand has been steady across most Districts. So far, there has not been a meaningful effect on originations due to rising interest rates, but the refinance market has dried up. However, Council members expressed concern that smaller banks are being pushed out of the market due to competition from nonbank players and the banks' inability to scale. Banks need to be able to invest in technology that allows them to compete with larger players, whose fintech platforms provide advantages. Some of these players are alternative lenders that do not have the same regulatory obligations as banks and can therefore move much faster and with lower overhead than Council members' institutions.

The Council believes the regulatory compliance standards they maintain are higher than those of nonbank competitors primarily because nonbank competitors are lightly supervised and therefore are less compliant. This is particularly true in areas like compensation for loan originators, where supervision is minimal and enforcement actions under the Dodd-Frank Act have been limited and not uniformly effective. Some Council members reported an expansion of poor lending practices driven by disparate forms of supervision.

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

Consumer lending demand varied by District and by type of product. A few Council members saw a slight improvement in demand, predominantly in home equity loans,

partially attributed to the high levels of consumer confidence. Most Council members reported that there was not yet any apparent effect on demand for housing finance as a result of tax reform, but they noted that consumers often have not determined how tax reform will affect their ability to deduct certain items, such as mortgage and HELOC interest and state real-estate taxes.

Several Council members reported that community banks are generally leaving the consumer lending space due to very low margins. Credit unions reported relatively stronger markets. However, credit card portfolios were mostly stagnant, and there was growing concern over the state of auto lending. Credit union competitors have been allowing dealer markups more frequently, which puts credit unions at a disadvantage.

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

The major concerns related to agricultural lending are the threat of tariffs and a potential trade war. Several Council members reported that these prospects would hurt prices for crops such as corn and soybeans. Some farms that focus on dairy are struggling a bit, though dairy is performing better in the Ninth District. Farms whose crops support wine or alcohol production generally are performing well. Another concern for community institutions is that they are increasingly unable to compete with the terms offered by the Farm Credit System.

The Eleventh District reported that more agricultural production is moving to Mexico with the support of U.S.-backed investors, who see moving production as more profitable. This decision is a business solution to address reduced availability of migrant farm labor. There is also a divide between agriculture that depends on machinery, technology, and other capital investment, and labor-intensive agriculture, which is under increased pressure due to immigration issues.

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

Council members reported that the prime issue in deposit markets has become maintaining existing funding and finding new sources of funding. Raising their interest rates has not brought in many more deposits, leading community financial institutions to reconsider funding strategies. Another problem is that as the population ages and money is passed from one generation to another, deposits are often drained from financial institutions.

Competition on deposit rates has been noticeable. Council members believe that community institutions mostly compete against other smaller financial institutions, not against the big money center banks. There was general agreement that deposit-rate comparisons between institutions should be based on regional averages rather than national averages and that supervision staff should be more aware of deposit-rate trends as affected by changes in monetary policy. Failure to make these adjustments will reduce financial institutions' ability to lend. Council members noted that large institutions are structured differently, a factor that regulators should take into consideration when supervising smaller institutions.

2. Economic Discussion:

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

Council members broadly see a difference in the economic strength of major urban vs. rural markets. Business conditions in most major cities are strong but are much less so in rural areas. Council members from the central states are seeing slowing population and economic growth, especially outside of major metropolitan areas.

While consumer and business confidence remains strong, small business firms were generally observed to delay capital expenditures last year because of uncertainty over pending federal tax reform. Enactment of the Tax Cuts and Jobs Act last year spurred enthusiasm, but concerns over proposed tariffs and potential retaliations by trade partners have raised uncertainty.

b. *Particular Indicators:*

i. *Inflation: 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 national indexes have not shown a pickup in inflation, Council members report that their business customers are seeing higher prices for a number of supply-side items. The threat of import tariffs has started to drive up prices for steel, aluminum, and other metals, and foreign retaliation could lead to further disruptions. Labor shortages are also driving wages higher, raising expenses for many firms (see below). Agricultural prices are mixed. Some are rising, but others are stagnant or down. On the other hand, moderate generalized inflation numbers reflect deflating energy and telecommunication costs.

Automobile prices had been sliding prior to last year's hurricanes but have jumped since.

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

Critical shortages of skilled tradespeople, along with escalating prices for construction materials, are hampering new construction. Also, young and other first-time homebuyers have become a much larger share of home seekers – but they are generally seeking entry-level homes in low supply. Demand has outstripped supply, and existing stocks of lower-cost homes have been drawn down. Moreover, most construction activity is not aimed toward entry-level homes. With rising materials costs and labor scarcity, builders are optimizing projects by concentrating on higher-priced homes and multifamily housing. As a result, prices for entry-level homes are rising faster than those for homes in the more expensive tranches.

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?*

The Tax Cuts and Jobs Act of 2017 had a minor effect on wages in most areas. More public companies boosted wages than private firms.

In a number of areas, low unemployment rates are making it difficult to find or replace staff. Workers are ever ready to change jobs, so labor-force turnover rates are very high. One Council member reported a fellow banker hiring 100 new staff and finding 94 of them gone within a year.

Competition for workers is strong, and labor quality is a challenge. Candidates often do not keep appointments for interviews. Wages are rising but this often does not seem to correlate with more or better qualified applicants. Employers are saying, “We can raise wages, but it doesn’t create workers.” Replacing staff for senior skilled positions is especially difficult and expensive. Firms are having to “pay up” and offer additional benefits to fill key positions.

It is difficult for banks or their business customers to find or replace staff with candidates that are capable and drug free. Some Council members reported that half or more of a pool of credit applicants is often disqualified based on a credit report or drug test. The quality of job applicants creates a dilemma.

These challenges have engendered several responses. Some employers are providing transportation or otherwise facilitating transportation as perquisites to attract new employees. Some firms are investing in artificial intelligence to supplement labor functions and expand labor capacity.

Younger workers have shown less interest in retirement benefits and more interest in assistance with repaying student loans. Also, workers have become more sensitive to location than wages.

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

Council members generally believe that consumer confidence has been stable but stronger in or near metropolitan areas. This belief is supported by the strength of consumer spending and business start-ups in these areas.

- 3. **Fintech:** *In the Council’s view, what are the opportunities and challenges for community depository institutions presented by the growing presence of fintech companies in the marketplace? How do these opportunities and challenges differ from those applicable to larger financial institutions? To what extent do such opportunities or challenges vary across specific segments (e.g., consumer lending, business lending, payments, and wealth management/advisory services)? Are there any special considerations or challenges that impact a community depository institution’s willingness or ability to partner with or enter into other kinds of third-party relationships with fintech firms? To the extent that any of these challenges relate to regulatory or supervisory matters, are there particular actions that the Council recommends regulators and supervisors should take in response?*

Fintech companies provide community depository institutions (CDIs) with opportunities to realize efficiencies and improve the customer experience. The Council observed, however, that the costs and benefits of engaging with fintechs vary greatly depending on the engagement

model. For example, white-label products can provide great value to CDIs, but other fintech relationships – for example, digital lenders that originate loans but seek funding from a CDI – may increase the CDI’s compliance obligations without providing substantial additional benefits to the institution or its customers.

The Council identified three general avenues for CDIs to engage with fintechs: working directly with fintech startups, engaging with core providers, or developing technology internally. Each path presents substantial challenges for CDIs.

Working with startups is challenging because CDIs and startups have different levels of risk tolerance. Startup culture encourages early failures and a process of iterating to success. CDIs do not have such freedom. A CDI that wants to engage directly with a startup must also consider, among many issues, how the startup is capitalized, what happens to the intellectual capital if the startup fails, and whether the startups can be relied upon to understand and fulfill obligations to the CDI and its customers.

Members of the Council agreed that, rather than work with a fintech startup, most CDIs would prefer to work with their existing core processors. Because there is little competition between core processors, however, CDIs hold little bargaining power. Members of the Council observe that core processors can make it difficult for CDIs to integrate other providers’ products and services into their systems, and processors’ contracts often make it difficult for CDIs to exit the relationship.

Given financial constraints and the practicality of attracting and maintaining requisite expert staffing, CDIs rarely find internal development to be the best option. Even if a CDI is able to devote the considerable time and money needed to develop technology internally, the CDI must weigh the concern that a new product could alienate its customers if not executed perfectly.

This concern around customer satisfaction exists in all contexts. For example, one bank chose not to work with a fintech after learning that transitioning to the new product would require the bank’s customers to reenter previously provided information. Introducing such unexpected friction can lead to customer attrition.

The Council believes that discussions regarding fintech innovation overly emphasize small startups. In the Council’s view, CDIs face much stiffer competition from both large financial institutions and large technology firms. Members of the Council observed that resources they might otherwise have had to support innovation have been directed toward compliance since the passage of Dodd-Frank. In this way, Dodd-Frank may have given large banks, who can realize economies of scale both in compliance and in innovation, an unintended advantage and further widened the gap between CDIs and large institutions.

The Council also has concerns about large technology firms offering financial products and services. Council members believe a number of questions need to be answered regarding “big tech” firms before they are allowed to partner with banks. For example, are there limits on how information is shared; who is making the decisions in these partnerships; at what point do issues around banking and commerce become relevant; and where does the risk reside in these partnerships?

The Council also noted that nonbanks are not subject to the same level of regulation and enforcement as CDIs and other banks. For example, one digital lender has a business model that cherry-picks the most creditworthy borrowers, which would not be permissible for a CDI.

Moreover, fintech lenders may not have Community Reinvestment Act (CRA) obligations. The Council believes that the current focus on CRA modernization presents an opportunity to consider how fintech companies should fit into the regulatory scheme.

The Council believes there are a number of steps regulators can take to support innovation at CDIs. First, the Council believes the Federal Reserve and other banking regulators should take steps to ensure all regulated financial institutions have equal access to critical banking infrastructure. For instance, the Council advises that the Federal Reserve own, operate, or control one of the real-time payment channels to ensure the continued access of CDIs to the payments rails. Second, the Federal Reserve and other banking regulators should take steps to ensure that all firms engaged in financial activities play by the same rules and that the rules are enforced equally, including but not limited to such critical areas as cybersecurity, privacy, and KYC (know-your-customer) requirements. The Council also encourages the Federal Reserve to keep an eye on the impact large technology firms have on the stability of the financial sector and to identify the safeguards that may be necessary around fintechs. For example, if necessary, large fintech entities could be designated as systemically important financial institutions. The Council believes the Financial Stability Oversight Council may be the best venue to start these discussions.

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?*

There was a consensus that examinations of late had generally been well executed and positive, with an increasingly collaborative dynamic forming between institutions and their examiners. However, some concerns were raised by Council members. The Council continued to express a broadly shared concern that compliance examinations are not going as smoothly as safety and soundness examinations. CRA compliance concerns surfaced related to determinations around the CRA assessment area, which increasingly are being caused by new technologies and market strategies that affect the ways in which institutions reach and follow their potential customer base. There is also growing tension between reasonable underwriting practices and the concerns that some of these standard practices would trigger fair housing/fair lending violations. This appears to be the result of an excessive supervisory focus on differences that exist across or within segments of customer populations, without consideration of the validity of underwriting and practices as is required by law. That requirement of supervision and enforcement was recently set forth and clarified by the U.S. Supreme Court in *Texas Department of Housing and Community Affairs v. Inclusive Communities Project, Inc.*

Related to the safety and soundness exams, concerns were raised that examiners were using inappropriate measures to scrutinize reasonable and competitively priced deposits in a rising interest rate environment. Supervision staff at some agencies are too dependent on comparisons to national deposit-rate averages to conclude that institutions may be raising deposit rates in a destabilizing manner. The national deposit-rate averages are biased toward the business strategies of very large banks, effectively underweighing regional deposit-rate differences, and fail to account for market-specific deposit strategies that community banks might pursue. Also, measuring bank deposit strategies against a trailing deposit average fails to recognize that banks are competing for deposits in a rising-rate environment that is a tool of monetary policy. Supervisory staff seem to not be adequately attentive to the impact of current monetary policy on

changing market rates, and as a result, are prone toward attributing deposit-rate changes to altered deposit strategies at the institution rather than to changes in market condition.

Off-site document requests by examiners too often are not being reviewed prior to the on-site examination, with some Council members noting that certain examination materials are available from banks remotely but are inaccessible by agency staff due to technological impediments on their end. Another concern was that examiners were prematurely expecting institutions to change practices in anticipation of breaching thresholds that trigger greater supervisory expectations, even when that threshold is far from being breached. This concern was also mentioned in the context of CRE concentrations.

The Council encourages further engagement to help regulated institutions gauge supervisory expectations for compliance with the pending implementation of impairment accounting requirements. This is especially important for Securities and Exchange Commission filers that presently are required to more accurately report expected costs of implementation.

On the personnel side, the retirement of seasoned examination staff at the banking agencies has also put stress on institutions that at times face longer and less efficient examinations, as well as the burden of being an institution overwhelmed by bank examination trainees.

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 Council anticipates that changes contemplated by Senate bill 2155 related to extending qualified mortgage (QM) loan status to loans held in portfolio will provide CDIs with the needed underwriting flexibility to offer a wider range of mortgage services. This is because most lenders have responded to the heightened risks associated with non-QM loans by restricting their lending to QM loans only or by making non-QM loans in a limited or targeted manner. Extending QM status to most mortgages held in portfolio, where lenders bear all default risks and therefore have interests closely aligned with borrowers, should increase credit availability, reduce customer cost due to reduced lender liability, and provide institutions with greater portfolio flexibility and earnings capacity.

Compliance with BSA/AML (Bank Secrecy Act/Anti-Money-Laundering) beneficial ownership requirements becomes mandatory in May 2018. These requirements are a source of tension with customers. Council members find that the documentation and resourcing necessary to comply with these new expectations is burdensome relative to the benefit, and they anticipate that investigative expectations for financial institutions are likely to be high. A significant problem is that customers often find it difficult to believe that financial institutions are only being as intrusive as is required by regulation. Also, some institutions report finding it difficult to serve money-service businesses and private ATM owners because the AML requirements for these customers are becoming too high. At a minimum, the Council recommends that the primary federal regulators issue a public statement detailing the obligations that customers face if they want to maintain banking relationships. This step alone would aid banks in creating better understanding and cooperation among a portion of the customer base that is resisting support of compliance efforts.

If an anticipated review by the Consumer Financial Protection Bureau of its Home Mortgage Disclosure Act (HMDA) filing requirements ultimately leads to a meaningful burden reduction

prior to the 2018 filing deadline that would likely be a positive development that would expand customer access to financial services and improve maintenance of customer privacy. Also, the Council is hopeful that changes made to HMDA reporting requirements will address existing reporting requirements that could adversely affect lending to small businesses and for CRE financing.

An interagency review of CRA requirements and methodologies is keenly anticipated by the Council. This review has the potential to address standing concerns about dated measurements and mandates set forth in CRA's implementing regulations.

Finally, the Council appreciates efforts by the banking agencies to address concerns about regulation affecting so-called high-volatility commercial real estate (HVCRE). The revised treatment of HVCRE, i.e., the high-volatility acquisition, development, and construction proposal, reduces risk weighting but expands the application of the regulation to certain lower-risk acquisition, development, and construction lending activities. This expansion could lead to restricted credit access, an unintended consequence of having certain low-risk CRE activities treated differently than in the past. The Council respectfully recommends continuing review of this dilemma.

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?*

Follow up – Complications resulting from state authorizations of cannabis businesses.

At its November 17, 2017, meeting with the Board of Governors, the Council voiced concerns about complications raised by state authorizations of cannabis businesses. The Council wishes to add additional information about the problems depository institutions are encountering as a result of differences between state and federal law. Among the issues discussed at the November meeting was a common fact pattern: When an existing CRE borrower chooses to lease all or part of a property to a cannabis business permitted under state law, the proceeds from that business, most often in cash form, raise problems for insured depositories and their regulators. Typically, institutions are addressing this problem by submitting a series of Suspicious Activity Reports. However, the nature of this problem is evolving. As CRE loans of this type are refinanced, determinations are being made that extensions of new credits in the face of suspicious activities cannot be permitted. As a result, existing clients are being turned away from insured depositories, and business is being driven out of the banking system. Financing often appears to be obtainable outside the banking system in ways that may be weakening AML oversight. The Council requests that the Board consider this new development, which is occurring with increased frequency as CRE loans roll over.