

Record of Meeting

Community Depository Institutions Advisory Council
and the Board of Governors

Friday, April 5, 2019

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 Council reports that banking conditions remain good, although regional differences are significant. For example, some markets (e.g., Texas and Florida) are very strong, while others are flat at best. General lending standards have been neutral for banks and credit standards have tightened for consumers. Competition for good credits remains high, and asset growth has flattened. Council members are optimistic, but uncertainty and volatility of consumer confidence have cast shadows over expectations for the longer term.

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

A decline in small business loan demand was a consistent theme outside of the hot markets. One District reported a significant downward shift in the small business lending environment. Delinquencies remain at historically low levels, and no credit problems are expected. Banks have maintained or are tightening their credit standards. Most Districts do not expect much change in growth. Small business loan performance seemed to be unaffected by the government shutdown, other than loans dependent on Small Business Administration guarantees.

Extremely tight labor markets are hampering small business growth and expansion, especially in industries such as hospitality and retail. The Eleventh District noted that rapid economic expansion and high demand for commercial real estate (CRE) loans are somewhat crowding out small business loans (e.g., commercial and industrial (C&I) lending is more resource-intensive).

- 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 last Council meeting in November? How are commercial real estate loans performing compared to the Council's expectations?*

Council members reported generally strong conditions, with southern Districts such as the Sixth and Eleventh reporting booming CRE markets. Midwestern and western Districts reported cooling but not declining CRE markets. Absorption rates are lengthening to fill properties, and some members expressed concern that urban areas were starting to see excess capacity (although nothing dramatic). One Council member noted that projects begun over the last several years are now coming online, which is causing some pullback by lenders and slowing of development. Population shifts, for example, individuals leaving high-tax states for lower-tax ones, are creating some

additional stresses. One Council member noted that hotel developments were “strained,” and numerous Council members expressed a view that multifamily projects were reaching overcapacity.

Rising appraisals for CRE have led to considerable refinancing of properties, with the cash-out being used to develop more properties. One Council member commented that developers were “sucking out every dollar” from the increased values, and then were “playing with house money,” demanding nonrecourse loans in the next deal. Nonrecourse loans, which were typically made to Super A clients, are now more broadly available, and loan-to-value ratios are rising. Some Council members expressed concern that the competition has brought in some less experienced lenders, particularly for multifamily developments. One Council member noted that regulators seem to be comfortable allowing larger banks to expand the volume of nonrecourse loans but were uncomfortable with smaller banks doing so.

Life insurance companies and other lenders not affiliated with banks or their holding companies are refinancing loans originated and held by banks with increasing frequency. This has left banks with shorter, riskier loans common in the early phases of projects, as the inverted/flat yield curve is allowing take-out financing at low rates.

- 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 last Council meeting in November?*

Most Districts noted a decline in demand since the last meeting, as rising material and labor costs for developers have led to fewer projects and even some cancellations of approved developments. For multifamily construction, the costs are getting too high for the rents they could realize. Several Council members from southern Districts noted that money is very fluid now, with capital flowing into Texas and Florida from around the country.

As in previous meetings, Council members noted a difference between urban and rural areas. Building restrictions were cited as a major cost and impediment to development. Council members also noted it was no surprise that the markets growing the fastest have fewer, or more flexible, requirements. One Council member noted that 25% of the cost of development is related to permitting.

- d. ***Home Mortgage Lending:*** *What changes has the Council seen in the mortgage market since the last Council meeting in November? 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 markets were constrained as rates rose, but the improvement over the last several months are helping to bring back some pent-up demand. As in the past, the Council members noted the bifurcation of the market, with low inventories of “starter” or lower-priced homes and large inventories of larger, more expensive houses. Building costs have hurt new construction, and many existing homes in the lower-priced range are in need of significant improvements.

There was considerable discussion about community banks exiting the market for home mortgages. The Third District reported that 25% of its banks had decreased or

eliminated their home mortgage portfolios. Most Districts described similar declines. Council members described concern that nonbank competitors are not held to the same standards as banks and that nonbanks do not have the same “skin in the game” as banks. One Council member stated that “mortgage loans are the easiest loan to underwrite but the hardest loan to close.” The sentiment was that the penalty for banks “doing something wrong” is more severe.

Home equity loans have increased with the growth in home prices. Council members are optimistic that the housing market and the home mortgage lending market will pick up for the rest of the year, but they are less optimistic about the beginning of the first quarter of 2020. Affordable housing was an important area, particularly given the cost of construction.

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

Council members described the consumer market as flat (moving “sideways”). One Council member noted slowing in auto sales and loans.

One Council member noted a rise in credit card delinquencies, but it was hard to decipher if this was just noise or really a trend—particularly since delinquencies have been so low.

Additionally, while economic conditions are strong, one Council member noted that a potential cause for a decline in consumer confidence is an increase in both the amount and the cost of personal debt—particularly student loan debt. The general sentiment was that high student loan debt is crowding out demand for other bank loan products.

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

Overall economic conditions remain challenging for portions of agricultural markets. Most Districts reported a growing disparity in outcomes for farmers, describing high levels of growth and profitability for large farms and weakening conditions for smaller operations. Technology has had an enormous impact on this sector and favors larger operations.

Most Districts expressed concern about the rising levels of competition from the Farm Credit System (FCS), especially but not exclusively as it relates to the expansion of FCS into nontraditional lending. One Council member stated that they were once very active in agriculture lending (25% of portfolio); however, they now do very little if any agricultural lending because of FCS competition.

The weather has had an enormous impact on certain areas, such as the Midwest and the South. Agricultural producers are generally in good shape financially and have high levels of equity that are being used to maintain cash flow. Land prices have held steady as a result.

Hog prices are rising in expectation of an increased demand from China. Hog prices have increased approximately 20-30% in the past six weeks. A Council member noted that barriers to entry in the agriculture sector have changed greatly over the past decades. The capital requirements to enter the agricultural industry are now very high.

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

Council members reported that deposit markets are tight. The cost of deposits is going up, and CD usage is declining heavily. A large portion of deposits in banks across each of the Districts is held by an aging segment of the population. One Council member noted that 90% of deposits are from customers over the age of 55, while only 5% are from millennials.

The Federal Deposit Insurance Corporation (FDIC) rate cap continues to be problematic, even for healthy banks for whom it should not be a constraint. Although the rate cap does not apply to well-managed and well-capitalized banks, most Districts stated that regulators are using the rate cap to criticize the liquidity management of banks. Council members strongly believe that the calculation is fundamentally flawed.

A Council member noted that millennials often do not value or recognize the importance of FDIC insurance on deposits, leading to higher balances being held in stored-value consumer applications and noninsured investment accounts.

2. Economic Discussion:

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

The overall economic outlook remains generally positive for Council members, although several Districts reported weakening activity since the last meeting. One Council member expressed the view that economic activity is not as robust as the data indicates. Some banks have begun to take proactive measures, such as adjusting underwriting standards and tightening credit standards. Business conditions differ by region with a pronounced divide between urban and rural areas.

The tightness of the labor market is having an impact on the business of Council members. Wages are pushing higher, and there is pressure to automate in order to help control costs. Prices are rising, especially for input costs and raw materials. The consumer is generally healthy, although some Council members anticipate a deterioration in consumer credit.

b. *Particular Indicators:*

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

Council members hold the sentiment that inflation is higher than the headline numbers are indicating. In most lines of business, it is evident that prices are rising faster than the 2% headline figure. Automation and the composition of the labor force were two reasons presented as to why national inflation numbers differ from what bankers and their customers are experiencing.

Looking forward, Council members expect higher prices for materials and other costs associated with doing business. Input prices are rising faster than they have before, but a corresponding increase in productivity has helped businesses absorb

those costs. The costs of products and services purchased by Council members appear to be rising more quickly, especially wages and technology services.

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

According to Council members, housing activity has changed little since the last meeting. There continues to be a shortage of supply, especially in affordable housing. The housing market appears to be moving sideways.

Housing activity slowed due to rising mortgage rates but has rebounded as rates have come back down over the past few months. Activity varies by region, as metro areas are performing better than more rural ones. The market has continued to be bifurcated between the lower-middle end and the high end. Smaller, lower-cost homes are selling incredibly fast and are seeing significant price growth. The high end of the market has stagnated, as it continues to be difficult to sell larger homes.

As the millennial generation continues to age into their household-formation years, there will continue to be pressure on the lower-priced end of the market. Demand has outstripped supply, especially for starter homes. There is little new construction of these homes, and the inventory that is available needs work, making them less appealing and more expensive.

The primary reason for the lack of home-building is that input costs are rising. Raw materials, infrastructure, and labor costs have increased, making it less profitable to build homes, especially lower-priced ones. Council members also noted that lot costs have increased significantly, exacerbating the situation.

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?*

With the continued economic expansion, all Council members reported that labor markets remain very tight. Competition to find workers is strong, and businesses need to bid up to attract high-quality workers. Retention has increasingly become a problem, as employees with as little as a year of experience in a role are being poached away by other companies. Wage growth continues to accelerate, while the cost of benefits has grown at an even faster rate.

A major area of concern that has continued to impact the labor market is the opioid epidemic. Banks and other businesses are having a difficult time finding workers who are drug free. This is especially the case in certain areas, such as the Rust Belt and the Northeast.

Additionally, Council members discussed the impact that consolidation is having on the labor market, both in banking and other sectors. While mergers and acquisitions continue to create transient opportunities to hire staff, the longer-term impact of consolidation is a reduction in the pool of qualified and experienced workers. This is of particular concern in the information technology field since

banks are constantly updating and adapting their technologies, and demand is increasing both in terms of quality and numbers of IT staff.

Various Council members noted that the labor market has become a hindrance on the potential growth of the economy. With workers in such short supply and an aging population, Council members highlighted the need for policies that promote participation in the labor force.

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

Council members witnessed deteriorating levels of consumer confidence at the end of the year. This was attributed to market turmoil, the government shutdown, and general uncertainty around policy and the economy. However, consumer confidence appeared to improve over the last two months. Consumers are now proceeding with greater caution, as more thought and coverage is being given to the possibility of a recession.

Consumer credit quality remains strong. Delinquencies have ticked up slightly but remain at historically low levels. Council members note that the overhang of consumer debt will affect future credit losses, while some categories of consumer debt are more vulnerable than others. Student loan debt is viewed as a major concern, as it potentially hinders other types of lending and slows overall economic growth.

3. *Small Dollar Lending: What do Council members see as impediments to the broader offering of small dollar loan products to LMI borrowers by community depository institutions? Please be as specific as possible. In particular,*

- *Are there innovations and new opportunities that are causing community depository institutions to reconsider the scale and scope of their small dollar loan programs?*
- *For those institutions that offer or have experimented with offering small dollar loan products at scale, what has been the experience and how has this informed the views of these and other smaller institutions in the space? For those institutions that have not offered or experimented with offering small dollar loan products at scale, what single factor most kept them from doing so?*
- *Are there other ways that community depository institutions can help consumers address cash-flow imbalances, unexpected expenses, or income volatility besides small-dollar credit products?*
- *What does viable, safe and affordable small-dollar credit look like to smaller depository institutions? Please be specific.*

Council members reported that regulatory and reputational risk impairs the ability of depository institutions to offer small dollar loan products to low- and moderate-income borrowers. Specifically, institutions may be reluctant to make small dollar loans as an “accommodation” to an existing customer because the institution could risk potential violations of fair lending laws, including a finding that the institution’s lending practices cause a disparate impact on certain populations. In addition, for institutions to make small dollar loans in a sustainable manner, the institution must price the loan at a level that may

subject the institution to criticism from regulators or community groups or result in a finding that the making of the loan is an unfair or deceptive act or practice (under UDAP).

- *Are there innovations and new opportunities that are causing community depository institutions to reconsider the scale and scope of their small dollar loan programs?*

Council members reported that there is no “silver bullet” innovation that would result in increased small dollar lending by depository institutions. Members reported that financial technology (fintech) companies seek partnerships with banks to offer small dollar loans. However, depository institutions are not constrained to offer small dollar loans because the institution lacks the underwriting technology, delivery platform, or other tool offered by fintech companies, but rather by the regulatory and reputational risks described above.

- *For those institutions that offer or have experimented with offering small dollar loan products at scale, what has been the experience and how has this informed the views of these and other smaller institutions in the space? For those institutions that have not offered or experimented with offering small dollar loan products at scale, what single factor most kept them from doing so?*

Council members reported that very few depository institutions in their Districts offer small dollar loan products at scale. One Council member, a low-income designated credit union, is an exception and has an overall loan portfolio that is 25% small dollar loans (by units, not by dollar volume). This institution has been able to conduct this volume of lending only after explaining to its regulators that the institution serves a heavily LMI population of consumers who would turn to costly nonbank lenders or not have critical needs met if the depository institution did not offer small dollar loans in the manner that it does.

For the significant majority of institutions that have not offered or experimented with offering small dollar loan products at scale, the regulatory and reputational risk described above was the single factor that most kept them from doing so.

- *Are there other ways that community depository institutions can help consumers address cash-flow imbalances, unexpected expenses, or income volatility besides small-dollar credit products?*

Community depository institutions also may offer overdraft protection, equity lines of credit, and credit cards to help consumers address cash flow imbalances, unexpected expenses, or income volatility. However, not all consumers who have short-term credit needs qualify for these other credit options.

- *What does viable, safe and affordable small-dollar credit look like to smaller depository institutions? Please be specific.*

Council members expressed the view that regulators can best encourage smaller depository institutions to make small dollar loans by exempting those loans, including the interest rate charged on the loan, from supervisory expectations and examination regarding fair lending and UDAP risk. Customers seek “accommodation loans” from depository institutions for a variety of reasons, such as to pay emergency expenses or to manage differences in the timing of their expenses with the timing of income. Institutions may make these loans sustainably on the basis of the customer’s existing relationship with the institution. The application of fair lending and UDAP expectations can discourage institutions from making these loans in this

manner by imposing expectations regarding interest rates and uniform underwriting across loan applications.

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 broadly view safety and soundness examinations as a collaborative and largely constructive exercise. However, Council members note a considerable degree of heightened interest in liquidity supervision across the Districts. Concerns were raised that examiners were evaluating deposit rates against the FDIC's rate cap and classifying deposits as non-core funding even when institutions offered reasonable market rates. The methodology for calculating the rate cap is flawed. Council members also raised concern that misclassification of core funding might result in lowering the CAMELS components for Management and/or Risk Management, which subsequently impacts the liquidity component. This constitutes a cascading effect on CAMELS components, all as a result of disputed core funding determinations.

The new current expected credit loss (CECL) standard was also an area of particular focus for some Council members (see Additional Matters under question 6). Even for institutions that were comfortable in their CECL preparations, questions were raised as to how to prepare for future examinations and limited help from examiner conversations on the issue. Council members noted that having a new pending regime for setting an institution's loss allowance, widely predicted to substantially raise loss allowances, reinforces the appropriateness of setting a lower community bank leverage ratio (CBLR) than the recent CBLR proposal of 9%.

The Council notes that the Community Reinvestment Act (CRA) Investment test includes peer comparison with institutions similarly situated, which is a source of burden. Sometimes peers seem not to be selected with care by exam teams. In other cases, peers may have differences in profitability, so that those with lesser resources tend to be downgraded on CRA. The Council suggests allowing alternatives, such as assessing efforts to meet community needs in local markets rather than peer comparison.

With regards to Bank Secrecy Act/anti-money-laundering (BSA/AML), Council members cited a need to have greater consistency between examiners and field offices, as rule application can be difficult for customers in particular industries and businesses. Council members also continue to report concerns about fair lending liability as a credit constraint to creditworthy borrowers.

The Council also notes that some examination teams are unaware of provisions in the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA) passed during the last Congress that provide relief from appraisal requirements for properties under \$400,000 in price in rural areas when appraisers are in short supply and not available in a timely manner. While clarification is pending from the banking agencies on the nature of valuations to be used when appraisals are not required, the provisions providing relief from rural appraisals were set by the EGRRCPA upon enactment.

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

The Council notes three general areas of increasing concern among community depository institutions: increasing competition from nonbank financial institutions, including in deposit substitutes; increasing practical problems caused by failure to update CRA standards in light of modern banking practices; and the potential damage to community depository institutions' liquidity risk management if membership in the Federal Home Loan Bank (FHLB) system becomes available to less well-capitalized and regulated nondepository institutions.

Digital and internet channels for gathering deposits have become extremely competitive in all Districts. Commercial customers and consumers have wide choices in deposit and cash management services, and the Council recognizes and values the benefits of these innovations. The Council also, however, stresses the importance of maintaining a level playing field for all businesses that compete for consumer and business deposits. Government agencies should hold fintech companies, commercial firms offering stored-value cards and applications, and other businesses to similar standards. Important areas of focus include AML, community reinvestment, data security, and customer protection. In addition, giving nonbanks direct access to the payment system would increase systemic risks by creating potential channels for contagion if significant payment transactions fail.

Striking the appropriate balances does not require curbing innovation. An appropriate level playing field could, for example, include streamlined, simplified, generally applicable BSA/AML procedures, which would benefit community depository institutions as well as promote sound operations by other firms. On the other hand, fintech and other firms dealing directly with customers should meet banking industry standards, such as the responsibilities of parties in electronic funds transfers under the Federal Reserve's Regulation E.

In considering innovation and the future of banking, the Federal Reserve must take a proactive approach and engage early with financial institutions and other stakeholders, rather than waiting to react to innovations after they have become part of the financial services landscape. Early engagement should not and need not inhibit innovation, but once new products or services are in the market, the impacts on the market, including the effects on community depository institutions, will already have been felt. For example, the Council encourages the Federal Reserve to engage more actively in research, discussions, and debates about crypto-currencies, blockchain, and related technologies that could potentially alter the payment and settlement systems in dramatic ways. Council members stand ready to participate in working groups that might be formed at the national or District levels.

Looking forward more aggressively is essential. If, for example, one or a few large market participants promote a proprietary settlement system that becomes a de facto standard, community depository institutions would likely have to adopt the system. Under these circumstances, a viable alternative would not exist. The Council believes that transaction settlement services (e.g., for real estate and securities transactions) will become increasingly linked to treasury management services and systems, and community depository institutions, most of whom will be unable to develop similar systems in-house, will be at a potentially serious disadvantage. Again, the Federal Reserve must play a critical role in maintaining a broadly level playing field.

In addition, the Council urges the Federal Reserve to consider carefully the extent to which banking through internet channels has changed the relevance of geography and other standards under the CRA and fair lending requirements. The act is now over 40 years old. The changes to the financial services market, including many aspects of how the “communities” that community depository institutions serve are defined, have made traditional approaches to compliance with the act virtually obsolete. Regulatory agencies have attempted to address these issues to some extent through review of institutions’ strategic plans, but this approach is time-consuming and has not eliminated all of the significant concerns. Pending a more comprehensive legislative and regulatory overhaul, one significant improvement would be adoption of consistent standards across regulatory agencies that recognize the community reinvestment value of an institution placing deposits and other funding with another institution that in turn lends the funds to low- and moderate-income customers.

Finally, many community depository institutions have raised concerns about the possible extension of FHLB membership to certain new nondepository members. The FHLB system was a critical source of liquidity for community depository institutions during the 2008-2009 financial crisis, and access to the system should be a key element in supervisory assessments of depository institutions’ overall liquidity. Admitting a new class of FHLB members, with substantially different risk profiles, business models, and supervisory regimes, would inevitably change the risk profiles of the FHLBs. Compromising the ability of the FHLBs to be a source of liquidity in distressed markets would pose a serious risk to the safety and soundness of community depository institutions. Given its critical role, the Council urges the Federal Reserve to remain cognizant of public debate about the FHLB system.

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?*

Current Expected Credit Loss

The Financial Accounting Standards Board’s CECL accounting standard requires banks to record allowances for credit losses on loans and held-to-maturity debt securities at origination, based on a life of loan loss expectation. CECL requires forecasting all future losses, a process that increases the complexity of this highly judgmental area of accounting, adds to the volatility of regulatory capital, and likely may add to procyclicality in the banking industry. Its upfront loss-recognition requirement also changes the economics of lending, as more capital is required at the time of origination. The standard will be effective in 2020 for SEC registrant banks, 2021 for nonregistrant banks with outside equity/debt holders, and 2022 for privately held and mutual banks.

Many factors will determine the regulatory capital impact of CECL for individual banks. However, preliminary estimates indicate that the CECL standard can increase the ALLL and its volatility by multiples for products that are long-tenored, such as residential mortgages, and for those loans that are issued to nonprime borrowers. Due to the inability of professional economic forecasters to foresee turns in the economy, banks are also noting that, had CECL been in place prior to the financial crisis, CECL would have added to the procyclicality in the industry. Further, the punitive effect of recording a lifetime loss upon origination severely curtails the incentive to provide credit during such times.

Community banks will be heavily affected. For instance, a recent study by Stonecastle Partners noted that several hundred community banks should consider raising capital just because of CECL's impact. Capital volatility will also be higher in most smaller-bank portfolios. The biggest challenge, however, may be the operational impact. Costly new systems and processes to track loan performance normally need to be purchased or developed for banks of all sizes. Regulators have suggested the sophistication of a bank's CECL process should be consistent with the sophistication of its operations. Nevertheless, the Council feels that significant procedural and data challenges will remain both during implementation and on an ongoing basis, especially in the face of increasingly stringent auditing standards.

Council members are concerned that CECL will result in higher and more volatile ALLL levels and higher operational costs that will reduce available capital and limit a bank's ability to meet credit needs, especially during an economic downturn. This need not be the case. Just as the present incurred-loss standard has been interpreted in different ways over that past 25 years to become a better tool to set loss reserves, CECL will be better or worse depending on interpretation and required methodology. The concept of more forward-looking loss methodologies is a laudable development, but there has been little feedback on how fundamental credit analysis should be blended with more subjective and volatile third-party forecasts of economic conditions. Without more consideration and guidance, all stakeholders, including standard setters, banks, their customers, investors, and the prudential regulators, are at risk for having hard-nosed credit analysis overwhelmed by subjective and volatile third-party forecasts. More focus now on how CECL is implemented and how the standard will be regulated and audited would reduce the likelihood of unintended consequences and disappointment during a future economic down cycle.