AGENDA

Meeting of the Federal Advisory Council
and the Board of Governors

Friday, December 14, 2012

Item 1: Current Market Conditions

Overview:
While there has been some modest improvement in certain sectors over the past few months, members report that the overall loan market is not growing. Credit is widely available to more creditworthy borrowers. Especially for C&I loans, competition has led to thinner pricing and, in some cases, to looser underwriting standards, which may be creating a bubble. Meanwhile, less creditworthy borrowers continue to have difficulty obtaining loans. For households, overall lending has been curtailed by the sharp increase in legal, compliance, and regulatory risk.

> **What is the Council's view of the current condition of, and the outlook for, loan markets and financial markets generally?**

- Members generally view a loan market that remains weak by historical standards but is improving modestly across most Federal Reserve districts; the outlook is for continued slow improvement. Banks are increasing their deposits and are eager to lend to qualified consumers and businesses. Profitability is constrained by competition and a low-rate environment.
- Business owners have started to liquidate assets and build liquidity rather than borrow for expansion and capital investment, largely due to fiscal uncertainty.
- Large corporate banking clients continue to remain opportunistic borrowers, and pricing is competitive. Continued low loan demand could drive more aggressive leverage and pricing and looser covenants as competition for borrowers heats up. Potential investment-grade borrowers are also increasingly turning to an active bond market as an alternative source of funding.
- Demand for consumer credit is generally improving, led by stronger auto and student lending, as well as home equity lines of credit.
- Real estate and construction lending continue to lag, with the exception of multifamily housing, though the latter may have peaked in this cycle. Residential construction lending is expected to increase in 2013 as the housing market continues to recover.
- The outlook for all loan demand is highly dependent on the resolution of pending tax and fiscal policy issues.
- Credit quality continues to improve.

(A) Small Business Lending:
Has credit availability for, and demand for credit from, small businesses changed significantly recently? Have lending standards for these borrowers changed?

- Lending to small businesses remains modest by historical standards. Some Council members report a slight increase in small business lending from third quarter of 2012 but attribute this primarily to artificially low interest rates. Credit availability is not an issue.
- The Thomson Reuters/PayNet Small Business Lending Index, which measures overall volume of financing to small U.S. companies, increased during the summer through August to 109.9, fell back to 94.1 in September, and rose again to 107.5 in October. Borrowing in October 2012 was up 11% from October 2011.
- Weak sales remain the top concern of small business owners, with additional concern about higher tax and regulatory costs.
- According to the October 2012 Senior Loan Officer Survey**,** credit standards for small businesses have not changed appreciably. The credit quality of small business portfolios continues to improve.
- Banks continue to review and improve product offerings for small business and make this a focus of their planning. Competition for high-quality small business customers continues to pressure loan spreads and profitability.

***(B) Commercial Real Estate Lending**:*
Has the Council's view of the challenges in the commercial real estate market changed? How are commercial real estate loans performing compared with your expectations?

- Members report that commercial real estate values have stabilized and are increasing slightly in some urban markets, especially New York. Suburban markets and markets in Florida remain very soft.
- Liquidity to the CRE market remains impaired because commercial mortgage-backed securities have not recovered from the financial crisis. Aggregate CRE loan growth among all FDIC-insured banks has remained modestly negative, down 2-3% from a year ago. However, in selected markets members report signs of increasingly aggressive competition.
- Continued sluggish business and employment growth are inhibiting a broader commercial real estate recovery, but the outlook for 2013 is for an overall small increase in CRE lending for the first time since 2008.
- Loan demand in 2012 is led by multifamily housing. Some members are concerned about possible oversupply of multifamily properties in 2013 combined with improving single-family home sales, resulting in weakness in rents and decreased demand.
- Commercial Real Estate loan performance is improving somewhat, but still lags performance of other types of loans. This lag is expected to continue until there is sustained improvement in business profitability and employment growth. Delinquent loan rates are improved at less than 5% but are expected to remain above pre-crisis levels for 6 to 8 quarters. Charge-off rates are showing steady improvement at 0.7%. Before the financial crisis this figure stood at 0.09%.

***(C) Construction Lending**:*
What is the Council's view of the availability of credit for construction and development projects? Has the Council seen any recent changes in the demand for construction loans?

- Members report that increased construction lending over the past year has been largely driven by multifamily housing and college student housing.

- Some members report stronger demand in recent months for energy-related construction loans (*e.g.*, oil and its distillates), loans for government-leased buildings, and loans for renovation of existing commercial properties.
- Well-structured projects in desirable locations, sponsored by proven developers, are attracting bank and institutional financing.
- Many markets still have a surplus of existing commercial properties available, often at much lower prices than new construction, which limits demand for construction loans.
- Residential construction loan demand remains very weak, though the outlook is for improvement in this space in 2013 as new home construction has begun recovering from historic lows. Small home builders continue to have difficulty obtaining financing.
- Lending standards have not changed appreciably. Construction loan underwriting characteristics include cash equity and pre-leasing to quality tenants, as well as limited-recourse and nonrecourse financing.

(D) Agricultural Lending:
Has agricultural lending changed recently? What is happening to valuations of farm land?

- Continued high global prices for most agricultural commodities have extended steady demand for agricultural loans. U.S. farmers have increased purchases of seed, fertilizer, and pesticides for 2013 even as the drought has limited 2012 harvests in many areas. Corn and soybean farmers are experiencing 40-year record earnings and are using those earnings to finance additional land and heavy equipment purchases. While a growing percentage of these purchases have been cash transactions, loan demand is steady.
- Nonfarm investors are increasing purchases of farmland as a portfolio diversification measure and to take advantage of record commodity prices, further increasing loan demand.
- Growers are also taking steps to reduce 2012 tax liabilities by making additional end-of-year purchases, which will result in additional lending opportunities through the end of 2012.
- Prices of agricultural land have stabilized at record highs, routinely reaching $4000/acre for high quality ground. Prices are still increasing slightly in some markets. Demand for farmland continues to be strong. While some consider the recent price run-up of 25% and more to be an anomaly, continuing upward pressure on commodity prices could continue to support strong demand and high prices for farmland through 2013.
- Farm income and loan demand could be impacted by a complete overhaul of the USDA farm bill in 2013. The present farm bill includes direct subsidies that are expected to terminate in 2013.

(E) Consumer Lending:
What changes has the Council seen in consumer lending?

- Members report modest but steady increases in consumer lending, led by student loans and auto loans. There has been a slight uptick in credit card lending in most markets.
- Consumer credit balances at the end of the third quarter were about $2.77 trillion, up about $60 billion in the quarter.

- Auto loan balances were up 7.2% in October 2012 from a year ago. Balances are now only 8% below their September 2007 peak level. The current outlook for auto lending is good, with sales pointing to a level of 14.3 million vehicles in 2013, a slight increase over 2012 and a substantial increase over 2011 sales. Lending standards appear to be loosening somewhat due to competition in this space, while margins are tightening.
- Some banks report increased regulatory scrutiny over auto lending, especially indirect auto, with a focus on documentation and fees and consistency at the state level. While this is appropriate, it may nevertheless result in reduced lending over the short term as banks adjust to new requirements.
- Student loans have been one of the fastest growing segments of consumer borrowing, with total balances increasing by $42 billion through the third quarter of 2012. Delinquency rates are increasing, with a 90-day delinquency rate of 11% reported in November by the Federal Reserve Bank of New York.
- Many Council members report significant recent increases in home equity lending, led by home equity lines of credit, as homeowners respond to lower rates and improved property values in many markets. This path is expected to continue into 2013.
- Revolving credit is volatile and was up just 0.5% in September over a year ago. Continued weakness in employment hampers further growth in revolving credit. Clients are showing more discipline around the use of credit cards than in the past, as evidenced by record low past-dues and charge-offs.
- The biggest change in consumer lending, as compared with pre-crisis trends, is the complete lack of supply in subprime lending, excepting for autos.

***(F) Update on Home Mortgage Lending*:**
What changes has the Council seen in the home mortgage market in the past three months?

- Mortgage rates fell to record lows during the week of November 21. The rate for 30-year fixed-rate loans averaged 3.31%, a decline from 3.98% a year ago. The rate for 15-year loans averaged 2.63%, down from 3.30% a year ago. Rates overall have declined by an average of 25 basis points over the past three months.
- The recent drop in rates spurred a jump in loan volume. Mortgage volumes were up in mid-November by 4.7% over those a year ago. Mortgage application data show activity has been driven by refinancing, which is up 60% year-over-year. Purchase loan applications were up a more modest 7%.
- Home equity loan demand has increased substantially, as homeowners respond to the interest rates that are dramatically lower than other forms of consumer credit.
- Capacity constraints are becoming an issue for some banks. Banks are reluctant to add capacity due to the great uncertainty over mortgage regulations expected in 2013 and to tightening government loan underwriting. The mortgage industry continues to wrestle with rapid change and uncertainty associated with higher guaranty fees, repurchase requirements, regulatory mandates, CFPB reviews, and digestion of the "Qualified Mortgage" and "Qualified Residential Mortgage" rules.
- Credit standards for mortgages remain extremely tight, despite the increasing demand. Homebuyers with less than perfect credit continue to have few options.
- Recently reported substantial losses by FHA may augur tightening credit standards and higher insurance premiums for FHA loans, which will reduce future volume.

(G) Housing Markets:
Has the national housing market finally turned a corner?

- Recent data continue to suggest a gradual, strengthening housing recovery. However, this apparent “fledgling” housing recovery has the potential to be slowed with uncertainty such as high unemployment levels and the “fiscal cliff.” There is also speculation that the housing recovery will not last because low interest rates are fueling the recovery instead of organic economic growth.
- From a national perspective, it appears that the housing market has begun to solidify modest gains. Several prominent national price indices have all exhibited upward trends in recent months. Goldman Sachs estimates that prices are near equilibrium, and it projects two-year upside/downside ranges of +9.1%/-0.4%, which indicates a strong likelihood of further price increases.
- Sales have increased nationwide, but current levels are still only about half of the pre-recession average. In the recent Beige Book, all 12 Federal Reserve Districts reported that existing home sales have strengthened. September’s existing sales pace was the second fastest in more than two years. New home sales outperformed existing sales in September, rising sharply to the highest level seen since April 2010.
- The months supply of homes for sale, an indicator of housing market strength, fell below the key 6-month mark to 5.9 months in September and 4.5 months in October, the lowest level since October 2005.
- New home construction and permits show a slight increase, primarily by large-volume builders, but increases in construction employment have been small. Small and independent builders remain on the sidelines due to limited access to capital.
- The majority of sales activity is still in the lower price ranges, due in part to limited availability of jumbo mortgage investors. Investors that are purchasing single-family homes, many of them foreclosed bank-owned properties, for rentals account for a significant portion of the increased activity.
- Data from the Census Bureau’s Housing Vacancy Survey confirm the pace of distressed sales released into the market has slowed. In the third quarter, the homeowner vacancy rate (share of owner-occupied homes that are vacant and for sale) continued to decline for the seventh consecutive quarter to 1.9%. This marks the lowest rate since the third quarter of 2005 and a full percentage point below the peak in 2008.
  There is still a substantial inventory of unsold foreclosed properties owned by banks and by Fannie Mae and Freddie Mac.

(H) Mortgage Foreclosures:
What changes has the Council seen in the pace of mortgage foreclosures during the past three months?

- Nationally, foreclosure starts have fallen consistently over the last year to the lowest level since 2007. From a peak of 316,000 in March 2006, starts fell to 159,000 in September 2012.
- Foreclosure rates are flat to decreased in most markets, with a few increases as in New Jersey. The Mortgage Bankers Association national survey reported a decrease nationally of 20 basis points, from the second to third quarters, to 4.07%.

- The majority of the slowdown is due to banks implementing greater short sales and loss mitigation efforts. High unemployment continues to be the greatest obstacle to reducing foreclosures.
- Timelines to complete foreclosures through the legal systems continue to be stalled, and foreclosure inventories remain elevated. States with judicial foreclosure lag those without in clearing their foreclosure inventories. Many states are continuing to implement new regulations that further impede the legal process. For example, Massachusetts enacted a law, effective August 2, imposing strict new regulations on demand noticing, loss mitigation, and foreclosure processes that are expected to lengthen foreclosure timelines in the state.
- Fannie Mae and Freddie Mac continue to hold a significant number of nonperforming and underperforming loans. The decision not to foreclose on these loans has avoided a mass dumping of homes on the market and has artificially lowered the national foreclosure numbers, but it creates a challenge for the future as these loans will ultimately need to be addressed.

<u>Item 2</u>: LSAPs and Mortgage Markets

(A) One goal of the FOMC's large-scale asset purchase programs (LSAPs) is to lower mortgage rates. Mortgage-backed securities (MBS) purchases tend to lower MBS yields, but the connection between movements in mortgage rates and movements in MBS yields is often difficult to discern. How do Council members perceive this connection? What is the "pass-through" of changes in MBS yields to changes in mortgage rates? To what extent are declines in MBS yields associated with changes in other longer-term interest rates?

- The majority of members observed that rates on agency-eligible mortgage loans are generally closely linked to MBS yields, but the efficiency of the pass-through of changes in MBS yields to changes in mortgage rates is currently being impacted by the following factors:
    - Mortgage origination capacity in the industry is constrained. As lenders approach and exceed their given capacity, they widen the spread between MBS yields and mortgage rates to slow volume down to sustainable levels.
    - The FHFA and the GSEs have systemically increased guarantee fees, which are a direct pass-through to mortgage rates.
    - The expansion of HARP earlier this year may be increasing spreads, as HARP-eligible borrowers are generally less price sensitive.
    - Increases in risk, required capital, and skill level of employees have permanently increased return-on-investment requirements.
- Many members observed that MBS yields are highly correlated to changes in other long-term interest rates, particularly assets with duration of 5 to 10 years.
- It was also noted that new LSAP programs can result in a disassociation of MBS yields from other interest rates on a short-term basis.

(B) Capacity constraints in mortgage lending are often mentioned as one reason mortgage rates do not adjust more quickly in response to lower MBS yields. What are the bottlenecks in mortgage originations?

- The impact of legislation, regulatory changes, and enforcement actions (GSE put-back risk, upcoming Basel III capital changes, increased operating costs, etc.), combined with uncertainty regarding the industry's future direction (Dodd-Frank Act, CFPB, breadth and depth of enforcement actions, etc.), have caused numerous large industry participants to exit the industry in part or in whole.
- New regulatory licensing requirements, net-worth standards, and other changes driven by legislators/regulators have increased mortgage lending barriers to entry.
- Management of put-back risk has significantly increased mortgage origination resource intensity and workload, as near perfection is now required. This has effectively taken considerable capacity out of the system.
- The expansion of HARP has consumed considerable capacity among originators with sizable agency servicing portfolios.

(C) Mortgage origination seems to be a source of profitability for many banks. Are more banks willing to invest to expand their mortgage lending capacity?

- The increased regulatory burdens and uncertainties of mortgage origination and servicing have lowered the appetite of many banks to expand their mortgage lending capacity.
- Mortgage products have become more expensive to offer. Many institutions at the regional and community level are at a cost disadvantage relative to those with national scale.
- Given the high percentage of current origination volume represented by refinancing, even the largest originators are less willing to invest in expansion that will likely be temporary.

(D) In the current environment, are banks tending to hold in their portfolios more or fewer of the mortgages they originate?

- The majority of members observed that there are many factors resulting in fewer mortgages being held in their portfolios, including:
    - Historically high premiums on conforming loan sales,
    - Concerns over interest rate and duration risk, and
    - The impact of preparing for Basel III compliant capital ratios.
- A few members mentioned that higher retention may be driven by higher yields on mortgages relative to other investment alternatives and potentially some concern over GSE put-back risk.

<u>Item 3</u>: Bank Merger Policy and Financial Stability

The Dodd-Frank Act added consideration of the extent to which a proposed bank acquisition, merger, or consolidation "would result in greater or more concentrated risks to the stability of the United States banking or financial system" as a factor in evaluating those proposals. In the Council's view, how is the policy of safeguarding financial stability in the U.S. best applied in this evaluation?

- Existing laws, regulations, and procedures provide for thorough reviews of mergers of banks and their holding companies. Board merger decisions have long included comprehensive analyses of such factors as capital, managerial resources, Community Reinvestment Act performance, and antitrust. Many of these subjects involve determinations that also address whether the proposed combination would result in "risks to the stability of the United States banking or financial system." Members generally recognize the importance of considering the possible systemic risk posed by some mergers and acquisitions but express concern that the Board carefully balance the interests of clarity of standards, future flexibility, and avoidance of such automatic triggers as asset size or deposit concentration. It should be noted that mergers are useful in resolving or recapitalizing institutions in difficulty.
- **Capital**. Regulatory expectations for capital have risen significantly in the last several years, and banking companies that might represent risks to financial stability will be required to maintain additional capital buffers. The results of CCAR and stress tests also offer the Board a reliable assessment of the capital position of the merging parties and provide comfort that the capital position of the resulting entity will be sufficient to reduce systemic risk. The apparent Board practice that the resulting entity must have higher than peer pro forma capital ratios discourages all but the most highly capitalized acquirers, as purchase accounting marks against the target's assets cause a capital reduction. This constraint is even more meaningful in mergers of similar-sized institutions.
- **Management**. Board assessments of the managerial resources of the combined company allow for consideration of the complexity of the resulting enterprise and provide grounds for denial or conditional approval. The Council submits that complexity, balance sheet composition, funding sources, and interconnectedness of operations may well be better indicators of increased systemic risk than absolute asset size.
- **Competition**. Existing law calls for traditional antitrust review of transactions, and a reliable process has developed using concentration measures agreed upon with the Justice Department. Congress has acted to allay concerns about undue aggregation of economic power by balancing the authorization of interstate branching with a prohibition on companies reaching by merger more than a 10% share of domestic deposits (Riegle-Neal Act) or more than 10% of total liabilities (Dodd-Frank Act). Although these standards address possible anticompetitive behavior, they also restrict the growth that might raise systemic concerns.
- **Other Factors**. The Council notes that many mergers promote efficiency, enable banking companies to better serve customers and communities, and actually reduce risk through diversification and increased earnings. Faced with increasing costs and low net-interest margins, many banking companies will seek to improve shareholder return through cost reductions available in a merger. Undue impediments to mergers may prevent some desirable industry consolidation. We urge the Board to develop guidelines outlining the kinds of transactions that warrant additional scrutiny and recommit to the goal of deciding applications within 90 days.
- **Other Mitigants**. As shown by current capital ratios and the results of stress tests, systemic risk has been reduced materially. Increased government confidence in measures to reduce the potential consequences of the failure of a large institution also reduces the impetus to interpret the Dodd-Frank Act aggressively to prevent substantial mergers.

Item 4: **Payment Systems**

How have consumer and business practices and preferences for making payments been changing? Are there significant impediments to meeting customers' needs for payments services, and if so, how should these impediments best be addressed? What are the Council members' views and concerns regarding the competitiveness of banks' payments services?

- The Council believes that the consumer payments landscape is undergoing massive changes, principally enabled by three major trends:
    - Consumers are migrating toward electronic payments over cash and checks, providing a foundation for change;
    - As noted in the survey results released by the Board of Governors last March, consumer usage of mobile smartphones continues to expand rapidly, enabling unparalleled levels of personalization and interactivity;
    - Consumers continue to demonstrate a strong willingness to adopt mobile financial products and services, including commerce and payments.
- These consumer and technological trends are leading to emerging fragmentation of the payments system that extends far beyond traditional industry players.
    - Payments have traditionally been facilitated by issuing banks, payment networks, and acquiring banks.
    - Today, mobile network operators, mobile hardware providers, and a proliferation of new digital and Internet entrants are also establishing payments relationships with consumers and/or merchants.
- While the Council welcomes and encourages innovation in payments, it is concerned about meaningful risks posed to the payments system and to consumers by under-regulated and inexperienced participants.
    - The increasing fragmentation of payments transactions across a host of nonbank providers is fostering uneven regulatory coverage, decreased consumer protections; unclear accountability for payment transaction risk, and more complicated disputes servicing.
    - Consumers are often unaware of the differences between regulated and less-regulated products and entities.
    - Less-regulated nonbank providers often lack robust, bank-grade operational and compliance controls, which may make the services they provide less reliable and stable than those offered by banks. These gaps introduce data security, privacy, "Know Your Customer," and anti-money-laundering risks.
    - As more and more electronic payment mechanisms emerge, the current payment system paradigm of storing credentials locally (on the mobile device) is leading to a proliferation of consumer payment credentials and to increased security, fraud, and privacy risks.
    - Inconsistencies in regulation across payments players is driving product innovation towards less-regulated products and entities, decreasing consumer protections, and impeding the competitiveness of more highly regulated bank payments providers.
- The Council observes multiple examples of these risks in practice:

- A product launched recently by Walmart and a three-party card network positions a prepaid card sold in retail outlets as a 'debit and checking alternative' but without providing a true deposit account or FDIC insurance. Consumers may be unaware of the differences between this product and an actual bank account. Additionally, this product leverages a regulatory exception for three-party payment networks granted by the Federal Reserve in its rulemaking under the Durbin Amendment, to gain the significant benefit of unregulated interchange rates.
- A large online payments provider permits consumers to maintain an account "balance" from which payments can be made, though the regulatory treatment of the balance and resulting applicability of consumer protections is arguably unsettled. The provider grants customers many Regulation E protections but does so only voluntarily and could change them at any time.
- Smaller banks (*e.g.,* Bancorp Bank, with approximately $3.1 billion in assets) are used by large-scale nonbank payments system players *(e.g.,* Google, PayPal) to issue payment devices, allowing these ventures to achieve favorable rates under the Durbin Amendment's small institution exemption.
- New mobile payments-acceptance-solutions providers aggregate merchants under their single merchant ID, enabling small businesses to accept card payments without applying for their own merchant account. For example, Square acts as the official merchant of record for merchants using the Square mobile card reader. The underlying merchant information is obscured in transaction data received by banks, which limits banks' ability to apply robust fraud and other controls and manage customer billing disputes.
- Third-party digital wallets capture user transaction data but likely without the protections and controls that exist at financial institutions for the management of that data. With these third-party digital wallets, the wallet provider often becomes the merchant of record (sometimes via "shadow" prepaid accounts that consumers are generally unaware they have opened), which may obfuscate transactional data and impede banks' ability to prevent fraud. The Council also has concerns that such wallets may cause consumer confusion and increase costs and risks for banks in servicing disputes.

- The Council believes multiple changes to the payments regulatory framework would promote innovation while ensuring consumer protections and the safety and soundness of the payments ecosystem.
  - As a general matter, regulators should apply payments rules consistently across all payment activities and system participants, regardless of the type of entity providing the product or performing the service. Functionally similar activities should be regulated in functionally similar ways.
  - The Council recommends that the Federal Reserve consider certain steps along these lines.
    - As an initial matter, the Federal Reserve should consider whether certain payment-related activities are more appropriately conducted only by regulated banking institutions rather than nonbanks. At a minimum, the Federal Reserve should devote additional resources to studying this emerging marketplace and ensuring that innovation does not occur outside of appropriate supervisory oversight.

        - One significant regulatory gap is the Federal Reserve's exclusion of three-party networks from the debit card interchange restrictions. The Federal Reserve should consider, in light of recent developments, whether the carve-out is appropriate. The exclusion creates a significant competitive advantage for those networks offering prepaid and debit cards and appears to permit Walmart, a strong proponent of lower debit interchange rates, to benefit indirectly from the very thing it opposed: unregulated interchange. From a contextual standpoint, it is important to note that, as the Federal Reserve is aware, Walmart has sought to enter banking formally for over a decade. Faced with opposition, Walmart now appears to have entered banking through the back door, without the regulatory framework that applies to banks and bank holding companies.
    - The Federal Reserve, working with other federal and state regulators, should address potentially critical gaps in data security, privacy, "Know Your Customer," and anti-money-laundering requirements for payment activities conducted by nonbank participants. Greater supervision of significant nonbank payments providers, commensurate with the risk posed, is necessary to ensure that the requirements are met in practice.
    - The Federal Reserve should encourage the Financial Stability Oversight Council (FSOC) to take up the issue of potential systemic risks raised by an emerging "shadow" payments system. The fragmented nature of supervision over the payments systems would appear to present precisely the type of issue that the FSOC was designed to address.
    - In addition, the Council recommends that the Federal Reserve and other banking regulators give increased supervisory attention to relationships between nonbank payment providers and smaller banks to avoid instances of rent-a-charter arrangements.
    - There is also a critical role for the CFPB here.
        - The CFPB should exercise its consumer protection authority in the emerging payments area, implement regulations across all payment providers regardless of entity type, and supervise nonbanks to the full extent of its authority.
        - The Council believes that the CFPB should consider expanding the scope of consumer protection regulations to cover certain emerging payment products, such as prepaid cards and consumer balances held at nonbanks. As the CFPB itself has acknowledged, some of the largest payments players today voluntarily provide many of the relevant consumer protections. But less-scrupulous providers may not provide these same protections, creating inconsistency and confusion for consumers.
        - The CFPB should also require transparency of rights and protections (*e.g.,* availability of FDIC insurance and consumer liability for unauthorized transactions) through conspicuous disclosures. Transparency is especially critical for novel payment products that may resemble other products in the market but afford fewer protections (*e.g.,* prepaid cards versus traditional deposit accounts).
    - Finally, the Council believes that new methods are needed to mitigate the risks stemming from the proliferation of consumer payment credentials. The Council

supports, for example, replacing the storage of customer banking credentials at the point of payment with robust, secure, standardized digital tokens. This approach would materially improve the safety, security, and privacy of consumer payment and banking credentials. It would also improve bank credential management and fraud processes.

Item 5: **Economic Discussion**

Do Council members see economic developments in their regions that might not be apparent from the reported data or that might be early indications of trends not yet apparent in aggregated data?

Members noted several recurrent themes:

- Most notably, the economic malaise in Europe is having some impact on the U.S. economy. Respondents report a gradual slowdown in exports to Europe, a fact that has not yet shown up in the domestic economic statistics. In New England, it is reported that some European-owned operations in that region are also retrenching.
- Home prices seem to have bottomed out and are slightly on the upswing in most sections of the country. This pattern is corroborated by the fact that mortgage loan activity has been picking up, sales of existing houses have risen slightly, and the supply of houses for sale continues to shrink, albeit very slowly. Loan delinquencies and foreclosures continue to trickle down in number from the seemingly emergency levels reached at the height of the crisis, with improvement coming in very small but nonetheless positive increments from quarter to quarter. Despite the improvements seen, continued gains in the housing arena are painstakingly slow and will likely continue that pace.
- Members report reluctance on the part of business managers to commit to long-term capital improvements or hiring with the extraordinary number of unknowns they face. Tax policy, the “fiscal cliff,” and the unknown full impact of the Patient Protection and Affordable Care Act (so-called “Obamacare”) have all resulted in so much uncertainty among businesses that capital spending and hiring have been put on the back burner until the fog begins to lift. Specifically, some members report that revolving loan utilization rates remain quite low despite the seasonal upswing that would usually be seen at this time of year. Commercial borrowers who rely on federal contract work are being especially cautious, as the resolution to the “fiscal cliff” may well include substantial reductions in the amount of contract work available. Those doing business on the private side report razor thin or even negative margins in a highly competitive marketplace.
- Business productivity gains have slowed considerably as the reductions in overhead that were associated with head-count reduction have run their course. Such reductions accounted for a significant portion of the growth in corporate profits that has taken place over the past several years, however a repeat of these gains is not likely.

Item 6: **Monetary Policy**

How would the Council assess the current stance of monetary policy? What do Council members see as the ongoing impact of the Federal Reserve's portfolio?

- Current monetary policy incorporates aggressive action on three substantial fronts: interest rate, balance sheet portfolio, and communication policies. Each of these actions has a compounding effect, the end results of which are not known due to the lag effect of these mechanisms on various segments of the national economy and subsequent behaviors of businesses, consumers, and investors. Members clearly agree that actions taken to date on all three policy fronts have been aggressive, though ancillary comments ranged from "ineffective" to "warranted" to "highly accommodative" to "radically accommodative." Most members believe the actions taken to date have contributed to significant improvement in financial market performance over the past 3½ years, compared with what would have been the likely alternative course. A few members commented that the transmission mechanism from financial market performance to economic improvement has been much weaker than historical relationships would suggest.
- Continued slack in the labor markets has restrained wage inflation. The members generally expect that near-term inflation will not significantly deviate from the Federal Reserve's comfort zone. Longer-term inflationary pressures will be a function of when "substantial improvement" in the labor market occurs, how quickly stimulus is removed, and how effective a soft landing will be in the context of that withdrawal.
- While economic improvements are evident, the pace and magnitude of those improvements have been quite sluggish and uneven. Three primary factors continue to weigh heavily on the strength of the recovery: housing, unemployment, and uncertainty. Uncertainty regarding the course of U.S. fiscal policy is of primary concern. Importantly, political and regulatory uncertainty is keeping investment capital on the sidelines.
- Members expressed concern that they are seeing some participants seeking yield by accepting greater incremental risks, either in credit risk undertaken or in duration extension. Small banks have exhibited declining interest in agency securities, with modest upticks in corporate bonds (both financial and nonfinancial names), CMBS, whole-loan MBS, ABS, and structured products. Competition for limited loan demand has resulted in lower fixed coupons, longer maturities, interest rate caps on floating loans, and aggressive teaser rates.
- One member conveyed concern that current monetary policy has created a regressive tax on retirees, charitable organizations, pensions, and others relying on fixed-income investments. These groups have experienced downward pressure on their purchasing power resulting from artificially compressed savings yields.
- The primary risks of the current monetary policy are overshooting expectations due to delayed response, creation of excessive inflationary expectations, and the distortion of efficient markets. One Council member expressed concern that the larger Federal Reserve balance sheet will be very difficult to "normalize." Unconventional policies make it more difficult to read signals from other market participants outside of the Federal Reserve.

How has the open-ended nature of the Federal Reserve's securities purchases – announced in the September FOMC statement – influenced financial markets?

- Members generally perceive that the open-ended nature of security purchases and the conditionality for stopping purchases in the future were reasonably well received when initially announced in September 2012. Subsequent reactions in the stock and bond markets were much more muted, as investor and economist attention shifted focus to fiscal concerns. Since the September announcement, stock market volatility has remained remarkably low, particularly considering the current fiscal uncertainty. Commodity prices remained fairly stable during this period, and the dollar increased relative to other major currencies, despite higher forward-inflation expectations. Spreads on corporate bonds narrowed over this period as well. MBS yields and retail mortgage rates declined, but the decline in mortgage rates did not keep pace with MBS yield declines. Severe capacity constraints within the mortgage origination business may be a primary cause of this differential.

- A few members stated the belief that the open-ended nature of the purchases was far less effective in driving the financial markets than prior securities purchase programs; however, these purchases have shared the spotlight with other drivers (such as the U.S. "fiscal cliff" and European economic and banking concerns). Participants recognized the Federal Reserve's actions were instrumental in stabilizing asset prices and easing funding conditions, but they also recognized that the Federal Reserve alone cannot engineer a faster recovery.
- One Council member stated that telegraphing low/flat rates into 2015 is harmful for motivating businesses to consider new investment. Such action encourages delay of purchase and expansion decisions, and the time-value-of-money penalty for not taking action sooner is quite small.
- At some point in the future, an unbalanced fiscal policy and open-ended debt monetization could negatively impact the dollar when some threshold of saturation has been reached. This, of course, could be a benefit to exports.