RECORD OF MEETING
Federal Advisory Council and Board of Governors
Thursday, November 30, 2017

Item 1: Current Market Conditions

What is the Council's view of the current condition of, and the outlook for, loan markets and financial markets generally? Has the Council observed any notable developments since its last meeting for loans in such categories as (a) small and medium-size enterprises, (b) commercial real estate, (c) construction, (d) corporations, (e) agriculture, (f) consumers, and (g) homes? Do Council members see economic developments in their regions that may not be apparent from the reported data or that may be early indications of trends that may not yet have become apparent in aggregated data?

General Outlook:

- The overall economic and financial outlook remains positive, driven by strong employment, favorable equity markets, and continued consumer and business optimism.
- The Council believes tax reform will add to economic activity and growth and that the absence of tax reform constitutes a risk.
- Businesses continue to feel uncertain regarding the tax and regulatory environment.
- Recent GDP growth has been strong, with two consecutive quarters of 3+% growth, despite the negative short-term impacts of Hurricanes Harvey, Irma, and Maria. The impact from these hurricanes on labor and materials has not been fully absorbed. Banks continue to support clients and communities in recovery.
- Consumer lending is stable to moderate, with growth driven primarily by auto sales.
- Commercial & industrial (C&I) lending growth is slowing, and the markets are becoming increasingly competitive. Such dynamics are creating a supply-and-demand imbalance that is pressuring loan pricing and structures.
- Larger companies are increasingly accessing the capital markets as an alternative financing channel.
- Commercial real estate (CRE) markets are generating solid and consistent growth. Market fundamentals remain strong, with high rents, low vacancies, and low cap rates.
- The market reaction to transitions at the Federal Reserve, including Governor Powell's nomination and the unwinding of the balance sheet, appears to be constructive.
- Geopolitical tensions persist, primarily relating to North Korea.

(a) Small and Medium Size Enterprises

- Small Business
  - Loan activity appears mixed; certain Council members report strong demand, and others report stable to flat growth.
  - Small business optimism declined slightly in September but remains near expansionary highs, according to the National Federation of Independent Business (NFIB). The NFIB's Small Business Optimism Index decreased to 103.0 in September 2017 from 105.3 in August, far above the September 2016 level of 94.1.
  - Small business owners are less certain about sales growth and business conditions

due to anticipated changes in tax and regulatory policies. Bullish expectations for policy changes in Washington have tempered in recent months, but most small business owners generally expect an improved business environment.
  - New business formation, innovation, and investment are occurring at a sustainable pace. Small business incubation is encouraged locally through space sharing, innovation spaces, university support of entrepreneurial activities, academic and pragmatic training, and increased capital for small equity investments.
  - The opioid crisis in America has also taken its toll on small business employment. In 2015, the opioid epidemic cost the U.S. economy over $500 billion and took more than 70,000 lives (U.S. Department of Health and Human Services). The emergence of this issue has had a negative impact on the job market, as a growing segment of the population cannot participate in the market due to opioid usage.
- Middle Market
  - Weaker demand for bank C&I loans is driving slower middle-market loan growth. Companies that have excess cash, as well as larger firms that secure financing through the capital markets, are driving slower demand for C&I loans.
  - Additionally, many companies have adopted a "wait and see" approach in relation to tax and regulatory reform.
  - Syndicated nonsponsored loan growth in the middle market decreased in 3Q17 to its lowest level since 1Q10 (Reuters LPC). Syndicated asset-based lending reached an eight-year low in 3Q17.
  - Competition continues from nonbanks that can invest across the capital stack, including debt and equity, making it difficult for traditional banks to compete on both structure and pricing. As such, Council members noted that certain banks are stretching on credit terms and pricing to attract new business.
  - Middle-market sponsored issuance is trending at its highest pace since 2014 (per Reuters LPC), driven by increased leveraged buyout (LBO) activity. Sponsors are securing aggressive financing terms, including record leverage on larger credits. Approximately 50% of institutional middle-market LBO deals were levered at 6x or greater between 1Q17 and 3Q17.

(b) Commercial Real Estate

- CRE market fundamentals remain stable. A combination of low cap rates and peak rents continues to propel values to historically elevated levels in many markets. CRE loan growth has been solid. Monthly growth has accelerated from 0.1% in September to 0.6% in October.
- Loan and financial markets remain open with substantial liquidity. Commercial mortgage-backed security (CMBS) and high-grade REIT spreads continue to contract due to highly competitive lending markets.
- CRE equity fundraising remains strong but is beginning to taper. Today's returns are more difficult to predict due to excess supply coupled with high land and construction costs.
- Despite the spate of retailer bankruptcies in 2017, bank loans secured and/or supported by retail real estate remain performing and have very little deterioration, as landlords aggressively pursue replacement tenants. Stressed retail loans are generally lower-quality projects located in tertiary markets and have thinly capitalized landlords. New loan originations for retail real estate (both bank and capital markets) are more scrutinized and highly structured, with capital available to "best in class" real estate and sponsors.
- Market fundamentals for multifamily property remain solid, with same-store cash-flow

growth slowing but remaining positive. Lending markets remain stable and liquid, with ample capacity for stabilized property from banks, CMBS, life companies, and government-sponsored enterprises (GSEs). The Federal Housing Finance Agency also recently announced multifamily lending caps that are slightly lower than prior-year levels (2018 caps of $35 billion vs. prior-year level of $36.5 billion). Cap exclusions will include loans to finance energy or water efficiency improvements and loans on affordable units in high-cost markets.

- Most major markets, including New York City, Boston, Chicago, San Francisco, and Los Angeles, continue to have strong fundamentals, with low vacancy rates and strong absorption of new inventory. Market activity in the Southwest is relatively brisk, while Midwest markets are experiencing moderate 2-3% annual growth.

(c) Construction

- The construction industry has moved into a mature stage of expansion, with construction starts expected to grow at a moderate pace of ~4% in 2017, down from 5% growth in 2016 and 11-13% annual growth from 2012-2015.
- Areas of strength include the single-family housing, industrial, office, and education (funded by school bond levies) sectors. Conversely, the industry is experiencing slower growth in the multifamily, retail, and hospitality sectors. Public-works activity has also been flat, as the current administration's infrastructure program has yet to materialize.
- The 2018 outlook is moderate, with overall construction growth expected around 2-3%. Potential growth in excess of expectations will depend on the success of tax reform and the passing of a federal infrastructure program.
- Single-family construction is expected to drive growth due to increasing homeownership by millennials and to rebuilding efforts in Texas and other hurricane-affected areas. However, certain Council members noted constrained new-home construction in many urban markets.
- Multifamily-housing construction has slowed overall, but with pockets of growth, including in Jacksonville and Tampa.
- Construction loan markets are open, but development financing remains selective for "best in class" projects and sponsors. Larger projects requiring syndicated debt remain challenging, while smaller, single-bank loans are readily available.

(d) Corporations

- Bank C&I loan growth has started to recover in recent months after three straight monthly declines from June to August (H8). C&I loans grew 0.6% and 0.4% in September and October, respectively,
- Corporate lending remains stable as a result of a constructive macroeconomic backdrop and low default rates. Stable commodity markets, heightened growth expectations, low default rates, and low volatility support a positive outlook for the remainder of the year and into 2018.
- M&A and LBO financing volumes are tracking towards a post-crisis record for 2017. In spite of persistently high asset valuations, M&A volumes have been bolstered by the high cash levels accessible to private equity and corporate buyers.
- Banks continue to be challenged by a high degree of liquidity among institutional investors, which is pressuring loan structures and pricing. Increased competition is further amplified by a scarcity of opportunities (outside of M&A).
- Uncertainty with respect to tax and regulatory reforms is curbing the appetite of many businesses to make long-term investments.

(e) Agriculture

- Commodity prices remain depressed for cereal grains, forage, and protein, putting pressure on asset quality.
- Seasonal investment in equipment is expected in Q4; however, meaningful lending growth is not anticipated. Competitive pressures are driving spreads to remain flat year over year.
- October's Ag Economy Barometer (index produced by the Purdue University/CME Group) is slightly ahead of September sentiment levels but is down from the scores seen in early 2017. Surveyed farmers are optimistic about continued low fertilizer and fuel expenses into 2018.
- Producers continue to focus on improved efficiency and meeting food safety requirements.
- There is a risk of a drop in agricultural real estate asset values due to negative returns on operations.
- Consumer demand continues to trend towards healthy and higher-quality foods (i.e., organic, all natural, traceable origin), with an added emphasis on convenience and value-added products.

(f) Consumer

- Consumer lending has leveled off and, in some cases, slowed. Asset-quality and delinquency trends remained relatively favorable in 3Q17, with improvements in nonperforming loans and stability in net charge-offs.
- Consumer sentiment remains solid overall. November's consumer sentiment index (University of Michigan) fell to 97.8, off strong gains seen in October.
- There continues to be intense competition from digital consumer-lending platforms.
- Auto sales increased considerably in September. September logged the first year-over-year increase in 2017 (+4.8%), driven by replacement-vehicle demand in hurricane-affected areas. The impact was expected to continue into October.
- Wholesale used-vehicle prices reached record highs in September. Prices increased 6.3% year over year and 2.8% month over month, driven by tightening inventories. Much of the wholesale price growth is attributable to recoveries following the recent hurricanes.
- Credit card account originations have seen a decline year over year. Despite this decline, outstanding balances have seen a healthy increase, at 7.5% year-over-year growth. The growth in balances has been coupled with growing delinquency rates and write-offs.
- Student and unsecured originations continue to see steady growth, while credit quality remains stable.
- HELOC demand has increased, driven by a rise in home values that is in turn offset by paydowns on older vintages of HELOCs.

(g) Home Lending

- The mortgage market has tightened since the U.S. presidential election, as higher interest rates have substantially weakened mortgage-refinance and home equity volumes. However, a strong labor market and continued economic growth are expected to support growth in purchase activity, which will modestly offset lower refinancing volumes.
- Total mortgage debt is currently 9.1% below the peak levels seen in October 2008.
- Markets are becoming more competitive with the expansion of digital offerings from non bank lenders and emerging digital start-ups. Some banks have announced plans for digital offerings, which will enable a large portion of the mortgage application process

to be completed online or via a mobile device.

- Banks are viewing the attractiveness of the mortgage and home equity space differently. Certain banks are exiting and others growing their mortgage and home equity lending platforms. Nonbank lenders now exceed 50% of new mortgage originations.
- The industry is monitoring the impact of new tax legislation that may affect the benefit of the mortgage interest deduction for homeowners. New legislation has the potential to impact home values and slow home-sales growth, particularly on the West and East Coasts.

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

- Consumer and business sentiment remains high. While the political and regulatory environments are creating uncertainty, most believe that any reform will be beneficial to operating conditions.
- Generally, Council members have seen stable operating environments across the board. Intense competition in the middle-market and corporate space is resulting in aggressive financing pricing and structures.
- Areas appearing to have the most variation in Council members' outlook include small business, commercial and residential real estate, and consumer lending, potentially due to regional differences.
- Manufacturers are increasingly voicing concerns regarding the availability of unskilled and skilled labor.

Item 2: Federal Reserve Regulation and Bank Holding Companies

Earlier this year, Bank of the Ozarks made industry news when it merged its holding company into the bank. From the Council's perspective, what are the costs and benefits associated with being a bank holding company?

Historically, bank holding companies and financial holding companies were established to enable organizations to participate in a broader array of activities than those allowed at the bank level. Their popularity climbed with the advent of trust preferred securities, which provided holding companies with the ability to issue parent-company debt and downstream it as equity capital to the insured depository. As the gap between what a bank can do and what a bank holding company can do has narrowed, and with the initiation and then elimination of trust preferred obligations qualifying as tier 1 capital, some of the reasons to maintain a parent company have diminished.

Today, the Council believes that the costs and benefits of being a bank holding company are largely dependent upon the strategic business model of each banking entity. In general, banking companies that are complex or that offer a variety of financial services are more likely to conclude that a BHC or an FHC structure aligns with the ability to execute their business plan. However, institutions that conduct nearly all of their activities through their bank and bank subsidiaries may find the potential reduction in costs and regulatory simplification of collapsing their bank holding company to be compelling. That was apparently the case for Bank of the Ozarks. Banks should consider the following factors, among others, to evaluate whether a BHC is appropriate for their enterprise:

Costs:

- ***Regulatory simplification*** – For national banks and nonmember banks, maintaining a bank holding company requires additional regulatory oversight by the Federal Reserve

Board. Eliminating the holding company may reduce the time and resources the organization dedicates to meeting the demands of multiple regulatory agencies, including examinations and applications.

- ***BHCs over $50 billion*** – Bank holding companies with more than $50 billion in assets are subject to Comprehensive Capital Analysis and Review (CCAR) participation and compliance, including the qualitative component of the capital rule, the requirement to develop a resolution plan to be used in the event of potential failure or material distress, Department of the Treasury fees for larger banking institutions, and Federal Reserve charges for SIFI supervision activities. National banks, member banks, and nonmember banks are not subject to CCAR.
- ***SEC Registration and Oversight*** – Bank holding companies are subject to the offering-registration requirements of the Securities Act of 1933, while banks are exempt from those requirements. In addition, a public holding company's securities filings and investor reporting are subject to oversight by the SEC, rather than the bank's federal banking regulator, leading to potentially inconsistent regulatory expectations and directives.
- ***Tier 2 capital cost*** – The cost of subordinated debt issuance may be higher under a BHC structure, as debt service at the holding-company level often requires a higher rate of interest to offset the lower ratings provided by credit rating agencies. While issuance at the bank level eliminates the adverse-rating disparity, regulatory capital rules disqualify a portion of the capital issued by an insured depository upon consolidation; consequently, more debt must be issued to have the same amount qualifying as capital.

Benefits:

- ***Expanded powers*** – BHCs and FHCs can conduct a wider range of activities than banks, for example, they can offer financing that would be ineligible as a bank receivable, engage in insurance and broader securities underwriting, acquire minority interests in non-financial enterprises, facilitate out-of-state acquisitions in certain jurisdictions that preclude interstate bank consolidation, and own companies that provide services outside of insured depository requirements.
- ***Capital flexibility*** – A BHC structure may provide flexibility in raising capital and other debt. Bank dividends and stock repurchases are constrained by state and federal law that require prior regulatory approval, whereas BHCs are subject to a notice requirement. Investors may have a higher level of confidence in a BHC's ability to support dividends or stock repurchases in the event of an economic downturn.
- ***Source of strength*** – The BHC may be positioned to improve the bank's capital and credit profile by downstreaming debt as equity capital or by acquiring distressed assets from the bank. Segregating financial services from the bank may also compartmentalize risk, as the bank and FHC may be more insulated from claims than under a single bank structure.

Conclusion:

Whether a bank has the independent ability to execute the organization's business plan may likely be the paramount concern in determining whether the company needs to be a bank holding company. In the absence of a complex structure or the need for a financial holding company, a number of banks may decide the regulatory burden of maintaining a parent company exceeds the value that the additional flexibility a BHC structure provides.

Item 3: Regulatory Change

Some regulatory reforms require legislative action, but other reforms can come through action by regulators. What specific actions do the Council members think regulators should take to reduce regulatory burden without impairing, or what actions could perhaps improve, the efficacy of the banking system?

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) and its subsequent regulations have made significant progress in improving the stability of the U.S. financial system. Banks have engaged in activities to strengthen risk management practices, including making significant investments to better monitor and evaluate risk. While the rules and regulations resulting from Dodd-Frank have largely improved the stability of the financial system, the Council believes that the current phase of maturity provides an optimal time to evaluate the efficacy of these rules and regulations and make appropriate adjustments. The U.S. Treasury Report, "A Financial System That Creates Economic Opportunities," published in response to Executive Order 13772, includes ninety recommendations, approximately fifty-five of which could likely be executed by federal regulators without direct legislative action. The Council supports the consideration of the recommendations in this report but encourages federal regulators to reevaluate the construct by which the rules and regulations were originally established. To do so, the Council recommends ensuring that rules and regulations are appropriately tailored to the size and complexity of the institution subject to the regulations, that efficiencies are achieved through increased interagency coordination, and that existing and proposed rules are transparently reevaluated. Leveraging this construct for reevaluating existing regulations, the Council recommends the following opportunities to reduce regulatory burden while improving the efficacy of the banking system.

Transparently Evaluate Existing and Proposed Rules

While the development of some rules required limited transparency; in general, a lack of transparency results in inefficient processes and increased compliance costs. The Council encourages the regulators to reevaluate existing rules and seek public input to ensure the rules and assumptions are efficient and effective. In addition, agencies should ensure that all new rules and regulations are published for notice and comment.

- CCAR supervisory scenarios, assumptions, and estimation methodologies should be published to allow for enhanced dialogue between banks and regulators and more effective challenge.
- Ensure that CCAR quantitative results and their primary drivers are transparent to local examiners in order to facilitate supervision and limit the potential for errors to persist.
- Reevaluate and transparently address assumptions leveraged in the liquidity coverage ratio (LCR) process.
    - o The types of assets considered to be high-quality liquid assets (HQLA) are currently restrictive and have the potential to increase pro-cyclicality, as the onset of stress will increase demand for a limited supply of level 1 assets. To mitigate this risk, all U.S. GSE securities should be considered level 1 assets, and the Board should evaluate other related recommendations in the Treasury Report.
    - o Runoff assumptions are currently overly conservative and exceed historical experience.
- The proposed NSFR (net stable funding ratio) should be evaluated to ensure that the key objectives of the rule are not already met by existing requirements.

- Resolution-plan feedback should be provided timely and transparently.
- Resolution-plan guidance should seek stability, and proposed changes common to all participants should be published for notice and comment rather than as confidential supervisory information.
- Reevaluate and seek comment on the Volcker Rule definition of "covered funds" to ensure it is based on characteristics of hedge funds and private equity funds and to ensure the market-maker exemption includes a broader array of capital-markets activities.
- Ensure that the SLR (supplementary leverage ratio) assumes its appropriate role as a backstop by recalibrating the definition of leverage exposure to exclude cash, initial margin on centrally cleared derivatives, and Treasuries.
- Evaluate the potential impact of CECL (current expected credit loss) accounting standards on regulatory capital and seek comment from the industry.
- Increase clarity and transparency around the goals and procedures of horizontal reviews.
  - By clearly establishing goals and expectations in advance, banks can begin to address self-identified weaknesses sooner rather than waiting for a supervisory issue.
  - Eliminate the tendency for best practices at more complex banks to "trickle down" and become guidance or supervisory issues for less complex institutions.
- Evaluate opportunities to modernize the Community Reinvestment Act for today's market dynamics, as detailed in the September 2017 Federal Advisory Council Record of Meeting.

Increase Interagency Coordination

The new regulations required by Dodd Frank have been implemented by various federal regulators or combinations of regulators, where appropriate. The Council encourages the Board to increase coordination of supervisory activities with the other agencies to reduce redundant requirements and identify efficiencies.

- The Board's and FDIC's shared oversight of the Dodd-Frank resolution-plan process should be coordinated with the FDIC's resolution-plan requirements for covered insured depository institutions in order to maximize production efficiency.
  - Submission dates for the two types of resolution plans should be coordinated to allow banks to achieve efficiencies in data collection and resource planning.
  - Data collection requirements for both resolution plans are largely redundant with other regulatory reporting and are already stale by the time of submission, limiting their value in the event of an actual resolution.
- The agencies responsible for Volcker Rule oversight should ensure effective coordination or nominate a single agency to lead compliance with the rule.
- The Federal Reserve should engage with the other agencies to ensure that the process for identifying issues that that result in matters requiring attention (MRAs) and matters requiring immediate attention (MRIAs) is better coordinated and more transparent so that banking institutions can manage remediation more efficiently.
- The Board is encouraged to increase coordination of consumer compliance with the Consumer Financial Protection Bureau (CFPB).
  - Supervisory examination work is frequently duplicated in areas such as UDAP/UDAAP, HMDA, fair lending, and consumer harm.
  - Federal Reserve supervisory processes and ratings have been unduly inhibited, delayed, and influenced by CFPB supervisory processes and ratings.
- Council members encourage the Financial Stability Oversight Council to play an active role in coordinating supervision by the various federal agencies.

Risk-Based Tailored Regulation

While Dodd-Frank's asset thresholds ($10 billion and $50 billion) for enhanced supervision would require legislation to adjust, regulators have the ability to tailor how they apply subsequent rules and regulations to the banks above these thresholds. By developing a multifactor, risk-based approach to tailoring regulation, the Federal Reserve can ensure that banks are effectively identifying and controlling risk rather than simply executing compliance exercises.

- Initial efforts to tailor CCAR have been effective, but further tailoring is necessary to appropriately size regulatory expectations and ensure efficient capital management.
  - Community and less complex regional banks should be exempt from CCAR/HCR, and capital planning should be supervised through ongoing monitoring.
  - The application of qualitative failures should be further limited.
  - Banks should be allowed to manage capital outside of an annual submission or manage capital to a ratio rather than by dollars paid.
- In addition to effectively tailoring the CCAR exercise, the Board should eliminate intracycle stress testing not required by Dodd Frank.
- Dodd-Frank only requires nonbank financial companies to submit a resolution plan to the agencies periodically. For firms that pose limited to no systemic risk, the regulatory burden of producing this plan annually should be addressed and tailored.
  - G-SIBs or banks with cross-jurisdictional activity should submit plans biannually.
  - For less complex domestic banks, new plans should only be submitted when there are material changes in the bank's complexity or organization that could impact its orderly resolution.
  - While not under the Board's purview, the requirements and cadence of the CIDI plan, which is not required by legislation, should be similarly reevaluated and tailored.
- Application of the LCR could be tailored based on the increased liquidity risk posed by a bank's varying levels of cross-jurisdictional activity. This approach would allow for more flexible liquidity-risk management, while focusing supervision on the areas of greatest risk.
- Regulators should consider opportunities to tailor Volcker Rule compliance activities, which could be streamlined for less complex institutions that have limited trading operations.
- The Council also discourages the Board from conservatively tailoring, or "gold plating," capital and liquidity regulations to better maintain level-playing-field considerations among banks.

Item 4: Bank Boards of Directors

The Federal Reserve Board recently proposed revised guidance for the banking entities under its supervision concerning the role of their boards of directors. The guidance is intended to refocus large institutions' boards on core responsibilities and reduce unnecessary burden on smaller institutions' boards. What is the Council's perspective on this proposed guidance?

The Council strongly supports the direction and tone of, and the principles outlined in, the Board's proposal setting out new expectations for bank boards of directors. The Council commends the Federal Reserve for acknowledging the importance of and distinguishing between a board's duty to provide active oversight versus bank management's responsibility for conducting day-to-day

operations. As the proposed guidance suggests, bank boards currently devote a significant amount of time to satisfying supervisory operational expectations that could and should be more effectively handled by management. This situation diverts a board's time and attention away from its core governance responsibilities.

In that light, the Council has several clarifications, augmentations, and encouragements that we ask the Federal Reserve to consider:

- Language in the proposal should be carefully considered to be consistent with the appropriate roles of the board and management. In best practices, the board is fundamentally responsible for (i) selecting the CEO and providing related motivation, guidance, and succession planning; (ii) helping management develop strategy and commensurate risk appetites; (iii) holding management accountable for executing the strategy and risk management; (iv) providing oversight for key capital management and risk management objectives, policies, functions, and positions; and (v) setting the tone at the top in regard to the organization's purpose, culture, and ethos. Management is fundamentally responsible for (i) developing strategy and risk appetites with help from the board, (ii) executing the bank's strategy and risk management program on a day-to-day and periodic basis, and (iii) implementing other policies and procedures, as approved by the board.
- Further guidance is needed regarding the role of board committees in corporate governance; specifically, guidance is needed on the conditions under which a board may delegate responsibilities to a committee. The Federal Reserve should expressly acknowledge that any board function identified in a regulation can be appropriately fulfilled by either the board or a duly authorized board committee; alternatively, the Federal Reserve could clearly identify the rare instances when delegation to a board committee is not acceptable.
- As the Federal Reserve recognizes, directors are already subject to a host of governance and fiduciary requirements (state and federal laws, SEC rules, exchange listing requirements, etc.) outside of the Federal Reserve regulatory framework. The Federal Reserve's requirements should avoid being overly additive to or in conflict with the existing requirements, which are both comprehensive and appropriate.
- The Council encourages the Federal Reserve's plans to review and coordinate the proposed guidance with related guidance and requirements from other agencies in order to achieve interagency consistency and efficiency.
- Any finalized guidance should be principles-based versus prescriptive and should not be used as a compliance checklist. Guidance should be applied flexibly and in a measured way, based on each financial institution's size, complexity, business model, and culture, in addition to other unique, institution-specific factors. The Federal Reserve's current method imposes a more uniform and rules-based approach to governance on diverse institutions, which adds costs and distracts boards from their primary fiduciary duties noted above.
- To achieve the Federal Reserve's desired return to the appropriate roles of boards and management, examiners must be equipped and trained so that they are comfortable with supervising under the new guidance, including being able to differentiate between appropriate supervision for large, medium, and small or less complex institutions.
- Boards and management should be jointly responsible for agenda development and the associated information flow, but management should have primary responsibility for initial agenda development. The board should be responsible for oversight, comment, and major changes.

- MRAs and MRIAs should be sent to and addressed by management only, unless management has not taken appropriate and timely action to address the specific issue or the issue is related to board governance. Boards, however, should be responsible for overseeing management's effective, timely resolution of the issues giving rise to MRAs and MRIAs.
- The Council recognizes that board self-assessments are an important tool to manage board effectiveness. For examination purposes, having banks provide a description of their self-assessment process and then discussing their process with examiners would be sufficient and optimal.

The Council very much welcomes the revised board of directors guidance. With the above suggestions, we believe the Federal Reserve's refocus on the core duties of boards of directors will improve the effectiveness and efficiency of governance and the safety, soundness, and compliance of financial institutions. Furthermore, the current regulatory framework increases the time burden and personal risk imposed on bank directors. The new proposal will allow banks to attract more qualified directors, which will strengthen governance, strategy setting, and ultimately, outcomes for individual institutions, the financial system, and the economy as a whole.

Item 5: Equifax Data Breach

What are the implications for the banking industry stemming from the Equifax data breach? What actions, if any, are needed from bank regulators?

Equifax's investigation and remediation of its data breach has shown that the breach was a straightforward attack with several implications for financial institutions, in addition to the attack's impact on consumer confidence about the security of their data. The breach reportedly affected the personal information of nearly 150 million persons. As a result, the data banks typically use for many business purposes, such as granting credit or authenticating customers' accounts or identities, may be less reliable. To date, Council members and their peers have experienced limited direct impact, but reports of incidents are expected to grow over time. Consumers may also experience delays in credit processing due to expanded data integrity questions, computer processes, and related security matters.

Specific implications for banks include the following:

- Management of vendor relationships must be a critical focus of a financial institution's information security program.
- Most breaches, including the Equifax breach, result from known vulnerabilities, which highlights the need to have strong cyber policy and procedures.
- The ability to authenticate customers' identities and accounts is fundamental, and banks must engage in a discussion across the public and private sector about new identification solutions, including alternatives to Social Security numbers. Advances in alternative authentication (active and passive) and biometrics will help strengthen authentication processes. The Council supports improving regulatory frameworks and laws in order to support these developments help ensure that innovation can take place.
- Organizations need to prepare for addressing a cyber incident with the same level of diligence that they put into preventing one, including robust communications with both the public and their commercial partners.

Council members pointed out that, while banks are subject to robust third-party risk management requirements, banks' control over how third parties (such as credit bureaus) store and process sensitive information is limited.

From a regulatory action standpoint, Council members believe that greater, more consistent regulatory oversight is needed for shared service firms such as Equifax and for firms that share consumer data. Banks are subject to extensive cybersecurity requirements, supervision, and examinations. The industry is collaborating with regulators on cyber-regulatory harmonization to improve oversight and increase efficiency. Nonbank financial or other institutions, such as credit agencies, are primarily overseen by the Federal Trade Commission and CFPB, which take a remedial approach. All firms that store data should be held to proactive preemptive standards.

Council members note the responsibility the financial industry has to manage cyber risk on a systemic basis. Shared- service firms often maintain significant amounts of consumer data. Developing greater regulatory consistency for cybersecurity will require a strong partnership between the public and private sector, including a discussion about the proper oversight of each sector and its components.

There also is a role for regulators in the ongoing discussion around the development of a new "digital identity" program in the United States. In light of Equifax's and other recent breaches that have exposed a significant amount of data that banks use to authenticate their customers' identities, participation in this discussion is a critical step to maintaining consumer trust.

Item 6: Tax Reform

How will the proposed legislation on tax reform affect the banking industry? What bank customers stand to benefit the most from the potential mix of lower rates and reduced deductions? What effect does the Council believe these efforts to change the tax code may have on economic growth?

Background and Overview

U.S. tax reform is currently very much in flux: the House recently passed its bill, while the Senate has issued its own proposal that differs in significant respects and continues to undergo revisions. Whether or when the comprehensive reform proposals will pass into law is uncertain, as is the final form the law would take. However, the bills are – at present – broadly consistent across several key provisions that will have an impact on the banking industry and on its individual and corporate customers, largely in the form of a $1.5 trillion tax cut. The proposals put forth include:

- a reduction in the corporate tax rate from the current level of 35% to 20% (taking effect in 2018 per the House bill but pushed to 2019 in the Senate proposal);
- a reduction in individual tax rates, weighted towards the middle class;
- a shift towards a territorial system, under which most earnings from business operations in overseas markets would only be taxed at the host-country rate and where a one-time, mandatory "deemed repatriation tax" would be applied to all earnings currently invested abroad;
- denials or limitations of various common deductions, exclusions, and credits, in particular (i) denying a corporate tax deduction for *net* interest expense above certain levels, (ii) denying a deduction for related-party business expenses over a certain threshold; (iii) denying an individual tax deduction for state and local taxes – including property taxes – and for certain amounts of mortgage interest and home equity loans (with the House and Senate offering competing proposals), (iv) eliminating the tax benefits for income from

certain municipal bonds, community reinvestment, and other development programs, and (v) denying a tax deduction to large banks for their FDIC premiums; and
- certain other beneficial provisions, including a near-doubling of the standard deduction, the immediate capital expensing of investments for businesses, and a lower corporate tax rate for certain exported goods and services.

Impact on Banking Industry and Its Clients

For the banking industry, U.S. tax reform should have a net positive impact, tied to the expected improvement in the U.S. economy. A reduction in the U.S. corporate tax rate to 20% should increase investment activity through many sectors of the economy, which should then lead to greater demand for financial services. Somewhat offsetting these positive impacts are the upfront write-downs of deferred tax assets that accompany lower tax rates and the upfront reduction to regulatory capital, recovered over time through a lower tax rate. In addition, the House and Senate bills remove the deductibility of FDIC premiums and certain tax-advantaged investment programs. Further, the proposed limitation on the deductibility of related-party expenses could have unintended consequences for the banking industry and needs to be addressed. The proposals limiting the deduction for *net* interest expense do not affect banks directly but may result in some short-term headwinds on the demand for credit. Similarly, the proposed limitations on mortgage interest may have a short-term impact on the housing market.

Across our corporate client base, the effects of U.S. tax reform are varied. For high-tech and pharmaceutical companies, the ability to repatriate earnings accumulated outside the U.S. is a particularly important feature. While repatriation may certainly lead to greater U.S. investment and merger activity, additional debt and share buybacks are also likely to occur. Capital-intensive industries will benefit from the immediate deductibility of capital projects, though those industries that rely heavily on debt financing for investment may be adversely affected by the new limitations on net interest deductions. High tax rate industries, such as energy and service industries, will clearly benefit most from a reduction in the corporate tax rate to 20%. Retailers may benefit from an expected increase in consumer spending. Multinationals across the board should benefit from a switch to a territorial system, which will allow companies to compete on more level terms with non-U.S. companies in overseas markets, while providing appropriate safeguards against certain investments in low-tax jurisdictions. Small businesses, other than pure service businesses, should benefit from the lower rate applicable to pass-through entities, resulting in more investment dollars for growth. Limitations on the deductibility of mortgage interest may have a temporary dampening effect on the real estate market in certain parts of the country and on related businesses.

For individuals, the reduction in individual tax rates in most brackets and the doubling of the standard deduction should return more money to the average family, which should spur consumer spending in many parts of the country. While individual tax provisions are expected to have sunset dates, we still expect to see a net positive impact in consumer sentiment. However, this impact is expected to vary across the country, as the denial of state and local tax deductions will negatively affect individuals in high-tax states and cities. In addition, changes to provisions dealing with low-income housing tax credits and private activity bonds (in the House bill only), which allow state and local governments to borrow on behalf of not-for-profits, could have a negative impact on the affordable housing market.

Impact on Economic Growth

The proposed individual and corporate tax cuts should be a catalyst for the demand for goods and services across many parts of the economy. This increased demand is expected to immediately

boost economic expansion, estimates range from 0.5% to 1.0% of incremental GDP, as well as spur some level of sustainable dynamic growth. Whether this expansion can be achieved will depend in part on consumer and business response. Indeed, as noted above, tax reform presents some potential risks to specific sectors, such as housing, and certain types of businesses. In addition, consumer spending in certain regions of the country may experience a temporary setback as a result of the loss of state and local deductions or because of the compression of individual tax brackets. Further, if dynamic economic growth does not sufficiently offset the $1.5 trillion net tax cut, private investment and consumption could be negatively affected by the budget deficit, increasing the need for spending cuts, which in turn can slow anticipated GDP growth.

For the labor force, increased spending by businesses benefiting from corporate and pass-through tax cuts would potentially boost the pace of employment, especially if regulatory relief kicks in at the same time. Firms' hiring intentions are strong and generally lead the unemployment rate by 12 months, suggesting an already tighter employment backdrop in 2018. Thus, the Council also expects businesses to channel new investment dollars made possible by tax reform towards improved labor productivity. In large part, this investment is expected to take the form of badly needed automation of routine functions and the retraining of the labor force to meet other business challenges.

Capital investment is already expected to grow in 2018 based on the Duke University CFO survey as well as the traditional nine-month lead of the Federal Reserve's senior loan officers' C&I lending standards data. Hence, immediate expensing should generate meaningful additional expenditures, though such pickups typically occur when capacity utilization tops 80%.

Item 7: Economic Growth and Inflation Outlook

While economic growth has continued, inflation has been unexpectedly low. Among Council members' business customers, what is their outlook for the pace of sales growth over the next twelve months? What are their plans or expectations with regard to pricing?

Overall, business confidence continues to improve, driven largely by expectations of tax and regulatory reform. Strong equity markets, low unemployment, and low gasoline prices are also contributing to the positive sentiment.

Small businesses remain optimistic about the economy, but many are continuing to hold off on capital expenditures and wait for tax reform, health care reform, and deregulation. Council members report that many small business clients are taking a "wait and see" approach to capital investment.

Tech companies appear to be more optimistic on economic growth and report they will be increasing capital expenditures and investment in research and development in the next twelve months.

Retail and agribusinesses are more pessimistic. Increased competition from online retailers is squeezing retailers' margins. Low commodity prices and high input costs are curbing profits for agribusinesses.

Sales Growth

- Sales-growth expectations for the next twelve months are generally positive but vary widely by industry sector.
- The latest Middle Market Indicator from the National Center for the Middle Market noted that 41% of the responding companies said their new-order pipeline had grown, which is 10

full percentage points higher than this reading's level at this time in 2016.

- Small business customers are indicating modest growth expectations and are hopeful that tax cuts will spur spending and drive increased sales.
- Retail clients report a range of expectations, from just "holding their own" to complete devastation, as they face an increasingly challenging Amazon-type business model.
- Auto sales are generally expected to be flat.
- Agribusinesses are expecting flat to slight decreases in sales volumes.

Pricing

- Overall, business clients report that pricing power remains somewhat limited, leading them to be especially resourceful in containing expenses in order to sustain profitability.
- Wage increases are expected to be a modest 2% to 3%, oftentimes not enough to cover the increased cost of employees' health insurance. Wage pressures seem to only occur when employers recruit talent from outside their organization.
- Continuing advances in technology and automation, along with persistent global competition, are likely contributing to the sluggish wage growth.
- The exception is the construction industry. Construction costs have been affected by higher labor costs. Wage inflation stemming from the recent natural disasters could further affect the total cost for new construction, as workers migrate towards potentially higher-paying jobs supported by insurance proceeds.

Some representative examples:

Large customers of several Council members illustrate the variances of expectations on growth and pricing.

Industrial manufacturer with over $4 billion in sales:

- Forecasting an increase in both sales growth and pricing during 2018, driven by cost pressures from price increases at their suppliers and the belief that the U.S. economy is growing.
- Real estate market is relatively strong, and fundamentals are strong.
- Energy is a significant input to pricing, but there is limited ability to pass through increases to clients.

Food and agriculture company with over $3 billion in sales:

- Overall growth will be 4% to 5% in 2017 and is expected to be the same in 2018.
- Pressure on margins will continue, with increases in labor and transportation costs.
- Major initiatives include (1) revisiting pricing policies, (2) improving analytics to support pricing decisions, (3) reviewing contracts with clients to tie in variances in commodity prices, and (4) increasing automation of existing facilities.

Consumer retail company with over $3 billion in sales and sources globally:

- Operating in a difficult environment, expects declining growth for 2018.
- Back-to-school season was below expectations, and there is moderate optimism for the holiday season. In the given environment, 2018 plans have been revised down.
- Limited pressure on production costs, combined with lower-growth expectations, reduces capacity for price increases.
- Actions for the next twelve months will focus on efficiency and cost reduction.

Among smaller businesses, which were generally more cautious, the following two struck a note of optimism.

Trade-show display and environmental graphics manufacturer with $9 million in sales:

- Sales increased 10% in 2017 and are projected to grow by 15% in 2018, based on orders in the pipeline and the belief that the economy is growing.
- Continuing investment in automation and technology for efficiency.
- Very little wage pressure except for new hires.
- Limited ability to increase prices and remain competitive.

Medical software company with $20 million in sales:

- Forecasting a 20% increase in sales due to a new product that significantly reduces costs and improves patient care.
- Prices are expected to increase, fueled by demand for the new product and lack of competition.
- Forecasting 3% salary increases across the board, but will really have to pay up to find new software developers.

Item 8: Monetary Policy

How would the Council assess the current stance of monetary policy?

Summary

The normalization of U.S. monetary policy is proceeding at a gradual pace, which seems appropriate given current economic conditions. Inflation is still substantially below the Federal Reserve's targeted level, but we expect modest movement towards the threshold in the next year. Financial conditions remain very accommodative; while we do not think a "Minsky Moment" is imminent, the Fed should be aware of the potential for asset-price excesses as a result of leaving interest rates too low for too long.

Tax reform would certainly have the potential to change the outlook for economic activity, inflation, and monetary policy. To this point, tax reform has not been factored into Federal Reserve forecasts or decisions. If passed, tax reform would have a positive impact on economic activity.

In summary, the Council believes the current approach to monetary policy and balance-sheet management is appropriate and should be continued.

Interest Rates

- A heightened rate of economic growth should provide context for additional rate increases in the coming quarters. U.S. GDP grew at better than a 3% annual rate in the second and third quarters of this year, and forecasts for the fourth quarter are solid. Our current expectations are for an interest rate hike in December, with two more in 2018.
- Investor expectations of future rate hikes have moved up somewhat in recent months, as growth has been solid and Federal Reserve communications have continued to highlight a desire to further normalize policy. The market is now discounting two rate hikes over the next year, which still below what Federal Reserve officials have communicated.
- The risk of collateral damage from rate hikes may be higher than in prior cycles, due to the extended period of low interest rates and the resulting increase in duration and credit risk that some investors have taken. The likely measured pace of tightening should somewhat mitigate this risk.
- However, the Federal Reserve should be mindful of waiting until inflation picks up too much before normalizing interest rates. In that instance, it would need to accelerate the pace of tightening, risking more significant market adjustments that could undermine the economic expansion.

- To this point, the Federal Reserve's forecasts have not reflected substantial changes in fiscal policy and certainly not the possibility of tax reform. If a tax reform bill passes, it could change Federal Reserve strategy.
- Long-term interest rates have remained modest, even as the Federal Reserve has raised short-term rates. The message to be derived from the relatively flat yield curve is a matter of considerable debate; some see it as a sign of imminent recession. But the appetite of global investors for sovereign bonds remains robust and may diminish the value of the yield curve as a recession indicator.

Balance Sheet

- The Federal Reserve's balance sheet reduction is underway and has been well received by the markets. Releases of assets will escalate according to a stated schedule. Barring something unforeseen, the outline for asset reduction should be followed without alteration.
- The announcement and execution of balance sheet reduction has had a minimal impact on long-term yields.
- The Federal Reserve should continue to consider the actions of other central banks.
- The Federal Reserve balance sheet is expected to reach its new steady-state level within three years, and the market is comfortable with the advanced reduction plan.

Inflation

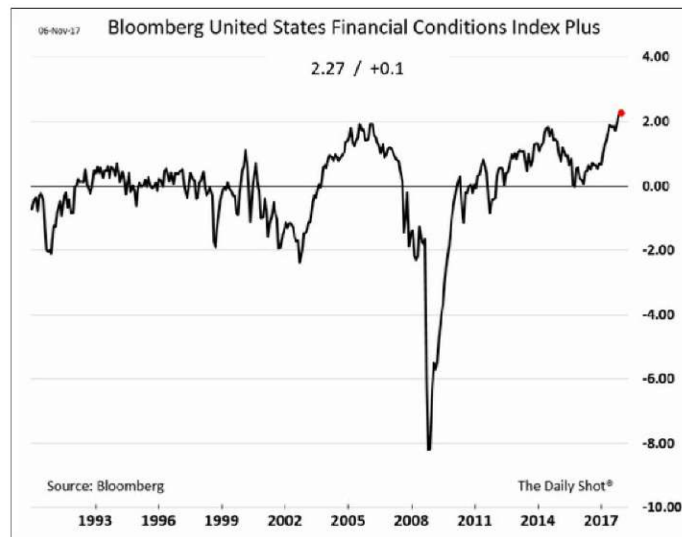
- U.S. inflation measures have retreated this year and have remained persistently below the Federal Reserve's 2% target. Transitory factors have been at play, but fundamental price pressures remain surprisingly absent. Persistently low inflation allows monetary policy to be normalized gradually.

Year-over-Year Change	Overal	"Core
Consumer Price Index	2.0%	1.8%
Personal Consumption	1.6%	1.3%

- Wage growth has yet to accelerate, despite historically low unemployment. Reasons include:
  - Low levels of productivity growth, which is tightly correlated with real wage growth over the long term.
  - Low inflation, which holds down wage demands.
  - Increasing application of automation and other efficiencies to hold down wages.
  - Global sourcing of human capital.
- There have been intermittent reports of labor-market scarcity in some sectors and regions. Firms report increasing challenges attracting and retaining qualified workers. These anecdotes may eventually aggregate and push pay levels upward.
- The disinflationary impetus of the 2014-15 drop in oil prices and the 2014-16 appreciation of the U.S. dollar are fading or reversing.
- Considering these changes and the fact that inflation expectations remain at or above 2%, indications are that inflation will firm towards the Federal Reserve's 2% objective in the medium term.

Financial Conditions

- Indices of financial conditions, which combine asset prices, market volatility, credit spreads, and other metrics, are easier today than they were prior to the 2008 recession.



- Equity prices continue to rise, supported by very strong corporate earnings. Valuation measures have increased.
- Credit spreads continue to narrow. With the exception of commercial real estate loans, bank lending standards remain accommodative.
- Leverage in the banking system is well below the leverage levels prior to the 2008 financial crisis. The potential for broad-based contagion if asset prices correct is therefore much lower today.
- The asset markets certainly bear close watching, but the risk of a "Minsky Moment" is not yet material.
- Overall, equity markets and other risky assets can adjust to a further reduction of monetary accommodation (rate rises, balance sheet shrinkage), provided the pace of increase is gradual and generally in line with market expectations.