Record of Meeting

Community Depository Institutions Advisory Council
and the Board of Governors

April 1, 2021

1. Economic Discussion:

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

Council members reported overall improving economic conditions across all Districts and are cautiously optimistic as states push to reopen now that the COVID-19 vaccine is being distributed and—in most locations—infection rates are falling. Consumer confidence has started to rebound, and Council members believe that consumers have a strong pent-up demand that will translate into increased spending over the next few months. However, conditions vary a great deal by geography, demographics, and industry.

Districts, such as the Seventh and Eleventh Districts, with states that have lifted social distancing restrictions and mask mandates, have reported rapid improvement as consumers begin to return to normal pre-pandemic activities. Exurban, rural, and suburban economies are also doing well, in part due to the many families that have migrated from urban areas. In addition, the manufacturing sector is strong, with high demand.

Conversely, states dependent on tourism are still experiencing a downturn, as are rural areas with broadband issues that are unable to attract migrating families who want to work from home or operate out of second homes. The hospitality and restaurant sectors have experienced continued strain in most markets, though Council members in the Seventh and Eleventh Districts noted some improvement. Urban markets and states with stricter COVID-19 restrictions have also had a more subdued recovery.

Council members were uncertain if the recent improvements reflected fundamental strength in the economy or simply a temporary boost due to the stimulus or COVID fatigue. Continued improvement remains dependent on the ability to effectively manage infections and virus mutations as well as on the success of the vaccine rollout. It seems to be a question of when—rather than if—the economy will improve, with rates of improvement varying by sector and geography.

b. Particular Indicators:

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

Three-quarters of Council members reported rising and worrisome inflationary pressures in their Districts. These Council members found inflation in their markets to be well ahead of the 1.4% headline inflation rate. Prices have been rising for fuel, construction materials, labor, and farm inputs. A rise in housing costs and in the prices for food and used cars has also been observed.

Council members noted that prices for suppliers have risen significantly, often escalated by tariff restrictions, and after a delayed response those higher prices are being passed on to consumers. Persistent supply chain disruptions, pent-up demand unleashing as the pandemic abates, and an acceleration of supplier price pass-through to consumers could be a perfect storm that bursts the bubble of perceived price stability. The likelihood of further large increases in fiscal stimulus is also disquieting in the current circumstances. Moreover, there is an abundance of liquidity to support an acceleration of spending should price expectations shift. Most Council members are concerned that inflationary pressures will be sustained rather than transitory.

ii. *<u>Housing</u>: How have home prices changed in recent months? Have there been any changes in overall housing activity in Council members' Districts?*

All Districts reported a hot housing market in exurban, suburban, and most rural areas, as families have migrated from urban areas to homes with more space to accommodate remote work. Record low inventory and raw material supply chain constraints have resulted in available homes continuing to sell quickly and above listing prices. As a result of strong price appreciation—particularly in suburban areas where demand continues to outpace supply—appraisals are lagging market prices. This lag, while disruptive to buyers, has not encumbered financing as much as one might expect.

Single-family home prices have continued to rise across nearly all Districts except for rural areas that have declining populations or broadband limitations. Council members noted weak prices for urban condos in the Northeast and rising prices for condos in vacation spots and growing metro areas with younger populations—particularly in the Sunbelt and on the West Coast.

Council members noted that many low- and moderate-income (LMI) households have been squeezed out of the housing market because of the highly competitive environment. Meanwhile, strong migration into suburban and exurban areas has placed a strain on local infrastructure.

iii. *<u>Labor Markets</u>: How have the labor markets in which Council members operate changed in recent months? In particular, please assess the degree of job loss or gain (and, in which industries). Please highlight in particular the impact of the pandemic on employment in the communities in Council members' Districts. What changes to wages have Council members observed over the past year?*

While employment levels have slowly improved, nearly all Districts reported that labor conditions remain strained. Unemployment remained high in sectors hardest hit by the pandemic, labor demand outpaced supply in some sectors and skill levels, and uncertainty lingered about the impacts of remote work.

While the headline unemployment rate fell to 6.2%, unemployment remained high for workers in sectors hardest hit by the pandemic, such as hospitality, restaurant, and tourism. Council members in the Tenth District raised concerns that unemployment has remained elevated in Hispanic communities, whose members disproportionately work in service sectors. Other Districts concurred. Conversely, upper-income households have nearly returned to their pre-pandemic levels of employment, and middle-income household outcomes are improving.

Nearly all Council members observed labor supply shortages in certain industries and skill levels. For example, as manufacturing has strengthened in the Third District, warehouse development has grown and become more dispersed, spreading the demand for labor. Manufacturers offering wages of $40 an hour are facing challenges finding qualified workers. Even the hospitality sector is having a difficult time finding labor in vacation areas that are on the rebound. Many workers continue to face housing and childcare constraints that prevent them from returning to work. Other workers are receiving more income from the economic stimulus package or the expanded unemployment benefits than what they are being offered from firms.

With regards to remote work, Council members have observed changes to the competitive landscape for recruitment. In the Fifth and Eighth Districts, for example, firms have started to expand the geographical areas where they scout for talent. This has led to stiffer competition and higher labor rates that are creating shocks for the firms operating in those markets. There is also greater uncertainty about the impact of remote work on productivity and company culture. More employers are feeling disconnected from their employees and have reported growing concerns about loss of control of productivity and work product. Council members reported that work-from-home policies may be negatively affecting the levels of employee engagement and eroding company culture.

iv. <u>*Consumer Confidence*</u>*: Are Council members seeing any signs of improved (or declining) consumer confidence? What is the outlook for consumer credit losses?*

While consumer confidence is lower for those who have been hardest hit by the pandemic, Council members reported a general rise in consumer confidence across all Districts. Much of this improvement has occurred in the last month, driven by a more successful vaccine distribution and falling COVID-19 infection rates in most areas. Council members reported that people are encouraged by the improvements, which signal a return to a more normal environment.

Council members reported that consumer credit losses have remained muted. Many consumers have been using their stimulus money to pay down debt or cushion their savings. Council members reported that the number of consumer loans on deferral is low, most deferral exits have remained current on payments, and the percentage of new consumers requesting deferrals has dropped.

2. Current Banking Conditions: *What is the Council's view of the current condition of, and the outlook for, loan markets and financial markets in general?*

a. Small Business Lending: *Have small business credit availability and demand changed significantly? Have lending standards for these borrowers changed given the impact of the pandemic on small businesses? Please comment on any observed increase in small business closures that may not be captured in the aggregated data and the impact of those closures on community depository institutions and the communities in Council members' Districts.*

Council members commented that small business credit demand has weakened to varying degrees across all Districts, with demand for Paycheck Protection Program (PPP) loans offsetting much of the decline. Demand for PPP funding, however, has reportedly weakened in the latest round as well. Most lenders reported receiving anywhere from one-third to one-half as many requests as they did during the first two rounds of funding. Despite weaker PPP demand, Council members commented that the latest round of PPP funding was especially well timed for sectors—such as the hospitality and small business sectors—that have continued to struggle throughout the pandemic.

Council members generally reported a tightening in standards for small businesses due to continued uncertainty. Lenders have been looking more closely at cash flows, business models, and how the pandemic may have impacted the outlook for prospective borrowers. While standards have moderately tightened, Council members reported that lenders are anxious to lend.

In the First and Sixth Districts, Council members observed small business closures, particularly concentrated in main street and micro businesses. Despite these closures, lenders reported that small business credit quality has remained strong overall. Small businesses have de-levered over the past ten years, so Council members suspect less debt has been associated with these exits. The PPP may have facilitated softer exits for those who were unable to weather the pandemic. Other possible explanations for the small business closures include exits driven by early retirements or by owners closing down and joining the traditional labor force.

Not all Council members observed small business closures. Notably, the Ninth District described few small business closures, with main street businesses and larger companies reportedly doing very well.

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

Council members reported weaker loan demand for most areas of commercial real estate (CRE), while noting a few areas that remained strong, such as certain owner-occupied, self-storage facility, and industrial real estate. In the Midwest, locations for large storage warehouses that house delivery centers for companies such as Amazon remained strong. There has been sustained pressure on commercial mortgages for hospitality and leisure properties, coupled with uncertainty for the future of office space.

An anecdote shared by one Council member revealed that property owners in Montana have been selling their properties, displacing struggling hospitality and leisure tenants. A Council member from the Twelfth District noted a disparity between urban and rural residents returning to work. Many companies located in urban areas in California—where commute times can be extensive—have chosen to extend remote work, while companies in rural areas have broadly chosen to return to the office as vaccinations gain momentum.

Council members noted a shift in concern away from the direct economic impact of the pandemic and toward long-term behavioral impacts that may affect CRE. Council members across all Districts noted that companies are broadly reducing their CRE presence, where possible and are trading larger office spaces for smaller satellite locations to better accommodate a remote workforce.

Some Council members described a surprising heterogeneity among retailers: While some retail businesses are shutting down, others are opening. — Sometimes new dedicated purpose properties are being built, often near failed retail properties that are less attractive.

c. ***Construction Lending:*** *What are Council members' perspectives on the availability of credit for construction and development projects? Have Council members seen any changes in the demand for construction loans since the Council's last meeting in November 2020?*

Council members noted strong demand for construction lending in certain sectors, especially for one- to four-unit housing. Warehouse building has remained active in many Districts as distribution systems continue to evolve and construction demand is higher from some manufacturers needing to increase capacity to meet product demand. Non-owner-occupied construction demand remains weak, and construction demand in all sectors is constrained by the high costs of materials. All Districts noted that they have experienced delays in the materials supply chain due to the strong demand.

d. ***Home Mortgage Lending:*** *What changes have Council members seen in the mortgage market? In particular, to what extent is the pandemic impacting mortgage lending (and/or servicing) by community depository institutions? Do Council members see any ongoing trends? How, if at all, is regulation impacting the participation of community depository institutions in this market?*

Council members universally reported strong demand for mortgage lending because of the sustained demand for housing. However, the Council noted that purchase mortgage lending is capacity constrained by limited and dwindling inventories, which has made finding available properties for purchase difficult for homebuyers. While community depository institutions (CDIs) have a significant volume of preapproved borrowers, many of these borrowers have not been able to find a suitable, affordable home for purchase. Appraisals are often coming in short in hot markets, and borrowers when possible are liquidating other financial assets to pay the shortfall in cash rather than lose the contract. In slower markets, a reappraisal might be sought, but in current markets a reappraisal request would likely result in the loss of the contract. The Council believes that the strong demand for limited inventory has created inflationary pressures that adversely affect LMI and certain minority homebuyers.

Many of the trends reported on housing demand and mortgage finance were evident before the pandemic and have been exacerbated by the pandemic and related policy responses. The growth of remote work, remote schooling, and needs for social distancing increased demand for housing by size, configuration, and location. In general, lower mortgage rates also fueled home demand. Low mortgage rates boosted demand for purchased homes as well as for the refinancing and remodeling of existing homes. A notable exception occurred in certain urban regions, particularly in the Northeast, where outmigration to suburbs, exurbs, and beyond reduced demand for condominium financing. Exceptions have been observed in certain resort areas and regions where there is strong in-migration, such as Denver, Dallas, and Houston.

e. ***Consumer Lending:*** *What changes have Council members seen in consumer lending through the course of the pandemic? Please share your views generally on borrowers' payment capacity in light of any changes observed in labor markets as discussed above in item 1.b.iii.*

Council members across all Districts reported weaker consumer credit demand. Household income has been sustained during the pandemic by stimulus payments and expanded unemployment benefits that often have replaced more than 100% of lost income. As a result, many households are highly liquid and flush with cash, particularly those that have retained employment throughout the downturn. Consumers not needing stimulus payments to support household expenses are using them to pay down debt balances and increase savings.

Some variability was seen in the Sixth District, where some lenders observed average indirect loan balances increase, offsetting other declines in credit demand. Additionally, demand for auto loans and other forms of consumer credit has started to rise, but growth of credit demand has been hampered by low product inventories caused by supply chain constraints.

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

Council members reported that conditions for farmers have broadly improved, though profitability and the ability to repay loans remained concerns in the sector—particularly for row crop, protein production, and dairy farm loans. A Council member from the Tenth District noted that stimulus and other government payments have eased what would have been a difficult renewal season. Agricultural sector PPP demand and direct Economic Injury Disaster Loan (EIDL) advances, for example, have been strong, reducing the rate at which producers draw on other existing lines of credit. Additionally, a late season price rally has supported agricultural producers in most commodity markets.

Council members across all Districts noted an acceleration in farmland price appreciation. A combination of improving commodity prices, low interest rates, and farmers flush with cash has led to too much money chasing too few acres of land. As a result, younger and entry-level producers are being squeezed out of the market.

In addition to rising land costs, Council members reported that rising equipment costs—along with other farm input prices—have put a strain on agricultural operations. Producers in the Fifth District, particularly tobacco farmers, continued to express interest in hemp as an alternative source of income. Conversely, interest in hemp production has waned in the Eighth District, particularly in Kentucky, after overproduction placed downward pressure on prices.

Despite the rising value of fixed assets allowing producers to tap equity for financing, Council members reported that lenders have been exercising caution. Many lenders have put firm caps on the amount they will lend per acre, regardless of the market rate, as land prices often far exceed economic production value.

g. ***Deposits:*** *What changes have Council members seen in local deposit markets? Describe these changes by segments (retail, small business, and corporate). What are Council members' expectations for the coming year with respect to deposit levels? Please also comment on how the growth in bank reserves will impact banks and their borrowers.*

Council members reported significant deposit growth in checking, savings, and money market accounts across all Districts. This growth has been fueled by federal stimulus in the form of PPP loans, direct stimulus payments, expanded unemployment benefits, and other federal assistance programs. Deposits have been coming from both existing customers and new relationships brought to the bank through government programs such as the PPP. With the passage of the American Rescue Act, this trend has shown little signs of slowing in the coming months.

The competitive landscape for attracting deposits has changed considerably. A Council member illustrated this point with an anecdote about a county treasurer seeking to deposit $100 million. Traditionally, there would be strong competition to attract such a large deposit. In today's environment, it is challenging to find a place to put this sum to work at most CDIs. In the case in question, the bank would have needed to charge a service fee—effectively resulting in a negative interest rate—to make the deposit economically attractive, so the deposit effectively was declined.

Council members expressed concern about how the incredible volume of deposits flooding into the banking system could be deployed effectively, what impact the deposits might have on capital ratios, and whether the volume would lead to looser underwriting standards or drive pricing competition between lenders in an already low net interest margin environment. One Council member questioned whether ballooning deposits could jeopardize the business model of community financial institutions.

3. **Technology:** *How are Council members integrating digital technologies into their operations and strategic plans? To what extent will members pursue partnerships with financial technology companies to implement those plans? What are the most significant opportunities and challenges community depository institutions face in taking advantage of technological advancements? In particular, please comment on challenges related to third party risk management and how regulation might better address these challenges.*

Over the past year, the technological agility of many community depository institutions (CDIs) has improved and most reported significant increases in the utilization rates of mobile and online banking applications, as well as digital wallets. CDIs have launched new applications, upgraded online account opening and lending platforms for both consumer and commercial customers, and leveraged new technology to implement the PPP.

Many CDIs continue to expand their digital presence and explore additional technological strategies to improve efficiencies and remain competitive in the marketplace. However, as CDIs continue their digital transformation, bankers are contemplating how to balance continued technological improvements with the ability to maintain personal relationships, which are the cornerstone of community banking. Relatedly, bankers are mindful of unwarranted market perceptions that community bank digital tools and service offerings are inadequate and outdated.

While CDIs believe that they were reasonably well prepared for the technological demands associated with the pandemic, the majority of CDIs are concerned that the accelerating pace of change may hinder their ability to remain competitive, which could lead to further consolidation. The challenges associated with staying current from a technological perspective are compounded by several other factors, including (1) an unwillingness or the inability of core processors to help banks integrate new technologies and (2) insufficient broadband service in many small towns and rural communities.

In addition, the burden of growing third-party assessment and management challenges presents an ongoing barrier to CDI adoption of new technologies. Many CDIs have difficulty recruiting and retaining staff with the expertise needed to identify potential third-party partners and conduct adequate due diligence and ongoing oversight of these firms. As technology evolves and becomes increasingly complex, banks noted that efficiencies could be gained by standardizing the due diligence and analysis of technology providers. A coordinated approach could also enhance banks' understanding of their third parties. To be successful, such an initiative would necessitate regulatory support and participation. The Council strongly recommends the formation of a public/private partnership aimed at reducing the extreme costs and inefficiencies of thousands of CDIs attempting to conduct due diligence and oversight of a more limited number of key third-party vendors.

The challenges associated with overseeing third-party providers of technology are likely dwarfed by the macro issue of cybersecurity. Banking institutions and their prudential regulators, including the Federal Reserve, are not likely to solve the challenges of cybersecurity alone. Every personal, business, and governmental entity is exposed to attack by well-funded and technically proficient criminal minds, as well as sophisticated and persistent state-sponsored cyberattacks. The Council encourages the Federal Reserve to call for a more coordinated federal approach to cybersecurity. Council members emphasized that bank cybersecurity cannot be treated in isolation; it should be treated as part of a broader national security issue that more fully integrates the resources and expertise of all government agencies.

4. **Examination Practices:** *Have Council members experienced problems with recent examinations? Have examination practices contributed to constrained access to credit by creditworthy borrowers? What steps can be taken to address the Council's concerns? What are the Council's views on the agencies' response to banks' forbearance practices during the pandemic? Has there been an impact on bank credit quality? What credits are most at-risk? What are banks doing to monitor and mitigate credit losses?*

Council members found the examination process—even for remote examinations—to have been relatively smooth under the circumstances, with some exceptions. In general, examiners seemed focused to a great extent on the ability of banks to work with customers and help borrowers in the community during the pandemic, and appropriate latitude was provided for discretionary judgements.

Remote examinations caused some problems for banks and examiners in regions that do not have high-quality broadband services because limited broadband capacity restricted efficient file sharing that is essential to remote examination. Also, those banks that had progressed more fully toward a digital environment had fewer problems with the switch to remote examinations. Some Council members reported repeat requests for data already in the hands of the examination team, suggesting more training or software development may be needed to effectively manage data in offsite examinations. Some Council members also expressed concern that the rapid expansion of offsite examination at times resulted in inadvertent transmission of data over unsecured network lines. In these cases, examination data and customer information may have been put at risk.

Council members felt communication with the examiners at times suffered in a variety of ways because of the expansion of offsite examinations. The development of relationships with examiners did not always progress satisfactorily due to limitations sometimes inherent in offsite examination practices. Often the range of available forms of communication were not adequately exploited. Some examiners preferred communication via email only, explaining that they were not comfortable with video communications. Other examiners said that they were not permitted to use video calls. Council members generally desired more direct engagement with examiners though all means available, particularly for discussions regarding credits that were impacted by the pandemic. Council members also experienced more duplicative requests during the shift to offsite examination. Those repeated requests taxed the availability of bank staff to respond to other inquiries, and seemingly duplicated examination team efforts. The Council recommended better guidance and training to address these and other off-site examination issues.

Council members noted that the federal banking agencies' response to forbearance practices was largely positive and appreciated by the banks. Council members are concerned about what will happen going forward. When things are "back to normal," will banks be evaluated using a framework that is different than the one being used in the current examination cycle?

Council members hope examiners will continue to grant a "sufficient recovery period" for customers as the economy begins to open up. Most Council members expressed concern regarding how future examinations will look at cash flows based on 2020-21 financials for commercial borrowers that were significantly impacted during the pandemic. Council members felt that even as the economy recovered, being "back to normal" will likely not happen until all the PPP forgiveness has been processed. Until then, smaller businesses and commercial credits are likely still to be in stressed or guarded conditions. One Council member expressed optimism that CRE and business recovery is expected to be sound, while another Council member noted seasonal businesses may follow a different path to recovery. The current tourist season is starting just as COVID cases seem to be re-spiking in some tourist areas, causing a pause.

Most Council members stated that residential credits have come out of forbearance successfully. The remainder of the consumer sector was harder to assess given the impact of government stimulus checks and temporary programs providing so much relief for consumers. Concern was expressed about what will happen to the consumer sector after this cycle.

All Council members agreed that credit evaluation practices changed at the bank level as needed during the pandemic. It is uncertain if these changes will be expected to continue and, if so, for how long. One Council member noted inconsistencies within and between banking agencies regarding the credit analysis process and classification practices, and the Council members expressed concern about these variances going forward. Notwithstanding these inconsistencies, Council members said that credit monitoring through the pandemic has been more intense, focused, and frequent—including more frequent reviews of appropriate credit grades.

The Allowance for Loan and Lease Losses (ALLL) methodology is a concern going forward. Council members believe much of the increased reserves recorded in Q1 and Q2 of 2020 were unneeded, but the result of implementation of Current Expected Credit Loss (CECL) requirements. The 2020 experience likely is indicative of high ALLL volatility that will occur in the future when cyclical changes occur. Quantitatively supporting actual expectations (under CECL or under incurred loss through "Q factors") is a struggle. Council members are uncertain how the auditors will react to increased ALLL volatility. Council members also are uncertain how examiners will respond to decreasing allowances in 2021 and beyond.

5. **Legislation and Regulatory Matters:** *How are recent changes in the statutory and regulatory landscape, including those made in response to the pandemic, affecting the ability of community depository institutions to continue providing services to their customers? In particular, please comment on the impact of the interagency guidance issued in May 2020 addressing lending principles for making responsible small dollar loans and the renewal of the Paycheck Protection Program enacted as part of the Coronavirus Response and Relief Supplemental Appropriations Act, 2021. What have been the effects on the industry generally?*

Perhaps the most important developments have been the adjustments examiners have made to the approach to examinations in light of customers' stressed situations and institutions' efforts to address their customers' problems. Several Districts reported generally positive examiner responses to both customer accommodations and difficulties in processing payments related to pandemic relief programs. Examiners are, however, expecting institutions to know the details of specific customers' situations rather than offer blanket leniency. Regulatory agencies should continue to act with patience so that institutions are not forced to be unnecessarily restrictive as customers work their way out of the economic effects of the pandemic.

The PPP provided important lifelines for many business customers. More recently, changes to PPP program revenue loss floors—intended to target businesses facing the greatest pandemic-related hardships—have still excluded some badly affected businesses because their revenue declines were (barely) insufficient to qualify. As a result, some valuable small businesses will likely be lost. The Federal Reserve's Paycheck Protection Program Liquidity Facility (PPPLF) was helpful beyond the levels of actual usage because it provided the certainty of backup liquidity, which encouraged more institutions to participate in PPP. The foreclosure/eviction moratorium resulted in financial strains for some landlords, but depository institutions in most Districts generally found the moratorium to be helpful. Institutions that participated in the Main Street Lending Program noted that relatively few of their borrowers fit within its structure, but the borrowers that did qualify benefited significantly from the program.

Institutions generally found the temporary adjustments to the community bank leverage ratio (CBLR) helpful. The Council recommended that CBLR accommodations be extended until the outlook for pandemic-related excess deposits, such as PPP proceeds, becomes clear. Accommodation should be matched to deposit runoff.

Several Council members noted that the EIDL program of the Small Business Administration (SBA) includes restrictive covenants, debt limitations, and other terms that borrowers likely will find problematic as they seek to revive business activity. Overall, however, SBA relief programs have been helpful and viewed in a positive light.

Small-dollar lending guidance was helpful to the lenders who participated in that market segment; however, many institutions had been discouraged from such lending by past regulatory actions and for the most part have not been active. In addition, implementation of the small business data collection program under section 1071 of the Dodd-Frank Act is still viewed as problematic—the extent of variation in details of small business operations means data are hard to compare and may be misleading.

In other regulatory matters, the streamlined customer due diligence process promised in the National Defense Authorization Act for Fiscal Year 2020 provided for a national identity registry, which may not be working as intended. This facility was expected to relieve institutions from repetitive work and compliance risk. However, some institutions expressed concerns that the new national identity registry could instead lead to increased due diligence expenditure, more suspicious activity reports, and other complications. Council members wanted the Federal Reserve to be aware of the possible flawed implementation of the intended relief.

Council members discussed two specific aspects of climate change: how to (1) provide recognition of positive actions and behaviors (e.g., taking account of positive efforts in Community Reinvestment Act assessments) and (2) address safety and soundness risks (e.g., floodplain changes). The Council is open to consideration of how certain climate-related variables may become input to existing risk assessment methodologies, but Council members are doubtful that climate risk is independent of other risk variables normally addressed by bankers. Regardless, the financial industry in general—and CDIs in particular—need a coherent approach rather than a patchwork of ad hoc efforts. It is important to take into account regional environmental and economic circumstances and avoid one-size-fits-all approaches. Furthermore, there is a great lack of certainty and clarity about the direction public authorities will take. Council members expressed the importance of CDIs having a seat at the table as public policy is developed. The participation of CDIs in the dialogue is critical to limit potentially negative economic effects that may arise from ideas that appear to be under consideration.

In most Districts, local Federal Reserve System officials seem focused on the risks of physical damage to both borrowers and CDI property. Council members feel that some of these problems should be addressed through adjustments in hazard insurance programs and coverage. For instance, some Council members noted that official flood zone maps are outdated and static: Some former flood zones are now at lesser risk, while other areas are at greater risk. This concern applies both to coastal areas and those adjacent to major river systems.

6. **Additional Matters:** *Do Council members wish to present any other matters affecting community depository institutions that have emerged from meetings of the Reserve Banks' advisory councils?*

<u>**Regulatory Arbitrage**</u>**:**

- **Emerging Non-Bank Competitors**

  Banks and credit unions encourage competition because it drives competitive pricing and leads to innovations that result in better products and services for customers. Avoiding regulatory oversight may save a new entrant the cost of compliance, capital buffers, and other stability requirements, but it should not be mistaken for innovation, regardless of technologies deployed. Regulations exist for a reason; they protect consumers and other financial institutions that provide services and conduct transactions as counterparties. When one segment of the industry is allowed to operate under fewer rules that provide economic gain to that segment at the cost of greater counter-party and systemic risk, the overall financial ecosystem is placed at greater risk. Like financial products should be offered under like regulations, and Council members encourage the Federal Reserve to engage more forcefully in policy reforms that embrace this principle. A financial system better aligned to provide like regulations for like products and services not only encourages financial stability but is necessary for the marketplace to distinguish between companies deploying advantageous innovations from those reaping the gains of regulatory arbitrage.

- **Special Purpose Charters**

  Just as non-banks may seek to avoid like regulation for like products and services, some novel financial institutions may pose a similar threat to stability. For example, the state of Wyoming has granted two Special Purpose Depository Institution (SPDI) charters to cryptocurrency businesses that will hold uninsured dollar deposits. The deposits will be backed by 100% reserves, and the funds on deposit cannot be loaned by the bank. This structure allows those SPDIs to avoid FDIC and Bank Holding Company Act (BHCA) supervision.

Meanwhile, the OCC is considering the application for a standard charter by an institution that does not take insured deposits so that it avoids FDIC and BHCA supervision and compliance expenses. Risks should be addressed that are similar to those raised by SPDIs.

- **Access to Payment System**
  Council members believe that gaining direct access to the Federal Reserve payment system is a goal of non-traditional financial institutions. The payment system—which has operated so well for so long—runs smoothly because all financial institutions with access to it are subject to similar regulation and oversight. By having the same access to the payment system and being subject to less oversight, the SPDIs and the OCC applicant (if approved) would increase the risk for all participants and their customers. The Council members strongly feel that the Federal Reserve should carefully review any applications to the payment system from non-traditional, more lightly regulated financial institutions.

- **Central Bank Digital Currency**
  Almost all central banks worldwide are researching central bank digital currencies (CBDC) and making plans to launch pilot programs to see how an all-electronic fiat currency might improve the payment system. Council members urged caution and expressed their support of the public comments made by Chair Powell, who stated that it is more important for the United States to "get it right than be first" when it comes to the development of a CBDC. Depending on the CBDC model, the entire business model of banking may be affected. The primary bank business model consists of taking deposits, making loans, and processing payments. If the Federal Reserve were to issue a CBDC that was transmitted directly to individuals, Council members are concerned that the ability of banks and credit unions to accept deposits and make loans would be adversely affected. Similarly, a CBDC that can be transmitted to individual wallets would also reduce bank-centric payment services. Any innovation that could negatively affect the three main banking lines of business must be carefully considered before any definitive action is taken.

- **Synthetic Identity Fraud**
  Synthetic identity fraud (SIF) is the creation of a new credit file using a social security number that does not connect to an existing file. A synthetic identity is established by submitting an application for credit that is usually denied because the credit risk agency will return zero credit history on the identity. But that first ping creates a file to be used later. The large credit card banks have been the primary target for SIF. CDIs in the past have been unlikely to see SIF, but in some cases mortgage and auto loan fraud indicate this is a risk vector that small and medium-sized community banks need to mitigate.

The Fair Credit Report Act allows banks and others to check the social security number for consistency with the federal government's records without requiring a wet signature. The new electronic Consent Based Verification (eCBSV) service allows collection of consumer consent electronically to verify data from the Social Security Administration that can be integrated into the underwriting process in real time. The implementation of the eCBSV service is at the end of its pilot phase at a handful of banks and service providers. Any bank or credit union can apply for direct access to eCBSV, but almost all CDIs will access it through a third-party provider such as a core provider or credit bureau.

CDIs have been at lower risk of SIF losses in the past, but fraudsters' tactics are changing. CDIs will have to consider using eCBSV through third-party vendors, and access and cost will be critical factors. Council members encourage the Federal Reserve to communicate the importance of this service to the Council's core providers. The Council recognized the leadership of the Boston District in this area, and believes that prudential regulators have a critical role to play in managing regulatory oversight of the eCBSV rollout in terms of privacy and data security. Council members also believe that SIF is being fueled by a lack of experience and insufficient oversight of new entrants and products. Any company creating and verifying identity data should be subject to oversight comparable to that applied to CDIs.