Record of Meeting

Federal Advisory Council and Board of Governors

Thursday, December 3, 2020

Item 1: Current Credit Conditions

What is the Council's view of the current condition of, and the outlook for, loan markets and financial markets generally? Have Council members observed any notable developments for loans in such categories as (a) small and medium-size enterprises, (b) commercial real estate, (c) construction, (d) corporations, (e) consumers, and (f) homes? In addition, what has been the impact of the fiscal stimulus provided earlier in the year on current credit conditions? What impact would additional fiscal stimulus have on future credit conditions?

General Outlook

Council members noted that loan and financial markets generally continued to stabilize over the last several months due to improving economic data and consumer sentiment, as well as low interest rates and earlier government stimulus measures. Credit is generally available, but underwriting standards have tightened across all categories and pricing is dependent upon the quality of borrowers' financials, their projected cash flows, and the severity of pandemic impacts on them. Some Council members report that loan pricing can be competitive, with one recently turning down a deal due to a large international bank competitor's lower pricing.

Corporate credit ratings are also stabilizing as evidenced by recent credit rating agency actions. While these agencies are currently downgrading three times as many credits than they are upgrading, this ratio is significantly improved from the more adverse ratio of 43 times in May and is more consistent with the ratio at year-end 2019. However, Council members also state that stabilization has been inconsistent across sectors, with some sectors continuing to underperform, especially hospitality, restaurant, travel, retail, and to a lesser extent, multifamily and office.

Investment-grade bond issuance continued to be robust during the third quarter, with refinancing activity accounting for 43% of year-to-date volume, given the low-interest-rate environment. The high-yield bond market had experienced similar trends. Year-to-date, issuance of $375 billion has outpaced 2019's full-year issuance by 38%. Leveraged loan issuance, which tends to be floating rate, declined by 19% through October, compared with the same period in 2019, but there have been signs of improvement since the middle of the third quarter.

Despite the recent stabilization in loan and financial markets, the current increase in cases of COVID-19 across the U.S. could result in increased economic uncertainty with potential further economic disruption. If borrowers experience additional stress, defaults could adversely affect credit market performance and pricing.

Have Council members observed any notable developments for loans in such categories as (a) small and medium-size enterprises, (b) commercial real estate, (c) construction, (d) corporations, (e) consumers, and (f) homes?

(a) Small and Medium-Sized Enterprises

After initially declining at the onset of the COVID-19 pandemic due to lockdowns and availability of Paycheck Protection Program (PPP) funds, which provided a boost of capital to preserve jobs and cover basic overhead expenses, lending to small and medium-sized business enterprises increased in the third quarter as businesses recovered. However, loan growth has been tempered since these entities have reduced operating costs and are funding operations with existing liquidity. Line-of-credit utilization has steadily fallen since its peak earlier this year.

While PPP funding significantly aided small business in the second and third quarters, the benefits are beginning to wane at a time when COVID-19 cases are increasing, which will likely lead to the re-imposition of business restrictions.

(b) Commercial Real Estate

Council members generally agree that commercial real estate markets have experienced mixed results. In the industrial and warehouse sector, significant new acquisition activity was noted by some Council members, as the move towards e-commerce continues, which is supporting values. Conversely, the office sector is experiencing uncertainty due to an expectation of reduced space requirements, with remote work models continuing to proliferate and gain greater acceptance.

Owners of retail space, especially malls, are under pressure, with tenants struggling to pay rent as online shopping continues to gain market share. The pandemic has accelerated this long-term trend and the retail sector has seen increases in bankruptcy filings since March, with the pace slowing in the late third and early fourth quarters. Discretionary retail, movie theaters, restaurant groups, and travel-related companies have been hit the hardest, comprising almost 40% of total bankruptcies over the last nine months. Retailers offering essential items such as groceries, personal health-care products, and building materials have performed better.

Multifamily markets are mixed, with softening in densely populated metropolitan areas where vacancy rates are rising, resulting in declines of asking rents and increased concessions to tenants. However, one Council member noted that multifamily trends in Florida have been positive, with higher rent collection and growth in acquisition activity.

Council members are also closely monitoring hotel loans, which have seen significant amounts of risk rating downgrades due to reduced occupancy rates caused by lower business and leisure travel. Industry data indicate that the nationwide average occupancy rate was 43% during the second week of November, down almost a third from a year earlier and also down from a rate of 48% during the third quarter, when travel and hotel bookings had started to recover. Council members are engaging in forbearance agreements with operators when feasible, which has helped commercial mortgage-backed security delinquency rates decline for the fourth straight month in October, after significantly increasing in the second quarter. The largest decline came in the hotel sector, likely due to forbearance agreements granted by lenders, but the hotel sector continues to experience higher levels of delinquencies relative to others. Going forward, the extent of rising COVID-19 cases, combined with the timing and effectiveness of vaccine distributions, will likely dictate the support needs of operators until occupancy rates increase.

(c) Construction

Construction of single-family homes climbed to the highest level in over thirteen years, accounting for 78% of residential construction. Low mortgage rates, combined with a desire by households to reduce their exposure to COVID-19, are fueling demand and contributing to declines in the multifamily sector.

In contrast, commercial construction has slowed, and banks generally report tightening underwriting standards and weaker loan demand across major categories of commercial construction, especially in sectors most affected by the pandemic. A prominent construction trade group reported that construction backlogs fell to 7.7 months in October, a decline of 1.2 months compared to a year earlier, as existing projects are completed and there are fewer new projects.

(d) Corporations

Loan and financial markets are providing robust support to credits that demonstrate good capitalization and financial stability, and borrower demand for loans is beginning to increase in industries that were not impacted by the pandemic, particularly technology and telecommunications, life sciences, and essential services such as food and beverage. Travel and aviation, hospitality and entertainment, and discretionary retail continue to underperform.

Council members noted that corporate borrowers remain conservative, curtailing operating expenses where possible (including hiring), conserving liquidity, and reducing capital expenditures. Credit line utilizations continue at low levels. Mergers and acquisitions have been active as valuations are at more reasonable levels and sponsor liquidity is high. October proved to be the busiest month of the year for mergers, which traditionally increase lending activity.

Nevertheless, there has also been an uptick in corporate bankruptcies. S&P Global Market Intelligence reported that twenty-nine companies filed for bankruptcy in the last two weeks of October, surpassing the number during any comparable two-week period since early August. It further reported that, as of November 1, 556 companies have filed for bankruptcy since the start of the year, exceeding the number of filings during any comparable period since 2010.

(e) Consumers

Consumer credit has been widely available across all sectors. There have been record extensions of automobile loans, which have increased in each of the last 26 weeks to an all-time high. Similar trends are observed in recreational vehicle financing and residential mortgage loans. Consumers generally entered the pandemic from a standpoint of strength, with low rates of unemployment at the time. Unfortunately, the economic impacts of lockdowns have been disproportionately concentrated among low-wage earners. To help mitigate these impacts, along with government stimulus programs, many lenders offered consumers payment deferral programs for a wide variety of accounts. Early in the pandemic, lenders also tightened underwriting standards amid the uncertainty. In the credit card space, as payment deferral programs abate and lenders gain better insight into the health of borrowers, Council members noted they are experiencing an increase in approved applications.

(f) Homes

The housing market has been supported by robust demand for single-family residences as the pandemic continues, driven by record-low mortgage rates and lower inventories of existing homes on the market in many locations. Sales of new homes increased more than 32% year-over-year, and roughly two-thirds of homes sold in September were either under construction or to be built. Robust housing demand and refinancing have increased mortgage processing volume, creating operational issues for some originators and lengthening appraisal processing times.

Despite the apparent strength in the housing market, high unemployment in the second quarter led many lenders to offer temporary forbearances to borrowers. Forbearance rates peaked at over 8% of all mortgage loans outstanding in June and have since declined to just under 6%.

In addition, what has been the impact of the fiscal stimulus provided earlier in the year on current credit conditions? What impact would additional fiscal stimulus have on future credit conditions?

The Council noted that fiscal stimulus provided earlier this year has been effective and important to households and businesses, providing them with liquidity and low-cost funding to meet their financial obligations. One Council member observed that household spending increased after stimulus payments were received and estimated that over half of the inflows were spent within 30 days.

Consumer and residential mortgage portfolios have been stronger than expected given the level of unemployment, likely attributable to stimulus aid and payment deferral accommodations by lenders. Additionally, the Payroll Protection Program has helped businesses of all types meet their continuing financial obligations.

The consensus of the Council is that some form of targeted stimulus directed to households and businesses most impacted by the pandemic could serve as an important bridge until vaccines are widely distributed.

<u>Item 2: Bank Responses to Challenges Faced by Customers</u>

What are Council members' experiences with trends concerning customers' ability to repay? Please comment on delinquency rates and deferrals and other loan modification approaches for commercial and consumer lending customers in light of the disruptive impact on customers caused by employment challenges, operational restrictions, and social distancing.

(a) Ability to Repay

- **Commercial** - With respect to commercial clients, problem asset ratios continue to climb. Credit issues are increasingly concentrated in high impact sectors across retail, travel, hospitality, recreation, senior housing, and oil and gas. The commercial office sector could also be challenged as some tenant companies reassess the need for in-person office work in light of increased work from home in the pandemic.

  Although many Council members noted that clients using P&I deferrals are performing better than expected and some borrowers have been able to resume contractual payments, many borrowers will require additional forbearance and long-term workout agreements. Banks are anticipating an increase in Troubled Debt Restructurings and non-accruals in the fourth quarter, especially in the hospitality and retail sectors. According to CMBS delinquency data, these sectors have been the driver of elevated delinquencies, with rates of 19.4% and 14.3%, respectively, in October.

  Outside of the most heavily impacted CRE and C&I areas, most borrowers have liquidity for the near term, as evidenced by a low number of requests for second deferrals from these borrowers. Depending on how the pandemic plays out, additional government support and liquidity programs could prove important if clients need to identify replacement funding.

- **Consumer** - Banks remain concerned about pandemic-related forbearance management in the coming months. The surge in forbearance numbers during the second quarter pressured mortgage-servicing operations, which sustained hundreds, and sometimes thousands, of weekly forbearance requests to alleviate the financial difficulties brought on by the pandemic. Bank servicers are deploying the CARES Act-required GSE or FHA forbearance programs for covered loans, as well as robust forbearance programs for portfolio loans.

  Recent data on COVID-related forbearance activity indicate that borrowers' financial conditions improved in the third quarter. Mortgage Bankers Association data as of November 3 show that loans in forbearance have decreased from a peak of 8.55% in June to 5.67%, affecting 2.8 million homeowners, and are on a consistent downward trend. There is lingering concern, however, that pandemic conditions are worsening and extended forbearances and additional loss mitigation efforts will be required. More than 70% of loans in forbearance are now in an extension, and substantial workout demand could be expected over the next 3-18 months, depending on the remaining duration and severity of the pandemic.

  Encouragingly, most Council members reported that mortgage loans that have exited hardship assistance are performing well. Additionally, few borrowers have qualified for an extension of their forbearance when documentation of hardship was required. Unlike the Great Recession, home-price-appreciation measures have remained positive throughout the pandemic and should support refinancing or sale options post-forbearance.

- **Government Stimulus Impacts on Ability to Repay** - Asset quality metrics tend to lag economic indicators, and this trend has been more pronounced in the current environment as widespread forbearance programs have mitigated the onset of loan delinquency. For many customers, pandemic economic impacts have also been significantly mitigated by government stimulus payments to consumers via Economic Impact Payments (EIP), Pandemic Unemployment Compensation Program supplements, and PPP funds to small businesses to help weather the economic slowdown resulting from measures taken to slow the virus spread. Many Council members worry that, without additional federal or state assistance, pressure on customer payment capacity will increase and result in a rise in delinquency rates and nonperforming loans. The delay in enacting additional stimulus also affects the most impacted industries in commercial portfolios.

(b) Deferral and Modification Approaches

Many banks provided blanket deferrals and modifications for any customers that requested them at the onset of the pandemic. Although the number of second-round deferral requests has declined substantially, banks have employed heightened scrutiny and due diligence in addressing these requests and have worked with customers to exercise interest-only or other, short-term, modifications versus full deferrals. Banks are also focusing on early identification and emerging trends across the portfolio and have instituted frequent outreach to customers and clients, particularly those in the most vulnerable industries.

Banks that offer credit cards have stepped up to provide flexibility to customers experiencing hardship. When the unemployment rate spiked to nearly 15% in the spring, banks moved quickly to provide relief and support for affected customers. For instance, banks offered fee waivers, debt forbearance, payment deferral, finance charge adjustments, and travel reservation change assistance when hotels and airlines closed, and provided proactive education about relief options available. While they regularly offer relief to consumers experiencing hardship in normal macroeconomic environments, many banks waived their proof-of-hardship requirements during this unusual recession, instead taking verbal statements from customers.

Legislative and regulatory policy initiatives encourage financial institutions to work with borrowers, including by managing loans on a risk basis using limited financial data and consideration of pandemic-induced covenant breaches. These risk-based workouts should help prevent depressed values by avoiding sales and foreclosures that could occur simultaneously.

However, many Council members expressed concern regarding the difficulty of assessing customer risk using traditional methods. For example, FICO scores do not provide meaningful insights as the average score in the third quarter was about 711, which is the highest since FICO started tracking in 2005. Similarly, credit insight into small businesses, which is traditionally score-based, has also been challenged. Government stimulus and lenders' deferral programs have assisted customers in a substantive way but are also making it more difficult to identify problems not caused by the pandemic, shifting the pandemic's impact on credit scores into the future.

Item 3: Current Economic Conditions

The pandemic and associated health measures and economic consequences continue to unfold. Since the last meeting, what changes have Council members observed in the conditions of and prospects for various sectors of the economy, including (a) households, (b) significantly affected businesses, and (c) state & local governments? Do Council members see any developments in these categories or other economic developments in their regions that are not apparent in reported data or that may be early indications of trends?

(a) Households

In September, the Council reported in the General Outlook on Households that "uncertainty" best described the Council's view of the COVID-19 pandemic's impact on the economy. This view is even more prevalent in the world (much less, the country) of today, and the uncertainty is predictive when we look forward. The surge in COVID-19 cases, tripling from a daily average in mid-October of 50,000 to 166,000 in mid-November; the run-off elections in Georgia; and the continued congressional gridlock on additional fiscal stimulus cement this view across all of our districts.

The economy's momentum coming out of the third quarter and into October began to wane quickly by mid-November. While household statistics had painted a continually improving picture since May, the pace of that improvement has now slowed. Total non-farm payroll employment rose by 638,000 jobs in October and the unemployment rate declined a full percentage point to 6.9%, which is down 3.3 percentage points since the July number the Council looked at during the September Council meeting. The 638,000 jobs gained in October compares to 672,000 gained in September and 1.5 million in August, thus demonstrating the slowing improvement rate. While both the unemployment rate and number of unemployed persons have declined for 6 consecutive months, as discussed in September, these job gains have not affected all Americans equally. Lower-paid workers in industries such as restaurants, hotels, and health care have seen their jobs and incomes recover more slowly than white-collar workers. Also decreasing, but at a slower pace than the national average, the October unemployment rate for Blacks was 10.8% and for Hispanics, 8.8%.

Consumer spending statistics also looked good in September and into October, with retail sales as measured by purchases at stores, online, and at restaurants increasing by 1.6% in September and another 0.3% in October. Big drivers of the sales increase came in categories such as bicycles, vehicles, electronics, and home improvement projects.

After 6 months of improving economic news for households, that news has turned to uncertainty and concern, as COVID-19 pandemic cases began to re-surge and COVID fatigue set in with people across the country. Couple these factors with the realization that around 12 million American workers will lose unemployment benefits, as two temporary stimulus programs (the Pandemic Unemployment Assistance (PUA) and the Pandemic Emergency Unemployment Compensation (PEUC) programs) are set to expire on December 26th. Also playing out now: state and local government bodies are discussing and reinstating restrictions and lockdowns in their communities. Businesses have sent employees back home, schools have returned students to all-virtual learning, and small businesses are dealing with the potential for additional restrictions that could adversely impact their annual sales, as holiday spending dominates the relative success of the retail year. For example, a locally owned chocolate shop located in a Midwest downtown realizes 60% of its annual sales in November and December, which is arguably about the same percentage for many small businesses. Another Midwest business in the restaurant industry saw a 25% drop in revenue from the week of November 10 to the week of November 17, as the COVID-19 pandemic resurgence made front-page news.

With no fiscal stimulus on the horizon, foreclosure programs expiring, the personal savings rate declining since its April peak, new restrictions and potential lockdowns, uncertainty for households is growing. Fortunately, as the Council has stated in previous meetings, households came into this pandemic better prepared than in previous recessions. As an example, for those who participate in the equity markets via individual accounts and retirement accounts, a continued "V shaped" recovery finds the broader market indices at or near record highs despite the aforementioned general slowing of the broader recovery. For households that have saved and invested well, this is a significant lifeline, which will be tested in a second surge. Households will need their savings, increased value in their houses, financial assets, and lower debt payments to support their spending and keep the solid economic recovery moving forward. That is a complicated and tenuous formula for households to maintain, but consumer spending has surprised many experts throughout this pandemic.

(b) Significantly Affected Businesses

Overall economic activity has improved materially since the September FAC meeting. While Council members reported a continuation of improving economic trends and business optimism, bolstered recently by the prospect of a near-term approval and distribution of an effective vaccine, economic conditions for businesses vary materially by sector. Companies operating in sectors directly impacted by the pandemic continue to struggle, and we have seen elevated bankruptcy filings and declining earnings in sectors such as travel, leisure, entertainment, retail, restaurants, and energy. The prospects for these sectors depend on the trajectory of the virus, the timing and effectiveness of a vaccine and therapeutics, and the timing and nature of additional government stimulus.

Council members continue to observe that across all industries, companies have embraced and accelerated their digital strategies, and those that are recovering or stabilizing are ones that have been able to adapt and pivot their strategy toward greater use of digital technology.

Another important observation of the Council is that "where" a business operates can be as important as "what" a business does. Geography is driving variability in outcomes across businesses. This is true not only with respect to different states and regions, but also whether businesses serve metro markets, suburban markets, or rural markets.

- **Travel, Leisure, and Hospitality -** The leisure and hospitality sector has been among the hardest hit by the pandemic amid social-distancing measures. Travel and tourism remain soft as personal, international, and corporate travel has declined dramatically during the pandemic. The air travel industry is at particular risk following the expiration of government aid. However, seven-day average airline passenger traffic as of November 26 (Thanksgiving) exceeded 40% of normal traffic, the highest since mid-March. While personal travel has increased over the last several months, the loosening of travel restrictions has slowed and even reversed in recent weeks as virus cases have risen across the nation. The roll-out of an effective vaccine brings optimism that personal and business travel may rebound beginning in the middle of 2021.
- Hotels are still experiencing high vacancy rates. Non-leisure properties are operating at 40-50% occupancy, up marginally since April, and average daily rates are depressed due to lack of demand. Hotels catering to corporate and luxury travel are the hardest hit. Full-service hotels continue to lag the market, in part due to lack of conventions and conferences, as well as limitations on large events. Regional leisure-oriented hotels, many with outdoor resort activities, experienced improved performance during the late summer and fall. Colder temperatures may challenge these outperformers. Many hotels in college towns were utilized for student quarantine during the fall season and have outperformed. Many hotel borrowers are coming off of initial payment deferral and will likely request additional relief from lenders.
- **Retail -** Within the retail sector, overall activity has rebounded strongly with five consecutive monthly gains following the initial pandemic shock. However, the recovery has been highly uneven, with companies that have relied more heavily on in-store transactions remaining severely stressed. Essential big-box retailers, larger grocery stores, and pharmacies continue to be the main physical shopping destination for consumers. Online retailers have outperformed during the pandemic as consumers have purchased more heavily through digital channels. Large retail bankruptcies have slowed since the last meeting, but bankruptcies earlier in the pandemic have reduced the number of stores open, reducing the speed and magnitude of the recovery. Expectations for holiday sales vary widely across the sector, and retailers have spread Black Friday promotions over an extended time period and shifted to online in order to reduce crowding.
- **Entertainment/Live Events -** The hardest hit segments of the economy remain those that are dependent on large gatherings and customer foot traffic. The live music and events sector, and related service providers (tour transportation, stage and sound production, etc.), continue to experience significant stress from the cancellation of concert tours and festivals. Most live events were deferred until mid-2021, depressing profitability in the sector for all of 2020 and much of 2021. Large theme parks in certain geographies have re-opened with limited capacity and social-distancing guidelines in place. A widely distributed vaccine and continued therapeutic progress will likely be needed to fully restore confidence in the live-event consumer base.

Tourist and group-related venues, especially indoor venues (e.g., museums, aquariums), have continued to underperform due to lower overall demand and pandemic-related capacity limitations. Additionally, fundraising efforts for these venues have been impacted (see not-for-profit section below). Outdoor venues (e.g., zoos), while still experiencing more limited demand than pre-pandemic, have fared better.

- **Restaurants** - Restaurants have been materially impacted by the pandemic. One Council member reported 32,000 restaurant closures nationwide, with some 60% of those projected as permanent closures. Full-service restaurants are struggling more than quick-service restaurants. Council members observe that full-service restaurants are generally running at reduced capacity and are seeing a 25-35% decline in revenue when compared to the prior year. The quick-service restaurant sector (QSR) has performed relatively more strongly, with winners in the QSR sector offering takeout and utilizing delivery models leveraging technology and contactless capabilities. Full-service dining will likely remain challenged and lag in economic recovery. Council members noted that some cities and states have recently reduced dine-in capacity again as a result of increases in COVID-19 cases. This, combined with the concern that winter eliminates the use of outdoor spaces to offset indoor dining restrictions in cold-climate regions, could jeopardize the viability of restaurants in these geographies. While the PPP provided much-needed relief to restaurant companies, most of these funds have already been spent, and even some well-capitalized operators may have as little as 6 to 12 months of runway remaining. Bank financing remains nearly nonexistent for restaurant operators.

- **Real Estate** - Although low interest rates are driving refinancing and some purchase activity, suburban markets are experiencing increased demand for rental and owned properties as families are seeking less populated communities. As households continue to migrate out of the more densely populated cities, rental rates and home prices have risen in less populated markets. Conversely, rental rates and property prices for residential space in cities are declining due to the lower demand.

  The multifamily real estate segment is experiencing stable to improving occupancy levels, and absorption and collection rates remain relatively strong. Most markets are not seeing large, widespread rent concessions, but the frequency and amount of concessions are increasing, particularly in large metro markets. The federal stimulus and enhanced unemployment benefits have supported the collection rates; however, Council members noted a risk of collections deteriorating.

  Except for life-science related tenants and projects, which are generally performing well, leasing and development activity have slowed considerably as tenants postpone expansion/relocation decisions. Departure of existing tenants and negotiation of more tenant-favorable lease terms are more common upon lease expiration/renewal. Tenants have a clear preference for non-urban, non-high-rise buildings. Offices continue to be sparsely occupied as many businesses are encouraging employees to work from home. Landlords and tenants are addressing social distancing for in-office employees and elevator/common area usage, among other topics, in response to the pandemic. Some landlords are investing in upgraded HVAC, UV, and other anti-viral technology. As noted in the previous quarter's update, the medium- to long-term outlook for office space is more uncertain as many businesses are extending work-from-home guidelines, evaluating ongoing productivity in the current work-from-home environment, and reconsidering the traditional need for significant centralized office space.

- **Health Care** - Some markets are again restricting elective surgeries due to surges in infection rates. Depending on the duration, these surges will further result in challenges for providers of discretionary medical services, as well as reduce the willingness of some patients to seek services for chronic or more critical conditions.

Many health-care providers are forecasting weaker performance as demand for service remains suppressed and practices have not been able to make up the gap that was created during the initial shutdown. Despite most states operating in various phases of "re-opening," due to a "second wave" of higher infection rates at this time, coupled with mandated restrictions, the demand for non-essential services remains lower than anticipated. Council members noted that with positive advancements in vaccine development, the outlook for 2021 and 2022 is more optimistic, and most are forecasting a return to pre-pandemic levels.

Various provider types and specialties are affected by COVID-19 differently. Assisted-living and long-term care facilities and nursing homes continue to be more adversely impacted than some other providers. Higher propensity for cases, the increased overhead costs for supplies (i.e., personal protective equipment and cleaning supplies), and the added costs of frequent testing of staff and patients have had a negative result on operating performance. Medical practitioners that have been successful in deploying video conferencing have been able to restore some predictability to revenue and cash flow. Safety continues to be an important factor in patient confidence in discretionary health-care services.

- **Energy** - This segment of the economy continues to be strained under the pandemic. With energy prices remaining flat, companies are focused on efficiency and cost controls. With the capital markets effectively "closed," and little functionality in the acquisition and divestiture markets, many companies that are starved for liquidity must reorganize and have been forced into bankruptcy. Loan deferrals, government grants, and fiscal spending are limited, with some lenders exiting energy financing and shifting focus of the industry expertise on workout and resolution management.
- **Technology** - This segment of the economy has experienced strong demand and improved performance. As businesses have shifted to "digital first" strategies and/or accelerated investments in digital capacity, technology firms have benefited. With the ability to leverage technology being critical to success for many other business segments, the technology segment is performing very well. The need for capital has been a driving factor in loan demand in this segment.
- **Auto Industry** - This sector has continued to recover from a low point in April/May, but production levels remain impacted by the global supply chain disruption. Inventories are lower due to these production challenges as well as to increased demand.
- **Nonprofit Sectors** - The pandemic continues to challenge the not-for-profit sector. The impacts vary depending on the financial strength of the organization and the ability of the individual firm to be innovative in this unique operating environment. A significant challenge is the material increase in demand for services that nonprofit firms provide while, at the same time, there is a dramatic decline in resources available to supply those services. The demand for services in our communities continues to increase, especially for the most vulnerable populations. The willingness to volunteer and support fundraising does not appear to have been impacted; however, the level of volunteerism has dropped due to safety concerns for employees (at the agencies and corporate-sponsored events alike), "stay at home" orders, and state mandates limiting the size of events or requiring changes to how a not-for-profit operates.

  As the Council noted last quarter, the nonprofit community is very creative and resilient. Firms have had to quickly change how they operate, deliver services, generate revenue and fundraise. Museums and the performing arts cannot respond as quickly. Despite the creativity of the nonprofit community, closures are anticipated as a result of COVID-19.

State and Local Governments

The economic impacts of the coronavirus pandemic continue to affect state and local governments through revenue shortfalls and spending increases. This financial strain is significant, as state and local governments are important drivers of employment and economic growth across the nation. The impact on any specific state is somewhat dependent on the amount of the individual state's revenue that is related to heavily impacted industries like tourism or energy. According to a study by the Urban Institute, at least eight states have reported revenue growth in the first six months of the pandemic versus the same period a year earlier, while many others are seeing revenue declines of less than 5%. However, at least six states are seeing much more severe revenue losses, in excess of 10%, and face further shortfalls, with Hawaii and Nevada expecting 23% and 26% declines, respectively, in fiscal 2021 compared to pre-pandemic estimates. In the aggregate, states' adjusted estimates suggest that, in the absence of further federal support, shortfalls will total about 11% of their budgets in fiscal year 2021 and 10% in fiscal 2022. The Center for Budget and Policy Priorities estimates that shortfalls faced by states, localities, tribal nations, and U.S. territories will reach between $480 billion and $620 billion through 2022 and could reach even higher in the event of a double-dip recession. Local governments also face substantial shortfalls, though less than the states - largely because localities rely more on property taxes, which so far have been stable.

Another potential risk to the most vulnerable municipal governments and the health of the municipal market is the Treasury Department's decision to allow the Federal Reserve's Municipal Liquidity Facility to expire at year end. While the facility was lightly used to date, budget impacts will be more severe in fiscal 2021 and could require additional borrowing in the absence of tax hikes or sufficient expense savings. If states are not able to raise taxes or find sufficient expense savings, the public markets could prove to be expensive as states attempt to borrow for budget shortfalls. Prices on Illinois bonds due in 2034 tumbled almost 7% after the defeat of its graduated income tax on its November ballot, evidence of waning investor support for the riskiest debt and potential liquidity issues. Fitch ratings outlooks are negative for most bonds, with Fitch noting that "timely and substantial" federal action could support stabilization of outlooks.

While state and local governments, which generally must balance their budgets, entered the pandemic in a relatively strong position, with $119 billion in general fund surpluses in the aggregate, many of these funds have been depleted and the states and localities will require additional federal assistance to avoid cutting necessary services in the years ahead. The lack of additional stimulus, either through extended unemployment benefits or direct municipal government grants, may have a material impact on the average government but could be devastating for governments bearing the brunt of the economic damage in the crisis. Job losses in the public sector resumed in September after recovering during the prior three months, with state and local governments having furloughed or laid off 1.2 million workers to date, far more than the 750,000 that lost their jobs during the Great Recession. As a result, many governments have executed or are weighing bond deals to borrow for deficits. Actions taken to alleviate these concerns, including tax increases, cutting state and local government workers, and cuts to public services, could act to prolong the recession. Some governments like New Jersey have already implemented tax hikes, while others like Illinois do not have the voter support to pass additional large tax increases to avoid much more painful budget measures and fend off downgrades, leading to warnings of an increase in the flat income tax rate and 15% to 20% across-the-board cuts in spending. The projected spending cuts being proposed by many states will diminish the reach and quality of public services. Georgia, for example, cut K-12 funding by nearly $1 billion, and California cut higher education by roughly the same amount. New York is threatening permanent 20% cuts to K-12 schools if it cannot find additional revenue. Finally, Florida's governor vetoed a spending bill passed before the crisis and ordered agencies to find ways to reduce spending by 8.5%. All of these measures will weigh heavily on economic growth and infrastructure investment for years to come and will slow the overall economic recovery.

Item 4: Deposits and Reserves

What changes have Council members seen in 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.

(a) Changes in Deposit markets

Since March, over $2 trillion in deposits have flowed into U.S. banks. This significant increase, which began with the onset of the pandemic, represents a combination of two primary drivers: altered behaviors as a result of the crisis (credit line drawdowns, reduced spending, debt repayment forbearance, etc.) and government intervention (PPP, individual EIP payments, additional unemployment assistance, etc.).

Generally, Council members' customers have held onto excess liquidity and have been reluctant to make future investments in their businesses as they wait for conditions to improve. Despite the widespread decline in pricing offered on interest-bearing products across the banking industry, there is limited migration of customers between banks. The noted exception would be those PPP customers who moved their relationships to banks that were able to quickly fund their applications for federal assistance. Council members expect customers to increase spending as a vaccine becomes widely available and as the economy shows consistent signs of growth.

- **Retail** - Overall, retail deposit balance growth started to flatten in the third quarter, as compared to rapid growth seen in the second quarter. Balance growth remains higher in demand deposit accounts (DDA) for greater ease of access. Lower- and middle-income households have experienced some reduction from peak balance levels, as stimulus programs have expired and some regions and industries remain disproportionately impacted by the pandemic. Continued increases in personal savings balances can also be attributed, to a degree, to the runoff of CD customers who prefer to hold onto additional liquidity in the current rate environment. Saving rates are anticipated to slow with holiday-related spending, although more conservative spending could occur if the prospects of further government stimulus deteriorate.
- **Small Business** - Small business balances are up, primarily due to PPP stimulus and expense discipline. These business accounts continue to remain liquid given the uncertain economic conditions and low-rate environment. Customers have maintained elevated levels of cash due to a steady inflow of deposits, after the initial balance surge stemming from government stimulus. PPP forgiveness is not expected to have a material impact on DDA balances based on current trends. Business expenditures on inventory, travel, payroll, and other operating costs appear to be down year-over-year; however, net operating cash inflows continue to increase, in part funding the steady rise in balance growth.
- **Corporate** - Corporate deposit balances saw the largest absolute increase in total deposit balances including other segments, through a combination of credit line drawdowns, short-term reductions in operating costs, debt repayment forbearance, and PPP funding. Balances resulting from government stimulus programs have remained relatively stable.

  Like the other sectors, corporate customers have moved more balances into DDA products, rather than into other Treasury-management products, as offerings on exception pricing continue to decline across the sector. At a market level, deposits continue to be readily available, as most clients believe the return on alternative and off-balance-sheet investments is not worth the risk.

(b) Expectations for 2021

The outlook for deposit balances throughout 2021 is mixed. Uncertainty around the likelihood and nature of future stimulus, the outcome of the election and its impact on tax and other fiscal policy, and the potential for additional lockdowns and development/delivery of vaccines will be significant factors impacting spending activity, investments, and savings rates.

Council members expect continued elevated deposit levels in response to the ongoing economic uncertainty, as well as a prolonged low-rate environment. While another round of government aid could likely be enacted, it is highly dependent on legislative compromise. Another round of stimulus measures would certainly accelerate further deposit growth.

(c) Impact of Increased Reserves

While a portion of deposits is expected to roll off, liquidity regulations will continue to drive demand for reserves. This growth in bank reserves will put continued pressure on finding more profitable avenues than depositing at the Federal Reserve. Excess liquidity continues to weigh negatively on interest margins, with banks across the industry evaluating alternatives to grow net interest income. The growth in deposit balances and related reserves should enable banks with strong credit fundamentals to grow portfolios, while banks in weaker positions may need to pull back on credit exposure.

Overall, banks remain awash in liquidity while recording strong capital levels. Banks are willing and able to meet the needs of borrowers, as the economic recovery starts to take hold and demand increases.

Item 5: Community Reinvestment Act

The Federal Reserve Board recently approved a Community Reinvestment Act (CRA) Advance Notice of Proposed Rulemaking (ANPR). What are the initial views of Council members on whether the ANPR strikes an appropriate balance between providing greater certainty in how banks are assessed through increased use of metrics and minimizing the associated data collection and reporting burden? What are the initial views of Council members on modifications and approaches that would strengthen CRA regulatory implementation to address ongoing systemic inequity in credit access for minority individuals and communities?

General Outlook

The Council supports the Board's efforts to modernize the CRA regulations to better reflect the significant changes in the banking industry, technology, and customer preferences that have occurred in recent decades; enhance the incentives for banks to meet the credit, investment, and service needs of underserved areas; and improve the efficiency and transparency of the CRA evaluation process. Overall, Council members encourage the Federal Reserve to continue to work with the other banking agencies towards the adoption of consistent CRA evaluation rules and procedures across charter types, which would reduce confusion and help spur desired investments and activities.

(a) Metrics and Data Collection

In general, Council members support the increased use of metrics along with the reduction in associated data collection and reporting burden. When properly tailored and adjusted for changing economic and market conditions, increased metrics can bring greater clarity, consistency, and transparency to CRA performance evaluations, and the proposed performance dashboard would speed delivery and improve the overall efficiency of the marketplace. At the same time, increased use of metrics enlarges the associated data collection and reporting burden. Council members appreciate that the Board is mindful of the burden and recommend that the Board prioritize to the greatest extent possible the use of existing data sources for banks of all sizes, even if it reduces the precision of some metrics. In particular, some Council members supported the use of the FDIC's Summary of Deposit (SOD) data in the performance metrics. However, some Council members noted that adjustments to such data might be necessary, such as for centrally booked corporate or internet deposits, to prevent them from significantly overstating a bank's deposits in an assessment area and to decrease the prevalence of CRA "hot spots."

Council members do not support the mandatory collection and reporting of data regarding consumer loans (including credit cards, motor vehicle loans, student loans, home equity loans, and other secured and unsecured consumer loans). Rather, Council members indicated that the evaluation of consumer loans should only be part of a bank's CRA examination under one of the two circumstances currently provided in the Interagency Questions & Answers Regarding Community Reinvestment (i.e., at the institution's election or when consumer loans constitute a substantial majority of the institution's business).

Council members also noted that the public reporting of such data would create an incomplete database, based on the increasing number of nonbank lenders entering and competing within the consumer loan market.

Under the Retail Services Subtest, the introduction of a formal collection of non-branch delivery channels data has the potential of being an effective way of gathering consistent information; however, implementation may require extra manpower and additional costs, particularly for banks that are not currently collecting such data

(b) Credit Access

Regarding credit access, the CRA provides the Board and banks with a crucial mechanism for addressing the credit needs of their entire communities, including access to credit. Thus, to the extent the Board can facilitate, expand, and clarify the types of loans, investments, and services that qualify for CRA credit and the areas in which they qualify, the Board can better address inequity in credit access. Council members support designation of areas of need, CRA deserts, and other similar communities (such as Native American communities) where banks could receive CRA credit for activity conducted outside their assessment areas. Council members also favor increased incentives to support minority depository institutions, women-owned financial institutions, low-income credit unions, and small business investment companies regardless of their geographic location. However, while Council members support these activities as one way to achieve an "outstanding" rating, members do not believe they should be explicitly designated as a required criterion to achieve an "outstanding" rating. Additionally, Council members believe that maintaining a focus on units/number of loans (as opposed to dollars of funding) in the Retail lending subset should encourage lenders to provide smaller-dollar mortgage and business loans, both of which are important to ensuring capital flows to minority and underserved communities.

One Council member encouraged the agencies to add minority-owned or minority-led debt or equity funds that finance small businesses to the types of entities that are currently "presumed" to promote economic development, which would help reduce barriers to entry for fund managers of color.

(c) Assessment Areas

In light of the focus of the CRA on ensuring that insured depository institutions meet the credit needs of the communities from which they raise deposits, Council members recommended that assessment areas continue to be delineated based on an institution's deposit-taking activities (rather than based on where the institution makes loans). Some Council members supported requiring institutions that raise a significant proportion of their deposits from outside their branch-based assessment areas to designate additional assessment areas, while others opposed such a requirement. Council members supported eliminating the requirement that assessment areas be designated around deposit-taking ATMs, noting that this requirement creates disincentives for institutions to provide convenient access to banking services.

Item 6: Artificial Intelligence

How is artificial intelligence (AI) being used in banking and, in particular, in credit decisions? Does AI improve the accuracy and fairness of decisions on consumer credit? How? Some observers believe

AI has the potential to help banks improve access to consumer credit for underserved consumers. How does the Council evaluate this assertion? Does AI have implications for the current regulatory framework?

The application of AI in all industries continues to grow rapidly, particularly to augment activities and decisions made by humans. AI encompasses many subdomains, including:

- **Machine Learning (ML) -** ML algorithms combine multiple statistics and computer science techniques to find patterns in large amounts of data. Data encompasses numbers, words, images, and clicks. When this data is digitally stored, it can be fed into an ML algorithm. ML powers many of the services Council members use today, including recommendation systems that enable next-best-offer management to automate personalized targeting of digital ads.

- **Deep Learning -** Deep Learning is an advanced form of ML that uses techniques to enable algorithms to find and amplify even the smallest patterns. These techniques are called Deep Neural Networks — deep because they have many layers of simple computational nodes that work together to analyze data and deliver results in the form of predictions. Deep Learning is used today in fraud detection, processing millions of credit card transactions to identify possible theft at the point of sale.

- **Reinforcement Learning -** Reinforcement Learning is a new frontier of ML. A reinforcement algorithm learns by trial and error to achieve a clear objective. It tries different iterations and combinations of steps and is rewarded or penalized depending on whether the approaches help or hinder reaching an objective. Reinforcement Learning is the basis of Google's AlphaGo.

- **Natural Language Processing and Speech and Image Recognition -** Natural Language Processing is a field of AI that uses Deep Learning techniques to give machines the ability to read, understand, and derive meaning from human languages. Similarly, Speech and Image Recognition allows machines to interpret human speech, voices, and images. AI converts these forms of data to conversational understanding (meaning and context) and then responds appropriately with programmed replies or computer-assisted actions.

- **Chatbots -** Chatbots are AI software that can simulate a conversation with a customer in natural language through messaging applications, websites, mobile apps, or through the telephone. Chatbots are considered one of the most advanced and promising expressions of interaction between humans and machines, built on Natural Language Processing in combination with Speech Recognition, ML, and sometimes even Deep Learning. While the first Chatbots were largely FAQ based, modern Chatbots across all industries are becoming "Conversational AI," able to recognize complex user intents and even understand customer sentiments. Council members noted examples of how Chatbots are currently leveraged within our organizations to engage customers in a personalized, scalable experience that simulates human conversation. AI is also used to analyze a customer's sentiment as well as enable the identification of complex issues better served by a human agent, allowing the chatbot to seamlessly connect the customer to the help they need. AI is important in this space, allowing computer systems to comprehend what the customer says or texts, as language is often nuanced. For example, a chatbot must know that "I would like to move money" has the same meaning as "transfer money."

- **Robotic Process Automation -** Robotic Process Automation is the automation of business processes and repetitive tasks usually carried out by humans. Robotic solutions have resulted both in full automation of processes and tasks and in assisted automation, in which human intervention is significantly reduced but not totally eliminated. While this may eventually lead to a reduction in staff service-oriented positions, these tools have enabled resources doing repetitive tasks to be shifted into more productive work. Council members noted various use cases of robotic process automation being used within audit services for repeatable tasks.

- **Next Best Experience** - AI is enabling Council members to deliver the Next Best Experience to customers and prospects in multiple ways. First, AI helps banks navigate with our customers across all channels in their micro-journeys and in real time. If a customer begins interacting with a bank via a Chatbot, they need not retell their issue to a customer service agent should they switch channels. AI-powered tools provide the customer's data immediately to the ideal agent to understand their needs. This leads to more serving efficiency and a better customer experience.
- **Prospect Acquisition** - AI enables the collection and stitching together of data in the digital environment to, when legally allowed, use first-, second-, and third-party data for hyper-specialized treatments and offers. First-party data are the data that banks collect (e.g., data collected from website behavior) about our customers and prospects. For prospects, this might be clicks, device, IP, browser, location, etc. Second-party data are someone else's first-party data that banks acquire and are legally authorized to use. Third-party data are usually aggregated from many different sources and contain rich behavioral or demographic information. Facing the large amount of information generated by the combination of these layers of data, the use of AI is beneficial to quickly find newer patterns, identify accurate micro-segments, and constantly adapt to newer trends.

Beyond many of the service-oriented examples noted above, AI is currently used for technology operations in resiliency and reliability management, including systems health detection. Organizations can track millions of events (server traffic, customer interactions, website capacity, etc.) in real time. This helps dramatically reduce resolution times for incident management.

AI is used to help banks and their customers with identity protection through fraud identification. Banks are using ML algorithms to analyze large data sets and help identify previously unidentified deviations or patterns. Further, in cybercrime investigations, AI is used to identify criminal patterns and quickly protect customer accounts and enterprise data. Council members noted the deployment of models to detect suspicious deposit activity from ATM and mobile channels and for setting rules and thresholds in credit card fraud detection. Council members believe broader application in fraud management, including AML/BSA, will occur through time.

Despite the rapid evolution and accelerating implementation on the service and operations side, the use of AI in direct credit decisioning is more limited at the current time. Council members believe this is likely to change, and the application of AI to credit decisioning will become more widespread in future years. Banks have already invested substantially in this space, and Council members discussed models currently in use as challenger models to test against traditional underwriting models. Some Council members noted that experiences to date suggested AI challenger models tend to decline more loans than traditional models.

Does AI improve the accuracy and fairness of decisions on consumer credit? How? Some observers believe AI has the potential to help banks improve access to consumer credit for underserved consumers. How does the Council evaluate this assertion?

Regulated banks will need to constantly ensure the right balance of predictive power, the ability to explain decisions, and fairness in credit decisioning. This aspect of bank lending is highly regulated for transparency. The nature of many of these AI models is that of a process in which the models self-learn and adapt faster from newer (instantaneous) data and customer behavior.

The Bank Policy Institute notes, and Council members agree, that AI has the ability to quickly capture, aggregate, and process a large volume and variety of data, yielding deeper insights into a customer's ability to handle credit and, importantly, expanding the universe of consumers for whom relevant and accurate data are available. AI systems also analyze alternative data to identify new patterns and correlations across data sets that are not captured by conventional models. Use of AI may produce a more robust and holistic assessment of a consumer's creditworthiness and thereby expand access to low-cost mainstream credit for millions of underserved consumers. These new approaches to credit can expand access to loans, particularly for traditionally underserved borrowers. Council members noted that a more appropriate focus would be on consumers' ability to pay versus ability to access: specifically, the real objective is to assess the financial health of the borrower to ensure they repay the loan.

According to the Financial Stability Board, credit scoring tools that use AI and ML are designed to speed up lending decisions, while potentially limiting incremental risk. Lenders have long relied on credit scores to make lending decisions for business and retail clients. Data on transaction and payment history from financial institutions historically served as the foundation of most credit-scoring models. These models use tools such as regression, decision trees, and statistical analysis to generate a credit score using limited amounts of structured data.

However, banks and other lenders may now use additional unstructured and semi-structured data sources, including social media activity, mobile phone use, and text message activity to capture a more nuanced view of creditworthiness and improve the rating accuracy of loans. Applying AI and ML algorithms to this constellation of new data has enabled assessment of qualitative factors such as consumption behavior and willingness to pay. The ability to leverage additional data on such measures allows for greater, faster, and cheaper segmentation of borrower quality and ultimately may lead to quicker and more accurate credit decisions.

Council members noted that, over the past few years, several fintech startups targeting the customers traditionally underserved by banks have emerged. In addition to more commonly known online lenders, there are firms that are working to provide credit scores for individuals with minimal credit files or are using their algorithms and alternative data sources to review loan applications rejected by traditional lenders for potential errors. For many "thin-file" consumers and the "credit invisible," a credit score cannot be generated, and a potentially creditworthy borrower is often unable to obtain credit and build a credit history. With the use of alternative data sources and the application of AI and ML algorithms to help develop an assessment of ability and willingness to repay, lenders may be able to arrive at credit decisions that previously would have been impossible. Research from the Federal Reserve Bank of Philadelphia and the Federal Reserve Bank of Chicago found that the use of alternative data allowed some borrowers to obtain lower-priced credit.

Council members believe these new approaches may have the potential to improve the accuracy and fairness of credit decisioning, while potentially improving overall credit availability.

Does AI have implications for the current regulatory framework?

Council members would encourage the regulatory framework to remain supportive of these new technologies, which can be additive to customer experiences, increase the efficiency of our institutions, and potentially provide a deeper provision of credit to a wider universe of customers.

In November 2018, Federal Reserve Governor Brainard highlighted the growing interest in AI across financial services in at least five capabilities; interest in these areas remains appropriate, and it will be important that the regulatory framework allows for balanced implementation.

The federal banking agencies and the Consumer Financial Protection Bureau have jointly recognized the benefits of using alternative data in credit underwriting, including in their Interagency Statement on the Use of Alternative Data in Credit Underwriting, issued in December 2019. The agencies found that the use of alternative data may improve the speed and accuracy of credit decisions, help firms evaluate the creditworthiness of consumers who may not be able to obtain credit in the mainstream credit system, and enable consumers to obtain additional products or more favorable pricing or terms based on enhanced assessments of repayment capacity. Recognizing "alternative data's potential to expand access to credit and produce benefits for consumers," the agencies sought to "encourage responsible use of such data."

Many banks continue to consider how best to use AI in the context of credit decisioning, grappling with the potential consumer protection aspects inherent in its use and the best methods by which to manage any such risks. Another potential challenge will center on model validation techniques as well as regulatory requirements for validation. AI essentially drives continuous change in models that are deployed by utilizing continuous data elements. While there are a number of potential advantages to using AI in credit scoring models, as noted above, the use of complex algorithms could result in a lack of transparency to consumers. This so-called black box aspect of ML algorithms may in turn raise concerns about the fairness and bias of AI. When using ML to assign credit scores and make credit decisions, it is generally more difficult to provide consumers, auditors, and supervisors with an explanation of a credit score and the resulting credit decision if challenged. Council members noted that the current regulatory framework does make it challenging for banks to implement ML capabilities, especially in the case of compliance with the supervisory guidance on model risk management.

Council members believe the use, application, and implementation of AI would increase with time. Council members would encourage the banking system and regulatory bodies to remain open and supportive of these technologies and recognize some of the complexities inherent in broader deployment.

Item 7: Economic Outlook and Associated Risks

All things considered, including the likely path of monetary and fiscal policy, what are the Council's expectations for overall economic performance with respect to real growth, employment and unemployment, and inflation? What are the greatest risks the Council sees to this outlook?

General Outlook

During the third quarter, the economy experienced a steep increase in GDP and employment as the country began its recovery from the shock of the pandemic. While the recovery is not yet complete, signs of a vaccine coming to market have brought optimism that the worst may soon be over. Inflation continues to be contained and is expected to remain below 2% for several quarters. The short-term headwinds to returning to pre-pandemic levels of growth include the concerns around the containment of COVID-19 and a lack of a fiscal stimulus plan. It should however be noted that even though the virus daily case counts in late November are higher than April daily case counts, the impact on the economy has not been the same. This is largely due to state and local governments' more measured approach to lockdowns, as well as the general public's greater acceptance of health risks posed by the virus.

(a) Real Growth

There was substantial progress made during the third quarter in the economic recovery, with GDP rising to an annualized growth rate of 33.1%, reversing more than half of the decline since the start of the pandemic. The Council is in consensus in the expectation that GDP growth will return to pre-pandemic levels by the end of 2021.

A significant driver of growth continues to be consumer spending, which grew 40.7% annualized during the third quarter. Housing also experienced a surge during the summer, with low interest rates coupled with a migration out of dense cities contributing to the increase in refinancing and purchase activity. The Council expects these trends to continue, bolstered by an increased savings rate.

Short-term growth is expected to remain muted due to the recent spike in COVID-19 cases across the country, which has prevented a full re-opening of businesses. A targeted stimulus plan aimed at consumers, impacted businesses, and state and local governments would ensure continued recovery until we reach a post-vaccine environment.

(b) Employment and Unemployment

There has been a significant recovery in employment, as 12 million of the 22 million jobs lost at the height of the pandemic in April 2020 (in non-farm payrolls) have been recovered and the unemployment rate dipped to 6.9% in October 2020. The Council expects the recovery to continue, but at a slower pace. The biggest factor contributing to the improvement of the labor market has come from businesses re-opening, but the activity has since slowed down, with rising COVID-19 cases coupled with businesses that have permanently shut down. The consensus within the Council is that the unemployment rate will end near 6% in 2021, which remains well above the 3.5% rate prior to the pandemic. The Council anticipates full employment recovery to take even longer.

(c) Inflation

With the unemployment rate remaining elevated, the Council expects inflation– currently averaging 1.5% – to remain well below the Federal Reserve's 2% target for the next few years. The risk of deflationary expectations has been addressed by strong policy actions from the Federal Reserve. One Council member noted that there has been inflation in a few sectors where supply chains have been disrupted or where demand has been strong, such as auto and residential construction materials, but this has been outweighed by low inflation in most parts of the economy.

Risks to the Economic Outlook

The Council observed that most of the expectations on growth are based on a vaccine being developed and widely distributed during 2021. The greatest risk to the outlook is if a viable vaccine is not available within this timeframe to fight the pandemic more resolutely, and cases escalate to the point of another widespread shutdown. There have already been announcements in certain regions of the country made around school closures and mandated curfews, as well as restrictions on non-essential travel heading into the winter and holiday season, which will have near-term effects on industries dependent on households traveling at the end of the year.

Most Council members also noted that there is a need for a fiscal stimulus package to support consumers, small and medium-sized businesses, and state and local governments. Earlier stimulus bills have created the necessary buffer for households and businesses to stay solvent, and it is expected that another will be required to help the economy return to pre-pandemic levels. The size and timing of a plan will contribute to the pace of recovery in 2021.

Item 8: Federal Reserve Policy

What are the Council's views on the stance of monetary policy? How does the Council view the current activities of Federal Reserve facilities created in response to the pandemic?

The stance of monetary policy is viewed by the Council as quite accommodative and supportive of the ongoing economic recovery. The early and strong intervention was timely and successful in avoiding a potential financial crisis. However, as the labor market is still far from maximum employment and may remain so for some time, and while inflation remains below 2%, the Council feels it is warranted for the Federal Reserve to maintain its federal funds rate target at the current low level. With policy rates at their effective lower bound, communications policy and the Federal Reserve's balance sheet activities have taken on even greater importance. Low interest rates have helped Q3-20 real durable goods consumption, led to very strong residential real estate activity, and aided consumer and business confidence.

Growth in the Federal Reserve's balance sheet has slowed as financial conditions have stabilized and improved. Treasury holdings have increased but at a reduced pace. This, along with Federal Reserve MBS purchases, has driven mortgage rates to a record low. A faster pace of Treasury or other security purchases may not be necessary at this time.

The current communications policy is highlighted by the updated "Statement on Longer-Run Goals and Monetary Policy Strategy," which confirmed a thoughtful, welcome shift in policy amid low inflation. In addition, the latest FOMC statement indicates that the Federal Reserve will not raise interest rates until labor markets suggest strong employment and inflation has averaged 2% for some time. The Council observed that this conditions-based forward guidance was beginning to impact, favorably, market expectations that the federal funds rate would not rise anytime soon and that the 2% inflation target was increasingly likely to be achieved.

Federal Reserve officials have broadly called for further fiscal stimulus. The Council supports this continued suggestion of additional fiscal stimulus, while caution may be needed to avoid adding to concerns about the economy's overall condition.

The Council views the Federal Reserve's various facilities created in response to the pandemic as very successful. The strong and supportive presence of liquidity facilities in various markets such as repos, primary dealers, money market funds, and municipals was needed and quite effective. Overall, these facilities' outstandings have now come down substantially from peak utilization, further reflecting their success.

Also reflecting considerable thought and effort are the direct lending facilities, such as the Main Street Lending Program. Although not experiencing significant uptake yet, they have been very supportive of market stability and credit availability.

The substantial outright and ongoing purchases of Treasuries and MBS (totaling $6.7 trillion thus far) have been extremely positive for general market liquidity and for the banking system's liquidity. The Council is supportive of the Federal Reserve's current monetary policy stance and messaging.