Record of Meeting

Federal Advisory Council and Board of Governors

Thursday, September 8, 2022

Item 1: Economic Activity

How do Council members see business activity among their clients and other contacts trending since the May meeting? Are Council members, clients, or contacts seeing any new areas of strength or weakness? Are there industries or geographic areas in which significant supply-side constraints persist? What is the Council's prognosis for the pace of economic activity across sectors during the remainder of this year?

How do Council members see business activity among their clients and other contacts trending since the May meeting?

Business activity has slowed, though there are pockets of strength. Consumer spending has moderated in response to rising interest rates and high inflation (notably for necessities such as food, energy, and—most significantly—rent), and it has been supported by high personal savings and the strong labor market. Spending continues to shift away from goods and toward services, particularly travel and dining. Housing markets have slowed from earlier unsustainable levels in response to higher mortgage interest rates; one Council member suggested that we are on the "cusp of affordability." Residential mortgage demand has dropped sharply, and bank deposit growth has moderated. Business spending has been restrained by supply chain disruptions and excess inventories. Profit margins are easing from high levels as firms, especially smaller businesses, are having a harder time passing cost increases on to customers.

Are Council members, clients, or contacts seeing any new areas of strength or weakness?

The housing market was singled out as an area of pronounced weakness, with first-time buyers priced out of many markets. Refinancing activity is notably weak because of the rapid rise in mortgage interest rates. Lower-income households are impacted more than other groups by the high cost of food and energy. Crop production has been adversely impacted by higher fuel costs and the severe drought. Retailers are working down excess inventory. The one consistent area of strength is the labor market.

Are there industries or geographic areas in which significant supply-side constraints persist?

Supply chain issues, especially related to staffing, continue to linger, though there has been some improvement. Many workers in the travel industry left the industry during the pandemic, and replacing staff to meet the surge in travel demand has been difficult. Material shortages continue to be problematic for the construction industry. Temporary lockdowns in China have disrupted the flow of parts for manufacturers. One sign of optimism is improved auto production amid an easing of the microchip shortage.

What is the Council's prognosis for the pace of economic activity across sectors during the remainder of this year?

The economy is expected to slow further this year as businesses cut back on inventories and investment, in part due to a perceived elevated risk of a recession.

Item 2: Labor Markets

Have Council members seen labor shortages increase or decrease, in their own institutions or in those of clients and other contacts, since the May meeting? What is the Council's prognosis for labor market conditions through the remainder of this year? In light of the prospective labor environment, how do Council members see themselves and other employers meeting their anticipated need for workers over this period?

Have Council members seen labor shortages increase or decrease, in their own institutions or in those of clients and other contacts, since the May meeting?

Since the May meeting, labor conditions have remained tight for both the Council members' and their customers' businesses. Although applicant volume is up and turnover is down, overall, the labor market continues to be broken. The workforce participation rate remains historically low and a record number of jobs remain open. However, incentives deployed to both attract and retain employees are starting to slow. In general, businesses have indicated they are not as concerned about ongoing labor shortages and do not feel the same sense of urgency as they have previously felt to fill open positions because businesses have learned to operate with fewer employees. Meanwhile, employees in certain sectors are being stretched due to open positions with significant labor shortages, which are most pronounced in durable goods manufacturing, wholesale and retail trade, education and health services, and accommodation and food services. In these industries, there are more job openings than unemployed workers with the requisite experience. Wage pressure continues and is especially acute in lower-paying service jobs, with many employees in those positions pointing to the heightened levels of inflation. Clients in the hospitality and restaurant businesses continued to report severe shortages of workers, and many of those businesses have had to curtail service levels or hours of operation because of a lack of staffing. With the continued adoption of remote work or hybrid work schedules by businesses, companies that cannot augment their service model with remote workers will continue to be challenged. Additionally, ongoing immigration challenges are restricting the talent pool, from laborers to skilled workers.

With the long-term outlook continuing to indicate a shortage of labor, talent supply is a key concern and growing in importance. The pandemic exacerbated growing digital, education, and skill divides around the globe, thus putting further strain on talent supply considerations and trends. As a result, many companies have continued to look for ways to automate and digitize processes to the extent possible to reduce (1) their reliance on skilled workers and (2) the impact of wage inflation.

What is the Council's prognosis for labor market conditions through the remainder of this year?

Council members expect labor conditions to continue to improve through the remainder of the year. This anticipated improvement will be partially driven by businesses deploying risk-mitigation strategies—including lowering expenses, reviewing headcounts, and slowing down hiring—ahead of market headwinds. These strategies will result in upward pressure on the unemployment rate toward the end of the year. Several companies in both the technology and financial services industries started hiring freezes or slowdowns in the second quarter of 2022.

Due to inflation, Council members expect continued increases in salary demands, especially in lower-wage and hourly positions. However, as the employment rate begins to increase, a gradual cooling of the elevated nominal wage growth across a broad cross-section of industries is expected. In the managerial and professional positions, candidates have tended to be more attuned to the market overall and thus more hesitant to move from one organization to another without financial assurances.

Finally, it is anticipated that people who have opted out of the labor market will begin to opt back in due to inflation driving the need for additional income. And—like currently employed workers—these individuals are expected to seek greater flexibility in terms of work-life balance. One Council member noted that the

need for workers still has not been met even after allowing the greatest flexibility and compensating at robust levels—which is an unsustainable situation.

In light of the prospective labor environment, how do Council members see themselves and other employers meeting their anticipated need for workers over this period?

To combat continuing rising wages, businesses are looking to third-party recruiters and contractors, and they are offering sign-on bonuses and multiyear guaranteed bonuses to attract workers along with front-running some hiring needs. Companies are proactively increasing base salary levels for key employees and working to ensure that communication and personal touch with employees remain high. Hiring for key roles will continue to progress, and firms will continue to look at adjacencies in skillsets and training-up the employee, internal mobility, and internal skill building to attract and retain employees. Additionally, companies are starting to offer more benefits to retain talent. Flexibility is by far the most sought out benefit in today's workforce, followed by paid leave, career development, and educational assistance. According to research by the Society for Human Resource Management, 42% of organizations that saw higher or much higher turnover in early 2021 have implemented new or additional remote-work or flexibility options to reduce turnover. Finally, companies are also reassessing their staffing needs. One Council member noted that their workforce is 9% below normal standards and given their continued ability to operate, they are questioning if certain unfilled positions are needed.

Item 3: Loan Markets

What is the Council's view of the current condition of loan markets and financial markets generally? Are there other conditions or developments that are particularly noteworthy in lending categories such as consumer, commercial real estate, residential real estate, construction, small and medium-size business, or corporate?

Summary

Loan demand has remained generally good as consumers and businesses try to maintain their spending under the pressure of higher prices and rising costs. Council members reported that household balance sheets remain strong. Some consumer credit delinquency rates have started to rise, especially for sub-prime and low-income borrowers, but they remain below historical norms. Council members reported stronger demand for C&I loans, though the demand is not yet at pre-pandemic levels. Roughly half of the Council members also noted a tightening of credit standards in various subsectors, including home equity lines of credit, commercial real estate, and certain syndicated transactions—particularly leveraged lending.

Consumer

Council members have observed an increase in credit card balances, which reflects the impact of inflation on food and gas prices. General credit quality remains strong, with past dues and non-accrual loans remaining at low levels, though several Council members noted that the increase in unsecured and credit card debt has historically been a bellwether of financial distress for consumers in past recessions.

Council members also observed a strong increase in home equity lines of credit, with positive application and loan volume growth year over year. Utilization of these lines has remained low, however, indicating that consumers may be planning to use home equity loans as emergency funding sources in the event of a sustained economic downturn.

Finally, Council members noted that there continues to be a proliferation of "buy now, pay later" financing options for consumers. Some of the companies active in this space have reported that in addition to the financing of large-ticket items, such as exercise equipment, consumers are also leveraging the product for daily items such as food and groceries. These companies are also reporting an increase in delinquencies, potentially signaling early signs of stress among a subset of consumers.

Commercial Real Estate / Construction

Council members reported a variety of trends in the CRE lending space, with some Council members remarking that the segment remains strong while others noted a softening of demand and tightening of underwriting standards in certain spaces.

In general, Council members agreed that the outlook for office CRE is uncertain as questions remain about how many workers will return to an office environment over the long run. As a result, there is continued low appetite, and market demand remains similarly low.

Multi-family CRE continued to generate strong interest across the U.S., as the affordability for single-family homes remained a hurdle for many potential homeowners. A few Council members noted that activity had softened marginally quarter over quarter.

In general, Council members noted that labor and supply chain issues remained important considerations across all CRE, and that those issues may limit future development, which could have either a positive or negative impact depending on whether the market enters a recessionary period.

Residential Real Estate / Construction

The residential mortgage market, both in the refi and purchase spaces, continued to see a reduction in loan volume driven by the rapid increase in mortgage interest rates and supply constraints, though these impacts are being felt differently based on region. With mortgage demand at its lowest levels in 20 years (per the Mortgage Bankers Association), Council members reported that home equity products are the only area currently seeing an increase in demand.

In general, these conditions are further exacerbating the affordable housing shortage and keeping rent growth elevated, though some areas have begun to see signs of a decline in housing prices. Some Council members also reported that mortgage insurance companies are beginning to price in additional risk in markets that are a concern, which aligns with Council members' expectations that delinquencies will increase over the coming year due to the pressure on household incomes caused by inflation. Council members also observed that underwriting standards in the residential mortgage space are generally unchanged outside of some tightening in home equity lending and subprime spaces.

Small and Medium-Sized Businesses

Several Council members observed a softening of the demand for lending activity in the small and medium-sized business space, with some Council members noting that this could be the result of companies not wanting to over-encumber themselves going into an uncertain economic environment. Headwinds including inflation, wage pressure combined with labor shortages, ongoing supply chain issues, and margin compression are also contributing to the softening of small business loan demand.

Other Sectors

In addition to the above, some Council members noted pullback in the areas of healthcare, franchise financing, and private equity/capital markets. Regarding healthcare, one Council member observed a significant pullback in new deal flow/demand tied to the rapid increase in rates and the growing threat of a recession on the horizon. In the franchise finance space, the softening appears largely a result of the impact of inflation, with consumers cutting back on discretionary items such as eating out. Meanwhile, commodity costs have increased significantly for key inputs such as poultry and beef. Finally, in the private equity/capital markets space, Council members noted a significant decline in activity as many large deals have stalled due to rising interest rates and decreased supply from traditional financing sources.

Item #4: Inflation

Based on Council members' own experience and the experience of their clients and contacts, are the prices of various products and services rising more quickly or less quickly than they were at the time of the May meeting? Has the recent pace and pattern of price increases changed the expectations of consumers and businesses about overall inflation? In light of the inflation outlook, are Council members or their clients and contacts changing pricing strategies? If so, how?

Summary

Council members reported some optimism that inflation has peaked and may be moderating, particularly in key segments such as energy and transportation. As one Council member said, the aggressive Federal Reserve policy tightening combined with a moderation of oil prices, rally in longer-term rates, curve inversion, and slowdown in home price appreciation all point to the beginning of a softening of inflation expectations.

Supply chain demands have eased to some extent, and the cost passthrough Council members reported earlier this year has played out as expected. It appears some clients and companies have reached an inflection point and may not be able to pass on additional costs to customers without eroding sales revenues or running into significant pushback.

That noted, there are still significant pressures in consumer commodity prices and within the labor market.

While gasoline prices have started to fall, easing some of the pinch on consumer pocketbooks, demands for higher wages in an already-tight labor market continue to persist in response to inflationary concerns and a higher cost of living. Consumers are unsure how quickly temporary price hikes will recede. Council members also stated that some industries (for example, healthcare and housing/shelter) are typically slow to adjust to price pressures and may see some inflationary hangover. These are trends that should be monitored closely in the months ahead.

Are the prices of various products and services rising more quickly or less quickly than they were at the time of the May meeting?

Council members reported that prices of various products and services have started to stabilize in key sectors, and the overall pace of price increases has slowed—an indication that the aggressive stance the Federal Reserve has taken on addressing inflation is meeting its defined purpose. That said, at least one Council member noted that it is not yet clear whether inflationary pressure will persist or revert to early levels. That evaluation could impact pricing strategy decisions at companies of all sizes in the months ahead.

Has the recent pace and pattern of price increases changed the expectations of consumers and businesses about overall inflation?

Although Council members expressed optimism that conditions are normalizing, daily headlines cite that inflation remains a top concern for consumers and businesses, both of whom believe that prices are too high. Gas prices, for instance, have seen a steady decline in the past few weeks, but they are still well above pre-pandemic levels. Companies—particularly small businesses—are working to find the right balance of cost passthrough and preserving margins, as spending habits change given current prices. Business expectations of continued inflation reflect ongoing pressure on the labor cost side of the house, as employees are demanding higher wages amid a tight labor market that is allowing them to take their skills to companies willing to pay them more. A Council member indicated that while key inflation metrics might have already peaked, or will peak soon, the bigger issue for customers is how readily these rates will recede, thereby reducing pressure on disposable income and business margins. Clarity of the Federal Reserve's position is becoming recognized by businesses.

In light of the inflation outlook, are Council members or their clients and contacts changing pricing strategies? If so, how?

Many of the same trends Council members reported earlier this year continue to be reflected in pricing strategies among their clients and customers. There has been a reasonable amount of passthrough, particularly in commodity prices, which has resulted in negative perception and ongoing concern about a recession and how consumers will make ends meet throughout the remainder of the year. Some of those costs have started to abate, particularly in energy and transportation segments. Stickier and slower-to-adjust industries may experience a residual effect that will take some time to play out. That spillover could result in an entrenchment of concern among broad audiences.

Council members also continued to keep an eye on global macroeconomic conditions, influenced by factors such as China's renewed zero-COVID-19 policy and the ongoing conflict between Russia and Ukraine. Supply chains remain strained because of these situations, and while some companies are adjusting their approaches to automation and inventory management, supply and demand may be affected and impact pricing strategy considerations.

In summary, while there are signs of improvement and a sense that inflation may further flatten, Council members believe clients are carefully watching the environment to determine if additional changes to their pricing strategies may be warranted. Council members remain hopeful that inflationary pressures will normalize in the next 12 months.

Item #5: Fed Policy

What are the Council's views on the stance of monetary policy, including portfolio activities?

Council members are supportive of the Board and the Federal Open Market Committee members' focus on reducing inflation by increasing the federal funds rate. Council members agree that the current situation requires continued aggressive policy action, including quantitative tightening, to eventually reach a restrictive—or at least a moderately restrictive—rate environment. Further, Council members believe that rates should remain elevated until inflation levels return convincingly closer to the Federal Reserve's 2% target.

The shift in Federal Reserve policy to return to data dependency is viewed as appropriate. CPI data continues to surprise to the upside, although there have recently been some signs of relief. At the same time, several economic studies, surveys, and commodity prices suggest that inflation could be starting to decrease. Oil prices are down 15% to 20% from June highs, and a host of other commodities—including copper, aluminum, and wheat—have dropped below pre-Ukraine war levels. However, economic activity continues to be robust based on recent employment reports, and the Employment Cost Index continues to tick higher. Despite 225 basis points of Federal Reserve rate hikes since March, U.S. labor markets continue to tighten, with the unemployment rate dropping back to a pre-pandemic low of 3.5% in July. Historically low unemployment rates will sustain elevated wages and work against the Federal Reserve's goal of reducing consumer inflation. The tight labor market will continue to put pressure on real wages and have a regressive impact those most exposed to the negative effects of inflation. In summary, while some of the more transient inputs of inflation have shown signs of cooling, core inflation remains quite high with some persistent signs of strength. Given the robustness of the job market and wage costs, a shift in Federal Reserve communication policy to a less hawkish stance may be premature. In turn, Council members recommend that the Federal Reserve should maintain the position of higher interest rates. Council members also suggest a normalization of the federal funds rate to a percentage point above the target inflation rate set by the Fed over the longer run.

With regard to portfolio activities, not much has changed since the last meeting. At least one Council member acknowledged that the balance sheet runoff is contributing to market liquidity constraints and added that while there have not been any breakdowns so far, the Federal Reserve will need to ensure that

the runoff does not lead to a breakdown in the functioning of the money market, bank deposits, or the Treasury market. Over time, as certainty grows around the effects of the planned balance sheet runoff, and as the market gets more clarity regarding the pace of rate hikes, it is expected that liquidity constraints and volatility will start to subside. At least one Council member mentioned that the Federal Reserve should consider outright MBS sales sooner rather than later if it wants to meaningfully shrink these holdings given the slowing housing sales and decreased re-fi activity. Overall, Council members are supportive of the Federal Reserve continuing to reduce the size of the balance sheet over the next few years, and some Council members mentioned having to increase the pace of that runoff. Council members recognize that there may be a decrease in prepayment speeds due to higher interest rates causing a slower runoff rate than desired and therefore the program may have to be adjusted. There was a good deal of debate over the portfolio activities.

Item #6: Affordable Housing

The recent rapid increases in housing prices and rents reflect not only strong demand but also a shortage of housing supply. Does the Council see any feasible policy or program options at the federal level for increasing housing supply? How might federal action most effectively increase the availability of affordable housing, given supply constraints?

Council members from across several regions, especially those with dense metropolitan centers, reported that the lack of affordable housing supply is not a new issue and has been a chronic source of concern for Council members not only as capital allocators, but as major employers in their respective regions. For decades, housing production has not kept up with job and household formation growth in most regions. Adding to the shortage of affordable housing are (1) the rapid increase in investors buying affordable housing (often paying cash); (2) increases in both short- and long-term interest rates; and (3) outdated housing policies and programs at the federal, state, and local level.

As an overarching principle, Council members believe that policymakers should seek greater coordination and alignment between affordable housing programs and related transportation and infrastructure initiatives.

Council members said that proposals for alleviating the housing supply shortage and lack of affordable housing fall into two categories: (1) the expansion of existing programs, such as the Low-Income Housing Tax Credit (LIHTC) and Private Activity Bonds (PAB); and (2) the consideration of other programs such as land disposition, guaranteed low- or no-cost financing, zoning reform, and investments in transportation and infrastructure. Council members noted that these transformational efforts combined with the continuance of traditional market-rate housing production create a holistic approach to finding solutions to address the housing supply shortage.

Potential expansion of current programs include the following:

- Expansion of the LIHTC:
  - Expanding the LIHTC, along with other existing programs, would help improve affordability and supply. The LIHTC has been one of the primary incentives that addresses housing needs and has been widely proven as an effective tool to create and preserve affordable housing.
  - Increasing the LIHTC income eligibility requirements, especially within geographic locations where housing costs outpace wage growth, would allow more working individuals and families access to affordable homes.
  - Increasing federal funding for the LIHTC would facilitate significant additional financing for affordable housing projects.
  - Leveraging PABs more effectively by reducing to 25% (down from the current 50%) the mandated PAB financing for the LIHTC projects could create nearly 1.5 million additional affordable homes.

- Increased federal support for the community land trust model, which has successfully provided permanent, stable, resident-owned housing for those in need.
- Similarly, complementary federal programs, such as Section 8, Community Development Block Grants, FHA, and VA down payment assistance, also should be expanded with additional funding and increased eligibility options.
- One Council member suggested that clarification of capital requirements for projects identified in locally approved community development plans—particularly to avoid punitive classification as highly volatile commercial real estate—could reduce regulatory barriers to affordable housing.
- Several Council members noted the risks that potential tax changes—particularly the implementation of a global minimum tax resulting from the recent Organization for Economic Co-operation and Development (OECD) agreement—could reduce the efficacy of U.S. tax-incentive investments in affordable housing. Council members urged the United States to negotiate the OECD framework so that U.S. taxpayers would not be subject to foreign top-up taxes as a result of participating in the LIHTC.

Additional programs that could help create new housing supplies and address the disparities between building costs and rental or purchase price include the following:

- Incentivizing affordable housing developers with federal funding programs that offer low- or no-cost financing for the developers' projects could provide a consistent and predictable source of funding.
- Redeploying underutilized government-owned land for affordable housing could help alleviate another major barrier to production.
- Supporting modular developments; alternative construction methods that lower production costs; and other innovative designs with subsidies, guaranteed financing, or mortgage insurance programs could help (1) mitigate the risk for developers and (2) address the need for more affordable housing in disadvantaged areas.
- Creating federal incentive programs to motivate state and local authorities to reform zoning and other land use restrictions to encourage density and increase affordable housing.
- Aligning and expanding public transportation and transit investment with affordable housing development is also key to solving the problem, especially in high-priced markets located outside of city centers. Connecting people to jobs along public regional transit corridors that are safe would greatly help make housing significantly more accessible.

Item #7: Probability of Recession and the Current Expected Credit Losses (CECL) Accounting Standard

Economic observers have different and shifting views on the probability of an economic slowdown. How does this variability in the economic outlook affect institutions' provisions for loan loss reserves under CECL? Are auditors and investors paying closer attention to the economic-forecast assumptions behind an institution's CECL estimates because of uncertainties about the economic outlook?

Council members noted that under the current expected credit loss (CECL) methodology, entities are required to estimate the CECL for their financial assets using all available information for assessing the collectability of cash flows, including internal or external information, or a combination of both, relating to current or past events, and a reasonable and supportable economic forecast. Recognizing that credit loss models will differ from bank to bank, Council members generally use a multi-scenario approach with probability-weighted economic forecasts as part of the CECL modeling process.

Currently, Council members noted that most banks have factored economic uncertainty into their models. Variability in economic outlook (holding other factors and assumptions constant) directly impacts the

CECL modeled losses, as credit losses estimated in forecasted scenarios are sensitive to the shape and severity of the economic scenarios used and the weights assigned to them. When an economic slowdown is more likely during the forecast period, it is common to place a higher weight on adverse scenarios, thus increasing loss expectations relative to a mild or benign economic environment. Additionally, an uncertain economic outlook can lead to varying results quarter to quarter, adding volatility to an institution's loan loss reserves. Many large U.S. banks increased their provision expenses and allowance levels in the second quarter, and Council members expect that community and regional banks followed suit.

In general, auditors are consistently evaluating CECL reserves and processes, including the economic assumptions and related support. However, auditors have not been overly focused on the forecast assumptions and instead have been more focused on the overall coverage of the portfolio, including the modeled losses and any qualitative adjustments. In addition, auditors remain focused on ensuring that sound processes are used to develop, review, and approve the scenarios and their corresponding weights.

In contrast, according to Council members, the level of investor attention paid to the forecast assumptions has been mixed. Some Council members commented that they have not yet seen a notably elevated level of focus by investors on the economic outlook and its impact on CECL. For these banks, investor focus has been on a more macro level and not specific to individual probability weights or scenarios. Other Council members noted that investors are concerned about the heightened volatility from CECL overall, with a more intense focus appearing to be on understanding where firms' provision assumptions lie between a stable outlook and a full stress event. One Council member observed that second-quarter investor inquiries across the industry earnings calls appeared to be more intensely focused on the credit outlook. Council members noted that some investors are still having difficulty understanding the mechanics of CECL, which can lead to frustration when the investors are trying to understand how different assumptions translate to credit loss provisions. Banks are working to help analysts better understand the CECL forecasting process. However, differences in modeling approaches from bank to bank, the sensitivity of estimates to different assumptions, and the unique macroeconomic environment in which banks have operated over the past two-and-a-half years will present ongoing challenges.

Item #8: FedNow

In 2023, the FedNow service will become available to depository institutions in the United States, enabling individuals and businesses to send instant payments through their depository institution accounts. Does the Council expect FedNow to change the business of banking, and if so, how?

Council members agreed that FedNow has the potential to positively impact the business of banking and could serve as an additional catalyst of change if the proposed payment rail overcomes some significant challenges. The potential is great for commercial payments, interbank settlement, and small bank instant payment access if interoperability, consumer education and support, integration processes, and fraud/mistaken payment mechanisms are successfully put in place. Additionally, modernizing the availability of FedWire and other applicable Federal Reserve products to 24/7 would complement the potential benefit to the payments system. Council members are more confident in FedNow's effectiveness for commercial payments than for individual payments, as they await more detail on consumer protection and support for the latter. .

Council members' views regarding the necessity of FedNow largely diverged along the lines of the size and complexity of their institutions. Some Council members are concerned that investments may be required in two systems if FedNow is not well integrated with The Clearing House's real-time payments system. Other Council members believe that FedNow is uniquely positioned in terms of connectivity and potential ubiquity, especially for smaller banks with high potential to change the business of banking.

Council members expressed that for FedNow to (1) be the most impactful, (2) become a standard for sustainable evolution of the instant payments industry, and (3) benefit all participants in the banking

system, it must address the same challenges as current networks, including scale, network operations and readiness, interoperability, consumer protections, education, and fraud and risk management. Assuming the ease of integration, technology providers expressed optimism about FedNow's prospects. In anticipation of its deployment, fintech are currently working with banks to create new products and services that deliver business accounting efficiencies. Outreach efforts should continue to ensure that banks throughout the system are aware of FedNow's opportunities and challenges. The Federal Reserve and its workgroups should continue to refine the scope and define the capabilities of the technology.

Item #9: Stress Testing and Credit Allocation

How do the stress test results and the overall stress testing framework affect banks' lending activities? Do stress tests alter the flow of credit or market making activity? Do stress tests affect credit availability in particular market segments?

How do the stress test results and the overall stress testing framework affect banks' lending activities?

All Council members agreed that lending activities may be impacted by stress testing. However, Council members reiterated the overall positive attributes of the stress testing framework, such as providing an opportunity to evaluate emerging risks that may arise from changing market conditions, economic factors, or business developments.

Council members noted that higher-stressed capital buffers restrict the amount of credit that can be extended to consumers and companies as they effectively become captured via higher regulatory capital minimums. Several Council members indicated that the stress testing framework can influence portfolio size and composition. Upon receiving poor stress-test results, banks tend to adjust their portfolios so that they more closely resemble those of banks with better Dodd-Frank Act Stress Test results.

Council members are broadly in agreement that stress tests have encouraged banks to allocate capital to activities that minimize their bank's losses during the stress test, and thus may require bank management teams to reconsider certain financing activities. What does this mean as a practical matter? One impact is that the traditional banking share of several lending asset classes (for example, mortgage origination, portfolio, and servicing) is below 50%. Consequently, businesses affected by the stress test leave the system and the purview of regulation. A second impact is the remaining system moves toward a median-like sameness among institutions. (There has been research that reflects the second outcome).

In addition, Council members commented that the potential for large variations in loss outcomes—given the lack of transparency in the modeling assumptions used by the Federal Reserve—may result in an overly conservative approach to capital allocation that may adversely (and abruptly) impact credit availability.

Do stress tests alter the flow of credit or market making activity?

Most Council members agreed that banks are likely to reduce the flow of credit to the assets that cause the largest increases in losses under the stress test. Specifically, where capital becomes a constraint or limiting factor, the stress testing results take on greater importance. Council members noted that the flow of credit may shift away from banks subject to supervisory tests to smaller banks or non-bank competitors not subject to the Federal Reserve-administered stress tests. Council members noted that non-stress test banks also are impacted, as the loss assumptions move into supervisory and management perspectives.

Council members also noted that given that stress test results are scenario dependent, credit availability in certain lending segments could be adversely impacted because of the hypothetical scenarios used in the most recent stress test exercise. One Council member noted that the annual changes in the stress scenarios has made it challenging to use the stress test framework to reliably inform strategic portfolio allocations.

Another Council member suggested that increased transparency around comprehensive capital analysis and review scenarios and modeling would provide greater predictability in the capital estimation process and thereby permit banks to more consistently allocate and deploy credit.

Do stress tests affect credit availability in particular market segments?

Council members noted both direct and indirect impacts on credit availability in certain market segments due to the stress tests. Elevated loss rates in recent years for oil and gas lending and non-owner-occupied commercial real estate impacted capital allocation decisions. A Council member noted that one large regional bank recently announced its decision to reorient its commercial real estate business after receiving its stress test results. Another Council member noted that higher stress losses tied to capital market activities had caused certain banks to limit their trading activities, thereby reducing the flow of credit and liquidity in the capital markets.