

## Record of Meeting

### Community Depository Institutions Advisory Council and the Board of Governors

Friday, April 8, 2016

1. **Current Banking Conditions:** *What is the Council's view of the current condition of, and the outlook for, loan markets and financial markets generally? Please describe any significant changes in the creditworthiness of applicants for loans, loan demand, and lending standards in general.*

- a. **Small Business Lending:** *Has credit availability for, and demand for credit from, small businesses changed significantly? Have lending standards for these borrowers changed?*

Credit remains freely available to small businesses, and demand for loans has increased since the last meeting. Desire for expansion and business lending has increased incrementally from the last meeting, and credit quality is good in both rural and urban environments.

However, there is more supply than demand for small business loans. Council members noted that small businesses have found other ways to get along without traditional credit, often managing growth in order to self-fund expansion. Other borrowers have tapped nonbank credit. The Council also observed that political rhetoric has affected the confidence of small businesses, who may prefer to wait on obtaining credit.

In addition, a demand-and-supply imbalance in oil markets has given pause to business owners in the oil industry and their creditors, who are retrenching.

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

Commercial real estate lending continues to be in high demand in many parts of the country. Similarly, credit availability continues to be strong, especially in large cities and urban areas. Foreign capital is also strong in these cities, with foreign capital often taking the form of cash investment. Smaller states and rural areas, though, continue to lag in comparison. Specifically, areas with a strong oil and gas industry have seen a significant slowdown in growth. In areas of high demand, borrowers have considerable leverage and often request looser underwriting covenants. As such, some markets are seeing a trend of longer amortization schedules, lower pricing levels, and decreasing cap rates.

Multifamily lending has been strong in most of the country, although Council members are becoming wary of potential overdevelopment. Most Districts reported strong demand for this asset class. For multifamily lending, HUD and the GSEs continue to provide attractive terms and pricing for purchases, and guarantees are creating more competition for community banks. Additionally, some markets reported the reemergence of the office-lending sector in certain urban areas.

The Council members reported a trend in CRE loans of banks trying to generate income through loan volume, which is causing slight alarm as it will likely lead to decreased profitability and an increase in capital requirements. Additionally, the higher loan volume leads to a greater CRE concentration, which is causing regulatory concern with the examiners.

- c. ***Construction Lending:*** *What is the Council's view of the availability of credit for construction and development projects? Have Council members seen any changes in the demand for construction loans since the beginning of the year?*

Demand for construction loans remains robust. However, borrowers have become more cautious, and there is a general sense that multifamily construction lending is at the top of the business cycle. Council members noted that, in densely populated areas, much of the increase in multifamily lending was driven by changing demographics. In other Districts, concerns about a bubble have caused traditional lenders to proceed with careful scrutiny of each loan made. Council members noted that the oldest millennials have started to move into the suburbs, which may impact the urban, multifamily rental market.

Prices in office and retail space have also increased since the beginning of the year but are not considered to be a bubble. Retail spaces within center-city areas shared in the price gains.

High volatility commercial real estate (HVCRE) continues to be a matter of concern that has some bearing on lending decisions. The HVCRE provisions of the capital rule still have not had an impact on loan prices, but there is concern that they will in the future. Additionally Council members reported that the agencies have shown inconsistencies in interpretation of the rule during bank examinations, causing further confusion.

- d. ***Home Mortgage Lending:*** *What changes has the Council seen in the mortgage market since the beginning of the year? Is a trend developing among community banks to increase, decrease, or cease home mortgage originations, and if so, what are the likely causes for and effects of this trend?*

Council members reported higher demand for home mortgages, more so for home purchases than refinancings. Low housing supply and a strong influx of foreign capital in the hottest areas often lead to bidding wars resulting in sales with a 10 percent premium over listing prices. Given this pricing trend, the Council is concerned about a growing shortage of affordable housing options.

A number of community banks have exited the mortgage origination business due to increased compliance costs and regulatory burden, which has been a common trend over the last few years. Those banks exiting were more likely to have had more-marginal mortgage operations, although some institutions made larger-scale, strategic business changes. However, some larger institutions are trying to capitalize on this trend by reentering or increasing their market share in the mortgage space.

Council members again expressed concern with the TILA-RESPA Integrated Disclosure (TRID) rule, noting that it had dramatically decreased customer satisfaction. In addition, TRID has added to the list of institutions curtailing or exiting the mortgage business because regulatory requirements require additional staff support or systems that are too costly for the bank.

Many community institutions have scaled back underwriting to only qualified mortgage (QM) loans, which can have a disproportionately negative impact on rural areas with higher proportions of nontraditional credit needs. However, non-QM lending appears to have recovered in part in 2015. Also, some institutions are offering jumbo mortgage loans with non-QM features, which continue to be in strong demand.

*e. **Consumer Lending:** What changes have Council members seen in consumer lending?*

Consumer lending continues to see strong demand, particularly with regards to home equity lines of credit and, to a lesser extent, credit cards and auto lending. Council members noted that credit unions' balance sheets are concentrated in consumer loans, and that auto lending – both direct and indirect – had expanded significantly due to low gas prices and pent-up demand. Additionally, some institutions have started to offer the same rates and prices for certain types of loans regardless of the consumer's credit strength.

Council members did express concern in regards to the easing and lengthening of auto lending terms over the past year. Additionally, the Consumer Financial Protection Bureau's (CFPB's) impact on indirect auto lending had been driving an increased number of borrowers to direct lending by credit unions and banks.

Council members also noted that student loans have become more difficult to underwrite and that more institutions are exiting this business line due to an

increase in regulatory burden on student loans and the aggressive entrance of financial technology (fintech) companies in this marketplace.

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

Low commodity prices and the strong dollar continue to negatively impact the agricultural sector. Council members reported that, based on current and projected prices, in some areas there would not be a profitable crop for 2016, and many farmers have been relying on crop insurance this year. In addition, low energy prices have hurt corn producers due to a lack of ethanol demand. In contrast, dairy prices have remained stable, and loans in this area have performed as expected.

Farm rent prices remain high, even as land and equipment values continue to fall. Farm land values are falling less quickly due to the support of foreign investors. Farm Service Agency resources remain depleted in part due to budget cuts.

*g. **Deposits:** Have Council members seen any changes in local deposit markets?*

Deposit availability predominantly remains stable to increasing across most Districts, as Council members reported that the federal funds rate increase had little to no effect on deposit rates. Some noted that there was disparity between rural and urban institutions, with rural institutions seeing little to no growth. For example, in rural areas, estate settlements often result in funds passed on to heirs. Since they often live in a different locale, funds exit the rural institution. Furthermore, rural areas have seen little to no wealth growth, thus hindering rural banks' ability to grow their deposits.

Some Council members noted that liquidity-driven competition among banks had caused a spike in some CD and money market rates, although changes in the federal funds rate seem to have had little effect on deposit rates. There was also concern expressed that millennial customers were increasingly choosing uninsured fintech services to hold their deposits.

**2. Economic Discussion:**

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

Overall economic activity has been slow and steady, with gradual growth among the Districts, although there continues to be a dichotomy between urban and rural areas. Inflation activity has improved somewhat within urban areas but is lagging within rural areas. Consumer purchases have continued to increase, even amid an uncertain future outlook for consumer confidence.

Labor markets have been generally positive and continue to improve, with demand for skilled labor increasing and some upward wage pressures. However,

some Districts reported that the banking industry has had difficulty finding qualified candidates for certain job positions.

Despite increasing economic activity, the Council remains concerned about a degree of uncertainty among businesses and consumers regarding the future of the economy.

**b. *Particular Indicators:***

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

Inflationary pressures have been mixed, broadly speaking. Within urban and metropolitan areas, there has been an upward increase in price pressure for rents and services. However, there has been little evidence of inflation within the supply chain.

Across regions, participants noted increases in prices for healthcare and construction projects, while prices for technology-related services have fallen within the intermeeting period. Within more rural areas, prices remained stable, except prices for gas and oil production had continued to decline.

Some Council members reported wage pressures in certain sectors and increased prices for skilled trade labor.

- ii. *Housing: How have house prices changed in recent months? Have there been any changes in housing activity overall in Council members' regions?*

Housing markets remained competitive across Districts, and demand continues to outpace supply. In densely populated areas, bidding wars have become common, with closing prices often 10 percent more than the asking price. Some Districts reported weak and slowing demand for the very high end of the single-family real estate market. This is partly due to downsizing baby boomers moving into smaller venues and younger consumers being uninterested or unable to purchase such homes.

Rural markets have seen decreased activity due to a lack of quality supply. Additionally, some Council members reported problems with appraisals being properly priced in these markets.

Multifamily rental housing also remains in high demand – especially within urban areas. Rents have been trending upward. Some developers have decided to hold onto multifamily projects and rent them out, as opposed to selling the units as condos as initially planned.

- iii. *Labor Markets:* *How have the labor markets in which Council members operate changed in recent months? In particular, assess the degree of job loss or gain (how much and in which industries). What changes to wages have Council members observed in the past year?*

Labor conditions have strengthened generally, and unemployment continues to fall. Employers reported some difficulty in the procurement of skilled labor, particularly in the areas of IT, healthcare, accounting, and compliance. In addition, the energy industry continued to struggle.

Council members also reported increased demand and wages for skilled trades within fields such as construction and plumbing. Furthermore, strong wages paid by certain companies for skilled tech workers have been increasing wage pressures within the banking industry when banks compete for the same talent.

Some members noted that healthcare costs may be preventing employers from adding full-time staff, with some opting to only hire part-time staff to avoid incurring that cost. In addition, there were some reports that companies were more averse to adding staff, instead focusing their excess capital on alternative investments.

- iv. *Consumer Confidence:* *Is the Council seeing signs of improved consumer confidence? What is the outlook for consumer credit losses?*

Some Council members believed that a considerable amount of consumer spending was due to pent-up demand and that consumers are tired of waiting for things to get better before making new purchases.

The Council indicated that consumer confidence continues to remain stable, but the outlook is uncertain. The uncertain outlook for the future stems from a variety of factors, including the bleak state of pension and retirement funds and the unknown outcome of the presidential election.

Districts reported that a disconnect exists between the confidence of consumers versus their actual behavior. Consumers seemed worried in theory, but their actions indicate otherwise, as housing and auto sales are both up. Perhaps partly driven by low gas prices, consumer spending is definitely trending upward.

3. **Payment Systems:** *What opportunities and challenges do community depository institutions face in meeting the payment needs and preferences of their consumer and business customers? What changes in needs and preferences have Council members observed? How will such changes affect community depository institutions and the overall payment system going forward?*

The Council has significant concerns regarding emerging payments products, based on changing consumer attitudes, convenience, and nonfinancial institution competitors. A decreased role of banks in the payment system increases the risks for consumers using the system. Financial institutions are subject to extensive consumer protection regulations, capital requirements, and stringent rules regarding consumer privacy and data security. Banks are also subject to on-site examinations to ensure that they are following the rules. Nonfinancial institutions offering payment services do not provide the same level of consumer protection or systemic strength.

Technology is evolving rapidly, and marketplace acceptance of new products is increasing. More consumers are also becoming comfortable with new technologies. Community depository institutions are working to meet the demands of consumers in these areas, but banks have concerns that some products offered by nonfinancial institutions may present risks that customers are not considering, including subpar data security and a lack of deposit insurance.

There is concern that participants in the payments marketplace, other than community depository institutions, have advantages in providing new payments products because they are able to operate on a larger scale (large banks) or with less regulatory oversight (nonbanks). It was also pointed out that implementing any new payment type would require integration with core service providers. Several Council members noted that reliance on third parties to provide services means that the institutions have less control over the product and its implementing process.

The Council supports the efforts of the Federal Reserve's Faster Payments Task Force, especially the creation of the faster payments effectiveness criteria. However, there is still concern about the time it will take smaller institutions to implement any accepted solution and the unknown costs related to offering the service. The Council discussed what role the Federal Reserve should play in any new payment system, including providing oversight or acting as an operator.

There is concern that the regulation of nonfinancial institutions and financial institutions is not consistent and that the lack of established oversight for nonfinancial institutions may present them with a marketplace advantage while placing consumers at risk. Nonfinancial institutions operate with less regulation and oversight.

The Council members did not recognize any substantial commercial customer demand for faster payments, but most members indicated that they would be offering same-day ACH products when they are implemented in September 2016.

4. **Examination Practices:** *Have Council members experienced problems with recent examinations? In particular, have examination practices constrained access to credit by creditworthy borrowers? What steps can be taken to address the Council's concerns?*

Examination practices continue to be viewed positively. The Council expressed an overall high level of satisfaction with the supervision process, with safety and soundness

examinations in particular receiving high marks. The Council mentioned that these high marks are evidenced by an improved examination tone, examiners exercising a fairer and more balanced approach when discussing supervisory issues and concerns, and a less intrusive presence toward the bank and its staff during on-site visits.

On the other hand, the Council registered more neutral-to-negative marks regarding consumer protection and Community Reinvestment Act (CRA) examinations. The Council is concerned with the seemingly endless and increasing compliance burden facing community banks to integrate the rapid pace of new regulations, which have more complex requirements, in short periods of time. The Council is also concerned that CRA regulatory requirements have not kept pace with the rapidly changing financial industry landscape. These rapid changes are impacting the community bank model, and certain prescriptions intended to help serve community credit needs have moved beyond what was originally envisioned by the CRA. The Council is unanimous in its opinion that the CRA needs modernization.

The Council is very encouraged that the agencies have listened to banker concerns, as being reflected in an improved examination process. Examiners are continuing to provide clear distinctions between suggested supervisory actions versus required supervisory actions, and the Council continues to see fewer large-bank “best practices” being applied to community banks in a “one size fits all” regime. While the Council is also very appreciative of the agencies’ support of more risk-based and tailored examination approaches, that support is not always reflected in field practices. The Council expressed some concern about practices that diminish the goal of providing risk-based supervisory activities and examinations, ranging from the front-end, fully loaded examination request letter to certain examination activities that do not focus on areas of high risk.

5. **Regulatory Matters and the Future of Banking:** *How are recent changes in the regulatory landscape affecting community depository institutions’ ability to continue to provide services to their customers? What has been the effect on the industry generally?*

Post-crisis regulation continues to significantly impair community depository institutions’ service to their customers and their ability to meet the credit needs of their communities. In general and across all Districts, community institutions report that the burden, related costs, and resulting negative impact on customers has continued to increase since the Council’s last report. The impact crosses all areas of institution operations: residential mortgage lending and servicing, payments processing, consumer account overdraft management, layered capital burdens (and the complexity of their calculation under Basel-based rules), and a host of others. In all these areas, institutions generally have responded by reducing business volumes and/or restricting the diversity of (and innovation in) product offerings. As noted in previous reports, many community institutions have been forced to withdraw entirely from business lines that now present too great a regulatory cost burden, too great an exposure to compliance risk, or both.

Most examples arise in consumer financial products and services. Residential mortgage lending, with new integrated TILA-RESPA disclosure requirements, has become



exponentially more complicated, and QM rules have caused high year-over-year volatility and lower average levels in the volume of non-QM loans. In addition, the directly conflicting regulatory approaches of the CFPB and the Federal Communications Commission (implementing the Telephone Consumer Protection Act) concerning contacting consumers via their cell phones has significantly increased compliance risks for mortgage servicers. Community institutions anticipate further mortgage-servicing-rule changes in the near future (e.g., affecting servicing of loans to heirs and assigns of deceased mortgagors), which will only further increase the adverse impact in the short term. In addition, the CFPB has indicated that it will expand its focus to include small business lending, and community depository institutions fear a similar experience in that business line – moving toward a “one-size-fits-all” approach about a number of credit issues will necessarily restrict flexibility to customers. As a result, some customers will likely seek solutions outside the regulated banking system.

Outside the consumer area, the increase in regulatory burdens and expenses has been less drastic, but the trends remain both negative and significant. Foremost is the burden on even well-capitalized institutions from the increasingly complex Basel capital rules. Many aspects of the rules (credit conversion factors, high volatility commercial real estate) target complexity that is irrelevant, or at most incidental to, most community institutions’ business models. In addition, at a time when cybersecurity concerns are central to risk management, applicable regulatory requirements fail to keep pace with the evolving threats institutions face. Finally, institutions face widespread regulatory confusion and conflicting government policies in dealing with marijuana-related businesses. This topic clearly calls for a national regulatory policy solution.

The Council believes that, apart from the burden of inappropriate capital regulations under the Basel regime, community institutions have generally adjusted to the regulatory landscape in the safety and soundness area, particularly since the changes in the examination environment noted in the responses to Question 4. The Council is deeply concerned, however, that evolving competition from “shadow banks” and fintech companies could change the landscape very rapidly and turn a significant but manageable regulatory burden into a serious threat to institutions’ businesses. It is essential that the institutions and their regulators work to make the necessary adjustments now, before the damage becomes serious.

6. **Additional Matters:** *Have any other matters affecting community depository institutions emerged from meetings of the Reserve Banks’ advisory councils that Council members want to present at this time?*

6a. **FASB Proposal on Allowance for Credit Losses**

By June 2016, the Financial Accounting Standards Board (FASB) is expected to issue a new accounting rule on accounting for loan losses and losses on held-to-maturity (HTM) debt securities. The FASB proposal (called the Current Expected Credit Loss Impairment Model – “CECL”) requires banks to record credit losses based on a “life of loan loss” expectation. This requires forecasting all future losses, a process that increases

complexity and could well lower the reliability of this highly judgmental area of accounting.

The banking agencies have been very supportive of CECL, and some have publicly stated that CECL is “scalable,” meaning that the costs and complexity will depend upon the size and complexity of an institution. The Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB) also have said it is scalable. “Scalability” is generally consistent with the notion of tailoring regulation to the size and complexity of an institution.

However, community depository institutions are concerned about definitions in the pending rule and the uncertainty of its potential implementation. The Council notes that proper implementation of today’s incurred-loss-impairment regime has been a subject of debate and reinterpretation for over two decades. Because CECL is based more loosely on principals than the incurred-loss model and because the proposal suggests complex data management and modeling requirements, CECL may well unleash even more debate and reinterpretation. Significant concerns exist that the banking agencies, external auditors, PCAOB, and SEC may have different definitions of how to achieve scalability. Without a common understanding of what constitutes scalability, the Council is concerned that the banking agencies will, effectively, defer these important decisions to others.

The Council requests that the Federal Reserve:

1. Work more closely with FASB, other primary regulators, banking institutions, auditors, SEC, and PCAOB to improve the proposal to ensure that the final standard is workable for banks of all sizes and reflects the economics of the business before the standard is issued in final form. The rule itself should address the question of scalability more directly, rather than engendering an uncertain debate after issuance. Also, institutions are being encouraged to start collecting data as soon as the standard is issued. Gathering data and setting up systems without a clear understanding of whether or how it will be used will be extremely costly.
2. Evaluate the costs versus benefits. The Federal Reserve should support only versions of CECL where the benefits justify the costs, which will likely depend on an assessment of how CECL will be implemented for smaller banks in addition to other considerations.
3. Scalability should permit institutions to record estimates of losses with reasonable confidence and at sustainable cost.

6b. **FINTECH**

The Council wants to highlight growing concerns surrounding the financial technology sector, or “fintech.” The Council is fully supportive of innovation in financial services

and believes that more discussion and direction need to be focused on this burgeoning segment of the industry. The objective should be to harness the economic benefits of innovation without sidelining depository institutions, which increasingly operate in a regulatory environment that limits capacity to innovate.

Specifically, Council members draw attention to the payments sector and marketplace-lending sector by posing the following questions: What minimum levels of consumer protections and safety and soundness requirements should apply, and how do they differ from the standards applied to depository institutions, and why? How should functional regulation be established for financial markets? How can the benefits of innovation best be secured without introducing unintended fragility into the payment system or introducing destabilizing pro-cyclical volatility into underwriting standards? How can privacy and data security best be guaranteed? How can technology itself be harnessed to help deliver the benefits of innovation safely?

The Council suggests that the Board take a leadership role, along with other regulators and government agencies, to address these questions and to formalize a structure for policy discussion and the development of action plans.