

RECORD OF MEETING

Federal Advisory Council and Board of Governors

Wednesday, November 30, 2016

Item 1: Current Market Conditions

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

General Outlook:

- The Council believes there has been only modest change in the current condition of, and outlook for, loan markets and financial markets in general.
- Small business owners remain cautious and indicate mixed signals related to improving confidence.
- Commercial real estate markets remain healthy and stable in most Districts, with the multifamily construction markets showing signs of moderation.
- Corporate lending remains competitive, with capital equipment financing well off the earlier pace.
- Stress is reflected in the agricultural markets because of the extended period of low commodity prices.
- For the consumer, unemployment continues to improve, although wage growth has been modest. The consumer remains optimistic, as evidenced by increases in household spending.
- The mortgage market continues to be healthy. Home prices have experienced 55 consecutive months of year-over-year increases.

(a) Small and Medium-Size Enterprises

- External measures of small business optimism (e.g., National Federation of Independent Businesses) continue to reflect a general sense of uncertainty amongst business owners. Entrepreneurs are reluctant to hire or build inventories, as they seek more stable political and regulatory climates and a more positive outlook for the domestic and global economies. It will be determined over the next several quarters if post-election business optimism translates into capital and labor investments.
- Current conditions for loan markets related to small and medium-size enterprises remain tepid, with loan demand over the past six months being lower than the previous six months.

- Loan demand is primarily for replacement of existing plant and equipment. In some cases, even replacement capital expenditures are being postponed. Bank pipelines continue to see limited expansion of plant and equipment investment. Access to credit is not a cited concern. The July Senior Credit Officer Opinion Survey reflects tightening conditions for C&I and CRE loans, although there is continued demand for commercial real estate.

(b) Commercial Real Estate

- Commercial real estate fundamentals continue to improve for most major property types. Investors are chasing yield and seeking "safe" tangible assets due to the ongoing low-interest-rate environment. Investor demand is pushing down cap rates to historic lows, and correspondingly, asset prices to historic highs. Investor demand for yield has increased interest and activity in secondary and tertiary markets where higher returns are available.
- The multifamily market remains healthy; however, banks continue to moderate lending activity due to balance sheet concentrations. The near-term outlook for this sector is favorable, as property performance metrics are extremely strong. However, property supply has started to exceed demand in specific markets and, therefore, vacancies have begun to rise slightly from their historic lows.
- The retail loan market has modest demand. This sector is still experiencing a very tepid recovery. Overall, vacancy levels have only modestly declined from their recessionary peak. Improvement in consumer sentiment is leading to an increase in retail spending, but many traditional retailers continue to close stores and decrease their physical footprint.
- The office-space market, like the retail-space market, has experienced a very slow recovery. Office vacancy rates have improved only marginally over the last several years. During this recovery, employers have been slow to add square footage for employee expansion. Expansions by technology and energy employers, which have led the office recovery, have slowed. Improvement in central business district properties has outpaced suburban locations.
- The availability of credit for speculative office or retail development remains subdued. Investor demand for this type of credit is also limited because both of these property types are lagging the recovery. Speculative development in the market for office and retail space is being pursued with substantial personal guarantees and significant equity investments.

Industrial assets have experienced a moderate recovery to this point, but investors and lenders are increasingly optimistic about this sector. West Coast port cities and intermodal hubs have led the recovery, while secondary and support markets are beginning to build momentum. Speculative development in major port cities is becoming more common.

(c) Construction

- Banks are able to get improved terms for new projects (40% equity, good recourse, debt yields in excess of 9%).
- There is much concern about the abundance of supply in many markets, but demand remains surprisingly resilient.

- Construction of new retail and office developments continues to be tenant driven, with very little speculative activity in the marketplace.
- There is a growing amount of new construction activity and increasing loan demand for large bulk industrial facilities in port cities and major transportation hubs, as the outlook for this sector has continued to improve. This trend is supported substantially by e-commerce demands for well-located distribution facilities.
- The hotel industry has continued its strong recovery in fundamentals. Revenue-per-available room now exceeds pre-recession levels and has set new record levels in 2016. Significant hotel development in some markets has begun to lead to oversupply. Markets under macroeconomic pressure, like energy-dependent cities, have begun to show demand-side weakness. Full-service properties continue to lead the recovery, with select-service and limited-services assets posting slower gains.
- Demand for single-family, tract-development financing continues to be tepid, due predominantly to the dominance of the publicly held homebuilder in most major markets.
- In Boston, two major condo/apartment building projects previously announced have been pulled by their sponsors, who cited concern over potential oversupply and limits on demand, especially for downtown luxury properties.

(d) Corporations

- Corporate lending, particularly in the shared credit market, continues to be highly competitive, resulting in pressure on both spreads and fees and in structural compromise. Most notably, there is a trend towards minimal amortization on term loans and a move to only one financial covenant (debt/capitalization or debt EBITDA (earnings before interest, taxes, depreciation, and amortization)) on investment-grade and even near-investment-grade credits. Competitive conditions have been exacerbated by reduced leveraged lending activity and the fuller migration of national competitors into nonleveraged markets.
- In the absence of significant economic growth and the related opportunities for building capacity or working capital, lending in the segment is disproportionately oriented around M&A activity and "shareholder friendly" transactions, such as share repurchases or dividends.
- Commodity prices, including oil, gas, coal, aluminum, and steel, remain depressed, with no immediate drivers for recovery. As a result, growth opportunities in these core industries are absent while asset quality has deteriorated materially, most notably in the coal, oil, and gas markets.
- Corporate clients continue to keep excess liquidity with banks, leading to expected deposit growth through the end of 2016. There is increased competition for large blocks of deposits, which has driven rates higher over the past few months.

(e) Agriculture

- In the third quarter of 2016, cattle and hog futures and prices have dropped sharply and are near their lowest levels in years. While a positive for consumers and processors, this will put pressure on growers' demand for beef. Pork prices decreased significantly in 2015 as a result of the pork supply glut. Hog prices had shown improvement in early 2016 due to improved supply conditions, reflecting an improving export market (driven by China - 25% of U.S. production) and increased demand from processing plants for

production of value-added product. However, robust supply has again overtaken demand factors.

- Grain trends are being driven by greater planted acreage and technological improvements in farming that have resulted in robust supply. A record corn and soybean crop is still expected in 2016. Ethanol production is a continued demand driver, as it consumes over one-third of corn production. Corn prices have been stable in 2016 but at only 50% of their peak in early 2013. Wheat prices continue to fall, but soybean pricing has increased throughout the year. Net farm incomes are expected to remain depressed again in 2016, after being only 45% of their 2013 levels in 2015. Grain logistics and handling companies have seen lackluster profitability.
- Protein producers, who use grain as a feedstock, should continue to benefit from lower grain prices, but producer profitability in 2016 will be contingent on effectively managing supply. Poultry prices have shown mixed results year over year.
- The wellness movement is uppermost in the minds of consumers and food processors across the food chain (from field to table). What has transpired is a focus on local sourcing, organic farming and production, sustainability, non-GMO foods, and freshness - all of which have upended the established food chain in the U.S. The traditional, large food processors are rethinking their business models (due to profit pressure) in order to capitalize on these trends. This has spurred the acquisition of smaller, less-traditional companies - albeit companies focused on these trends - by larger companies at significant enterprise value to EBITDA multiples.
- Brexit could have a significant impact on the U.S. protein sector if the U.S. dollar continues to strengthen relative to the euro, as the U.S. has already lost share in Asia to European producers.

(f) Consumers

- Spurred by more jobs and rising income, household spending has been growing and consumer confidence remains buoyant.
- Consumer demand for automobile lending continues to soften in the face of the industry's message that sales have reached a plateau. The use of incentives (which reached a high of \$3,888 per vehicle in September) and fleet sales as a counter to plateauing retail sales will be the statistics to watch going forward. For comparison purposes, incentives were below \$3,000 per vehicle from 2009 to 2013.
- Demand continues for home equity lending. Drivers of demand include improved home values, improved economic conditions, and consumer reinvestment in their homes via renovation/home repair/maintenance projects that were previously postponed. The industry is still experiencing portfolio runoff, but it has slowed.
- There is also increased demand for unsecured and deposit-secured lending that is most likely due to the streamlined process for obtaining these loans compared to the requirements and length of time required to close a home equity loan. Marketplace lenders are impacting the unsecured borrowing landscape by providing the convenience of broad-based online borrowing offers, although funding for marketplace lenders has slowed, causing a corresponding decline in production.
- Consumer spending overall is up. Consumers are, however, saving more, as reflected in credit card payment rates - balance growth is muted compared to spending growth.

(g) Homes

- The mortgage market continues to be healthy for home purchases. Move-up borrowers may choose to remain in their homes and invest in home improvements. The industry is expecting volume to be up 12% in 2016, in contrast to earlier projections that volume would be down. The level of mortgage activity needs to be closely observed, given the post-election increase in long-term rates.
- Current home purchases are expected to increase by 11% over 2015 and represent 53% of the market. We expect a mix shift from refinance to purchase loans due to higher rates.
- Refinances are expected to be up by 14% in 2016 and represent 47% of the market.
- Existing home sales are on the rise (up 1% year over year) with demand being driven by first-time homebuyers, who accounted for 34% of sales in September.

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

- Economic developments remain broadly consistent with trends in the aggregated economic data.
- The worst of the energy crisis may be over in the 11th District. Texas employment growth picked up pace in the third quarter, surpassing national job growth for the first time since the energy bust started.

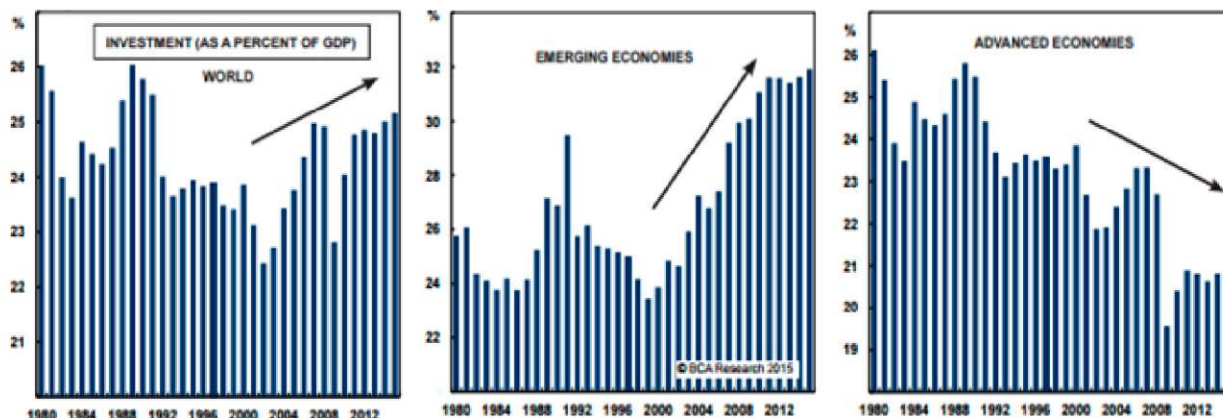
Special Topic:

What is the Council's assessment of investment spending by businesses?

OVERVIEW OF INVESTMENT

The Council reports that investment in the twelve Districts continues to lag the overall economic recovery. Core U.S. business investment (Nondefense Capital Goods Orders Ex-Aircraft) is down 10.8% since the recent peak in the summer of 2014.

Given the mobility of capital, it is notable that investment spending on a *global* basis is healthy, but that picture belies a "tale of two cities," as shown below. Although worldwide investment (percentage of world GDP) has returned to its historical norm since 2000 (left), investment spending by emerging economies has surged in the period (center), fully offsetting an investment decline in advanced economies (right).



Source: IMF WEO.

FACTORS SUPPRESSING U.S. BUSINESS INVESTMENT

The chart above (right side) also depicts a *secular* downtrend in advanced-economy investment over the past few decades, a condition present in the U.S. as well. This indicates a larger, more systemic problem, usually described as a "*decline in competitiveness*" for U.S. business, which the Council attributes primarily to the following six factors:

- (1) **Globalization:** Capital mobility combined with cheaper overseas labor has led to out-bound capital spending by advanced-economy companies *into* emerging economies, amplifying global overcapacity while reducing U.S. capital investment and productivity, and thus real growth potential.
- (2) **Savings glut:** The emerging-economy savings glut has been exported to the U.S., lowering U.S. interest rates and raising U.S. debt levels, thus reducing the incentive for U.S. capital spending.
- (3) **U.S. corporate "de-capitalization":** Investors have favored "Dividend Aristocrat" stocks as well as bond-proxy stocks for much of the post-crisis period, preferring corporate de-capitalization over capital investment. To satisfy the practice of investors' "reaching for yield" as nominal interest rates have fallen, corporations have sought to boost the return on capital by limiting capital spending, in effect restraining the denominator of (Capital Income) divided by (Capital Stock). Reflecting this trend, stock buybacks and dividends are 123% of S&P 500 earnings through the third quarter of 2016, and according to a Carlyle Group study, when five-year rates dropped by 0.5% between February and May 2016, the S&P Dividend Aristocrats Index outperformed the S&P 500 by 5.8%. However, with the expected return on financial assets declining, there may now be a *positive* relationship between business investment and interest rates such that *both* may rise as the practice of reaching for yield subsides.
- (4) **Dollar weakness:** From its peak to trough (2002 to 2011) in the first decade of the new millennium, the U.S. Trade-Weighted Major Currency Dollar fell 40%. Although a more competitive currency is associated with export growth, a side effect of U.S. dollar weakness was that it lowered the buying power of U.S. consumers, reducing domestic demand and capital spending incentives.

- (5) **Tax differences:** Corporate inversions and the debate regarding earnings repatriation are byproducts of different tax regimes. For example, the U.S. taxes (only) income at one of the highest corporate rates in the world, while foreign jurisdictions tax corporate income at a lower rate than the U.S. but *also* tax consumption (the VAT), refunding the latter at the point of export. This affects U.S. export competitiveness and thus business investment but may be remedied by U.S. corporate tax reform, investment tax incentives, and changes to cross-border tax policy comparability.
- (6) **Regulatory burdens:** Regulatory changes have had the effect of inhibiting investment and credit, e.g., Sarbanes-Oxley, Dodd-Frank, Department of Labor fiduciary rules, and others. This adversely affects U.S. competitiveness and investment.

OUTLOOK POSITIVE FOR U.S. INVESTMENT

Cyclical trends favor the advanced economies

Advanced-economy business investment (including that of the U.S.) has lagged, but the Council sees U.S. investment improving. Again, there is a "tale of two cities" aspect, part of a global re-balancing of savings/investment and exports/imports alongside what appears to be a slowing in world trade volumes. Specifically, there are signs that over-investment by emerging economies is peaking while conditions are improving for advanced-economy investment, based on two events:

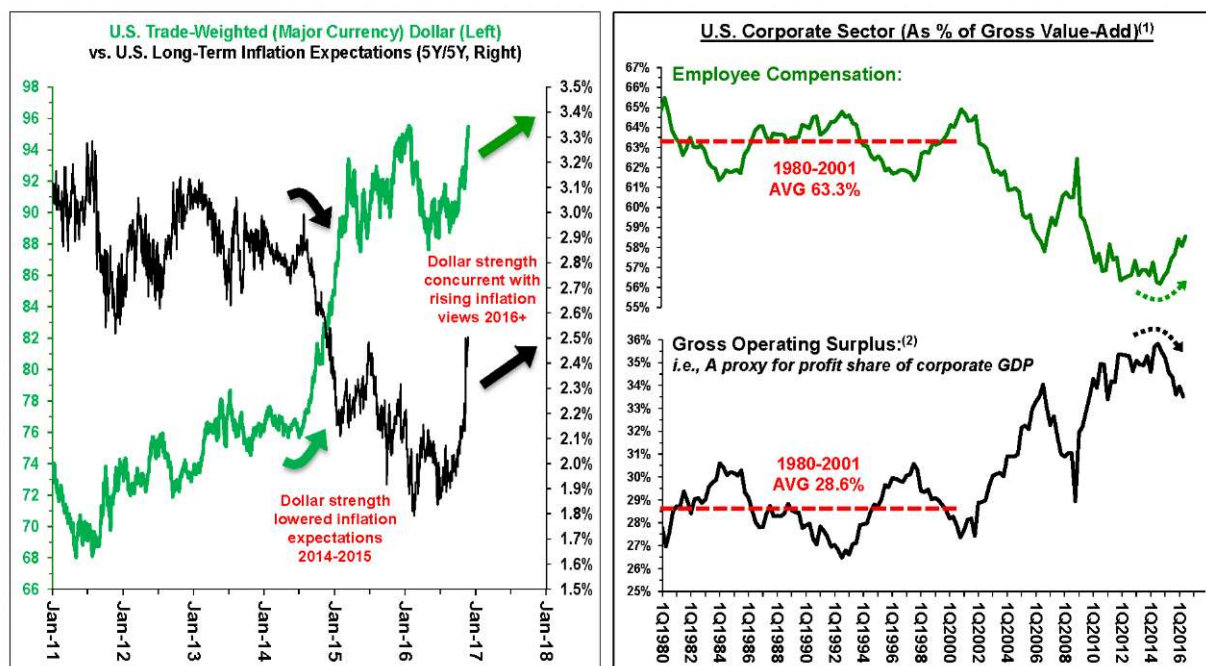
1. **Emerging-economy rebalancing:** Reflecting ample domestically generated savings, China's credit boom created \$15 trillion of credit between 2010 and 2015, representing 90% of credit creation worldwide. As China pursues rebalancing, its reliance on capital spending (state and private-sector corporate investment as well as housing) and debt will slow, and domestic consumption should consume a greater portion of domestic savings. In addition, normalization of U.S. interest rates, probably followed by other advanced economies with a lag, should cause emerging economies to experience net capital outflows and currency weakness, furthering the cause of emerging-economy rebalancing, albeit under some duress. Emerging economies beyond China are taking note and adjusting policies to promote balanced demand.
2. **Advanced-economy recovery:** The stronger U.S. dollar has attracted foreign direct investment of \$600 billion in the second quarter of 2016, roughly three times the volume of recent years. Overall, declining U.S. unemployment rates, a narrowing of the U.S. output gap, rising U.S. wages, and the potential for a greater fiscal role in GDP may further the cause of U.S. economic rebalancing in a favorable way. This should enhance U.S. domestic demand, leading to capital investment, productivity, and real growth in a virtuous circle.

Emerging economies, after a 450% gain between 2001 and 2010, began a period of underperformance. Since 2010, the emerging economies returned 13%, while the S&P 500 is up 90%.

Pro-growth U.S. policy responses that promote capital investment

The Council believes the two principal channels of policy in the U.S. - **monetary policy** and **government policy** (fiscal & regulatory) - appear to be aligning in a favorable way.

U.S. monetary policy continues to effectively achieve its dual mandate of price stability and full employment, laying the groundwork for necessary government policy actions. Continued gradual adjustment in the stance of monetary policy is now possible in the context of a strengthening dollar *and* rising longer-term inflation expectations (left chart below). Also within the dual mandate, recovery in the U.S. to full employment (i.e., NAIRU) has resulted in only a moderate 2.8% year-over-year increase in average hourly earnings to this point, and in a broadly positive sense, the yawning gap that developed after the turn of the millennium between *labor's* and *profit's* shares of U.S. corporate GDP has begun to close in favor of a rising labor share concurrent with a falling profit share (right chart below). For many companies, this should lead to capital investment to preserve profitability, thereby potentially creating a favorable cycle of increased productivity, sustainable real growth, and improved investment spending.



Source: BEA & Bloomberg data, Stifel format.

(1) GrossValue-Add is the value of goods & services produced by the corporate sector(gross output) less goods& services used in production (total intermediate inputs).

(2) Gross Operating Surplus is gross output less the cost of intermediate goods and services (to give Gross Value Added), and less employee compensation. It is gross because it makes no allowance for depreciation of capital. It is the portion of income derived from production by incorporated enterprises that is earned by the capital factor of the economy.

U.S. government policy has been a subject of investor discussion and may positively impact U.S. GDP in three ways: (1) fiscal spending (e.g., infrastructure, defense), (2) tax reform/rate reduction, and (3) regulatory reform. This would be a positive change compared to recent years. Specifically, in addition to tax increases and regulatory burdens, fiscal austerity since 2010 has produced a cumulative 7.3% of GDP reduction in government fiscal deficits, which has *exceeded* the 4.2% of GDP recovery in private investment (business capital spending plus household-sector residential investment) since 2010. That difference of about 3% of GDP, or \$500 billion, is a "hole" in GDP that the Council believes can be filled to the benefit of business investment by (1)

fiscal stimulus (e.g., infrastructure, defense) in the near term and (2) economic rebalancing, interest rate normalization, dollar strength, tax policy, and regulatory reform in the longer term.

RECOMMENDATIONS TO ENCOURAGE INVESTMENT

In order to promote business investment, the Council believes that the Fed should continue the process of gradual adjustment in the stance of monetary policy, such as raising interest rates while maintaining accommodative negative *real* interest rates in the period 2017-2018. In addition to the dual mandate, the Fed may continue to monitor *global* economic recovery, price signals, and the relative context of policy movement as embodied in U.S. dollar indices.

Item 2: European Banks

What is the outlook for the European banking and financial system in light of the current financial difficulties experienced by some large European banks? What is the potential impact of those difficulties on the U.S. banking industry?

As a whole, the European banking sector and financial system are much stronger today than at the outset of the crisis.

Since 2008, European banks have significantly de-risked their balance sheets, decreased their leverage, and increased their capital bases, particularly through large-scale capital increases. Liquidity is also strong. The recent ECB/EBA stress test was also important to further restore market confidence by indicating the continued progress of European banks in capital management and strengthening. Overall, the result of the stress test implies that there is limited systemic risk in the European banking sector and, consequently, situations have to be assessed on a case-by-case basis.

The European banking sector is very diverse and displays differing situations among banks and geographies.

For example, most Nordic banks are trading at a premium to book value, which underlines the inherent high profitability, stability, and overall attractiveness of the region. On the other hand, German banks and Italian banks are trading at significant discounts to book value, reflecting structural challenges and asset-quality concerns, respectively.

In addition, banks and markets have reacted very differently to the financial crisis. The Benelux Union (Belgium, the Netherlands, and Luxembourg) was strongly impacted at the outset, but its banks have been pro-actively restructured and refocused, which explains the current healthy returns of the local banks. French banks have received little support from their government, highlighting the relative resilience of their model. Both markets continue to benefit from a domestic retail environment that is relatively concentrated and profitable. In Italy, the sector remains quite fragmented and challenged by high cost bases, an adverse macro and credit environment, and specific issues at some banks still to be fully addressed. Large Spanish banks have been pursuing a pro-active effort of diversification outside the Eurozone into Central and Eastern Europe, the United Kingdom, and the Americas.

However, European banks continue to face multiple headwinds, including regulatory, challenges to business models, political risk, and in some specific situations, issues with nonperforming loans (NPL) and a "litigation tail risk."

Regulatory uncertainty is one of the major issues impacting European banks. The previous proposals of the Basel Committee could potentially result in significant risk-weighted asset inflation. Credit risk would be impacted by restrictions applied to internal ratings-based models and floors on mortgages. Operational risk could also be measured more conservatively. European banks and politicians and the European Commission have all stressed that any material increase in capital requirements would constrain lending and most probably put some strain on an already fragile Eurozone recovery. Uncertainty about the outcome of so-called Basel IV weighs on European bank management's ability to make strategic decisions. But there is a growing expectation that the ultimate outcome might be more favorable and pragmatic than originally anticipated.

Leverage is also an important regulatory constraint for larger European universal banks. First, the financing model for corporates remains largely bank balance sheet driven as opposed to capital markets sourced. Second, the vast majority of mortgage loans remain consolidated on banks' balance sheets, as the opportunities to deconsolidate these loans are few. The RMBS market in Europe is more limited than in the U.S., and the covered-bond model, which is traditionally used in Europe, implies that the bank keeps the credit risk on its balance sheet.

Paradigm shifts in several activities are causing banks to rethink their position in the value chain. In retail, digitalization is challenging historical models. In fixed income, the European Union's Markets in Financial Instruments Directive II is gradually shifting models away from traditional bilateral business to trading venues, which requires heavy IT investment and a global footprint. The emergence of "fintech" specialists in selected segments of the value chain might also be a long-term disruptive factor.

The long-term implications of Brexit are uncertain, and political headwinds in Europe continue. The prospective long-term impact of Brexit on European growth and the spillover effects on banks' profitability and risk profile call for prudence. Even if fears of European disintegration are overdone, Brexit has underlined the increasing political risks on the continent. Presidential elections in France and Germany in 2017 add to the political headwinds. Uncertainty about the future organization of European financial markets will impact large wholesale-bank strategies.

In some markets, banks remain vulnerable because NPL issues have not been fully addressed and work-out processes remain inefficient. Some banks also face a "litigation tail risk" that is difficult to assess from the outside and thereby fosters uncertainty and speculation. Such situations affect the market perception of European banks overall and the financial system.

Profitability is the major midterm challenge of European banks.

For the sector as a whole and a number of banks specifically, the lack of profitability may be the biggest challenge. Listed EU banks are expected to generate an average return on equity of 8% in 2017, which is below an assumed cost of equity of more than 10% for most banks. Moreover, the

8% average return reflects a wide spectrum of ROEs, depending on the country and business model. Nordic banks generally enjoy returns above their cost of equity (in the 10% to 15% range), whereas in jurisdictions such as Germany, Austria, and Italy, banks operate with returns in the mid-single digits.

Over the past 12 months, negative revision of earnings-per-share expectations for European banks has been significant. The pressure on profitability comes from a combination of low or negative interest rates, subdued economic growth, pressure on revenues due to business restructuring, the impact of widening credit spreads on investment portfolios, increasing regulatory burden, and an elevated cost of risk within the periphery. Negative interest rates are the most concerning factor, reflecting both the ECB's quantitative easing and banks' reluctance to apply negative rates to depositors.

Consequently, a change in sentiment towards the European banking sector would require a combination of (1) synchronized global growth; (2) ECB tapering, triggering the end of the negative rate environment; and (3) regulatory certainty and stability.

The fixed-income market has been supportive.

Over 2013 to 2016, Western European banks have raised €105 billion of new-style additional tier 1 (AT1) and €182 billion of tier 2 debt. Despite notable volatility in the AT1 market in the first quarter of 2016, subsequent changes to EU regulatory requirements that better align regulators' and investors' objectives should reduce the risk of coupon loss and future market volatility. Although fixed-income investors, like equity investors, are concerned about NPLs and net interest margins (NIMs), recent shifts in the macro/political outlook may be supportive for banks.

Bail-in of debt has now become operational for European banks. Investors accept the need for this but hope to see a consistent and predictable application of these powers. The fragmentation in national approaches to bail-in/insolvency frameworks has created considerable complexity for the market. So a harmonized European approach - perhaps along the lines of the newly adopted French approach with two classes of senior debt - would be beneficial. However, given the significant cross-country variation in banks' business and funding models, it would be vital to preserve flexibility in the way banks transition their existing debt into this new framework.

Against such a backdrop, European Banking and Capital Markets Unions are a key focus of European political agenda.

The European Union is very focused on both the European Banking Union and the Capital Markets Union. Key pillars include (1) the Single Supervisory Mechanism, now fully in place, which has been running the Comprehensive Assessment and Stress Test, and will be running annually the Supervisory Review and Evaluation process; and (2) the Single Resolution Mechanism, which is setting bail-in provisions. While the resolution regime attempts to avoid state-sponsored bail-ins, the European Commission is very diligent about reviewing all cases of state intervention and assessing potential qualifications for state aid, which can give rise to punitive remedies. The European Commission has reaffirmed its commitment to developing

capital markets in Europe and has included it as one of ten priorities it announced post-Brexit. Given the overreliance on traditional bank lending as a source of finance across the EU27, it is in everyone's interest, not the least of which are the companies that want to raise risk capital to invest in jobs and growth, for continued access to the London financial center from the continent. Time will tell.

European banks are pro-actively addressing this challenging environment through continued deleveraging, ambitious cost-cutting, and business-model reviews, thus paving the way for potential future pan-European consolidation.

Refocusing on core markets implies some banks will be exiting some geographies and businesses and redeploying capital in core activities. They will continue to make significant IT investments in new retail and fixed-income models. In investment banking, models will concentrate on businesses where returns exceed the cost of capital. In financing, European banks will seek to focus on the more profitable illiquid asset markets, such as infrastructure and real estate.

Disciplined external growth initiatives will be considered in defensive businesses in the low-interest-rate environment. These businesses include asset management and private banking (providers of fee income), as well as high-yielding asset businesses such as leasing and consumer credit.

Domestic consolidation should help rationalize models, generate economies of scale, and improve profitability.

Finally, more-focused and efficient banks, coupled with increased European integration, is expected to facilitate pan-European banking consolidation and, in particular, the emergence of leading corporate and investment bank (CIB) franchises competing with U.S. firms for regional, and potentially global, leadership.

This situation potentially presents a number of opportunities for U.S. banks.

The stress tests have shown there is limited systemic risk in the European banking sector. The significant valuation differential between U.S. and European banks illustrates the gap in profitability expectations and risk premiums between the two regions. Investors consider that U.S. banks have been quicker to deleverage their balance sheets and reposition their business models. The difference in risk premiums can be explained by some very specific cases creating a perception of lingering tail risk in the European banking system.

The structural challenges that European banks face underscore the need for a level playing field in the region. As the European Banking and European Capital Markets Unions progress, such a level market should develop.

Efforts to refocus have pushed large wholesale European banks to downsize their international networks and distracted them from aggressively expanding market share in several CIB businesses.

Taken together, these developments create opportunities for international U.S. banks. Their ability to offer large and midcap corporate businesses access to a global network is a key competitive advantage. U.S. banks can source long-term assets globally, warehouse and tranche risk, and distribute to investors globally. Their global reach and higher IT investment also give them a strong advantage in the transforming global fixed-income markets. Their agility in deploying capital to the most profitable businesses is also proving key to their success. These advantages are behind the increasing dominance of U.S. banks in European investment banking and capital markets.

However, the European banking environment also presents some risks for U.S. banks. First, risks associated with some specific European names generate risk for their U.S. counterparties. Second, despite the strong push for European Banking and European Capital Markets Unions, increased political fragmentation might also fragment banking markets. For U.S. banks active in Europe, this could lead to higher costs and stronger competition from domestic players. Finally, any stress on European banks might create a "risk-off" type of environment that would have consequences for capital markets across all asset classes.

Item 3: Stress Testing

After a recent review of stress testing by the Federal Reserve, including the Comprehensive Capital Analysis and Review (CCAR), changes have been suggested as a further step in the evolution of these tests. What are the Council's views on these suggested changes?

With regards to the Notice of Proposed Rulemaking (NPR) released on September 26, 2016, along with remarks discussing additional proposed changes, the Council supports the efforts of the Board of Governors to tailor CCAR and DFAST by recognizing differences between bank holding companies (BHCs) of different sizes and business models. However, the Council also has concerns with certain elements of the NPR and requests further clarifications on the additional proposals as part of a future rulemaking in 2017.

Analysis and Discussion of the NPR and Additional Proposals:

Elimination of the Qualitative Objective for Large, Noncomplex BHCs:

- The Council members support the NPR's removal of the qualitative objection for large, noncomplex BHCs. Shifting this review to the regular supervisory process, with its targeted horizontal assessments, is an appropriate step given the progress the industry has made toward meeting capital-planning and stress-testing requirements.
- Further clarity and details surrounding the application of the qualitative review to the supervisory process would help to facilitate a better understanding of what will be required during these reviews:
 - o The NPR states a reduction in the supporting documentation for the CCAR submission. However, the NPR also indicates that this same documentation may be required to be produced on request as part of the supervisory examinations.
 - o How will this supervisory process function? Will it differ from other examination procedures and protocols?

FR Y-14 Reporting Requirements:

- The proposed changes to reporting requirements are welcomed, but the Council would encourage the Board to further review the FR Y-14 reporting requirements and eliminate other reporting provisions that are unnecessary and/or outdated:
 - o While the increase in materiality thresholds from 5% of tier 1 capital basis to 10% is appreciated, the thresholds may result in many banks still reporting relatively small portfolios. One suggestion is a change to calculating the thresholds as a percentage of risk-weighted assets.
 - o Eliminating certain components of the pre-provision net revenue (PPNR) schedules, such as the PPNR metrics worksheet and the reporting detail on the other PPNR schedules, would meaningfully reduce regulatory reporting associated with the FR Y-14A reports.
 - o Consider moving the FR Y-14M reports to a quarterly as-of date.
 - o Given that the FR Y-14 schedules tend to evolve and expand over time, an internal Board review of the schedules on a regular, repeating basis may create a mechanism by which the schedules are systematically simplified and clarified as appropriate.
- The Council supports the proposed modifications to the FR Y-14 reporting schedules by raising the materiality threshold for material portfolios and changing the modeling losses to the median loss rate. However, these changes are limited, and the materiality threshold is still a marginal amount at the increased 10%.

Simplification of Initial CCAR Applications:

- The Council welcomes proposed changes to the initial CCAR applications. Extending the deadline for an initial filing, harmonizing DFAST and CCAR submissions, and extending the time for new entrants to submit FR Y-14M reports are welcome proposals that will assist new entrants to the capital-planning and stress-testing process.

Blackout Period:

- The Council believes the proposed blackout period is unnecessary because unforeseen events could justify a proposed capital action outside of the normal CCAR process. Moreover, this change could disrupt markets by introducing significant risks to the financial system, such as a market disruptor that prevents acquisitions of troubled institutions, conditions capital decisions on nonmarket factors, and may encourage the shifting of financial activities to shadow banking entities.

De Minimis Limitation:

- The NPR proposes a significant reduction in the size of any de minimis capital distribution from 100 bps (1.00%) of tier 1 capital to 25 bps (.25%).
- The Board included this provision because it stated some institutions were using the de minimis process as an automatic additional capital distribution.
- This significant reduction will further lead BHCs with state member banks to only seek capital distributions annually as part of the CCAR process and lead to excessive pressure to maximize capital distributions during the CCAR process.

- As an alternative, the Council recommends that the Board consider keeping the de minimis exemption at 100 bps (1.00%) but tie the use of the exemption to the performance of the BHC compared to the BHC's capital plan.

Stress Capital Buffer (SCB) :

- A proposal to replace the capital conservation buffer with a new SCB, which would be an individualized calculation and minimum common equity tier 1 capital under the Federal Reserve's severely adverse scenario. The SCB would have a minimum floor of 250 bps (2.50%), and any breach would have restrictions on capital distributions and executive compensation.
- The SCB could potentially be punitive for some BHCs, although potential offsets could be available through changes to the severely adverse scenario and risk-weighted asset assumptions.
- Additional details on how the SCB would work are necessary for the Council to opine on the notion of an SCB.

Assumed Capital Actions in the Severely Adverse Scenario:

- Further possible amendments outlined a proposed change to a BHC's assumed capital actions under the severely adverse scenario.
- This proposal would allow a BHC to assume only four quarters of common dividend payments and would discontinue share repurchases in the severely adverse scenario.
- The Council supports this proposal, as this assumption appropriately balances supervisory goals with realistic capital distributions that BHCs would more likely pursue under the severely adverse scenario.

Static Risk-Weighted Asset Projections:

- The additional amendments proposed simplification of the assumption on balance sheet size under the severely adverse scenario by assuming a flat balance sheet and risk-weighted assets in the supervisory severely adverse scenario.
- The Council supports this proposal, as it is an appropriate assumption under the severely adverse scenario that also reduces uncertainty related to scenario assumptions.

Item 4: Low Interest Rates and Consumers:

How have the persistently low interest rates of the last eight years affected consumers' saving behavior? Are consumers saving more to achieve their savings targets, or are they channeling their savings into risky financial products to reach for yield? As consumers approach retirement, how are they compensating for lower interest rates?

How have the persistently low interest rates of the last eight years affected consumers' saving behavior?

Overall, consumers have been taking a more cautionary approach towards their finances since the financial crisis. This caution has manifested itself in several ways:

First, consumers seem to be compensating for lower savings returns by saving more and spending less than they otherwise would. Accordingly, U.S. savings rates have increased from an average of approximately 3% pre-crisis to an average of nearly 6% post-crisis. Tighter consumer credit standards may also be contributing to the increased savings rate.

Second, despite low interest rates, consumers generally have not engaged in speculative investments in an attempt to boost yield. A large amount of these new savings is going into safe assets - bank and money market accounts and Treasury and agency securities.

Third, consumers continue their steady flow of deposits into banks, and they have also shown a preference for liquidity over yield. As the interest rate differential between savings deposits and CDs shrank, consumers migrated to the former.

Fourth, while rising home values and stock prices have improved household net worth, many consumers have also been improving the health of their personal balance sheets by paying down debt.

The Council noted that there are many households with little or no savings and for whom interest rates are of little consideration.

Are consumers saving more to achieve their savings targets, or are they channeling their savings into risky financial products to achieve yield?

About half of all households own stocks or financial assets. They are benefitting from the rise in equity markets and are probably more inclined to reach for yield. There are increased inflows into equity and investment funds. Investors in fixed-income securities and pensions are taking on higher-risk investments, such as high-yield bonds. And there is strong retail demand for new fixed-income issuances of both investment and non-investment grade.

Among a small group of professionals and higher-income consumers, there has been some shift toward more-risky, long-term investments, such as limited real estate partnerships.

As consumers approach retirement, how are they compensating for lower interest rates?

As consumers approach retirement, they are compensating for lower interest rates with some combination of saving more, spending less, and working longer. The single largest way that retirement-age consumers are compensating for lower interest rates is by working longer. A Gallup survey in 2014 showed that the average retirement age had averaged between 59 and 60 years from 2002 through 2012 but had risen in 2013 and 2014 to 62 years, with the median expected retirement age for nonretired individuals moving to 65 years.

In order to save for retirement, consumers continue to use a combination of products such as 401(k) accounts, Roth IRAs, mutual funds, bond funds, and annuities. By and large, retirees are not channeling their savings into risky instruments. Baby boomers saving for retirement tend to choose relatively low-risk assets.

Nonetheless, some investors, including retirees, search for yield by taking on somewhat riskier assets, as evidenced by high demand for dividend-paying stocks and the recent outperformance of the utilities sector.

In short, it appears that some consumers, unable to achieve their retirement targets by using additional savings to offset the prolonged low interest rates, are channeling a portion of their savings out of traditional savings products into slightly riskier investments. While these consumers have moved a portion of their savings into slightly riskier investments to increase yields, they still seem to see return of principal as more important than return on principal.

Item 5: Current Risks in Banking

In the Council's view, what are the greatest risks facing the banking industry today? Have banks and bank regulators appropriately prioritized their resources to address those risks? Are there particular areas that bank regulators should emphasize or de-emphasize?

The Council notes that market and credit risks are always the highest risks to the banking industry. However, the Council has identified numerous other risks as well. In the interest of brevity, we have summarized these risks under five broad categories, in no priority, most of which are also interrelated:

1. **Market and credit risks, specifically continuing low rates and the impact on credit quality and profitability:** Continuing low rates continue to burden the industry in several ways:
 - a. Industry profitability from an ROA standpoint is weak; many banks are unable to earn their cost of capital from a shareholder perspective (ROE), forcing banks to choose booking riskier assets for higher spreads or to further consolidate.
 - b. Similar to "administered prices," low short-term rates mask the true supply of and demand for credit and lead to asset price inflation in financeable longer-term assets, such as bonds and commercial real estate mortgages. When rates eventually rise, refinancing of these assets will become more difficult, potentially leading to forced sales and also pressuring valuations on comparable assets. Asset quality has steadily improved coming out of the Great Recession; however, there have been signs of deterioration in certain asset classes (e.g., agriculture, technology credits, energy).
 - c. NIMs have been compressing over the longer term; however, the "lower for longer" rate environment post-2008 has been exacerbating that trend. Credit-adjusted NIMs have a low level of provision expense, given the benign credit environment of the past several years; however, that will likely change once the credit cycle inevitably turns.

Regulators have appropriately issued guidelines covering the earnings and credit risks, and most banks have also responded with appropriate caution and controls. Some institutions have stretched for yield either with lengthened duration or by taking increased credit risk. In terms of asset quality, it seems that while regulators have been very focused on CRE concentration, there may be a lack of focus in other areas. Focusing on CRE may be too

broad. Rather, the approach should be unique to each institution and its local economies, lending expertise, and policies/people/controls around underwriting. The risks associated with data integrity and model validation become even more evident in times of economic change, particularly as higher rates loom in the near future. Having the resources at the second and third lines of defense for these issues continues to be a challenge.

2. **Cybersecurity and associated financial crime and fraud risks:** Cyber resiliency and enhanced cyber risk management is a primary focus of regulators in the U.S. and abroad. Bank operating systems and networks are subject to increasing risks from evolving cybersecurity threats that could disrupt a bank's operational capacity to provide critical services to the economy. Breaches could result in the disclosure of confidential client or customer information, reputational damage, regulatory penalties, and financial losses. Organized crime is using technology to perpetrate financial fraud. Financial crimes, such as money laundering, identity theft, and account takeovers, pose substantial risks to banks and their customers. Banks must remain vigilant and develop appropriate protection capabilities through investment in defensive resilience and recovery across technology and personnel. Most banks are currently and appropriately reassessing their cyber-risk operating models and strengthening their first and second lines of defense.

Regulators have provided very useful guidelines and frameworks for defending banks against these threats, but additional cooperation and assistance from regulatory and governmental agencies is recommended, as the industry cannot win this battle on its own. The answer to the question "are we safe" is **no**, and we never will be completely safe, so we must all remain vigilant together.

3. **Technological innovation and impact on customer delivery and basic business models:** In an increasingly competitive financial services arena, the banking industry is challenged to aggressively innovate to meet the evolving wants and needs of its customers. Emerging technologies and digitization trends are creating real risks that financial institutions' payments, wealth management, deposit, and credit businesses may be disintermediated to nonbank players. The growth of the shadow banking system is indicative of these trends. Customer behaviors have shifted towards online and mobile delivery, putting legacy branch and other physical delivery systems at risk.

Most larger banks are appropriately prioritizing and preparing for these risks, as evidenced by substantial investments to improve systems, capabilities, and expertise in these areas. Many smaller banks are challenged to find sufficient resources in an environment in which margins are constrained, regulatory burdens have increased, and talent comes at a premium. Small banks are also dependent on core providers, who may lack flexibility and are too costly. Regulators have been intently focused on this issue and are looking at alternative methods, including potentially limited charters, to ensure a level playing field for all participants in the financial services field.

4. **Regulatory and compliance burden and risks:** Changes in laws and regulations affecting the banking industry, as well as changes in the interpretation and enforcement of such laws and regulations by applicable governmental and regulatory agencies, require the

constant evaluation and modification of business practices and internal controls. The cumulative impact is an increase in the complexity of achieving compliance, as well as an increase in the resources necessary to meet the demands. Smaller banks in particular are challenged to find both the financial resources and the talent. Larger institutions must contend with new financial stability standards and shifting stress-testing and resolution-planning requirements. Banks have become a smaller part of the one- to four-family residential mortgage market, in part because of the complexity of new regulations, which one could argue have decreased the availability of mortgages, especially for lower-income borrowers. BSA/AML risk is all-encompassing from a product and service perspective, covering all clients, entities, and geographic locations.

Regulators have always appropriately focused on safety and soundness but in recent years have increased their priority focus on compliance. However, clarity on expectations and intent could be improved. Guidance on leveraged lending is one example. Further clarity on unfair, deceptive, or abusive acts or practices (UDAAP) is another. Continued evaluation of regulatory requirements for banks of varying sizes and complexity is encouraged. The recent proposal from the Federal Reserve to eliminate the qualitative aspects of CCAR for some banks with less than \$250 billion in assets was welcomed by the industry.

5. **Conduct and reputational risks:** Recent market developments have highlighted the critical nature of the conduct risks facing banks, which also have severe reputational repercussions. Banks must ensure that sales practices and incentive compensation are properly aligned to their ethical standards and that a culture of responsible finance is disseminated throughout their organizations. From an external perspective, misconduct by customers and third-party vendors could also have implications for banks and could result in violations of AML laws, enforcement actions, and substantial fines. Operational errors, charges of compliance shortcomings, and identity thefts affecting bank customers (even if not the fault of the bank) all contribute to a very risky environment.

Proper procedures and controls must be implemented and maintained to identify and remediate conduct issues that arise. Since the financial crisis, banks have slowly regained their customers' trust, but it is still below historical levels and remains fragile. Regulators have been appropriately vigilant about these risks but often react to the issue of the day. We need a more consistent and comprehensive approach, rather than just a response to each new crisis.

Item 6: Monetary Policy

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

With the election over and Donald Trump our president-elect, the uncertainty around economic conditions is high. However, the markets have reacted favorably to the anticipated changes thus far. The anticipated fiscal-policy adjustments, including changes in infrastructure spending, tax cuts, and regulatory relief, could stimulate the economy substantially.

Council members offered their opinions with respect to interest rate policies, and they unanimously agreed that continuing on a path to normalization was appropriate. They characterized the current stance of monetary policy as justifiably accommodative.

Recent forward guidance has successfully conditioned markets for a December rate hike and promoted a slightly steeper yield curve.

- The fed funds futures market is currently pricing in a December move.
- The yield spread between 2-year and 10-year Treasuries edged higher over the same period.

Furthermore, progress toward the U.S. mandate of maximum employment and the Fed’s target of 2% inflation has continued nicely this year.

- Monthly payroll expansion has averaged 178,000 this year, well above the level required to keep unemployment constant (estimated to be 100,000 positions each month).
- The labor force participation rate has increased from 62.4% to 62.9% during the past 12 months, overcoming a secular downward trend (retirements are believed to cut 0.2% annually from the participation rate).
- Hourly wage growth has increased 2.6% over the past year.
- Prices continue to firm up, as illustrated in the table below:

(change over past year)	CPI	PCE Deflator
Overall	1.5%	1.0%
Core	2.2%	1.7%

At least one Council member acknowledged that maintaining a monetary policy of low rates has helped prevent a significant strengthening of the dollar, which, if rates had been allowed to go higher, could have further exacerbated the fall in agricultural commodity prices, resulting in even further stress for our agricultural borrowers.

The Council continues to believe that economic growth, employment, and now inflation support slow, measured increases in federal funds rates (e.g., one in 2016, 2 to 3 in 2017). Slow, measured increases are appropriate based on the data and would allow for and show some monetary policy latitude in the event of an unexpected economic downturn. This would enhance consumer and business confidence and would allow for savings-return relief to a broad demographic that is in, or approaching, retirement; would help deflate any asset bubbles that may have developed over a long period of near-zero rates; and would enhance the credibility of central banks – all potentially accelerating the economic recovery while also allowing the Fed to meet its legislative mandates.

12:00 pm – Luncheon for Council and Board members in the Board Room