Record of Meeting

Community Depository Institutions Advisory Council and
the Board of Governors

Friday, November 17, 2017

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.*

Overall, the condition of, and outlook for, loan and financial markets is generally good and stable. Changes in creditworthiness, loan demand, and lending standards were not significant, and where they occurred, were specific to certain market segments or geographies.

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

The majority of Districts report that demand for small business loans is strong in metropolitan centers. New businesses are opening, and existing firms are growing and purchasing new equipment, due in part to an increase in entrepreneurial activity from younger borrowers. Increased competition for quality loans is placing downward pressure on loan pricing. However, the Fifth District observed weaker demand for small business loans in small, rural communities.

While loan demand is high in metropolitan centers, regulatory barriers prevent some financial institutions from adequately satisfying this demand. Many small businesses that are unable to expeditiously receive credit approval from traditional financial institutions are turning to digital nonbank lenders. The Council believes the efficiency of digital channels is in part driving this trend, though differential credit-underwriting requirements between banks and nonbank lenders may also be a factor.

Regulatory requirements and the intransigence of core service providers have hampered the ability of community financial institutions to leverage technology that could improve their application processes, which puts them at a competitive disadvantage with regard to attracting potential customers who prefer digital processes. The Council also notes that differences in the terms of loans provided by traditional financial institutions and digital lenders are beginning to narrow.

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?*

Council members report strong commercial real estate (CRE) demand, particularly in urban centers. Outside of urban centers, the Council reports strong demand in transit hubs and education markets. The First District notes that CRE demand is also doing well in rural hospitality. However, the Third and Seventh Districts report that multifamily and hotel lending is beginning to level off, signaling the possibility that those loan markets are reaching capacity. The leveling off of multifamily lending is characterized by differences in the absorption of multifamily inventory in urban markets, which are increasingly neighborhood specific.

Council members noted that CRE guidance issued by regulators in 2006 related to acquisition, development, and construction (ADC) loans in excess of 100 percent of capital and 300 percent of capital for all CRE loans has limited banks' ability to make creditworthy loans. There is a noticeable disparity in how supervisors interpret this guidance. Some see the guidelines as suggested limits that can be exceeded as long as a bank's risk-management processes are robust enough. Others view the guidelines as hard ceilings, regardless of a bank's strong underwriting standards or strong levels of risk management. The Council believes an update to this guidance or examiner training would help improve the situation.

The Council also voiced skepticism about the effectiveness of the ADC loan concentration guidelines in reducing systemic risk. Financial institutions are increasingly collaborating in order to satisfy client needs. If a community institution is unable to finance a CRE loan due to the impact it would have on its portfolio concentrations, it shares the customer with a peer that has a lower concentration in that area. Additionally, the Council has observed that more CRE loans are being pushed outside the industry to so-called shadow bank entities.

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?*

Construction lending demand remains strong in most metropolitan areas. Council members note that, similar to the situation with CRE loans, concentration limits are hampering the ability of community financial institutions to satisfy demand. Additionally, a shortage of physical housing was also noted by the Council, particularly in rural regions.

Community financial institutions note that the cost of construction has risen considerably since the Great Recession. The Council generally reports that there is a labor shortage. Many Districts report that the opioid crisis has further reduced available labor pools, contributing to the decline in labor supply. The costs of construction supplies are also increasing. The Council member from the Eighth District noted a recent glass shortage, possibly due to increased demand in regions affected by the recent hurricanes.

Council members also voiced some concerns over appraisals (See response to question 6-a in "Additional Matters). The Seventh District, in particular, has observed several incidents in which the post-build appraisal was significantly lower than the appraisal conducted before construction began. Finally, Council members cautioned that any rapid increase in interest rates could have adverse effects on both construction lending and CRE lending.

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?*

Mortgage lending demand varies across Districts. For example, Council members in the First District reported tepid demand, while other Council members, such as those in the Sixth District, report that demand has far outpaced supply. In Districts where demand for home mortgage loans is very strong, prices are being driven up, which is leading to appraisal concerns about lagging valuations.

The Fourth District noted a shift in providers of one- to four-family loans. Increasingly, these loans are being financed by large mono-line nonbanks, which are crowding out many community financial institutions. If one or more of these nonbank lenders shifted their business strategy or experienced business difficulties that removed their lending capacity, Council members voiced concerns about the impact that situation would have on credit availability.

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

Consumer lending demand also varied by District but was generally flat at banks. Credit unions reported relatively stronger markets. While the First District noted flat demand, the Sixth District reported very high consumer demand, largely driven by the auto industry.

The Eighth District reported a tightening of standards for indirect auto lending since the previous meeting, due to softening in the market and to supervisory pressures.

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

Overall, agriculture lending is better at this time than the Council expected, even with lower commodity prices. Costs are dropping, yields are strong, land prices are holding up, and agriculture balance sheets are in good shape. Delinquencies are low and holding steady. However, low commodity prices may increase delinquencies going forward. The Council noted that large inventory gains will likely keep commodity prices stressed. Additionally, the Council member from the Eighth District noted that many farmers have high levels of equipment debt, especially relative to collateral values.

As the prices of various commodities decrease, some farmers have begun to switch to more profitable crops. For example, in the Second and Twelfth Districts respectively, more farmers are beginning to supply microbreweries and grow marijuana. Technology changes in the agriculture sector are quickly approaching and could change the makeup of the industry and rural communities, but these changes remain in their infancy. Community financial institutions' main competition comes from the Farm Credit System. Access to federal Farm Service Agency funding and group insurance remain critical to the industry.

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

Council members generally agreed that deposit growth had leveled off or declined since the previous meeting. The issue is particularly acute in rural regions. As the rural population ages and money is passed from one generation to another, deposits are often drained from rural financial institutions. Some Districts ranked deposit growth as their number one challenge.

Competition on deposit rates has ramped up. Council members noted this competition was particularly strong for certificates of deposit. However, the Council noted that competition was coming from many areas, including the stock market, large banks, and money market accounts. Competition from money market accounts has largely been driven by regional banks. Council members also believe the increased appetite of large banks for consumer deposits is largely driven by liquidity coverage rules.

2. Economic Discussion:

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

Council members broadly see a major difference in the economic strength of major urban vs. rural markets. While this difference has existed for some time, the situation has deteriorated this year. Outside of the major cities, a common expression is "We're in tough shape."

The coastal hurricanes in Texas and Florida are not expected to have a lasting impact on the economies of those states. Due to insurance payouts and rebuilding, employment, and overall business growth, these strong economies are expected to return to trend by the first quarter of 2018. The wildfires in California are expected to have a longer-term effect on some industries there, especially on viniculture.

Council members from the central states are seeing slowing population and economic growth, especially outside of major metropolitan areas.

Council members report small business firms are delaying capital expenditures because of uncertainty about pending federal tax reform.

b. ***Particular Indicators:***

i. <u>*Inflation*</u>*: 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?*

Most Council members see tame inflation, except in construction costs. Inflation is generally seen as rising in major urban markets, not elsewhere. As noted below, home prices and compensation for skilled labor are rising rapidly in metropolitan areas and in non-metro areas where centers of higher education, transportation hubs, and distribution centers are located.

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

Several Council members note that housing is becoming a problem in certain markets. There is a lot of construction around metropolitan areas. However, critical shortages of skilled tradespeople, along with escalating prices for construction materials, are hampering building. The costs of labor, concrete, lumber, and glass are rising fast. Home prices and values are rising rapidly in what has become "sellers' markets," to the point that cities that used to be affordable are becoming less so.

Some Council members cited critical shortages in low- to moderate-income homes in many areas.

iii. <u>*Labor Markets*</u>*: 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?*

Several Council members are concerned about the health of their local labor markets. The availability of skilled employees is thin in many areas, particularly in urban areas and for IT, cyber security, and compliance staff and for tradespeople. Due to new immigration limitations, some firms are recruiting heavily in Puerto Rico.

In some markets, firms are challenged to find qualified new workers who are free of substance-abuse problems, and firms are also having trouble finding and retaining the workers without paying high salaries. Also, healthcare costs continue to rise, adding to the cost of labor. Some Council members noted that salary gains are stronger than national figures indicate. As highly paid older workers retire, firms expecting to reduce their labor costs by hiring less experienced staff are instead having to raise salaries to attract or retain capable younger staff.

In rural areas, wages are stagnating, and a population exodus translates into ongoing turnover.

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

Council members generally believe that consumer confidence has been stable but stronger near metropolitan areas. This belief is supported by the strength of consumer spending and business starts in these areas.

Confidence is not as strong in rural areas, where economic and jobs growth has been weak.

3. **Payment Systems:** *The Faster Payments Task Force resulted in a number of solution proposals and recommended next steps. What are the Council's views on the proposals and recommendations? Do you believe that the Federal Reserve should assume certain operational roles related to messaging, processing, or settlement in supporting ubiquity and competition in, and equitable access to, faster payments?*

The Council appreciates the time and effort that members of the Faster Payments Task Force contributed to create the final report and the recommendations it contains. However, regarding the recommendation to explore and assess whether the Federal Reserve should become a faster payments operator, the Council recommends a strong "Yes."

The Council believes there are several reasons the Federal Reserve should be an operator of a faster payments system. The Federal Reserve plays a similar operational role in processing checks, wires, and ACH transactions. By acting as a competitor to the private-sector operators, the Federal Reserve would keep costs down for all financial institutions.

With the Federal Reserve acting as an operator, all financial institutions could have equitable access to the payments system. With only private-sector operators of faster payments systems, smaller financial institutions would not have the same assurance that they could compete on an equal footing with larger entities. There is concern that volume-based pricing would put smaller financial institutions at a disadvantage over larger institutions to a large degree.

Currently, smaller financial institutions can connect to some of the existing faster payment systems, but only through a core processor. This presents a challenge: core processors perform vital functions for most financial institutions, but they do so for a fee. There is great concern among financial institutions that even if volume-based pricing is not realized, core processors will mark up the cost of their service, making the faster payment product expensive related to its worth. As a result, smaller financial institutions will be at a disadvantage because large entities will connect directly to the system, and they will not be subject to any markups from their core processor.

The Federal Reserve has a long-standing interest in ensuring that the payment systems it operates function smoothly and are protected against any cyber threats. By operating a faster payments system, the Federal Reserve would be providing a “hardened redundancy” to help avoid any disruptions in the financial system in case any one of the private providers was forced offline. In this case, the Federal Reserve would increase security by eliminating the risk that one single point of failure could bring the faster payments system down. By reducing the threat of a payments-related cyber event, the Federal Reserve would be contributing to our national security.

The Federal Reserve should act as quickly as it can to bring a faster payments operation to market. We understand there is a well-defined process for determining whether additional services should be provided by the Federal Reserve, but the potential damage to financial institutions increases with each day.

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?*

The Council is generally optimistic about the direction of the examination process, noting that the increased use of off-site file review has been positive. Still, certain persistent challenges remain. For instance, the Council expressed a broadly shared concern that compliance examinations are not going as smoothly as safety and soundness examinations. Some bankers found that compliance exams were particularly onerous when the examiners reviewed new bank products. This overly detailed review of new products at the earliest stages of customer adoption stifles bank innovation and leads institutions to focus more on future compliance exams than on serving customers. As stated by a Council member, the risk/reward calculus is out of balance when it comes to product innovation. Product innovation is being constrained, which in turn limits credit growth.

Another shared concern was related to the timeliness of compliance examinations and the challenge for smaller institutions that receive information requests for materials that require consistent back and forth with examiners in the months leading up to an examination. These off-site exchanges, combined with the eventual on-site examiner presence, led to a sense that certain examinations were excessive compared to what was appropriate for the bank.

The Council also noted that the institutions they represent were subject to a myriad of examinations, making the number of days an institution is subject to review by multiple external parties greater than the banking agencies may fully appreciate. To the extent there are duplicative reviews of materials, examinations could be streamlined if the examiners-in charge were to narrow the sample size of their review of certain materials and rely on the reviews of others when appropriate.

The Council found that IT exams have been an area of concern, noting inexperienced examiners and redundant examiner inquiries that were not directed at issues of reasonable concern. Further, the limited availability of IT examiners has translated into repeated and piecemeal visits to certain institutions before an IT examination is completed.

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?*

Despite broad-based improvements in the capital positions of many banks and the corresponding reduction in systemic risks, the post-crisis regulatory climate has a continuing, significantly inhibiting effect on community depository institutions. Their ability to serve customers and meet the credit needs of their communities suffers from both the cost burden and the heightened risk of criticism in a supervisory environment that remains very conservative. The significant shift in staffing resources toward compliance positions, and away from customer-facing and customer-supporting roles in lending and services, has meant increased expenses for banks and less flexibility for them to offer competitive products and make other innovations. Given the pressure on community bank earnings in a historically unprecedented period of low interest rate conditions, these combined influences have a powerful, cumulative, and negative effect.

As noted in previous reports, tailoring regulatory requirements and examinations to the size, scope, and complexity of a specific institution and its business lines could significantly reduce that institution's regulatory cost burden. Several specific areas offer the potential for major improvements. For example, the Community Reinvestment Act (CRA) is long overdue for modernization, but pending any legislative updates, regulators could take into account the evolution of deposit-gathering in an era of growing direct banking. Measuring deposits only by branch correlations no longer provides an accurate picture of many banks' funding. Tracking deposits by Zip code, for example, would show a more realistic relationship between a bank's deposit base and its lending area. In the supervisory and CRA areas, regulators should routinely approve the use of a correction period to address negative findings, without imposing an immediate rating downgrade. The potential for community banks to enter (or in some cases, re-enter) business lines under revised, tailored regulatory expectations would improve the credit available to communities and enhance the foundation for economic growth, which would be especially meaningful in rural communities.

To mitigate current tendencies toward industry consolidation, regulators should make a coordinated effort to expedite the chartering of new community banking institutions. Small-market entrants should have a faster track to commencement of business and have a clear, reasonable period to achieve CRA and other goals. Supervisors should recognize that during a de novo bank's start-up phase, before it achieves significant growth, the bank would present relatively insignificant risk to the deposit insurance fund. These banks would, however, be on track to serve local community needs in ways that bank consolidation may inhibit. Chartering flexibility would thereby protect the long-term health of local community credit markets.

Some evolving regulatory requirements simply add complexity and expense, far exceeding any risk mitigation they achieve. For example, to respond to regulators' follow-up inquiries about SARs (suspicious activity reports), banks must often incur significant legal expenses and divert other compliance resources to answer information requests, even when there is no doubt that the bank itself has acted properly. Similarly, guidance on key-vendor management causes many banks to conduct individual assessments of major vendors that already serve broad segments of the industry. The cost of these duplicative efforts could be avoided if major vendors were evaluated using an assessment process similar to what is used under the Shared National Credit Program. Finally, the proposed small business lending and new additional Home Mortgage Disclosure Act reporting requirements are simply solutions in search of a problem, since there is no apparent evidence of institutions' failure to meet credit needs. All of these requirements threaten to increase the operating expenses of community institutions to unsustainable levels, thus increasing the pressure for further industry consolidation.

The tailoring of regulatory requirements as described in this section would have a broad, beneficial impact on many supervisory areas. The Council notes that successful application of tailored regulation means examination staff will necessarily exercise discretion and judgment in many areas, and examiners will therefore require adequate training. The Council believes that close attention to the training and development of field examination staff deserves careful, ongoing attention.

The Council notes several promising developments in the regulatory environment, though each will require additional thought and attention to realize potential benefits. Recent bipartisan legislative initiatives offer several specific improvements, such as allowing "qualified mortgage" treatment for loans banks hold in portfolio and proposed incremental improvements to deal with shortages of qualified appraisers. The prospect of new leadership at the Consumer Financial Protection Bureau may provide an opportunity for greater collaboration with other supervisors. Also, the Federal Reserve has expressed a willingness to review its approach to assessing the effectiveness of boards of directors and to realign its approach to the appropriate division of labor between boards and management. The Council again stresses the importance of applying this and other guidance in ways appropriate to the size and complexity of specific banks, as well as the importance of thorough training for examination staff. The proposed board guidance has the potential to encourage qualified, desirable candidates to serve on bank boards, and a healthy board is an additional key mitigant against economic pressures for industry consolidation.

The Council believes that all of the recent developments have significant positive potential. The Council also strongly encourages supervisors to take an objective look at the many unintended consequences of recent regulations. Moreover, the Council believes that it is essential for bank supervisors to champion the benefits of the community banking model. Shrinking the community bank cohort (particularly without providing offsetting flexibility in the de novo chartering process) means that smaller community credit markets will be continually shortchanged. Concerns about any possible disparity between urban and rural economic conditions should not be exacerbated by a loss of capacity in smaller credit markets.

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?*

a. Appraisal Issues

Council members identified appraisal-related issues that have an impact on the services community depository institutions provide to their markets. Changes to qualification criteria for appraisers are needed to remove the impediments that delay new entrants into the appraisal field. If adopted, these changes should help attract new appraisal professionals. Council members support the joint regulatory proposal to increase the threshold requirement for use of licensed appraisers for certain transactions in order to lower the costs and expedite the processing of these transactions. The Council also supports having more flexibility to use valuations for low-risk transactions in general and when banks are competing in the marketplace with loans being sold to Fannie Mae or Freddie Mac that permit a property inspection waiver. These changes would help alleviate the appraiser shortage and its impact on the banking industry, including by permitting targeted and low-cost appraisal alternatives when appropriate.

b. Marijuana Businesses and Banking

More and more states are permitting various forms of marijuana businesses. Consequently, demands for banking services from this business segment are increasing, and cash from these businesses is being spread through the normal channels of commercial enterprise and consumer expenditures. Because banking services to marijuana businesses have remained limited compared to the growth of these enterprises, the extent of cash transactions as part of the economy has grown substantially in some areas, sometimes testing established norms for Bank Secrecy Act (BSA) compliance systems. In turn, banks' compliance risks have increased, resulting in an elevated number of supervisory inquiries.

Community banks not providing banking services to marijuana businesses should not be victimized because the states in which they operate permit such commerce or because of the BSA issues and other collateral effects associated with serving marijuana businesses. Similarly, banks offering services to marijuana businesses, thus bringing transparency and security to state-licensed marijuana operations, should have adequate compliance guidance that does not impose onerous requirements on the business of banking.

Council members request leadership by the Federal Reserve to address these problems. Clearer guidance from and coordination among the federal banking regulators is in order. The Council suggests that the Federal Reserve might also be a catalyst for broader discussion and understanding between banking agencies and federal law enforcement agencies.