**Record of Meeting**

**Federal Advisory Council and Board of Governors**

**Thursday, February 4, 2021**

## 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) consumers, and (f) 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 is cautiously optimistic about overall loan and financial market conditions at the start of 2021, as the economy continues to stabilize with the rollout of the COVID-19 vaccine, a low interest-rate environment, and additional fiscal stimulus that has bolstered the consumer and business communities.

Credit remains generally available, although it has been extended primarily to firms with which there is already a relationship and to industries that have remained resilient or have recovered from any financial impacts of the pandemic. Several Council members indicated that the recovery has remained a tale of two borrowers: (1) those able to proceed with more expansionary plans and (2) those struggling to remain viable. This description applies to the consumer segment as well—a large swath of the population is still struggling from the impact of the pandemic while other parts of the population are either unaffected by or even benefitting from the pandemic. There also has been a noticeable disparity in consumer and business confidence based on the degree of reinstated shutdowns that vary by state and local governments.

During 2020, both investment-grade and high-yield bond markets posted record issuances, with $2.0 trillion of new investment-grade bond issuances and $570 billion in high-yield bond issuances. The Council anticipates both of those market trends to slow in 2021.

**(a) Small and medium-size enterprises**

The Council observed that loan demand from small and medium-sized businesses remained modest during the fourth quarter. The NFIB surveys have shown a decline in small business optimism toward the end of the year, as sales increased but still remained lower than pre-pandemic levels when seasonally adjusted. The near-term outlook remains uncertain as the COVID-19 vaccine is being rolled out at a slower-than-anticipated rate. The Council noted that businesses remained focused on expense control and have been resisting expansionary spending. This is especially true for businesses in states that reimplemented shutdowns during the fourth quarter.

The Paycheck Protection Program (PPP) provided a second opportunity for businesses to receive short-term capital. In particular, the Second Draw program created eligibility criteria that are met by small and medium-sized businesses that have experienced meaningful reductions in sales. The Council does not anticipate a repeat of the aggressive rush for these funds that occurred with the initial program, but Council members do believe this program will provide necessary relief to businesses that were severely impacted by the pandemic. Due to the new eligibility criteria, the Council expects the new PPP loans to be smaller in size and generally benefit smaller businesses.

**(b) Commercial Real Estate**

Loan demand for commercial real estate has remained low. Most Council members observed that banks have maintained conservative lending standards and have primarily extended credit to those with existing relationships and in industries that were not severely impacted by the pandemic. Rents and occupancies remained flat or declined in certain sectors—such as retail, office, and hospitality—and it has remained difficult to underwrite deals outside of stronger industrial and multi-family credits given the uncertainty of future cash flow.

Occupancy levels in the office sector remained low in most major metropolitan cities. The future of work strategies implemented by organizations now and more importantly during the middle of 2021 will play a meaningful role in determining whether there will be an oversupply of office space. One Council member noted considerable investments made in office space in cities including Miami and Austin by several large companies; these investments may contribute to an acceleration of migration from other more traditionally dense cities.

Certain property types—such as warehouse and industrial properties—have seen less negative impact and are largely benefitting from the increase in e-commerce. To date, rent collections have been only marginally lower in this space.

**(c) Construction**

Construction starts and lending showed signs of modest growth during the fourth quarter. Commercial construction remained subdued in the fourth quarter with minimal new requests for financing as projects were delayed. However, the Council observed that certain states, including Florida and Texas, saw an increased demand for construction lending, and investors have been increasingly putting funds toward this strategy. Conversely, New York City posted its lowest figures in new construction activity and filings since 2012, illustrating how far the city remains from recovery.

Residential construction remained robust in the fourth quarter, as housing starts for December increased 5.8% compared to November and 5.2% compared to a year ago. The Council noticed even stronger residential construction demand in tier 2 cities including Nashville and Austin due to an increase in population inflows.

**(d) Corporations**

Loan demand continued to modestly increase in the fourth quarter, led by industries less impacted by the pandemic, including technology and telecommunications, life sciences, and essential services such as food and beverage. Travel, hospitality and entertainment, and non-essential retail continued to underperform as travel during the holidays remained subdued, creating a downstream impact on the industries that heavily rely on this seasonal norm.

Much like the other segments, some industries have survived or outperformed during the pandemic while others have been severely impacted. The Council noted that corporate credit in recovered sectors saw noticeable credit upgrades toward the end of the year, reversing the trend observed during the second quarter. There was also a noticeable increase in merger and acquisition activity in this segment.

**(e) Consumers**

Consumer confidence declined in the fourth quarter as the resurgence of COVID-19 cases increased in many areas of the country. Meanwhile, the economic impacts of lockdowns continued to be disproportionately concentrated among low-wage earners. During the fourth quarter, consumer delinquencies remained stable, which can be partially attributed to the Economic Impact Payments (EIP), unemployment benefits, and lender forbearance programs.

Standards continued to tighten for all consumer lending products during the fourth quarter, but demand improved for the first time since the onset of the pandemic. Consumer loan balances declined over the course of 2020, led by credit card balances, which were 11% below their pre-pandemic level. Delinquencies also continued to fall, as consumers have been in a net saving and investing position and have increasingly paid down debt. Fiscal support to individuals also created a short-term floor on consumer credit deterioration.

Auto loans performed particularly well, with credit metrics that were as good if not better than pre-pandemic levels. Strong demand for automobiles helped boost collateral values, and various fiscal programs provided financial stability to borrowers.

**(f) Homes**

Residential lending activity continued to surge as households continued to move out of more densely populated cities or upgrade to larger properties, taking advantage of the low-interest-rate environment. Mortgage originations were led by refinance activity.

Sales of new single-family houses in December were at a seasonally adjusted annual rate of 842,000. This was 1.6% above the revised November rate and a 15.2% increase year-over-year, which can be attributed to low interest rates and the desire and ability of consumers who are working remotely to move to less densely populated cities. One Council member observed that lenders focusing on the non-Agency market had started reopening or had fully reopened their credit boxes to pre-pandemic levels.

Delinquency rates for mortgages continued to decline through the fourth quarter, but it remains to be seen what the impact will be once forbearance programs under the CARES Act expire.

## Item 2: Agriculture

**The pandemic, tariffs, and changing climatic conditions present challenges for U.S. agriculture. What does the Council see as the likely future path for this sector of the economy, both near-term and longer term?**

### Impact from the pandemic

Entering 2020, the challenges for the agricultural sector were lower prices for many commodities, significant weather challenges, uncertain world market conditions, and increased tariffs. Agriculture producers were preparing to meet these headwinds through adjustments to production and continued expense control when the pandemic took hold. The speed of the pandemic's spread offered little opportunity to cut production or modify the supply chain. Many crops were already in the ground, and demand came to a grinding halt. As consumption demands drastically fell due to sharp declines in leisure, hospitality and biofuel demand, many farmers were unable to offload their crops and livestock. Processors were initially unable to pivot in their production to accommodate stores rather than restaurants, and many packing plants were shut down. Further down the supply chain, shippers and exporters were impacted by freight costs, a lack of container availability, and a backlog of ships sitting outside global ports. As a result, substantial losses occurred while the agriculture infrastructure tried to realign and adapt to the pandemic-driven supply chain shifts.

Farm income, however, rebounded in late 2020, as commodity prices surged late in the year, production improved, farmers and ranchers adapted to the changing demands, and expenses were generally lower. The United States Department of Agriculture (USDA) forecasted that 2020 net cash farm income (NCFI) for farm businesses across the nation will average 33% higher than 2019. This increase is due, in large part, to government assistance from two rounds of Coronavirus Food Assistance Program (CFAP) packages, the completion of the 2019 Market Facilitation Program (MFP) payments, the PPP, regular farm bill programs, and a myriad of other individual state agriculture relief programs. These programs may have accounted for nearly 40% of net farm income in 2020, but this is unknown until final numbers are released. Overall, balance sheets ended far stronger than when the year began. Many, if not most, farmers and ranchers realized a profitable year as indicated by the number that (1) met their debt obligations and servicing requirements and (2) chose to defer grain and cattle sales into 2021 to address the tax liabilities created by strong earnings in 2020.

**Impact from tariffs**

Tariffs are always concerning and problematic for farmers whose crops are heavily exported, as tariffs create a great deal of uncertainty and volatility in the market. These factors have become more prevalent over the past few years, as the United States has sought to establish a more equitable trading relationship with the world marketplace. To advance this effort, significant tariffs were levied on U.S. imports (largely Chinese manufactured goods), which sparked material tariffs on U.S. exports (largely comprised of agriculture products). Damage to agricultural commodity prices was the initial result. To offset the damage, the U.S. government provided targeted government assistance through the Market Facilitation Program (MFP) to augment price support programs that were already in place. MFP support proved vital to maintaining the financial position of most producers impacted by tariff battles. Given that the Phase One trade agreement was signed in January 2020, one of the largest tariff issues was effectively resolved prior to the spread of the pandemic in the United States.

Throughout 2020, the agriculture sector was a vital component of the economy. Strong international demand (mainly out of South America) due to crop shortages helped to keep prices up. And with the help of a weaker dollar, economies of scale, and cost-containment strategies, producers were able to generate positive cash flows in the current environment.

**Changing Climate Conditions**

Climate conditions, both domestic and international, can greatly impact the supply of crops. Weather events, such as hurricanes, floods, and droughts, are not new to farmers and ranchers. However, the frequency, intensity, and duration of climate change events posed additional challenges for the industry. According to the National Oceanic and Atmospheric Administration, 49% of the continental U.S. ended 2020 in drought. Drought remains a perennial threat to the U.S. agriculture sector, causing lower crop yields, higher production costs, and increased financial stress to farmers. Crop insurance has been, and will continue to be, an important tool for American agricultural producers to use to help offset potential losses resulting from adverse weather conditions. Various federally developed and backed programs are in place and differ based on the type of coverage and crop.

Overall, U.S. agriculture is better positioned to respond to climate change than many other economies. Because U.S. agriculture is more capital intensive and high tech, it is more agile in responding to changing climate conditions. The sector continues to monitor emerging policy issues— as well as related laws and regulations—related to climate change. Most producers appreciate that some level of regulation is needed to help control land use, foster watershed protection, address methane gas emissions, and create programs designed to promote sustainable usage of soil and water. However, the industry notes that regulations can create challenging and expensive compliance issues.

**Near-term outlook**

As previously noted, the industry is facing numerous challenges, that vary depending on commodity, location, and role in the supply chain. Initial 2021 survey results among agricultural producers indicated that their greatest concerns were commodity price volatility, weather and climate, and trade agreements and related issues. However, the agricultural sector is resilient, and there are many reasons to be optimistic about its future.

Agriculture will continue to be impacted by COVID-19 in the near term. The prevalence of cases in non-metro areas has been growing, and according to the USDA Economic Research Service, among non-metro counties, the highest COVID-19 case rates were found in farming- and manufacturing-dependent counties.

It will be important to see how quickly states can roll out and administer the vaccine in these communities. Farmers and ranchers are optimistic that as the economy continues to recover from the pandemic, retail and restaurant activity will rebound, leading to increased demand for food and related products.

The USDA's agricultural trade forecast projects agricultural exports of $140.5 billion in 2021, an increase of $5.5 billion primarily due to higher exports of soybeans and corn, mostly to China. Wheat exports are projected to decline to $6.0 billion, down $200 million because of competition from Russian exports. Livestock, poultry, and dairy exports are forecast at $32.3 billion, up $500 million. Purdue University economics reporting has expressed the possibility for additional government agricultural aid and incentive policies under the new administration, citing potential re-engagement of the U.S. with international climate policy and beneficial trade deal discussions. Specific intent will become clearer when the first budget publication is released this month or next.

Major commodity prices showed stable to improving trends. With economic recovery in the U.S. and abroad driving stronger demand for food, prices are set to increase during 2021. Agricultural borrowers are showing positive cash flow results and will generally be able to meet credit obligations. Agricultural land values, even during the pandemic, have stayed stable with minimal deterioration in value. The farming sector maintained significant equity in its farming operations; this equity will continue to help farmers make needed adjustments throughout the coming year. Increased economic activity will also lead to a rebound in non-farm wages, which are used to supplement operating expenses, capital expenditures, and cash flow.

**Long-term outlook**

The United States has the strongest agribusiness infrastructure in the world, with not only highly productive and high-yielding farming operations, but also strong infrastructure and technologies in food storage, food processing, food engineering, transportation, and packaging. Numerous technological breakthroughs have helped increase crop yields and make crops more resistant to droughts. Recent advances in animal health and nutrition have facilitated higher growth rates and greater herd sizes. Alternative commodity production, such as pulse crops, continued to expand, and profitability margins of these new crops (peas, lentils, hemp) helped provide greater diversity and a competitive advantage for U.S. producers. Current trends support optimism looking forward.

As has been the case for decades, expansion in the agriculture sector is expected to follow the national trend of consolidation, with fewer operators producing agricultural products on the same amount of agricultural land. This trend will be accelerated over the next five to ten years, given that the average age of current farmers is mid-to late 60s. The current real estate market provides an opportunity for older producers to sell their operations for a profit and then retire.

Likely influences on profitability over the next five years include supply chain stability, ethanol policy, trade variability, livestock health, and the remaining effects of the pandemic. Additionally, the agriculture sector will be impacted by a need to focus on the balance between government support (approximately 30% of net farm income since 2016) and alignment with domestic and global markets. Overall, there are substantial reasons to be cautiously optimistic about the agricultural sector. Despite recent short-term interruptions caused by the pandemic, tariffs, and weather conditions, the farming industry continued to be resilient and make the necessary changes to adjust for variables in supply and demand.

## Item 3: Forbearance

**What are the Council's experiences with forbearance during the pandemic? What programs have worked and what programs have not worked? What has been the impact on bank credit quality? What credits are most at-risk? What are banks doing to monitor and mitigate credit losses?**

**What are the Council's experiences with forbearance during the pandemic?**

Due to the uncertainty caused by the COVID-19 pandemic and the lockdowns imposed by certain states in March 2020, banks were quick to grant deferrals of principal and interest payments to their customers to provide payment relief to assist customers in preserving cash. Most banks granted 90-day deferrals upon request from the borrower without requiring proof of hardship or financial need. After the initial 90-day deferral, a second round of 90-day deferrals were rolled out to borrowers using a more needs-based approach, including credit and structure enhancements where appropriate. The number of deferred loans as a percentage of total loans topped out in the second quarter with banks in the KBW Nasdaq Bank index averaging 6.6% and banks in the KBW regional bank index averaging 14.5%. Post 180 days, longer-term deferrals were considered for only the most impacted industries and granted under the CARES Act guidance on a case-by-case basis. It was noted by several Council members that many customers continued to make payments even during their deferral period.

For consumers, bank servicers are actively working to assist borrowers experiencing financial hardship from the pandemic. To help those consumers stay in their homes and receive financial relief from mortgage debt, bank servicers deployed the CARES Act-required GSE or FHA forbearance programs for covered loans as well as similar robust forbearance programs for portfolio loans. For loans held in portfolio, banks are working to ensure that households that are financially impacted by the pandemic receive immediate support through temporary suspensions that extend from 90 days to 12 months, as needed. Banks noted that most borrowers that entered into forbearance programs returned to making payments. The majority of the remaining borrowers in forbearance appeared to be directly related to the industries most impacted by the pandemic. One of the biggest risks is that when borrowers need to resume making mortgage payments at the end of the one-year forbearance period, these payments may put stress on both mortgage and non-mortgage debt.

**What programs have worked and what programs have not worked?**

For businesses, deferrals and modifications were the preferred programs, as they provided immediate relief and a cushion to clients that were temporarily impacted. The Small Business Administration PPP was well received and—combined with deferrals and modifications—provided a bridge for many businesses until shutdown orders were lifted.

For consumers, deferrals (i.e., pushing payments to the end of the loan) have been much more successful than forbearances (i.e., skipping payments and making them up later over a period of time). As most consumers did not have the extra money to make catch-up payments, deferrals allowed borrowers to simply resume their normal monthly payment and return to "current" status in credit reporting. One Council member noted that offering extensions and pushing out payments—especially on products secured by a depreciating asset—may not be the best option on an ongoing basis. As a result, new offerings were created that allowed customers to make reduced payments (e.g., 50%) for a period to stay current, while also continuing to pay down the balance; this approach worked well during the pandemic.

Another benefit of deferral was that it helped cushion higher payments by the borrower caused by escrow account shortages. Borrowers were not only skipping principal and interest payments, but also their escrow payments. Because banks continued to make tax and homeowner insurance payments on behalf of the borrowers, many escrow accounts had large deficits. Typically, escrow analysis is done on a twelve-month basis, but with the pandemic, banks have had the ability to stretch escrow over twenty-four months. By stretching this analysis period over twenty-four months, the payment shock to borrowers was reduced.

**What has been the impact on bank credit quality?**

Bank credit quality was significantly less impacted than in prior recessions. Overall charge-off levels remained low, and with the passage of the CARES Act, banks were not required to account for credits impacted by the pandemic as troubled debt restructurings. Aided by government stimulus and the re-opening of economies around the country throughout the year, the level of deferrals and modifications as a percentage of total loans decreased to below 2% for most banks. While there were still industries and specific borrowers that continued to be impacted by the pandemic (which will result in increased non-accruals and credit losses in 2021), those potential losses are expected to be less than originally projected and able to be absorbed by the large provisions for credit losses booked at the onset of the pandemic. That said, pandemic-related financial stress was experienced by both businesses and consumers outside the banking system, and that stress was not quantified, as it was not reflected on any bank's balance sheets.

Overall, loan delinquency rates rose over the course of 2020 but remained historically low. Bank credit card delinquency rates fell to the lowest level in at least three decades in the third quarter as balances declined amid lower spending on travel and dining out. Mortgage loan delinquency rates increased but remained below that of the 2008-09 recession, even including forbearance. In the third quarter, the mortgage delinquency rate was 7.7%, according to the MBA, including loans in forbearance, but was 2.8% for bank-held mortgages, according to the Federal Reserve.

**What credits are most at-risk?**

Commercial credits most at risk were in industries such as travel and entertainment (i.e., movie theatres, restaurants, cruise lines, airlines, sporting event venues); hospitality; retail (those that sell non-essential items without a digital strategy); commercial real estate (especially hotel properties and retail centers not anchored by grocery or essential goods stores); non-profits; and energy. With respect to consumers, those who worked in the-aforementioned affected industries were the most at risk.

**What are banks doing to monitor and mitigate credit losses?**

Most banks established proactive measures to monitor credit risk. These measures included increasing staffing in the workout and recovery departments, increasing the frequency of reviews for the largest borrowers and those in the most impacted industries from annual to quarterly, executing targeted loan sales for borrowers that are not expected to recover quickly, tightening credit underwriting or exiting lending for stressed industries, and increasing discussions with regulators on credit quality and outlook.

Additionally, banks proactively reached out to customers—both business and consumer—in person and through statements, letters, emails, and web and mobile messages—to let them know about their options (e.g., deferral, forbearance, PPP, refinance, or repay) to get through the pandemic. The outreach by the banks also showed that they were ready to assist their customers.

## Item 4: Current Economic Conditions

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

### General Outlook

Despite continued uncertainties surrounding the path of the virus, Council members generally felt a greater sense of optimism regarding future economic expansion than was the case at the last meeting. The feeling that there is a "light at the end of the tunnel" is reflective of the commencement of the distribution and delivery of the COVID-19 vaccines, additional fiscal stimulus, and the completion of a peaceful transition of power in Washington, D.C. As stated above, uncertainty remained with respect to the speed of vaccination distribution—which had the potential to be uneven across the country—new strains of the virus, and rising cases and hospitalizations in some regions, all of which could result in further government actions that adversely affect economic activity.

Council members uniformly noted fewer requests for payment deferrals and modifications, a reduction in delinquencies, slight to moderate improving credit metrics, and increased deposit levels since the last reporting.

**(a) Households**

The second wave of COVID-19 infections returned short-term stress and a level of income insecurity to households since the last FAC meeting. With some geographies across the country (and the world) reporting positive infection rates in the double digits, most states slowed down and in some cases, reversed measures to "re-open" local economies.

Coming off peak unemployment in early second quarter, the improvement in the unemployment rate tapered off at year end. While both the unemployment rate and the number of individuals out of work have declined for six consecutive months, overall employment conditions remained negative, and the job gains Council members witnessed have not benefitted all Americans equally. Lower-paid and hourly wage earners and those in industries such as restaurants, hotels, entertainment, travel, and some healthcare sectors saw their jobs and incomes recover more slowly than salaried workers. The Economic Impact Payments did provide relief, but there were signs of a K-shaped recovery.

Holiday spending and borrowing, as measured by credit and debit card use, were below historical seasonal highs, as increased online spending was not enough to offset declines in in-store spending. Although households remained generally liquid, Council members noted the continued risk of higher delinquencies in certain categories of consumer credit, as some households have been relying on enhanced unemployment benefits and the federal stimulus payments to make debt service payments.

The general outlook remained "uncertain" for most American households. However, there was some positive trending in consumer sentiment driven by the prospect of a stronger second half of 2021 given the commencement of the COVID-19 vaccine distribution and the promise of further stimulus. This may result in stronger GDP growth, reflecting the forecasted pent-up demand for leisure/recreation, travel, and social gatherings that are currently limited by government restrictions.

**(b) Significantly Affected Businesses**

Overall, economic activity continued to slowly improve in many segments of the economy, but economic conditions varied materially by sector. Businesses in the retail sector and those that rely on large in-person gatherings in their operating model, such as entertainment and leisure, continued to be the most dramatically affected by the pandemic. Businesses that require (1) a reliable and consistent supply chain to maintain sales or (2) supplies to provide services continued to experience disruptions for some products and materials, albeit to a lesser degree. Increased COVID-19 infections and added safety protocols interrupted production of output supporting some industries, such as construction, meat and poultry, and groceries. Most businesses—outside of hospitality, entertainment, gyms, and some transportation entities—have been managing through the pandemic with PPP, the Main Street Lending Program, and lender payment deferrals providing a vital lifeline for many of them.

Council members continued to observe that companies that have a digital strategy and have effectively leveraged technology have mitigated economic impact, stabilized operations, and are recovering faster.

Geography and markets served are also factors impacting businesses and industries. Council members continued to note that different states and regions have implemented various levels of restrictions, resulting in different outcomes for businesses and economic activity. Even within geographies, businesses operating in—and serving—metro markets often have different outcomes than those operating in suburban or rural markets.

- **Travel, Leisure, and Hospitality** – This segment of the economy remained among the hardest hit by the pandemic amid social-distancing measures. Travel and tourism remained well below pre-COVID-19 levels, as interstate and intercontinental travel operated under restrictions. The relaxation of those restrictions resulted in some increased travel. However, given the resurgence of virus cases in the last few months, states rolled back some of their "re-opening" guidelines and reinstituted restrictions. There is optimism for this sector, but it is highly dependent upon how successful the mass vaccination distribution is. The outlook remained focused on a rebound in personal and business travel starting in the second half of 2021.

High vacancy rates were characteristic for all hotels regardless of property type, with non-leisure properties operating in the range of 50% occupancy at depressed rates due to low demand. Full-service hotels and operators supporting corporate and luxury travel continued to be hit the hardest as government restrictions on large events remained in place in every state. Resort-oriented hotels located in warmer areas of the country were not as negatively impacted as their competitors located in harsher-weather geographies. With respect to hotel operators and their employees, a potential tailwind in the recovery for this segment is the pent-up demand caused by postponed weddings and family travel events. With more than 12 months of these events canceled or postponed, there is a likelihood of an aggressive surge in spending for some venues and travel activities as soon as restrictions are removed. "COVID-19 hotels" near colleges and universities that have been used to house students and employees during quarantine may outperform other properties. Additional relief is likely to be needed for this sector.

- **Retail** – Within the retail sector, recovery was highly uneven; businesses that rely on in-store transactions were more adversely impacted than online retailers. Non-store retailers outperformed during 2020, while performance for most brick and mortar stores was down sharply. Twenty large retailers filed for bankruptcy in 2020, up from 11 in 2019 (according to Bloomberg). The opinion of the Council members did not change since the last FAC meeting with respect to consumers' preference for certain big-box retailers, larger grocery stores, and pharmacies as their primary physical shopping destinations. The shift to online retail by consumers favored those businesses that have been able to provide products and services through digital channels. Despite extended sales events and favorable pricing/terms, performance fell short of expectations for the holiday season.
- **Entertainment/Live Events** – Council members did not observe a change in the live music and events sector and associated service providers (tour transportation, stage and sound production, etc.) over the last few months. The industry generally canceled or postponed most live events until at least mid-2021, resulting in limited profitability in the sector for all of 2020 and challenges to profitability for much of 2021. Although recovery for this sector is highly dependent on the lifting of government restrictions and improved consumer health confidence, some Council members believe that because individuals and the business community rely on these events for social reasons or to maintain or deepen business relationships, there is pent-up demand for entertainment and live events. Meanwhile, large theme parks in warmer geographies re-opened, operating under strict capacity limitations and the enforcement of CDC guidelines (i.e., mask wearing, practicing proper hand hygiene, and social distancing) to reduce the risk of spreading the virus.

  It is expected that tourist and group-related venues, especially indoor venues (e.g., museums and aquariums) will continue to underperform until (1) enough vaccinations have been administered to achieve "herd immunity" and (2) government restrictions are lifted. Financial stability for this segment of the economy is highly dependent on fundraising efforts, which were materially impacted (see the Nonprofit Sectors section, below). Although outdoor venues (e.g., zoos) continued to perform better than indoor venues, demand was low when compared to pre-pandemic periods.
- **Restaurants** – Occupancy limitations and a continued reluctance by consumers to return to dine-in restaurants resulted in full-service restaurants continuing to struggle more than quick-serve locations—and those that survive will lag in the recovery. The quick-service restaurant sector and

those full-serve restaurants that have been able to expand or facilitate "take out" capacity, use delivery models, or offer outdoor dining performed relatively better than others. Restaurants that have used technology (i.e., online ordering) and provided the option of contactless delivery were able to maintain some of their sales activity. However, restaurant operators that received first round PPP funding have generally exhausted that liquidity. Even well-capitalized firms cannot operate for much longer under the current constraints. The second round of PPP funding, which is designed to help these businesses, will likely be a lifeline for many restaurants. Alternative financing remained nearly nonexistent for most restaurant operators, and more of these businesses are likely to close permanently during the first half of 2021.

- **Real Estate** – As families continued to seek less densely populated living situations, suburban markets experienced increased demand for properties, both rental and owned. This dynamic, coupled with the low-interest rate environment, resulted in increased rental rates and home prices. The healthcare crisis, political climate, and occurrence of civil demonstrations in many of the major cities across the country may have exacerbated the decline in demand for residential space in cities. This decline drove rental rates and property prices down in urban markets. Overall, despite this urban/suburban dichotomy, multifamily real estate continued to experience stable to improving occupancy levels, and absorption and collection rates remained relatively strong.

  Work-from-home policies remained in place across the country, and some jurisdictions reversed portions of their "re-opening" plans as infection rates rose. Offices continued to be sparsely occupied, operating well below 50% capacity limits in most states, and in the 15-20% range in major metro markets. Landlords and business tenants were successful in implementing social distancing for in-office employees in response to the pandemic. As noted in prior updates, the medium- to long-term outlook for office space is uncertain as many businesses are (1) actively evaluating productivity in the ongoing work-from-home environment and (2) reconsidering the traditional need for significant centralized office space.

- **Health Care** – With the rise in infection rates across the country, many markets restricted elective medical procedures. Staffing levels were also impacted by rising infection rates and the need for quarantining and isolation for more of the general population. The efficacy and speed of the distribution of vaccines for the general population will have a meaningful impact on the health care industry. The willingness of patients to use technology to receive routine and less-complex medical services combined with patient confidence in the safety protocols of their local practitioner helped some medical practices return to "seeing" patients on a more regular basis. Despite the success of tele-med solutions, which have been available in the market for some time, patients have not completely accepted "virtual" house calls as a viable option. Demand for non-essential services remained lower than expected and with the increase in infection rates, many patients delayed seeking medical care.

  Due to the nature of assisted-living and long-term care facilities and nursing homes, these facilities were more adversely impacted than some other providers. The vulnerable nature of the patients and the increased cost to ensure resident and employee safety negatively impacted operating results. These facilities will benefit in the near term, as, in most states, occupants and workers are high on the priority list for vaccinations.

  Many healthcare providers forecasted weaker performance for 2021—at least through mid-year. Council members noted that the outlook for the second half of 2021 and for 2022 is more optimistic given the approval of effective vaccines in the market and pent-up demand for elective treatments.

- **Energy** – This segment of the economy continued to be strained under the pandemic. Companies have been focused on efficiency and cost controls to drive operating results. Liquidity continued to be a challenge for many companies, forcing some businesses to consider formal or informal reorganization plans. Industry experts remained focused on workout and resolution strategies, as alternative financing solutions continued to be limited.

- **Technology** – The technology segment has performed well and continued to see strong demand for products and services. Although the shift to digital for many business segments taxed existing resources, businesses continued to shift or accelerate investments in digital capacity. The need for capital was a driving factor in the increased demand for financing in this sector.
- **Auto Industry** – Overall demand remained strong. While this sector continued to be negatively impacted by disruptions in the global supply chain, production and output improved since the last meeting.
- **Nonprofit Sectors** – The impact of COVID-19 in the not-for-profit sector varied depending on the financial strength of the organization and the ability of the firm to adapt to the pandemic operating environment. Demand for some services provided by nonprofit firms continued to increase, especially when the services supported the most vulnerable members of our communities. At the same time, resources available to these firms did not keep up with demand. Volunteers and donors were still willing to be engaged; however, the level of participation in volunteer activities was materially below the resources required to sustain the services needed. The duration of "stay at/work from home" orders coupled with state mandates limiting the size of events resulted in material changes to how a not-for-profit operates today. Council members noted that some of these changes in operating models are likely to be permanent.

  As the Council noted last quarter, the nonprofit community overall is highly creative, which has contributed to its resiliency. While revenues were down across the not-for-profit sector, endowments held up due to the strength of the equity markets, and charitable giving showed a level of resiliency. Despite the flexibility and creativity, not all firms (i.e., museums) have adapted fast enough or far enough to avoid closures in the future.

**(c) State and Local Governments**

Due to the pandemic, state and local governments— important drivers of employment—faced continued financial strain from revenue shortfalls and increased spending. From a revenue perspective, some states had already implemented tax hikes, while other states contemplated new revenue sources such as legalized mobile sports betting and adult recreational use of marijuana. Stable property tax incomes provided some cushion for local governments; however, substantial shortfalls still existed. State and local governments furloughed or laid off 1.4 million workers to date (as compared to 750,000 in the Great Recession). A potential risk to the most vulnerable governments is the health of the municipal markets. If states are not able to raise taxes or find sufficient expense savings, the public markets could be an expensive alternative. With the depletion of general fund surpluses, states and local municipalities will require additional federal assistance to avoid further cuts to necessary services. The lack of additional, specifically directed federal stimulus may have a material impact on the average government.

Further straining state and local budgets were the limited resources and increased costs associated with providing a safe and an effective primary and secondary education using multiple operating models (in-person, hybrid, and remote learning). The added burden and responsibility of broadly distributing the COVID-19 vaccines will further strain state and local government resources. Budget cuts, hiring freezes, and—presumably—layoffs remain likely.

The pressure on state and local governments varied considerably by COVID-19 impact, geography, population size and demographics, and the mix of urban/suburban populations.

## Item 5: The Outlook for Banking in 2021

**(a) What will be the drivers of bank profitability?**
**(b) How are bank balance sheets likely to evolve?**
**(c) How will banks' delivery of retail services adapt to customers' changing needs and expectations?**
**(d) What are the prospects for significant changes in industry structure?**
**(e) What will be the most significant legislative or regulatory issues for the industry?**

### (a) Drivers of Bank Profitability

The Council's outlook for banking industry profitability was driven by a consistent view of several favorable and unfavorable trends.

The most challenging unfavorable element of industry profitability was the continuation of historically low interest rates, which are compressing bank interest margins. The Council was also consistent in its view that loan growth will be under pressure due to the continued impact of the pandemic, although successful vaccine rollouts may result in increased business and consumer borrowing later in the year.

Favorable drivers for bank profitability are expected to be led by reduced loan loss provisions and, in some cases, the recapture of previously allocated reserves as the economic recovery progresses. At the same time, actual loan losses are expected to increase and peak in 2021 as the credit impacts of the pandemic are recognized and loan forbearance ends. Banks' continued focus on expense efficiency and branch rationalization should help support operating leverage as well as continued necessary investments in technology and cybersecurity.

Profitability will also be impacted by uncertainties related to additional economic stimulus, corporate taxes, fiscal policy, and regulatory oversight. These uncertainties, along with the potential for additional lockdowns and delays in vaccine delivery, will be significant factors impacting spending activity, investments, savings rates, loan demand, and, ultimately, bank financials.

### (b) Balance Sheet Evolution

Bank balance sheets grew significantly as consumer and business deposits expanded in response to fiscal stimulus, PPP lending, accommodative monetary policy, and reduced business and consumer activity. This growth has resulted in record levels of liquidity and reduced wholesale borrowings on bank balance sheets. The Council generally expects liquidity to remain at these elevated levels in 2021, given modest loan demand along with accommodative fiscal and monetary policy. Some members expect this high level of liquidity, combined with lower commercial loan opportunities, to result in some banks moving out the yield curve, extending duration in order to offset these factors. Some Council members expect to see loan growth in the areas of C&I, residential mortgage, and other consumer lending.

### (c) Adapting Delivery of Retail Services to Customers' Changing Needs and Expectations

All Council members reported a significant acceleration in the use of digital channels brought on by the pandemic. At the peak, this took the form of decreased teller transactions (over 30% decline), increased logins (up over 20%), increased mobile transactions, and a broader implementation of digital signature capability. This utilization appears to have transcended age groups and is not restricted to younger customers. Some Council members reported that since peaking, activity had regressed toward pre-pandemic digital adaption rates, which were already at double-digit levels.

The pandemic also understandably increased the utilization of bank drive-thru facilities. Some Council members reported increases of 15% for 2020, prompting them to consider expanding drive-thru facilities in new branch locations.

In addition, many Council members reported that they reduced branch locations to rationalize distribution given the customer activity patterns observed during the pandemic. Branches will remain relevant, but the role of the branch will continue to evolve from a model built on routine, teller-based transactions to a location focused on advice, sales, and complex problem resolution. As a result, in many cases the staff will have to be "up-skilled" and equipped with new tools and technologies to help fulfill customer needs.

While strengthened by the pandemic, trends toward digital acceptance (particularly mobile) were already in place due to the evolving experiences provided by fintechs and other technology companies. For instance, in a recent survey conducted by MX Technologies, 79% of respondents reported that they would like their "banking experience to be similar to the experiences I have with Netflix, Amazon, and other tech companies that understand my needs and offer recommendations based on my information."

**(d) Prospects for Changes in Industry Structure**

All Council members anticipated continued consolidation in the industry driven by the need to create efficiencies and scale to fund investments in technology needed to (1) meet customer demand for more digital and easier-to-use products and (2) respond to heightened cybersecurity risks. Due to the pandemic, bank mergers and acquisitions stalled in 2020 with only 109 transactions, which was less than half the average of the previous four years. The Council expects an increase in acquisition activity in 2021.

New non-bank providers of financial services will likely continue expanding, focusing on areas such as retail deposit gathering, payments, and consumer and small business lending. The growth of such entities will depend on access to equity capital and funding. Several such entities have pursued bank charters to build a stable deposit funding base, while others have partnered with, or sought to acquire, regulated banks. These trends are likely to continue in 2021, pending greater clarity regarding the regulatory framework for new entrants to pursue bank charters.

**(e) Significant Legislative or Regulatory Matters for the Industry**

- The Council believes that over the past several years banking agencies have greatly improved their level of cross-agency coordination in dealing with the banking industry. The Council hopes this cooperation will continue as agencies work toward modernizing CRA and enhancing consumer protection. The banking industry looks forward to working with the agencies in advancing these areas and continuing to successfully support consumers and businesses during the pandemic.
- Care should be taken regarding any changes to the rule temporarily excluding deposits at the Federal Reserve from the leverage ratio calculation of large banks, as any changes could impair the ability of these banks to continue to support the economy during the pandemic.
- Prudential Oversight: Under a Biden administration, it is possible that changes to capital and liquidity policy could occur, such as increased capital requirements, a review and rollback of temporary COVID-19 relief, and more severe stress-testing scenarios. As discussed with the agencies over the past few years, banks hold high levels of capital and they have strong capital and liquidity oversight practices in place. Requiring additional capital constraints during the pandemic and subsequent recovery could be a disincentive for banks to provide additional credit or flexibility to customers. Government relief and agency flexibility has helped mitigate the effects of the pandemic, and continued support would be beneficial to banks and their customers to soften the economic impact of the pandemic.
- Changes in Tax Policy: The Biden administration has indicated a preference for the corporate tax rate to increase from 21% to 28%.
- Recent increases in stock market volatility should be considered in order to understand any potential financial system impacts.

Other possible significant or regulatory matters noted by the Council include cybersecurity risk management, Basel III finalization, housing finance reform, and climate-related stress testing of large banking organizations.

## Item 6: Fintechs and Access to the Federal Reserve System

**Fintech firms are changing the payment system landscape both domestically and internationally. From the Council's perspective, what are the most significant opportunities and risks that these developments pose to the effective and efficient functioning of the payment system? How could the most meaningful payment system risks, including fraud, be better managed? What role, if any, do Council members think the Federal Reserve could play?**

### (a) Opportunities and Risks

Council members support responsible innovation in the financial service sector, both by traditional full-service banks and by non-bank financial technology companies (fintechs). Successful fintechs have displayed impressive speed-to-market and the ability to bring user-friendly solutions to targeted markets and use cases.

Council members have engaged in partnerships with fintechs to improve the delivery of banking services and provide new capabilities in areas including consumer lending, small business lending, corporate treasury management, back-office functions, and payments. During these integrations, banks have also worked to maintain their adherence to the risk-management controls, policies, and procedures expected of regulated institutions.

- **Risks from Non-bank Fintechs**

  One of the more significant risks to the safe and efficient operation of the payment system is the potential for direct participation by fintechs without full, bank-like federal regulation and supervision at both the bank and holding company level. By its very nature, the payment system is particularly reliant on the financial strength of all of the members of the system.

  At the federal level, Council members are subject to supervision at the bank and holding company level by combinations of the OCC, FDIC, Federal Reserve, and the CFPB—depending on charter and size—and subject to a robust supervisory framework that sets standards for capital and liquidity, as well as for managing operational risk, credit risk, reputation risk, consumer protection, cybersecurity, and systemic risk for the provision of financial services. Non-bank payments fintechs are not subject to a similarly robust supervisory framework. If these fintech payments companies were to become weak points in the payment system, they would increase the risks across the entire system, including at depository institutions.

  Council members, for example, have seen fintechs that are involved in payments be a significant source of fraud and account takeover risk, due in large part to their cybersecurity practices. Non-bank payments fintechs generally are not subject to a unified cybersecurity review, unless they are licensed as state money transmission businesses. The absence of a cybersecurity review creates significant risk to consumers and the financial system, given the substantial quantity of consumer financial information that may be held by fintechs.[1] For example, FinCEN Director Kenneth A. Blanco has noted that cybercriminals have used fintech firms and data aggregators to facilitate

[1] Plaid, for example, has stated that it has consumer information for at least 25% of the people in the United States. *See* https://www.cnbc.com/2020/01/13/visa-to-acquire-plaid-the-fintech-powering-venmo-and-other-banking-apps-for-5point3-billion.html.

account takeovers and fraudulent wires, and to create synthetic identities that can be used for fraudulent purposes.[2] Indeed, fraud attacks saw a significant increase in 2020.[3]

The increased fraud attacks have the potential to undermine consumer trust in banks. For example, fraudsters can use a consumer's transactional information obtained through the "hack" of a fintech/data aggregator to dupe the consumer into providing the fraudster the consumer's bank log-in credentials to purportedly transfer money into the consumer's account. If the fraudster uses those credentials to drain the consumer's bank account, the consumer is out the money (as Regulation E protections likely will not apply) and will likely lose trust in their bank, which they expect to protect their money.

- **Risks from Limited-Purpose Charters**

  Council members also believe that recent efforts to charter new types of limited-purpose banks (e.g., Wyoming's Special Purpose Depository Institution and an OCC-chartered limited-purpose national bank without FDIC insurance) pose increased risks to payment systems. A primary objective of these novel business models, licenses, and charters appears to be to evade some of the consolidated federal supervision to which a traditional full-service depository institution and bank holding company is subject, while gaining certain traditional bank privileges such as access to the Federal Reserve's payment systems and discount window.

  To the extent a firm were to gain such access without consolidated supervision by the Federal Reserve, Council members believe it would undermine the Federal Reserve's ability to understand risk in the system from either the firm or the activities of its parent holding company.[4] Some of these novel structures also seek to avoid the Bank Holding Company Act's separation of banking and commerce, potentially distorting the traditional economies of the financial system, including the payments system. Moreover, in the event of insolvency, a "fintech bank" without FDIC insurance would not be subject to the FDIC's well-established resolution regime, potentially resulting in a disorderly resolution and potential spillover effects.

  Council members believe that only entities subject to the full set of bank prudential standards and examination, at both the bank and holding company level, should have direct access to the payment system or the Federal Reserve's discount window. Anything less creates systemic risks.

**(b) Managing Payment System Risks and the Role of Federal Reserve**

Managing payment systems risk is the responsibility of every participant, and Council members continued to deploy new tools to manage the most meaningful payment systems risks, including fraud. New technologies, whether developed in-house or by external fintech firms, continued to make significant advances in fraud detection and prevention. Account-level security measures, such as multifactor authentication, biometrics, and device binding, have seen increased adoption across Council members.

New real-time monitoring tools, including developments in the use of artificial intelligence, have proven promising at identifying and stopping suspect payment activity, including payments that raise anti-money laundering and sanctions compliance concerns. Council members appreciate the role the Federal Reserve has played in supporting the development and adoption of these new technologies,

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[2] Prepared remarks of FinCEN Director Kenneth A. Blanco, delivered at the Federal Identity (FedID) Forum and Exposition, titled, "Identity: Attack Surface and a Key to Countering Illicit Finance" in Tampa, Florida, on September 24, 2019.

[3] See Jordan Reynolds, "9 Reasons Why Digital Fraud is On the Rise," Security Magazine (Nov. 12, 2020) (noting there were 1.1 billion fraud attacks in the first half of 2020, which is double the attack volume compared to the second half of 2019).

[4] While certain limited-purpose charters are recognized in the Bank Holding Company Act (such as limited-purpose trust companies and credit card banks), these entities are subject to significant limits on the scope of their operations and/or their ability to access the Federal Reserve's payment system or discount window. See 12 U.S.C. § 1841(c)(2)(D) and (F).

including the December 3, 2018, "Joint Statement on Innovative Efforts to Combat Money Laundering and Terrorist Financing."

Council members have been carefully watching developments in less regulated systems that can also be used for payments, including cryptocurrencies. In some cases, these technologies show promise for addressing traditional customer payment needs, including speed of settlement and cross-border payments.

Council members recognize, however, that as new payment services providers and systems continue to come to market, there is an increased risk of fragmentation across disparate systems. The Clearing House's real-time payments system represents the next major improvement to banking's payments infrastructure, showing significant gains in speed, finality, and consumer protection over legacy systems, and the FedNow System may also offer such benefits.

We encourage the Federal Reserve to work with the other federal banking agencies and the industry to promote policies that advance financial stability and reduce risk in the payment system while supporting responsible innovation. To the extent the Federal Reserve decided to explore providing new types of limited-purpose depository institutions with direct access to Federal Reserve payment services or accounts, we recommend that the Federal Reserve first establish a clear, uniform policy, subject to notice and comment, for evaluating whether to grant such access.

## Item 7: Climate Change

**Risk Management: How do Council members' institutions manage the financial risks associated with climate change and to what level of granularity? To the extent insurance or hedging strategies are being used to manage these risks, what other parties or sectors may be holding climate risk? What are the most significant challenges faced in managing these financial risks?**

**Disclosures: What challenges do Council members' institutions face with the quality and comparability of disclosures used to assess the climate-related risks of individual loans and investments? How do Council members' institutions disclose their own exposures to climate-related financial risks? What frameworks are used in such disclosures? What are the most significant challenges faced in making disclosures about your portfolios?**

**Comparability: Does the Council view these challenges as differing across institution types? Do smaller and larger institutions face similar challenges?**

### (a) Risk Management

**How do Council members' institutions manage the financial risks associated with climate change and to what level of granularity?**

Financial risks associated with climate change emanate from a variety of sources, including credit and investment portfolios, business strategies, physical operations, and the longer-term transition away from carbon-intensive activities. There has been increasing awareness among financial institutions of the need to define and develop risk management frameworks that incorporate these risks into strategic decision making on multiple levels, including investment approaches and the long-term structuring of portfolios.

Council members reported a range of practices, and they generally agreed that the broader industry is in the early stages of incorporating climate change into risk management frameworks. Banks engaging in activity overseas are subject to international guidelines already in place, including statements from the European Central Bank and the Prudential Regulation Authority that clarify their expectations regarding climate change risk management. Institutions subject to these guidelines have been developing frameworks to meet host-country expectations. Some members have also formed environmental, social, and governance committees or teams to provide cross-enterprise oversight and develop tools, processes, and procedures to manage climate risk.

One Council member established a global climate risk function that leads work to manage climate risks at an increasingly granular level in the enterprise. It is using new data and methodologies to develop climate risk assessments at the country, industry, and individual counterparty levels. Other Council members are implementing similar tools and processes to assess environmental risk from individual transactions to portfolio level analysis, with the goals of (1) making informed decisions on transactions and industries and (2) informing longer-term strategies. More generally, mid-size banks are incorporating climate risk into their individual credit evaluations to a greater extent, which can impact pricing, loan structure, insurance requirements, and loan sale strategies.

Financial institutions are striving to improve their measurement and evaluation of carbon emissions from existing and prospective clients. One Council member reported that its trust company sources third-party data—such as carbon emissions per unit of production, usage of renewable energy sources, and climate risk scores—to help quantify climate exposure in its portfolio and maximize risk-adjusted returns. These types of metrics should become more widely used over time as interest in allocating investments toward environmentally conscious portfolios continues to increase.

**To the extent insurance or hedging strategies are being used to manage these risks, what other parties or sectors may be holding climate risk?**

Lenders require borrowers to obtain hazard, flood, and other appropriate insurance to protect collateral values. Insurers have been at the forefront of climate risk analysis and are taking actions— through use of scenario analysis, pricing adjustments, and the development of climate-related derivatives and other hedging activities—to address risks to which they may be exposed.

One Council member noted that banks are increasing their use of government-sponsored mortgage securitization vehicles as a strategy to manage climate risk, especially for loans in coastal geographies in the Southeast Atlantic and Gulf coasts, which are prone to hurricanes, flooding, and sea-level rise.

As insurance and hedging strategies evolve, banks will continue to hold capital against these types of risks and price credit accordingly, which will promote stability within the financial system and the broader economy.

**What are the most significant challenges faced in managing these financial risks?**

As regulators have noted, there is no systemic and broadly accepted method for analyzing, modeling, or pricing climate risks, and well-developed supervisory frameworks do not yet exist, making comparability across institutions and industries difficult. The lack of common definitions and standards is a foundational challenge for the industry and regulators. This challenge is compounded by having little historical data available for study, including corporate data across carbon-intensive sectors. Additional data may be dependent upon long-term climate-related trends and outcomes.

Collaboration within and across industries will be necessary to ensure that adequate methodologies are deployed to manage the risks. Council members reported that financial institutions and other corporations are participating in and supporting recently developed external frameworks, such as the Task Force on Climate-Related Financial Disclosures (TCFD), created by the Financial Stability Board. The TCFD's mission is to allow participants to share insights, gain perspective, and incorporate best practices into their programs. As climate change will affect a wide cross section of the economy, institutions of all sizes and sectors will benefit from contributing data and ideas in frameworks such as the TCFD. Wide participation in these frameworks will also ensure that risk management models ultimately developed will incorporate flexibility to account for variability across institutions, borrowers, sectors, and geographies.

**(b) Disclosures**

**What challenges do Council members' institutions face with the quality and comparability of disclosures used to assess the climate-related risks of individual loans and investments?**

There are no standard requirements that promote consistent disclosure related to clients and customers of financial institutions, making climate-related risk assessments for individual loans and investments difficult, and Council members reported that available data is sporadic in terms of quantity and quality. This view is supported by a report from the Carbon Disclosure Project (CDP) that notes that key challenges for users of voluntary climate disclosures include their variable quality and completeness and lack of actionable data.

The development of uniform data standards and metrics for disclosures will be critical to adequately identify and compare climate risks across businesses and sectors, and frameworks such as the TCFD and CDP support the development of more standardized and effective disclosures. The World Economic Forum has also been working on the issue with large financial institutions and accounting firms, encouraging the adoption of standard metrics, which would help investors understand the extent to which companies are developing business models that progress toward the UN's Sustainable Development Goals.

As more uniform disclosures are developed, larger clients will be more able to comply with disclosure guidance as compared to smaller firms. The TCFD found that 42% of institutions with more than $10 billion of assets were likely to follow disclosure guidance while only 15% of institutions with assets less than $2.8 billion were likely to follow such guidance. The development of more uniform and thorough disclosures will ideally help close that gap.

**How do Council members' institutions disclose their own exposures to climate-related financial risks? What frameworks are used in such disclosures?**

Council members reported that financial institutions' practices vary across the industry. One member annually discloses climate-related risks and greenhouse gas emissions using principles from frameworks developed by the TCFD and CDP. Another reported it has endorsed several TCFD recommendations and is assessing the work necessary to integrate the recommendations into its businesses. Other firms are also researching disclosure frameworks and report that as these programs are refined, more consistent use of disclosures should expand.

**What are the most significant challenges faced in making disclosures about your portfolios?**

Accurate disclosure of climate risk inherent in banks' portfolios will entail quantifying the extent of carbon emissions financed on banks' books and obtaining robust emissions data for specific borrowers. Frameworks have been developed, such as the Partnership for Carbon Accounting Financials (PCAF), which is a global partnership of financial institutions working to develop and implement a harmonized approach to assess and disclose greenhouse gas emissions associated with their portfolios. The PCAF's mission is to facilitate financial industry alignment with the Paris Climate Agreement.

**(c) Comparability**

**Does the Council view these challenges as differing across institution types? Do smaller and larger institutions face similar challenges?**

The Council believes that the challenges of climate risk vary across institution types, depending on the composition of each institution's customer base, the diversification of its portfolio, and its geographic locations. For example, mortgage lending in flood-prone and coastal areas carries greater climate-related risk than other activities. Smaller institutions, especially community banks, can face substantial risk as opposed to more diversified lenders, as community banks' loans tend to be more geographically concentrated, and commercial real estate loans constitute a larger share of their portfolios. While they are more diversified, larger banks are also exposed—not only through physical exposure to climate risk in their portfolios, but from longer-term transition risks related to carbon-intensive industries and their related supply chains.

There are also challenges related to the development of data, risk models, and climate risk management frameworks that differ across institution types. Less diverse firms that may not have sufficient exposure to affected sectors—or that have fewer resources to engage in research—may have difficulty developing mitigation strategies without further guidance from the industry and regulators. However, these institutions may also benefit from their less complicated portfolios, which may require less complex, more manageable due diligence and risk management protocols.

The Council is supportive of efforts to assess risk management and disclosure frameworks to meet the unique challenges of climate change. As the financial industry and regulatory community consider these challenges, prospective guidance and regulation should be (1) designed to assist institutions of all types and sizes to measure, monitor, and disclose the associated financial risks and (2) tailored to the complexity of specific types of institutions.

## Item 8: Federal Reserve Policy

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

### Economy

Overall, the economy continued to recover, albeit at an uneven pace, with some sectors posting record years and others suffering significantly. Going forward, the outlook will depend on the success of the COVID-19 vaccine and is expected to remain muted until coronavirus case counts drop meaningfully and normal personal and business activities can resume. This muted outlook is expected to persist even in light of potential new government stimulus.

Nevertheless, most Council members anticipate that the vaccine will gain success in the second half of 2021 and support a more favorable economic outlook for the second half of the year. Consumption, construction, manufacturing, and housing are expected to experience strong growth. Some Council members anticipate a boost from pent-up demand once consumers feel safe to resume spending on goods and services they have done without during the crisis. In this scenario, the most severely impacted sectors, such as retail, restaurants, travel and hospitality, would experience the steepest recoveries.

### Monetary Policy

In response to the severe economic downturn last spring, the Federal Reserve intervened in the money markets to bring short-term interest rates down to near zero percent, initiated quantitative easing measures, and established several liquidity facilities under the Federal Reserve Act's 13(3) powers.

In September, the FOMC stated that interest rates would remain near zero until the labor market reached levels consistent with maximum employment and inflation rose to 2% and was on track to exceed 2% for some time.

With policy rates at their effective lower bound, asset purchases have taken a greater role in monetary policy. December's FOMC statement included the Federal Reserve's plans to increase Treasury and agency MBS holdings by at least their current pace until "substantial further progress has been made toward the Committee's maximum employment and price stability goals." Although this statement provides some clarity that asset purchases will continue in the near term, some Council members expressed concerns about the ambiguity of the messaging around "substantial further progress" and noted risks to market pricing of inflation expectations, among others.

Large-scale asset purchases have helped keep both mortgage and longer-term Treasury rates low, with the 10-year note yield only recently rising above 1.0% for the first time in nine months. In addition, the MBA reported that mortgage rates reached a record low in December.

In recent months, long-term rates have risen modestly, reflecting a strong rebound in the economy and an optimistic outlook for growth in 2021. Furthermore, inflation expectations have risen modestly from the very depressed levels witnessed last spring.

Council members expect the labor market to be far from maximum employment for many years, and while inflation remains below 2%, most agreed that the Federal Reserve's highly accommodative stance is appropriate. Council members also appreciate the Fed's thoughtful communications policy and recognize it as a stabilizing factor in financial markets.

However, some Council members raised concerns about substantial additional increases in the Fed's balance sheet given the strong recovery in financial market functioning. They noted several signs of froth in the credit and equity markets, which could worsen with significant additional injections of liquidity into the financial markets. Credit spreads have declined to below pre-pandemic levels and equity prices are at all-time highs. Lofty equity valuations in the high-growth technology and new economy stocks are also exhibiting bubble-like behavior.

Additionally, the banking system is awash in deposits, which some members at least partially attributed to reserve creation by the Fed. These members viewed a reduction in the rate of reserve creation in the coming months as appropriate. Finally, the impact of major policy shifts around government spending, taxes, and—even more importantly—regulation, are unknown but represent a risk.

**Federal Reserve Facilities**

From March through June 2020, the Federal Reserve opened lending facilities to (1) provide liquidity and (2) quell market jitters for primary U.S. Treasury securities dealers, money market mutual funds, lenders under the PPP and Main Street Lending programs, and the financial markets for commercial paper, asset-backed securities, and corporate and municipal bonds and loans. These swift actions by the Fed likely prevented the health crisis from developing into a financial crisis by restoring liquidity, credit availability, and rational pricing to the financial and lending markets surprisingly quickly last spring.

The Fed has had tremendous credibility from day 1 in this crisis, evidenced in the way the market responded to the mere presence of these facilities even before they went into use. Total usage of these facilities rose from nothing to $208.6 billion in July before plateauing in August through October. Total credit has since tapered to $201.6 billion, with increases in the PPP Liquidity Facility and Money Market Fund Liquidity Facility offset by declines in the Main Street Lending Facilities, Municipal Liquidity Facility, and Term Asset-Based Securities Loan Facility.

Ongoing support of these 13(3) credit facilities was capitalized by funds provided through the CARES Act. As those provisions of the act expired, the Treasury and Congress declined to extend support for many of the programs beyond 2020. While take-up at many of these credit facilities had been limited, they likely played an important role in providing a backstop should financial conditions deteriorate. Removing the Treasury's capital support for these emergency lending facilities would not be without risks.

Although the Consolidated Appropriations Act removed funding for some Federal Reserve facilities, it revived the PPP by appropriating $284.5 billion in new funds. The act reopened applications for businesses seeking PPP funds for the first time, while expanding the authorized uses for PPP loan proceeds and increasing flexibility to obtain loan forgiveness. Many Council members expect to see an increase in demand under the program, and some even expect to see the facility exceed its prior peak of $70 billion.