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Community Depository Institutions Advisory Council

November 16, 2023

1. Economic Discussion:

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

Council members from the twelve Federal Reserve Districts provided diverse economic insights about their respective Districts—ranging from continued robust consumer spending in specific customer segments and regions to slowdowns in other segments and regions.

In the Second District, the Council member noted robust consumer spending and economic activity being driven by the housing sector; however, there are concerns about a consumer spending slowdown, increased loan delinquencies, and higher household debt. The First District Council member noted economic stability with a slight spending decrease, particularly in rural areas.

The Eighth District is facing a housing inventory challenge and a slowing labor turnover rate. In contrast, the Sixth District is experiencing a flourishing housing and construction market, accompanied by a growing economic class gap and rising home prices. The Fourth District, which benefits from investments such as battery plants, is maintaining overall stability despite labor and wage challenges.

The Third District Council member reported generally stable economic conditions with a slight deterioration. The Ninth District presented a mixed scenario, with stable inflation, high cattle commodity prices, and challenges in labor and construction hiring. The Fifth District Council member offered a positive outlook tempered by concerns about rising health insurance and technology costs.

The Tenth District Council member noted economic stability but signaled a decline in consumer confidence and a pullback in spending by commercial businesses. The Seventh District raised significant labor concerns. The Twelfth District Council member highlighted urban and rural economic disparities, with rural economies outperforming in commercial real estate versus urban markets.

b. Particular Indicators:

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

The discussion around inflation revealed a complex situation throughout the country: higher health, property, and casualty insurance costs; labor market conditions that continue to drive up

prices; and improvements in supply chains that help moderate these pressures. In terms of consumer expectations, Council members expressed concern that households might be expecting prices for consumer goods to drop to pre-pandemic levels, which is not likely to materialize any time soon.

In the Sixth District, hazard insurance premiums have experienced a sharp 120 percent increase, which is causing significant concern. This issue is echoed in the Second District, where insurance losses from recent disasters in the Northeast have resulted in skyrocketing insurance premiums, contributing to inflation headwinds in that region.

In the First District, the reluctance to reduce prices indicates the efforts of businesses to recover from previous economic shocks when their operating costs surged. The Third District reported an increase in service fees, attributing the increase to businesses taking the opportunity to recoup lost profits. In the Tenth District, there is a sense of stabilization in the rate of inflation—not necessarily disinflation, but a cooling of the overall inflationary trend.

The Twelfth District emphasized the need to distinguish between federal economists' perspectives and on-the-ground realities, noting a lack of consistency with local observations and policymakers' perspectives. In the Eighth District, widespread elevated insurance premiums were mentioned, with health insurance premiums experiencing a significant surge. Despite these challenges, service-related issues and general price stability for products and goods were noted.

Overall, the Council members noted that the inflationary landscape presents a complex picture, encompassing regional variations and a range of factors influencing pricing dynamics.

ii. Housing: How have home prices changed in recent months? Have there been any changes in overall housing activity in Council members' Districts?

Several common themes were noted in regard to the housing sector, including a housing supply shortage across the country, especially in rural towns. While rent prices have moderated, they are still high, and building activity is focused on multifamily homes.

Council members also provided diverse observations regarding the housing sector in their respective regions. Council members from the Third District noted that the lack of housing inventory remains a challenge, though there has been a slowdown in home sales and an increase in days on the market. For multifamily, there has been a decrease in rents, and occupancy rates remain high.

In the First District, home prices continue to rise, but there is a shortage of homes listed for sale, including in the high-end market. The scarcity of affordable housing in Boston is leading to challenges for businesses to hire and retain staff, and, therefore, businesses are relocating from Boston to the suburbs to meet their staffing needs. Additionally, homelessness is on the rise in the First District, and there are significant concerns that housing projections will not meet housing needs.

Council members from the Eighth District reported strong development in multifamily units, mitigating housing availability issues, but there is a lack of low -to-moderate-income (LMI) housing in this District. While rents are starting to dip, occupancy remains strong. In the Fourth District, both occupancy and rents are high, with a growing percentage of people choosing to rent.

The Fifth District reported that construction challenges have been attributed to the labor shortage rather than to higher interest rates. In the Seventh District, it was noted that inflation has benefited existing homeowners, but first-time house buyers are negatively impacted, believing homeownership is unattainable due, in part, to student loan repayments.

In the Ninth District, the significant number of multifamily projects that are simultaneously in progress is raising concerns about the sustainability of demand for all these projects once completed. Council members from the Sixth District reported that housing prices remain elevated, but bidding wars have decreased, leading to a tempering of prices to more moderate levels.

Overall, the housing market exhibits various dynamics—from rising prices and housing shortages to concerns about affordability and the impact on first-time buyers.

> *iii. Labor Markets: How have the labor markets in which Council members operate changed in recent months? In particular, please assess the degree of job loss or gain (and, in which industries). Please comment on the changes to wages that Council members have observed over the past year.*

Council members offered diverse insights into recent changes in labor markets across the Federal Reserve Districts. In the Seventh District, businesses' ability to attract talent requires reaching out to candidates an hour away due to a "messy" labor market. This is partly due to Baby Boomers exiting the labor market and younger workers leaving the Midwest. The potential issue of growing high-skilled talent was raised, considering the average ACT score among high school students is 19, which is the lowest since 1991. Council members in that District are tracking the steep drop in high school standardized test scores as a potential leading indicator of future challenges in hiring and retaining talent. There is concern that the pandemic might have had a negative impact on school-aged children, many of whom are just entering college.

The Tenth District noted that metro markets experienced rising service costs, but those costs have started to stabilize. Businesses in the services and construction industries are still facing labor shortages, which makes it challenging to find skilled laborers. In the Third District, a labor shortage has caused a slowdown of construction projects, while in the Second District, there is a moderation of labor inflation with the slowing of labor turnover rates.

The Fourth District observed a decrease in labor turnover, evidenced by job cuts in larger banks, leading to an increased availability of an experienced workforce for community depository institutions (CDIs). In the First District, there is concern regarding how daycare closures will

affect the labor supply of female employees. The Twelfth District reported no significant difference in comments.

The Fifth District highlighted industry-specific challenges, with parts suppliers facing labor issues due to the UAW strike, and pockets of individuals simply choosing not to work.

These insights collectively depict a complicated labor market picture. Along with dealing with the changing dynamics in employee turnover rates, top concerns of businesses include the ability to attract workers, labor shortages that affect construction projects, and the rising costs of employee benefits.

iv. Consumer Confidence: Are Council members seeing any signs of improved (or declining) consumer confidence? What is the outlook for consumer credit losses?

Council members offered diverse perspectives on consumer confidence and the outlook for consumer credit losses.

In the Eleventh District, observations of full malls and restaurants suggest a positive outlook for consumer confidence. However, in the First District, the atmosphere was described as skittish, reactive, and fragile.

The Third District noted that concerts and restaurants have been packed but added that lower-income individuals might be struggling with higher prices, indicating a varied consumer landscape. In the Tenth District, although people are spending, there is concern among Council members about increased credit card usage and the potential formation of a consumer bubble. The fear is that when this bubble bursts, demand may decline.

The Sixth District observed an increase in credit card balances, with higher-income consumers and businesses paying off debt, and lower-income individuals accumulating debt. Despite current activity, a decline in consumers' cash balances is anticipated. In the Fourth District, the spending trend among Baby Boomers was highlighted, along with the excess cash in their balance sheets. The expectation is that people will continue spending until they tap out. In terms of timing, Council members are aware that this tapping out might happen gradually, given federal programs such as the CHIPS Act, the Inflation Reduction Act, and the infrastructure bill.

The Second District raised concerns about a generation of consumers who have never experienced a recession and may not understand the downsides of "buy now, pay later" (BNPL) loans. In the Eighth District, a significant financial literacy gap was noted among an entire generation of people who may not understand the risks of using credit cards and other financial products.

These insights paint a nuanced picture of consumer confidence, with indications of both positive and fragile sentiments. Concerns about potential credit bubbles, financial literacy gaps, and the impact of generational experiences on consumer behavior add complexity to the outlook for consumer credit losses.

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

Council members generally observed a slowdown in bank earnings in 2023 compared to the prior year, leading to lower net income and lower overall budget projections for 2024. Declining net interest margins are key contributors to the downward trend in net income projections, indicating continued funding pressure for the banking sector—particularly community banks.

Whereas the banking industry had previously seen consistent demand for lending—with room for growth—banks are now becoming more selective in their lending and are focusing instead on their lending niche to small businesses. This tightening is primarily being driven by higher funding costs and interest rates, rather than by credit risk. Council members noted that many banks are pausing further lending, choosing instead to reserve available credit for their best clients rather than pursue growth. Banks with ample liquidity have been able to benefit from the situation, financing new deals for firms turned away by other banks that have reached their credit limit.

a. ***Small Business Lending:*** *Has credit availability for, and demand for credit from, small businesses changed significantly? Have lending standards for these borrowers changed? Do Council members see evidence that prevailing economic uncertainty is slowing economic activity in this sector?*

The current landscape for small business lending is mixed. Council members from the Second, Fourth, and Ninth Districts reported robust demand for small business loans, while other Council members reported a softening in overall lending. A significant divergence exists across regions of the country, as the Tenth District reported that credit demand has held up fairly well in metropolitan areas but has slowed in rural areas, which constitute the majority of the District. Community banks are seeing stronger loan demand in markets that do not have a strong regional or national bank presence compared to markets dominated by large institutions.

Around half of the current loan demand comes from banks' existing business clients. While overall loan demand is declining, banks are seeing increased demand from select businesses in anticipation of potential funding challenges. There has also been a noticeable increase in micro-startups seeking banking services. Large banks seem to be less interested in small dollar loans that cost more to originate in relation to the size of the loan.

There is a perception that loan demand has eased due to higher interest rates and a negative economic outlook, but some of the reduction in lending has been a strategic business decision made by banks. Council members reported that banks are deliberately pulling back on loan participations, conserving liquidity for their existing customers as well as anticipated changes in banking regulations. Where CDIs are lending to new small business customers, there is concern about competition from the direct lending program of the Small Business Administration (SBA).

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 Council's last meeting in April 2023? How are commercial real estate loans performing compared to the Council's expectations?*

Community banks generally reported a cautionary slowing in commercial real estate (CRE) lending, as banks recalibrate their credit availability due to higher funding costs. Higher interest rates are also putting downward pressure on the demand for CRE credit, but underlying demand has remained healthy in some of the markets that CDIs serve. For example, in the Second and Sixth Districts, Council members reported that market demand for CRE credit has remained robust, particularly in urban areas where there is high demand for multi-unit residences, hotels, and vacation properties. The multifamily housing sector has continued to see substantial construction, with a record number of multifamily units currently under construction. Low availability of homes for sale has driven multifamily construction and the demand for rental properties. As the supply of multifamily properties increases, Council members are hopeful for some relief to the historically tight housing inventory.

Council members noted that CRE concentration and credit quality are not uniform across regions, and that significant variations exist between banks' business models. Office and retail lending has been extraordinarily slow. While there has been a lot of discussions about office conversions to residential spaces, this conversion activity remains low.

There has not yet been a significant deterioration in CRE credit quality, and Council members do not believe their specific CRE loan portfolios will see any meaningful weakening. Any deterioration will be consistent with regular cyclical CRE market trends. As CDIs' CRE loans are typically repriced every five years, there is growing concern that as loans reprice at higher interest rates, CRE projects will face a reduction in potential income, further impacting loan demand and credit availability.

One Council member noted a fundamental change in banks' underwriting standards for CRE loans. Prior to the 2008 financial crisis, banks primarily assessed CRE loans and credit risk based on a property's collateral value. Today, banks place greater emphasis on a CRE property's cash flow and profit margin, minimizing the credit risk experienced pre-2008.

c. ***Construction Lending:*** *What are Council members' perspectives on the availability of credit for construction and development projects? Have Council members seen any changes in the demand for construction loans since the Council's April 2023 meeting?*

Council members echoed the sentiment that the banking industry is tightening the availability of credit. On the demand side, higher financing and input costs have continued to slow construction loan demand. On the supply side, because of the profitability concerns that remain in the construction sector, banks are raising their credit underwriting standards and conserving their

liquidity. At the same time, banks are working with higher funding costs because customers have drawn down deposits that flooded the industry during the pandemic.

The Council also anticipates that return on assets will likely continue its downward trend. Council members noted that even if construction loan demand was sustained, banks would still likely pull back their lending to reduce credit concentration and focus on more profitable lending categories.

> *d.* ***Home Mortgage Lending:*** *What changes have Council members seen in the mortgage market? How, if at all, is regulation impacting the participation of community depository institutions in this market?*

Over the past few years, there has been a significant shift in the allocation of investor volume in the mortgage market. Banks' share of mortgage origination volumes has dropped from 85 percent to less than 20 percent. This change is attributed to regulatory interventions such as stringent Basel capital rules imposed on large banks, prompting them to retreat from certain types of home mortgage lending. Consequently, mortgages that were once sold and serviced by banks are now being originated and serviced by less regulated nonbank entities.

Council members concur that the housing market has experienced a decrease in available properties for sale, leading to a lack of activity in the mortgage origination market. And higher rates have caused the refinancing market to dry up. CDIs that previously held a prominent position in mortgage lending have scaled back their involvement due to various factors, including requirements by the Federal Home Loan Bank (FHLB) that mandate a certain percentage of mortgages to be held in their portfolios. This requirement presents a predicament for CDIs that want to engage in mortgage origination and servicing without retaining these loans on their balance sheets.

Moreover, bankers have seen a noticeable surge of consumers accessing the equity in their homes by obtaining home equity lines of credit (HELOCs) and second mortgage lending versus refinancing their first mortgages. However, bankers are concerned about the associated credit risk, especially if future home prices decline. While consumers' use of HELOCs is more predominant in some markets, it has not yet translated into a broad-based increase in loan volume.

Regarding multifamily lending, higher interest rates and servicing costs for multifamily lending are causing delays in the completion of these projects. Consequently, these projects are lingering on banks' balance sheets longer than anticipated, impacting the overall credit availability to fund new multifamily construction projects.

> *e.* ***Consumer Lending:*** *What changes have Council members seen in consumer lending? Please comment specifically on credit card and auto lending.*

The current economic landscape presents a mixed scenario in the consumer lending sector. There has been an evident rise in overall credit usage, especially among lower-income individuals who

often resort to credit to manage household expenses. In contrast, higher-income earners are actively reducing their debt, contributing to a bifurcated landscape across income brackets. Overall, credit usage has not surpassed pre-pandemic levels. Consumer spending remains robust, and the outlook for underlying demand remains strong, supported by recent increases in minimum wages for lower-income workers. Despite concerns over credit quality and consumer confidence among lower-income groups, the low unemployment rate may continue to sustain their wages and support their spending patterns.

There has also been notable demand and solid performance in auto lending, despite concerns over potential declines in collateral values and initial signs of rising delinquencies. Council members from the Second District highlighted the growth of auto lending in their region, fueled by agricultural demand for truck loans, some of which have an extended repayment term of up to 12 years, reflective of the useful life of a truck.

Council members observed that the topic of BNPL payment plans, once prominent, has dwindled in discussion. This shift might be due to increased understanding of the risks associated with BNPL and lessened inflationary pressures, easing the financial strain on low-income consumers who live paycheck to paycheck.

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

The agricultural landscape has seen stable loan growth over the past six months. Although input prices remain elevated, their availability has improved due to recovering supply chains. Despite concerns about reduced rainfall, technological advancements have facilitated solid crop yields, particularly in areas such as the Midwest. This has translated into stronger performance in livestock and robust cash flows for farmers. Council members highlighted the need to differentiate between producers' cash flows and government subsidies when underwriting loans in the agricultural sector.

Land sales remain high nationwide as farmers reinvest surplus cash into farmland. The agricultural sector continues to show overall strength, with significant interest in soy, diesel, and resilient ethanol markets. While the transition to electric vehicles raises concerns about future corn and ethanol demand, this shift is expected to be gradual, not an immediate threat.

Additionally, there has been an ongoing strategic assessment of lending practices for the cannabis industry, with limited participation from major financial institutions in tier 1 retail lending. In this business, a tier 1 firm, which typically has to meet state licensing requirements, is engaged in the business of dealing in seeds, processing, product testing, planting, and other elements of cultivation, as well as dispensaries. Tier 2 firms service tier 1 firms and include hydroponic suppliers, packaging suppliers, licensing consultants, industry associations, and marijuana software providers. Tier 3 firms include lawyers, accountants, food delivery businesses, and property owners. Challenges with obtaining title insurance for properties leased to dispensaries persist. However, tier 3 lending, which more indirectly finances the industry, presents revenue opportunities due to strong pricing power in the market.

g. ***Deposits**: What changes have Council members seen in local deposit markets? Describe these changes by segment (retail, small business, and corporate). What are Council members' expectations with respect to deposit levels?*

The banking industry continues to face competitive pressure for funding, primarily due to intensified competition for deposits as customers have alternative investment opportunities such as treasuries and money market mutual funds. Council members from the First and Third Districts raised concerns regarding the ability of smaller institutions to attract and retain deposits. Larger banks are now outpricing smaller institutions on deposit products, creating apprehension about rising funding costs. However, recent observations suggest that pressures on deposit competition might be easing, enabling banks to price their services without facing as much external competition for deposits. And there is still room for banks to raise interest rates in line with increases in the federal funds rate.

Operating bank accounts for commercial customers remain the most stable deposits, but a growing number of small businesses are utilizing their own cash for financing to avoid higher borrowing costs. High certificate of deposit rates have become more defensively oriented, aimed at retaining deposits rather than actively acquiring new deposits. Customers have been displaying heightened sensitivity to interest rates. Retail deposits are notably rate sensitive as well.

At least one District highlighted concerns about the current deposit insurance framework disadvantaging CDIs. This cohort is interested in the reinstatement of the Transaction Account Guarantee program, due to the increasing competitive offerings by larger banks. Operating deposits from businesses are a critical source of funding for CDIs, and banks are concerned about continued outflow of these deposits to larger banks. Municipal deposits have been a reliable source, but banks are now facing particular scrutiny as these entities have alternative avenues for their deposits apart from CDIs.

The end of quantitative easing has further contributed to deposit run-off, as the Federal Reserve shrinks its balance sheet, reducing the money supply available for deposits. Overall, while there are signs of easing pressure in deposit competition, concerns linger around various deposit categories and the potential impact of market dynamics on banking funding.

h. ***Mergers and Acquisitions Activity**: What trends are Council members observing with respect to mergers and acquisitions among depository institutions and their holding companies?*

Despite a sluggish mergers and acquisitions (M&A) landscape this year with minimal deals, a growing desire among CDIs for M&A persists due to a challenging outlook for profitability and heightened regulatory pressures. Bank earnings have demonstrated the difficulty in achieving profitability in the current economic landscape, and banks have increasingly recognized that the current community bank business model may not be economically viable in the long term. Nevertheless, there is a consensus that M&A activity will revive in the foreseeable future.

A notable development in the M&A environment is the engagement of credit unions in acquiring banks. Credit unions, functioning akin to mutual banks and not publicly traded companies, hold a tax advantage, enabling them to engage in deals that might seem economically unviable for other financial institutions. This trend further intensifies as credit unions venture into commercial lending space beyond their traditional consumer customer base. However, the M&A environment remains relatively dormant primarily due to mark-to-market value challenges.

Larger credit unions are receiving an increase in inquiries from banks seeking to sell, primarily because other banks are unable to make acquisitions in the current environment. Entities with ample liquidity and capital hold a distinct advantage, positioned as desirable candidates for such deals. Banks with large accumulated other comprehensive income (AOCI) losses might face challenges in 2024 if they are unable to comply with regulatory orders to bolster capital unless they opt for mergers.

Council members speculated on the prospect of the Bank Term Funding Program (BTFP) being extended for some additional time to help banks cope with the AOCI challenges until interest rates come down.

3. ***Community Reinvestment Act***: *Do Council members have any additional views on the agencies' work to update the regulations implementing the Community Reinvestment Act (CRA)?*

While Council members expressed some points of satisfaction, they emphasized a high level of concern regarding the agencies' updates to the regulations implementing the Community Reinvestment Act (CRA). Considering that CRA had not been updated since the mid-1990s, Council members agreed that there was a desire from the banking industry for modernization and greater clarity in some aspects of legacy CRA regulations. Council members expressed appreciation to the agencies for clarifying and expanding the list of community development activities.

However, the Council had a limited amount of time to consider the almost 1,500-page rulemaking prior to its November 15 and 16 meetings, and Council members primarily had to rely on summary documents rather than in-depth analysis. Council members expressed dissatisfaction with what they considered to be a lack of transparency and consistency, particularly given the new metrics and the reliance on peers' CRA performance as components of their own rating. For instance, reliance on peer performance will require community banks to predict competitors' CRA plans as strategies for CRA performance are set for their own institutions. Further, CRA data will be backward-looking, meaning that supervisory targets will not be known at the beginning of an evaluation period, adding to the uncertainty. The overwhelming nature of these changes and others contributes greatly to current uncertainty and lack of clarity around the updated regulations.

There is also a feeling among Council members that agencies did not consider or incorporate all the feedback provided by the banking industry over the years prior to the release of the final rule, resulting in a note of resignation expressed by Council members.

Council members agreed that legacy CRA required modernization, as previously the rules were too subjective or did not always accurately represent the extent of community involvement of financial institutions, especially community banks. The Council's immediate impression is that the rule takes its prescriptive approach to an extreme and does not offer a clear path for community banks to meet the prescriptive expectations without significant adverse consequences. For instance, the retail lending test is expected to require a new infrastructure of staffing and data collection applications. Council members were unanimous that the updated regulations would significantly increase costs for community banks, and that alternatives were proposed—but not adopted—that might have mitigated this likelihood.

Council members expressed deep concern that the increased costs related to implementation and compliance may lead to even more and faster consolidation in the banking industry. Council members agreed that more consolidation conflicts with the goals of CRA—fewer and larger CDIs will mean less community bank involvement and less development tailored to the needs of the communities in which they operate. As a result, Council members believe that parts of CRA "modernization and strengthening" seem at odds with the goals and intent of the CRA, particularly for CDIs, which have a history of knowing and meeting credit needs of their communities, including LMI neighborhoods.

Beyond the large direct costs of increased data collection and the software, manpower, and training that the new CRA rule will require, the Council pointed out that significant senior management resources will be diverted to understand and interpret the rule, and away from revenue generation, risk management, and serving the needs of their communities. This shift in focus could result in fewer activities encouraged by CRA transpiring, thus negating the policy goal. The Council also expects bank managements to mitigate CRA risks by changing business strategies where feasible. Also, CDIs, particularly in rural areas, raised concerns about whether they will be able find new staff with the right skills to manage new compliance obligations.

The Council fears that the path toward implementation of the new CRA rule will be bumpy and have unintended consequences. To smooth the path, Council members suggested that the agencies help to prepare financial institutions for changes by sharing training materials intended for training supervision and examination staff, as well as providing access to the analytical software that will be used by examiners to determine the scores. Council members did not believe that the asset size thresholds will protect smaller CDIs. The cost of software, which would disproportionately impact smaller CDIs, and lack of clarity on the data required were two of the largest barriers to implementation, followed by increased labor costs and a lack of experts in their regions. Finally, the Council encourages the banking agencies to exploit the processes of training agency staff, writing examination procedures and engaging in outreach with the regulated industry to find avenues that achieve desired results and minimize unintended consequences.

4. **Examination Practices***: What has been the experience of Council members in the most recent examinations? In particular, what has been the experience of community depository institutions in the aftermath of the bank failures in March 2023? Have you seen examination practices impact the flow of credit? How can supervisors improve their communications (both formal and informal) with supervised institutions?*

Council members reported that, overall, examinations have been running smoothly, and several Council members expressed that communications with examiners have improved, which helps in managing examination expectations and preparing for examinations. However, it was noted that some communication issues remain.

Some problems are emerging, perhaps related to recent market and economic disruptions and uncertainties. For example, after providing significant information prior to an examination as requested, once on-site, examiners often request additional information or shift their focus. Also, examinations are taking more time to complete, and examination reports are being delayed, seemingly because of more internal reviews at agencies.

Many CDIs reported more examiner focus and questions on bank liquidity and safety and soundness, and there were reports of examiner demands for unnecessary higher levels of liquidity, which bankers thought were not warranted. The impression being given is that examiners prefer additional cushion at CDIs even if the management is strong and risks are little changed.

Council members also reported that fair lending focus has intensified. In the last few years, referrals to the Department of Justice have increased with regard to possible redlining. In some instances, the consumer examiners issued matters requiring attention (MRAs), directing banks to take corrective action to establish new branches and expand financial literacy programs.

Beyond their questions and comments about the appropriateness or effectiveness of fair lending exams, Council members expressed concern about the growing length and cost of safety and soundness examinations, especially given that, ultimately, few issues are detected and few MRAs issued. During an exam, bank staff often have to curtail regular responsibilities to focus on gathering data for examiners and responding to their questions, which means bankers have less time to serve their customers.

5. **Regulatory and Payments Matters:** *How are recent changes in the regulatory and payments landscape affecting the ability of community depository institutions to innovate as well as continue providing services to their customers?*

As a general matter, Council members are concerned about the cumulative impact of all the regulations that have been issued over the past 10-15 years. And over the past two years, many CDIs believe that the federal banking agencies have issued new proposals and final regulations that will hurt the economic viability of the CDI business model. Council members said that regulatory efforts are simply helping to speed up the trend toward greater industry consolidation, contradicting the current administration's interest in promoting competition in the banking industry and having a viable CDI business model.

In particular, Regulation II (the debit card interchange rule) has introduced novel sustainability concerns for institutions below $10 billion who have growth plans that either include merging or growing their asset sizes independently. Concerns about sizeable revenue cuts when a bank crosses that threshold may encourage CDIs to reduce lending to stay below the threshold. The

threshold cost will become larger if the current Regulation II price cap proposal is implemented, potentially encouraging growing institutions to merge rather than stay independent in order to "leapfrog" this cost through scale.

With regard to Regulation II, Council members voiced concerns about pending restrictions on their fee income. Council members are interested in correcting the misperception that the Durbin Amendment "exempts" community banks, including as it relates to the current price cap that the Federal Reserve proposes to amend. CDIs rely on fee income (1) to support the cost of services, such as free checking, that are currently available at no extra charge and (2) to cover increases in operating expenses to implement fraud prevention and mitigation measures. Debit card interchange fees are one example. In the past, these and other fees covered most costs of debit card programs, but that coverage has already been eroded. Per-transaction fee revenue is difficult to track because of core processor limitations, but the general impression is that it has been dropping. Even for those CDIs not subject to Regulation II, competitive pressures from larger banks mean that fee limitations affect CDIs. If fees continue declining, at some point, CDIs will begin to curtail customer services.

Council members were concerned and somewhat puzzled by the Federal Reserve's statement that it is not seeking comments on the cost implications of the proposal to amend Regulation II. The Regulation II's routing provisions impact not only interchange revenue but also the fraud protections and liability frameworks at CDIs of all sizes (net interchange). When fraud reductions are possible in a certain transaction channel, the fraud prevention measures taken require significant investment by CDIs that is often funded by interchange revenue. Fraud costs keep increasing every year, while income from net interchange is falling for CDIs.

A Council member cited studies that suggest pricing benefits to merchants' customers have not materialized since the imposition of interchange fee limits. Instead, Council members noted that merchants have been introducing service charges (or surcharges) to cover the cost of interchange fees. Often, these surcharges are higher than the fees they pay to payment processors. Council members noted the opaque nature of these practices, and generally believe that the Regulation II proposal is picking winners (merchants) and losers (banks) with no evidence of customer benefit. Council members suggested that the Federal Reserve withdraw the proposal and re-introduce it once an appropriate cost-benefit analysis has been conducted.

FedNow

Except for a small number of institutions, CDIs generally have delayed adoption of FedNow. Originally, they faced limitations based on their core processors' ability to make system changes. Also, Council members reported that the initial system modifications to implement FedNow generally cost in the high five figures, which they cannot justify in the face of negligible customer demand. More significantly, other system changes required to meet new regulatory requirements (Community Reinvestment Act reporting and data collection required under Dodd-Frank section 1071) or to improve cybersecurity have further slowed adoption of FedNow by CDIs.

At least one Council member commented that there would be interest in implementing FedNow if it had true payment-to-payment capability. Another Council member shared that they had made a strategic decision to invest in implementing FedNow with a view to providing value-added services to business customers.

6. **Additional Matters:** *Do Council members wish to present any other matters affecting community depository institutions that have emerged from meetings of the Reserve Banks' advisory councils?*

Council members were interested in understanding if the BTFP would be extended beyond March 2024, at least until the negative impact from AOCI has been resolved by falling bond rates. CDIs are using the BTFP to manage the AOCI hit, and there is concern that losing access to the program might have liquidity consequences.

Council members expressed concerns about deteriorating liquidity conditions in general, and challenges dealing with continued deposit outflows, including losing access to the BTFP program and the planned regulatory changes to the FHLB system—many of which will occur through the supervisory processes instead of via formal rulemaking. The FHLB changes will highly likely cause FHLBs to raise costs to CDIs, tighten collateral conditions, and consequently reduce CDIs and other banks' ability to continue accessing FHLB funding. There is concern about the lack of holistic thinking among regulators, individually and collectively, and the unintended consequences of their policy actions.

The third point raised by Council members was in the context of the pending finalization of the SEC's climate disclosure rules. Council members expressed concern that, once finalized, the FHLBs may have disclosure obligations related to the collateral they hold. Should that be the case, the burden could fall on CDIs and other banks, consequently raising the effective cost of FHLB advances or disincentivizing borrowing from FHLBs.