

**Record of Meeting**  
**Federal Advisory Council and Board of Governors**  
**Friday, February 8, 2019**

**Item 1: Current Market Conditions**

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

**General Outlook**

- The financial markets have experienced volatility since the prior meeting. Equity markets entered correction territory, bottoming on Christmas Eve. New issuances in the debt markets halted in December with poor liquidity in the secondary markets as credit spreads widened rapidly. After the New Year, focus renewed again on the relative strength of the U.S. economy. This was highlighted by a strong payroll number, reasonable earnings reports, and an indication that the Federal Reserve could be patient in evaluating future rate hikes. These elements were enough to offset weaker sentiment numbers. Debt markets have rebounded since and have seen a healthy level of new issuances and tightening of spreads in the secondary markets.
- The U.S. Treasury (UST) market has rallied, which in part reduces concern of significantly higher UST rates -- bringing spread buyers back into the market and reducing potential headwinds to housing markets resulting from higher mortgage rates.
- Loan markets have remained surprisingly strong and stable. Price competition remains robust and terms and conditions have eased slightly. Nonbank lenders continue to play a part in the loan market as they increase in number and offer aggressive terms and conditions.
- Overall, borrowers continue to invest and expand their businesses, while their view of future periods reflects a degree of uncertainty.

**Has the Council observed any notable developments since its last meeting for loans in such categories as (a) small and medium-size enterprises, (b) commercial real estate, (c) construction, (d) corporations, (e) agriculture, (f) consumers, and (g) homes?**

The Council noted minimal developments in these categories since the prior meeting, indicating that loan demand and pipelines remain strong despite market volatility.

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

- Small and medium-size enterprise activity finished 2018 up over 2017, but with a noted decline in demand during Q4. The shutdown stalled some SME activity, especially for business acquisitions and new business start-ups, but the impact has been minimal as Small Business Administration loans are a small portion of the total SME credit market.

**(b) Commercial real estate (CRE)**

- Modest loan growth continues for CRE primarily in multifamily, medical/health care, and hotel asset types. Competitive pressures on pricing continue to dampen permanent originations. Delinquencies remain at historically low levels.

- Overall, competition from nonbank lenders, such as mortgage REITS, funds, and alternative lenders, remains robust. Debt funds, which have the advantage of being able to hold an entire transaction, have become significant capital providers to the CRE markets.
- There continues to be a significant amount of institutional capital looking to invest in CRE, but concerns over late-cycle dynamics have kept transaction levels relatively moderate.

**(c) Construction**

- Construction loan demand seems to be slowing as a result of rising material and labor costs, increased borrowing costs, and moderating growth in rental rates.
- In the "for sale" construction markets, single-family and townhome markets have softened due to interest rate increases and increasing home prices. However, homebuilders report interest from buyers for moderately priced units and that inventories remain generally balanced.

**(d) Corporations**

- Commercial and industrial lending continued to strengthen in Q4, growing an annualized 10.4 percent in the quarter and 6.8 percent in 2018.
- While delinquencies remain near three-year lows, the effects of the government shutdown on Q1 are still to be determined.

**(e) Agriculture**

- Agriculture remains challenged by tariffs and continued price weakness in select sectors. Tariff impacts are mainly concentrated on exported commodities like soybeans. Loan growth declined 4 percent in December compared to the year before. Noncurrent loans continue to increase slightly, and risks for the segment remain elevated overall.

**(f) Consumers**

- Demand for automobile lending remained steady. The recent trend of increased subprime lending for new vehicles by captive lenders continues, while used-car sales rose to an all-time high, with prices up 4.3 percent year over year.
- Unsecured installment loan demand remains strong, while credit card aggregate balances decelerated as the fourth quarter progressed, declining 0.2 percent month over month, the first month-over-month decline since late 2013.
- Credit quality has deteriorated slightly. Auto lending delinquency rates have risen to five-year highs, and credit card delinquencies have risen recently from low levels. Additionally, the impact of the government shutdown, while still unknown, could impact consumer credit, as certain government employees and contractors went without pay during the shutdown.
- Overall, the consumer capacity to borrow remains strong, and year-over-year spending continues to increase.

On the question of the government shutdown's impact on the economy, Council members noted that the industry broadly gave payment forgiveness with zero interest loans made easier by the quick legislative guarantee of past pay. All Council members reported limited borrowing among the 800,000 persons affected by the shutdown. Given the short duration and the low likelihood of a repeat shutdown, the impact to the economy seemed to prove transitory.

**(g) Homes**

- Housing remained weak through year-end, with sales of existing homes down 7 percent year over year, driven by low inventory levels and elevated interest rates.
- However, early January data indicate an uptick in weekly mortgage applications. This could be a reflection of the roughly 40 basis point decline in mortgage rates in recent weeks, though moderating home prices may be contributing as well.

**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?**

- While loan demand in the prior quarter closed strong and pipelines remain full, there is a notable level of uncertainty remaining in the market, resulting from the potential for another government shutdown, trade concerns, equity market volatility, slowing growth in China, and Brexit. As a result, loan activity could be muted in 2019, despite the fact that many key economic indicators are favorable for loan demand.
- Another key economic development being monitored by the Council is the progressing impact of Amazon's HQ2 and other expansionary activity in Virginia, New York, and Nashville. While speculative investment is already apparent in regional residential data, current data do not fully reflect the broader impact of new commercial development, economic revitalization, and the creation of additional service and "like kind" jobs in these markets, as other technology companies look to locate near Amazon.
- The Council also continues to note a shortage of labor when it comes to trades (roofers, painters, etc.) and drivers. This shortage is believed to be a result of the overall job market and the possible immigration policy, but numerous clients have noted that the shortage of trade workers has limited their ability to meet full demand.

**Item 2: The Outlook for Banking in 2019**

- (a) What will be the drivers of bank profitability?**
- (b) What are the greatest competitive challenges facing the banking industry?**
- (c) Is the industry well positioned if interest rates rise further?**
- (d) How is deposit pricing evolving?**

**(a) What will be the drivers of bank profitability?**

Delivering positive operating performance in a predicted economic environment of solid but lower growth in 2019 is the key near-term performance question. The undercurrents of pre-tax profit growth include:

- Increased importance of loan and earning-asset growth to drive net interest income growth, given flat yield curve trends and the predicted monetary policy path;
- Modest growth in fee income, as stable-to-improving activity levels across consumer, corporate, and institutional customers are somewhat mitigated by strong competition. For money-center banks, capital markets activity (investment banking and trading) is expected to remain sensitive to the markets. Meanwhile, mortgage banking continues to reflect both a flattening in housing activity and rate increases.
- Balancing efficiency-ratio improvements with investment spending (particularly investments focused on innovation and technology) is crucial to 2019 profitability. Council members pointed out increased difficulty in maintaining that balance, as rising tech-related investment spending outpaces the ability to identify major cost savings.
- Council members generally do not expect loan loss provisions to be a large contributor to or detractor from bank profitability in 2019.

**(b) What are the greatest competitive challenges facing the banking industry?**

- **Continued competition from nonbanks.** Council members resoundingly pointed out the threat of nonbanks. Private equity firms continue to pose a formidable threat to banks in the commercial lending space, especially given their approximately \$1 trillion in already raised, undeployed funds locked in for four to six years ("dry powder"). Wholesale-funded marketplace lenders are targeting personal and small business loans by leveraging their

technology to compete, though their competitive impact has been diminishing as core-funded traditional players have responded by improving related technology and response times. Council members also noted the significant share of mortgage lending by nonbank competition.

- **Increased customer demand for digital banking.** Council members also pointed out the challenge of executing digital transformation, while minimizing risk and customer impact.
- **Regulation.** Council members cited the need to regulate financial services by activity, applying the same regulations to all market participants equally, regardless of their legal structure.

**(c) Is the industry well positioned if interest rates rise further?**

- Council members point out that the industry remains modestly asset sensitive, and should generally benefit if interest rates rise further. However, the dynamics for 2019 may be more nuanced than in 2018, mostly due to increased deposit competition. If short-term rates continue to increase, deposit repricing may accelerate. If long rates increase, this scenario can be somewhat positive to net interest margins as well, though to a lesser extent than if short-term rates rose.

**(d) How is deposit pricing evolving?**

- Council members pointed out increasing deposit competition in 2019, though the level of competition will be somewhat determined by the need for financing the balance sheet growth. If rates stay stable, deposit repricing may continue for another two to three quarters.
- In particular, Council members cited more competitive pricing for CDs and other longer-term savings products from regional and community banks with higher loan-to-deposit ratios. Digital offerings for money market and savings accounts are increasing from both players with traditional branch networks and online-only banks.

### **Item 3: Fintech and Banking**

**Is the Council concerned about the decision by the Office of the Comptroller of the Currency to begin accepting applications for special-purpose national bank charters from fintech companies? What does the Council see as the costs and benefits of this charter, and how might the charter eventually affect the business of banking? In the Council's view, are there other alternatives that would better accommodate the emerging digital-banking model?**

#### **Definition of a Fintech**

A fintech is a nonbank financial services company that offers credit, credit management, payments, deposit accounts, automated savings solutions, investment services, or financial advice. Fintechs operate across state lines and leverage the internet and non-human, digital interactions as the primary medium for interacting with their consumers.

#### **Regulatory Background**

In a July 2018 policy statement, the Office of the Comptroller of the Currency (OCC) announced that it would begin accepting applications from nondepository fintech firms seeking a special-purpose national bank charter. The announcement came after a two-year period in which the OCC conducted outreach and reviewed public comments on two key industry publications (December 2016 -- *Exploring Special Purpose National Bank Charters for Fintech Companies*, and March 2017 -- *Licensing Manual Draft Supplement: Evaluating Bank Charter Applications from Financial Technology Companies*).

The OCC policy statement outlines a path that enables fintechs to provide financial services while avoiding state licensing requirements, other applicable state regulatory considerations, and the need to formally establish themselves as a bank holding company (BHC).

The OCC's release indicates that fintech charter applicants will be supervised along the lines of similarly situated national banks, and fintechs would be subject to certain requirements regarding capital and liquidity, risk management, commitment to financial inclusion, and contingency planning.

The OCC's special-purpose charter does not allow fintechs to engage in deposit-taking activities. Because the special-purpose charter does not support deposit taking, it would likely be most attractive to payment fintechs.

Fintechs do have two other options to gain regulatory oversight and integrate into the federal banking system, including deposit-taking activities:

- Full-service national bank charter, governed by the Bank Holding Company Act
- Industrial loan company (ILC) charter

Fintechs could also seek to establish operations on a state-by-state basis, outside of the federal banking system.

### **Is the Council concerned about the decision by the Office of the Comptroller of the Currency to begin accepting applications for special-purpose national bank charters from fintech companies?**

The Council supports a competitive environment in which consumers and businesses have choices in financial services, both products and providers, and can benefit from technological innovation and other advances in order to bank securely, efficiently, and effectively.

Council members also desire a level playing field that permits traditional banks, fintechs, and other market participants to compete fairly and be held to the same operating standards. Regulation should be based on activity, not the type of entity engaged in the activity, and we believe that the special-purpose charter accomplishes this with adequate oversight.

The benefits of providing a path for fintechs to become national banks may include offering consumers greater choice, promoting financial inclusion, and increasing competition. As indicated in the OCC's licensing manual, any entity seeking the charter must demonstrate a commitment to financial inclusion by providing fair access to financial services and supporting the fair treatment of customers.

The American Bankers Association supports the proposed charter, as it would level the regulatory playing field by holding fintechs to the same standards of safety, access, and fair treatment that national banks are subject to. In an opposing viewpoint, the Independent Community Bankers of America expressed concern about the proposed charter: "any limited purpose fintech bank charter could end up having all of the advantages and benefits of a full-service bank charter with limited supervision and regulation."

### **Political and Legal Considerations**

On the same day the OCC released its statement, the Treasury Department released a "Report on Nonbank Financial, Fintech and Innovation" under Executive Order #13772. The order articulated the Trump administration's positions on fintech regulation, argued for a national bank charter for fintechs, and, accordingly provided political support for the OCC's policy statement.

Congress has become increasingly interested in the regulation of fintechs. The Senate Banking Committee has held numerous hearings examining the topic, most recently in September 2018. This interest is expected to continue. During her first policy speech, House Financial Services Committee Chairwoman Waters outlined her priorities for the fintech industry. She expressed both hope and concern about the growing industry, wanting to encourage fintechs to meet the needs of unbanked and underbanked consumers but also wanting to ensure that vulnerable consumers would be protected.

This past fall, New York State and the Conference of State Banking Supervisors have both challenged the OCC policy statement in federal court, asserting that the OCC lacks the authority to grant national bank charters for fintechs.

**What does the Council see as the costs and benefits of this charter, and how might the charter eventually affect the business of banking?**

**Costs and Benefits for Fintechs**

Fintechs that apply for and receive special-purpose national bank charters will be supervised like similarly situated national banks, including oversight of their capital and liquidity, safety and soundness, directors and management, and they would also be subject to periodic examinations, limitations on affiliate transactions, and heightened anti-money-laundering (AML) requirements. For some fintechs, these requirements and limitations will be of little consequence, but for others they could be significant.

The chief advantage of the special-purpose charter for many fintechs would be the ability to preempt federal and state laws, and the second advantage would be having only one supervisory regulator, the OCC.

Another potential advantage would be the ability to provide payment-processing services without having to partner with another bank or savings association. Finally, under current law, the parent company of the fintech would not be considered a BHC and therefore would not be subject to the obligations and limitations of BHCs.

To date, there have been very few fintech applications for charters of any kind. In fact, the last ILC to be approved by the FDIC was back in 2008.

**How might the charter eventually affect the business of banking, and are there other alternatives that would better accommodate the emerging digital-banking model?**

Despite the limited number of applications from fintechs for special charters, banks have accelerated their ability to bring innovations and new services to their customers by partnering with fintechs in different and innovative ways. Several models have emerged to date:

**Model 1:** Banks are acquiring fintechs and integrating their products and services into their core banking applications. In targeted cases, these fintechs may provide services to multiple banks. Under this model, the fintechs operate within the guidance of the acquiring bank's charter and continue to benefit from the bank's overall risk and control support.

**Model 2:** Banks offer new products by leveraging fintechs' platform/capabilities, while still providing the bank's brand, balance sheet, and regulatory and compliance infrastructure.

**Model 3:** Banks are creating consortiums (e.g., EWS/Zelle) whereby fintechs are established with bank support in order to provide efficient and scalable services in targeted areas (e.g., peer-to-peer money transfer) to all participating banks.

**Model 4:** Banks are establishing partnerships with supporting fintechs by allowing them to operate under the bank's charter.

Despite the recent emergence of Model 4, it is far more likely that banks will continue to leverage Models 1 to 3 more frequently. Model 4 will likely continue to be used by the industry in a surgical fashion only, particularly in cases where the customers, products, and/or service "footprint" offered by the fintech do not materially overlap with the bank's core offerings.

The continued prevalence of Models 1 to 3 is mostly driven by banks' recognition that customer demand for innovation, high-quality insights, simplicity, and efficiency can only be met when financial institutions combine fintech innovation with a deep understanding of customers and their financial needs. Fintechs operating in a standalone fashion with very targeted solutions cannot typically provide this combination, nor do they typically have the requisite compliance infrastructure to fully adhere to the safe and sound practices administered by established banks.

The creation of more flexibility and options to help spur innovation, however, needs to be effectively weighed against four major risks:

1. Overall industry risk exposure during negative economic cycles may significantly increase.
2. Customer data protection and third-party risk management must be effectively managed.
3. It is not clear that fintechs operating with distinct bank charters will be able to meet customers' most pressing needs.
4. The regulatory and risk management infrastructure required of fintechs to comply with the special-purpose charters could substantially increase costs for fintechs and impact their rate of innovation.

Finally, Council members believe that special-purpose charters should ensure that fintechs are held to all operational standards that apply to banks, including compliance, AML, cybersecurity, data and privacy protection, etc., in order to protect both the consumers and the financial system more broadly.

### **Summary**

Innovation in the financial-services sector has the potential to enhance the banking experience and promote financial inclusion. Regulatory policy should support innovation emanating from both traditional banks as well as nonbank startups. As traditional banks and nonbanks innovate, protection of customers' financial data must also be a priority.

Regulators should continually examine how innovation is affecting banking. The regulatory environment must evolve to ensure that the safety and soundness of the financial system is protected and maintained. Coordination among regulators and iterative dialogue with the industry is paramount to achieving the correct balance between innovation and financial stability.

As the regulatory mosaic continues to develop for nonbanks seeking a national bank charter, it is important that the fintech charter confers rules and oversight that align with those for traditional national banks and are applied consistently with those for any traditional national bank. Regulation that focuses on activities can help ensure that all companies offering financial services are subject to consistent regulation when they provide like services.

### **Item 4: Affordable Housing**

**In many cities, finding affordable housing is difficult for low- and moderate-income households. Many economists argue that the problem is restrictions on housing supply, not the lack of availability of low-cost financing or other financial products for these households. What are the Council's views on the best methods to enhance housing supply?**

#### **Background and Recommendation**

Homeownership, for both homeowners and non-homeowners, remains fundamental to American values. A 2018 study from the National Association of Realtors found that 75% of non-homeowners believe homeownership is part of their American Dream, while 9 in 10 current homeowners echoed the same sentiment. However, affordability continues to be a major hurdle in delaying that dream, especially in geographic markets where rapid economic expansion and an influx of wealthier and higher-income home buyers and renters pressing against a limited housing supply has priced low- to moderate-income (LMI) workers out of the housing market.

The supply of affordable housing took a hit after the Great Recession and has not meaningfully grown since 2015. According to a study from the Joint Center for Housing Studies of Harvard University, in 2016, there was a shortage of 7.2 million affordable housing units for extremely low-income renters. For every 100 extremely low-income renters, only 35 affordable housing units were available. On the purchasing side, the availability of homes that a middle-class family could afford has declined in 86% of the largest metro areas, as revealed by Redfin Real Estate Research.

Under current federal guidelines, “extremely low-income” (ELI) is defined as household income below 30% of the HUD Area Median Income (AMI). “Low income” (LI) is defined as household income at, or below, 80% AMI. “Moderate income” is defined as household income between 80% and 120% of AMI. Rental or mortgage payments that are 30% or less of household income are considered affordable.

While there are federal tax credit and subsidy programs meant to increase access to affordable housing for LMI households, there remains a housing shortage for ELI and LI households. Additionally, due to program restrictions, there is a sector of the population referred to as “workforce housing” (60% to 120% AMI) that does not qualify for assistance yet continues to be burdened by the rising costs of necessities, such as food, clothing, transportation, and medical care.

To increase access to affordable housing, the Council believes that federal, state, and local government entities can increase housing supply by:

- Reducing barriers to development
- Investing and expanding federal programs
- Exploring new, innovative market incentives to create more affordable housing (i.e., Opportunity Zones)

### **Making Housing More Affordable**

There are several factors to consider when determining the best ways to enhance housing supply. Additional supply could be achieved by either increasing the number of new housing units produced or increasing the amenities of existing housing that would otherwise be undesirable or underutilized through rehabilitation.

Constraints on new housing supply include exclusionary zoning and land-use regulations (i.e., lot-size restrictions, zoning approval processes, density restrictions, growth boundaries, and structure type) and the high price of construction materials and labor. That said, the most significant limitations to new housing supply arise from the regulations imposed predominantly by state and local governments. Developers estimate that additional regulations levied by localities create an additional 25% burden on the expense base. These regulations limit new housing development and increase housing costs, and if modernized or relaxed, could have a positive impact on housing supply.

Another option to enhance housing supply would be to improve amenities of existing units located in less desirable areas. Upgrading or rehabilitating existing units in LMI areas or improving access to, and the quality of, public transportation could make these areas more desirable. Improving amenities and enhancing neighborhood assets in LMI areas may be more effective than increasing supply in high-priced areas. Rehabilitating or preserving older affordable housing, through Historical Tax Credits or other financial incentives, may be a more cost-effective option. Also, both the private and public sector should consider investing in more housing units. Issues around affordable housing go beyond supply and include factors such as the cost of transportation and its availability in areas accessible to employment opportunities.

Reducing the barriers to the development of affordable housing is not a simple task. To achieve better results, the Council believes that key stakeholders, interest groups, and partnerships have “one voice” at the local, state, and federal level.

### **Increase Affordable Housing by Expanding Programs and Exploring New Incentives**

While eliminating regulatory constraints on new housing development, improving amenities, and enhancing neighborhood assets in LMI areas can help increase housing supply, these steps would have a limited impact on the issue of affordability. Simply put, increasing housing supply without constraining rents would not necessarily improve affordability. For example, according to a 2017 article from the Non-Profit Quarterly, the share of high-income households (earning at least \$100,000) that rented their homes increased from 12 percent to 18 percent between 2005 and 2016. High-income households drove 22 percent of the overall growth in renters. The number of units renting for \$2,000 per month or more increased 97 percent. Thus, it is important to continue to support federal programs, such as the Low-Income Housing Tax

Credit (LIHTC) and the Section 8 housing subsidy, which address both the supply and demand sides of the issue, respectively.

LIHTC was created by the Tax Reform Act of 1986 as a vehicle to provide market incentives for the development and rehabilitation of affordable rental housing. Real estate developers use the credits or sell them to investors to raise needed capital for real estate projects, which helps to reduce the debt or equity contribution required for developers to build affordable rental units. Since its inception, the LIHTC has created or preserved 37,727 unique properties and roughly 2.3 million units. To date, LIHTC is estimated to cost the federal government \$9 billion annually.

Section 8 housing subsidies provide direct payment assistance in the form of vouchers to low-income families. Created by the Housing Act of 1937, local public housing agencies administer the vouchers based on household income and family size, and beneficiaries are free to choose any housing that meets the program requirements. Tenants pay 30% of their income (after certain deductions are taken out) for rent and utilities, or a minimum of \$25 per month. In 2018, Congress approved \$11.5 billion in Section 8 housing subsidies to support over 4.7 million families in need of rental assistance.

The challenges with the LIHTC and Section 8 programs today include a limited amount of subsidies available. Furthermore, LIHTC properties are required to rent to households at or below 60% AMI, which leaves the sector of the population earning between 60% and 120% AMI without affordable housing options. This workforce housing population lacks sufficient options for affordable housing since they earn too much to qualify for LIHTC or Section 8 housing, yet do not earn enough to have access to suitable housing costing 30% or more of their income.

Additionally, units financed by LIHTC are only designated to be affordable for up to 30 years. According to a 2018 study from the Urban Institute, as of 2015, an estimated 2 million units remain active, while approximately 50,000 units have left the program. Nearly 200,000 additional units had an inconclusive program status, and due to limited tracking beyond their compliance period, it is impossible to know whether these units are still affordable.

To increase the supply of affordable housing and improve private-sector engagement to ensure long-term sustainability, continued investment in affordable housing programs is important. Additional modification of the rules, as evidenced by the recent LIHTC change to include the concept of income-averaging; consideration of increasing the designation period; and exploring new, innovative market incentives will increase access to existing supply. Also, innovative and effective governmental programs could successfully marry public and private resources to tackle the issue of housing shortage.

#### **Item 5: Emerging Risks**

**As the long-lived current expansion continues to unfold, are there particular areas in which Council members see economic or financial risks beginning to emerge? How might policymakers consider mitigating these risks?**

Emerging risks are those that have not yet become apparent, often involving an element of surprise. For example, the potential for inflation that is significantly higher than expectations has been absent from most of the economic analysis among financial market participants. Given the intertwined nature of markets, monetary policy, and government, any major surprise could reverberate and pose a threat to the economy.

**Corporate leverage is a risk due to potential market stress and negative effects on capital expenditures.**

Higher corporate debt is the result of low interest rates, tax code incentives (e.g., interest deductibility, buybacks vs. dividends), ample liquidity, and a desire by corporations to de-capitalize amid global excess capacity. In the past five years (2013-18), U.S. nonfinancial corporate debt has increased 36%, from \$7.0 trillion to \$9.6 trillion, rising faster than corporate-sector nominal GDP, which increased 22% in the period.

Coverage ratios for U.S. “large cap” public companies appear sufficient, but in a profit recession, coverage may fall to a level below past recession levels. In turn, this situation may cause corporate credit spreads to widen substantially. For example, the Baa corporate [Moody’s index] spread to the U.S. 10Y Treasury note is now 2.3% compared to a 20-year range of 1.4% to 6.3%. Beyond rated corporate bonds, the proliferation of bank debt with inadequate protective covenants could prolong credit difficulty and restrain bank lending.

At a market level, corporate debt is structurally illiquid in periods of economic stress, especially in light of the Volcker rule having reduced trading liquidity on Wall Street relative to debt outstanding. Market liquidity risk differs from corporate refinancing risk, the latter mitigated by longer corporate debt maturities through greater reliance on bond markets and a reduction in commercial paper and bank debt. On a macroeconomic level, if corporate cash flow is constrained by debt service, then corporate capital spending plans may be shelved, with an adverse effect on labor productivity and inflation in the *next* business cycle.

Overall, while the level of U.S corporate debt is historically high in both nominal terms and relative to corporate GDP, corporate-debt coverage ratios appear adequate, and the banking system appears well capitalized. But as an emerging risk, if a period of financial stress creates substantial illiquidity in financial markets, widening of credit spreads and the constriction of credit availability could affect business activity.

**Fiscal sustainability threatens the efficacy of monetary policy, and the current trend is unsustainable.**

Total government revenue (federal, state, and local), largely derived from income and payroll taxes, has not exceeded 30% of U.S. GDP. In contrast, government spending is consistently in excess of 30% of GDP, creating deficits. The U.S. has historically consumed in excess of domestic savings, importing foreign savings surpluses. As “twin” fiscal and trade deficits continue and expand, it is noteworthy that U.S. GDP derived from *incremental* debt is falling, which is an *unsustainable* trend.

For monetary policy to be effective, progress must be encouraged at the policy level with regard to net national savings (including government savings via fiscal balances) to fund domestic business investment, productivity, and growth.

In terms of government policy, and in the wake of the recent government shutdown, an emerging risk is the upcoming debt ceiling which, if an agreement is not reached, would result in significant disruption in the U.S. and have global implications. While the current consensus is that this is a low-probability risk, a reprise of the debt ceiling standoffs that occurred in 2011 and 2013 would be a high-impact event for markets.

**Trade tensions, currently with China, are a complicating factor.**

Tariffs are a tax on the U.S. economy and create uncertainty, while impacting overall sentiment. Thus far, in dollar terms, the tariffs imposed are modest compared to the tax cuts and spending increases of 2018. However, in March, 2019, the tariff rate is scheduled to rise from 10% to 25% on \$200 billion of imports from China, roughly 25% of which are consumer goods. As an emerging risk, the consequences of escalating trade actions are clear: higher prices in China and the U.S., supply-chain disruptions, less purchasing power for consumers in these countries, higher import costs, and heightened financial market volatility.

In addition, a no-deal Brexit may worsen economic conditions in Europe and aggravate the region’s ongoing slowdown, possibly causing an outright European recession, which would present a spillover risk for the U.S. economy.

**The downshifting neutral rate due to external factors has reduced the Federal Reserve’s room for maneuvering.**

The neutral rate (the rate at which GDP is on trend and inflation is at target) has shifted down, reducing the Federal Reserve’s ability to respond to future crises and recessions. While the Federal Reserve was able to cut rates by an average 588 basis points over the past three rate-reduction cycles (1989-1992, 2000-2003,

2007-2010), the current levels for the federal funds rate and the interest on excess reserves rate of 2.40% provide less flexibility for the Federal Reserve before the zero bound would be reached. The Council attributes the lower neutral rate (currently estimated by Stifel to be 2.75%, as of January 2019) to elevated global dollar debt, adverse demographics (which hinder potential GDP), and deflationary technologies. Our 2.75% current estimate of the neutral rate compares to an average 4.4% rate in the decade of 2000-2010.

### **Cyber-risks are a matter of national defense.**

The recent disclosures of successful attacks against governments and related critical infrastructures have underscored the importance of cyber-risk management. While most attacks are motivated by profit, foreign state-sponsored attacks have sought to exfiltrate data and disrupt corporate activities. This remains a financial risk, given the interconnected nature of the financial system and the confidentiality of financial data, including private personal information. An identifiable risk is that a major security breach at a systemically important financial institution could have a domino effect on confidence in the entire financial system, even though other financial institutions may be unaffected.

### **Item 6: Employment and Inflation Dynamics**

**What are the labor market conditions in Council members' Districts? What strategies are employers using to hire and retain good employees? Are employee wages rising, and if so, how fast? Does the Council see any evidence that price inflation is picking up?**

#### **(1) What are the labor market conditions in Council members' Districts?**

Overall, labor market conditions appear to range from solid to tight in all Districts. These are some of the most challenging employment conditions many Council members have seen. With unemployment staying low, employers are experiencing problems both hiring and retaining qualified employees; it is taking more time to fill positions. The offer-acceptance rate has remained relatively unchanged; however, the number of qualified candidates receiving multiple offers has increased. Without doubt, qualified employees are in universally strong demand. There is also a shift as candidates/employees favor employers whose values align with their own.

Overall, job creation continues to set records for this recovery. The average job creation during 2017 was 179,000/month and is up 25% to 223,000/month in 2018. The last four months have averaged 250,000/month. A very strong continuing performance, particularly for late cycle.

#### **(2) What strategies are employers using to hire and retain good employees?**

Employers are utilizing a historically wide range of strategies to attract and keep employees. As the hiring challenges escalate, so do the variety of responses.

Some tactics being utilized:

- Increased recruiting expenditures
- Wage increases (moderate so far, except for certain skill sets)
- 3-4% increases planned for 2019 by most employers (some a bit higher)
- Company-wide increased minimum wages are spreading. For example, a substantial majority of the Council members are at, or above, a \$15 per hour minimum wage.
- Signing bonuses (fairly broad use at this point)
- Telecommuting options expanding
- Flexible work scheduling widely utilized
- New types of benefits – wellness benefits, student loan repayment assistance, financial wellness counseling, commuter benefits
- Increased financial benefits, such as increased 401(k) matching and increased company stock-purchase plan discounts
- Improved healthcare benefits
- Housing and relocation costs more fully covered

- Equity positions offered more frequently
- Sometimes positions are being offered during first interviews
- Professional development options
- Increased training and education
- Greater career mobility
- More focus on being sure that employer core values have clarity and alignment with employee expectations

Importantly, and quite positively, a significant number of individuals who had left the labor force are now returning. The December numbers indicated this quite clearly. In the last twelve months, the number of “not employed and not looking” workers declined by over 600,000. This is happening broadly, ranging from workers who are less qualified but willing to learn to those who, for personal reasons, had previously stepped back from full-time work. As a result, the unemployment rate has actually increased slightly. Overall, this is very encouraging and is leading to an increase in corporate training and retraining programs.

**(3) Are employee wages rising, and if so, how fast?**

Hourly wages for all private workers have been rising moderately, but in the 3% range. The employment cost index for wages and salaries increased 2.9% year over year in Q3:2018 and apparently increased 3% for the full year of 2018. Increasingly, organizations are raising their minimum wage to remain competitive in the market. The positive labor market and wages continue to bear close watching, as they continue to be strong into January (the government shutdown notwithstanding). The increases are not, however, breaking out significantly, as of now.

**(4) Does the Council see any evidence that price inflation is picking up?**

The Council does not see convincing evidence that overall inflation is picking up meaningfully at this time. Upward pressure on wages and rising input costs may lead to higher inflation in the future, but not so far.

**Item 7: Monetary Policy**

**How would the Council assess the current stance of monetary policy? Does the Council foresee any impact or significant disruptions to the financial system if interest rates continue to rise?**

Feedback from the Council suggests broad agreement with the Federal Reserve’s stance on monetary policy. This includes its recent statements signaling a pause in the momentum of future rate increases, given concerns around growth abroad, tightening financial conditions, and the consequences of the government shutdown.

In the Council’s view, the current stance does not appear to be either accommodative or restrictive, leaving the Federal Reserve the latitude to take a measured response in either direction based upon available data.

Overall, the domestic economy, while slowing from a strong mid-2018, is still on firm footing, and Council members see little disruption to the financial system from additional measured increases in rates, particularly if they are supported by the inflation or employment data.