

## RECORD OF MEETING

### Federal Advisory Council and Board of Governors

Thursday, September 3, 2015

#### **Item 1: Current Financial and Economic Conditions**

**What is the Council's view of the current condition of, and the outlook for, loan markets and financial markets generally? Are there any notable developments in loans for (a) small and medium-size enterprises, (b) commercial real estate, (c) construction, (d) corporations, (e) agriculture, (f) consumers, or (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:*

- Overall, loan markets remain highly competitive for all loan asset classes, with continued downward pressure on margins and increasingly aggressive terms. Banks continue looking for loan growth, expense reductions, and productivity enhancements to offset margin compression.
- Loan demand has generally increased during 2015 but remains tepid compared to this stage of past economic recoveries.
- The international economic events of the past few weeks have the potential to challenge the cautious optimism of consumers and businesses and could undermine the growing confidence that has been noted in the first half of 2015.
- Small business demand is growing, but businesses remain cautious regarding capital expenditures. Demand for SBA (Small Business Administration) loans continues at high levels, particularly loans secured by real estate.
- Middle-market loans and refinance markets are highly competitive, especially for quality borrowers. Banks continue to compete on terms and conditions. Customers have become emboldened to request aggressive terms, such as unsecured borrowing, no personal guarantees, no covenants, minimal fees, and extended maturities. If the incumbent bank doesn't amend its offering, customers don't hesitate to take relationships out to bid.
- Commercial real estate demand is strong. Competition for quality credits is keen. The market is liquid with a large number of active participants, both banks and nonbanks.
- Large corporate borrowers continue to have ample access to bank lending and funding via the capital markets. Large corporate loan demand is modestly higher, with increases mostly due to M&A and financial restructuring of balance sheets.
- Agricultural lending demand is strong and competition for quality assets continues among both banks and nonbanks.
- Consumer confidence remains generally cautious yet with increasing optimism. Demand for automobiles remains strong. The mortgage market is forecast to grow 20% year over year in 2015, driven by a strong purchase market.

- Early third-quarter economic data suggest that moderate economic momentum will continue throughout the second half of the year, accompanied by ongoing moderate job growth and gradual declines in the unemployment rate.

*Impact of Energy Prices:*

- The outlook for the U.S. economy suggests that loan demand will continue to grow during the second half of 2015; industries that may be an exception to this growth pattern are energy and exchange-rate-sensitive industries. The energy industry is likely to be an exception to the positive growth story of the U.S. economy in the second half of 2015, as low energy prices are resulting in a significant decline in oil and gas drilling activity due to the sub-\$50 price per barrel of oil.

**(a) Small and Medium-Size Enterprises**

- Small business optimism continues to increase, although it has not reached pre-crisis levels. Despite higher levels of optimism, small businesses continue to delay capital expenditures and are accumulating capital and liquidity. The 7<sup>th</sup> District, however, reports that clients are beginning to spend more on equipment and are evaluating expansion opportunities.
- Clients are receiving significant unsolicited interest by third parties exploring possible acquisitions.
- There are pockets of growth in certain markets, but there has not been a broad-based return of small business customers seeking new credit.
- Competition is fiercest for the better-established small businesses with more complex needs.
- Notable competition exists from community banks offering long-term fixed rates on owner-occupied commercial real estate. Given this competition, loan-to-value (LTV) ratios are becoming more aggressive, and loan yields are approaching the lowest levels possible.
- Small businesses report that access to credit is readily available, which aligns with the continued intense competition on rate and structure.
- Top concerns for small businesses continue to be taxes and government regulations.

**New Observations Since the May 2015 FAC Meeting**

- The Senate's action to renew federal loan guarantees for small businesses and raise the cap for the SBA's 7(a) loan guarantee program to \$23.5 billion from \$18.75 billion signals the government's interest in supporting small business. Reaching the cap of the previous SBA program sooner than expected reflects a positive outlook for more borrowing demand from small businesses for the balance of 2015.
- The lending market is quickly becoming more aggressive with borrowers requesting and receiving covenant-lite structures. Borrowers are increasingly seeking unsecured financing and an unmonitored borrowing base when collateral is pledged.
- The level of interest from potential buyers suggests that M&A activity will increase over the next 12 months.

## **(b) Commercial Real Estate**

- The improvement in commercial real estate markets has been observed for several years, and most markets today are stable to improving.
- Multifamily developments continue to be performing at high levels. Valuations are high given the low cap rates. Demand for rental housing is strong. Many new projects are being constructed in urban, in-fill locations. Increased supply being delivered over the next few years should be carefully monitored for its impact on vacancy and rental rates. Potential overdevelopment poses the greatest threat over the medium to longer term.
- The retail loan market has modest demand. This sector is still experiencing a tepid recovery. Overall, vacancy levels have modestly declined from their recessionary peak. Growing e-commerce will remain a headwind.
- The office market has also experienced a slow recovery. Office vacancy rates have improved marginally over the last several years. Improvement in central business district properties has outpaced suburban locations.
- Industrial assets have experienced a moderate recovery, but investors and lenders are increasingly optimistic about this sector. Port cities and intermodal hubs have led the recovery, while secondary and support markets are beginning to build momentum.
- The hotel industry has continued its strong fundamentals recovery. Revenue per available room now exceeds pre-recession levels. Full-service properties continue to lead the recovery, with limited-services assets posting the slower gains.
- Multiple sources of financing for CRE have returned to the marketplace, including commercial mortgage-backed securities (CMBS), life insurance companies, foreign banks, and nonbank lenders (GSEs, private equity, HUD).
- The majority of new project opportunities are presented by larger sponsors (REITs, pension fund advisers, fund sponsors, and national investors). By virtue of the breadth and diversity of their capital sources, these entities continue as the most active investors.
- Capitalization rates of solid assets in desirable locations may be lower than 5%; weaker properties in challenged locations remain above 10%.

## **New Observations Since the May 2015 FAC Meeting**

- Recently, the lending market has been pushing back on transactions that are too aggressively structured and priced. As a result, a view is emerging that the market is finding a floor on both price and structure. The market also appears to be maintaining discipline with regards to leverage levels, with no measurable increase in advance rates. Despite these comments, current structures are aggressive with nonrecourse debt available for structures with less than 70% LTV. Additionally, “springing” guarantees are becoming more common, as clients do not want contingent liabilities on their balance sheets.
- Early in the economic recovery, the flow of new investment was centered in larger, coastal markets. This balance is shifting as investor interest returns to secondary and tertiary markets, spurred by the improving health in these markets and increased competition in primary markets.

## **(c) Construction**

- The supply and availability of credit for commercial real estate construction projects remains ample but varies by both property type and location. Loan terms available for

these opportunities continue to become more aggressive, especially in terms of guarantee structures, repayment terms, and pricing.

- Large multifamily construction loans for experienced developers in larger metropolitan areas regularly attract multiple lenders competing for the business.
- Conversely, the availability of credit for speculative office or retail development remains subdued. Investor demand for this type of credit is also limited, given that both of these property types are lagging the recovery.
- Loan availability and demand for hospitality construction projects continue to increase as property performance metrics have returned to pre-recession levels.
- Lenders are keeping a close watch on markets with robust supply pipelines and are maintaining discipline around speculative construction and exposure to energy-related markets.

#### **New Observations Since the May 2015 FAC Meeting**

- The Council notes caution on the part of developers, general contractors, and lenders related to multifamily projects. The 11th District reports that quality subcontractors are in high demand and, consequently, construction costs are increasing. Coupled with higher land costs, the development of new projects is becoming more difficult to justify. Increased costs require that projects obtain higher rental rates compared to rates in the broader market.
- There is a growing amount of new construction activity and loan demand for large bulk industrial facilities in port cities and major transportation hubs, as the outlook for this sector has improved.
- Several Districts report that university cities have experienced significant new construction of dormitories. With minimal new development over the recent past and positive enrollment trends, a number of educational institutions are encouraging development of privately owned and operated on-campus housing.

#### **(d) Corporations**

- Corporate lending is expected to continue its moderate growth, although spreads continue to decline.
- Corporate lending, particularly in the shared credit market, continues to be highly competitive with the result being pressure on loan spreads, fees, and structures. These conditions have been exacerbated by reduced leveraged lending activity by banks and the migration of larger banks into the nonleveraged credits. Over 80% of the leveraged market is being served by nonbank competitors.
- Asset quality improved for C&I loans, as net charge-offs declined 35% from the previous quarter and 17% from the year-ago quarter. Past-due loans declined 5% from the prior quarter and 25% year over year. Nonaccrual-status loans worsened, experiencing a 13% increase from the prior quarter, but only a .3% increase from the previous year.

#### **New Observations Since the May 2015 FAC Meeting**

- Banks are experiencing loan-volume pressures as corporate clients continue to access the debt capital markets and the equity markets.
- CFOs are increasing their requests to restructure credit arrangements ahead of a perceived third-quarter interest rate hike.

- Loan structures are stabilizing as the banking industry is holding firm against covenant-lite transactions. Tenors remain typically at five years.
- The downward pressure on pricing continues due to the large number of banks looking for funded assets. However, there is some recent anecdotal evidence that suggests pricing is “bottoming.”
- Continued uncertainty in the energy sector has resulted in a pause in loan growth in this market. Rig counts have plummeted as capital expenditures budgets have been cut in response to the decline in commodity prices. After a short period of stabilization, crude and gas prices have softened again, prompting additional concern over the intermediate-term health of the energy industry.

#### **(e) Agriculture**

- Throughout 2014, agricultural grain prices declined rapidly as a result of record acreage being planted and overall ideal growing conditions. The decline in grain prices has reduced farm profits and land rents, tempering what had been a rapid run-up in farmland values and related fears of a price bubble.
- Recent declines in oil prices will provide a small improvement in farmer economics, as fuel is a material cost for most farms.
- The grain-price decline resulted in more favorable margins from protein producers who use feed grains to raise animals and for food processors who utilize grains as raw materials.
- Chicken producers remain quite profitable now due to low feed prices and high prices for substitute protein products.
- Cattle prices are near all-time highs as a result of herds having been dramatically reduced due to the drought in prior years. Beef herds are at the lowest level since the early 1950s.
- Smaller operators will continue to be challenged as domestic agricultural industries evolve into ones increasingly affected by global supply and demand for key commodities. With the continued introduction of technological efficiencies and broader global competition, the agricultural industry is subject to global markets, which require capital flexibility and highly honed management techniques to navigate thin commodity margins. The smaller farmer will be challenged to marshal the capital required for land and equipment investment, as well as for hedging requirements.

#### **New Observations Since the May 2015 FAC Meeting**

- U.S. crop farmers are beginning to feel the effects of low prices and higher operating costs. Input costs have risen broadly, pushing some farmers’ margins into negative territory; hence, there likely will be less investment in equipment and the potential for deterioration of used equipment values.
- Avian influenza was initially found in the Northwest in early 2015 and has been spreading east and south through wild bird migratory flyways. It has now been found in commercial turkey and chicken farms. In reaction, numerous countries placed import restrictions on U.S. poultry.
- In June 2015, the governor of California issued an executive order requiring a 25% reduction in urban water use across the state. Agricultural companies were largely spared direct impact. However, California is a large producer of water-intensive products,

including fruits, nuts, wine grapes, and dairy. If drought conditions persist, there eventually will be implications on agricultural access to surface and groundwater.

- Nontraditional bank lenders, including cooperative banks, farm credit lenders, and insurance companies, are becoming aggressive in the agricultural market.
- The 12th District reported an increase in loan requests for new production and processing facilities, creating new capacity in protein (animal) processing by updating or replacing older, less efficient plants.

#### **(f) Consumers**

- U.S. bank call reports for June 30 show total consumer loans outstanding of \$1.4 trillion, up 4% from a year ago. Growth was driven by auto lending, up 7%, and credit card loans, up 3%.
- Consumer loan demand is growing, but borrowers remain generally wary of additional debt due to the uncertainty in the economy.
- Consumer attitudes and willingness to spend are improving, yet they are still not at pre-recession levels.
- Consumer loan delinquencies have remained consistently low throughout 2015, and FICO scores are improving.
- Auto loans continue to experience low credit losses, primarily assisted by strong used car values.
- Equity positions in homes are still limited, and the impact of a significant increase in rates could create a pause in home appreciation and extend the marketing time.

#### **New Observations Since the May 2015 FAC Meeting**

- Rate competition for consumer loans has intensified, with average net yields at or near historical lows. Competitors are chasing similar high-quality, short-duration asset classes. Credit losses in the prime sector remain at or near record lows.
- The New York Federal Reserve Bank reported that student loan balances, which are the largest component of nonhousing debt, reached \$1.19 trillion as of June 30, 2015, compared to \$1.01 trillion in auto loans and \$700 billion in credit card loans. The percentage of student loans more than 90 days past due continued to increase in the second quarter, rising 40 basis points to 11.5%, compared with 8.4% for credit card loans and 3.4% for auto loans.

#### **(g) Homes**

- Overall conditions in the housing market were mixed over the past few months. New-home sales declined in the most recent month reported, while existing-home sales increased. Foreclosures increased on a monthly basis but decreased on a yearly basis. Home prices increased overall, but the level of growth was not consistent across all regions. There has been a significant surge in home prices in one District and in demand in Miami, Houston, Los Angeles, and Silicon Valley.
- According to the U.S. Census Bureau, housing starts were at a seasonally adjusted annual rate of 1,174 million in June, 9.8% above the previous month and 26% higher than the previous year. Housing starts were mixed across the regions, rising 35% in the Northeast and 13% in the South but falling 6% in the West and .7% in the Midwest.

- Existing-home sales fared better than new-home sales, increasing two of the last three months reported, according to the National Association of Realtors. In June, existing-home sales increased 3.2% from the previous month to a seasonally adjusted rate of 5.49 million homes. On average, the median home price has increased 7.5% year over year through June 30, 2015.
- New buyers are poised to enter the market, as rent prices continue to increase and negative credit events from the crisis migrate off of borrowers' credit reports.
- There is continued robust home equity lending with generally prudent structures and underwriting.

### **New Observations Since the May FAC Meeting**

- Home loan activity picked up in the second quarter. According to data from the Mortgage Bankers Association, mortgage originations totaled \$395 billion in the second quarter of 2015, up 20% from the first quarter and 33% year over year.
- The July Beige Book noted increased residential real estate activity across several Districts, with home sales and prices generally increasing.
- The CFPB recently announced a postponement of the new TILA RESPA Integrated Disclosures effective date from August 1 to October 3, citing a delay in a technical clarification. This was welcome news to much of the industry, as many lenders are struggling to deliver a functioning, compliant solution. In the last few days, Congress has proposed legislation extending this grace period from October 3, 2015 to February 1, 2016.

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

- The Council observes nothing of note.

### **Special Topics**

#### **How do Council members judge asset valuations (1) in certain housing markets and (2) in fixed-income markets, differentiated across types of securities or issuing jurisdictions, and specifically in response to the availability of liquidity?**

##### **(1) Certain Housing Markets**

- Asset valuations in housing markets nationally appear, in general, to be fairly valued as compared to overall economic growth. The National Case-Shiller Home Price Index fell 28% from the July 2006 peak to the low in February 2012 but has since recovered by 30% from the lows. Price-to-income ratio is slightly below the long-term averages, while the price-to-rent ratio is slightly above the long-term averages. The National Homebuyer Affordability Index also suggests that housing remains fairly valued. Annual change in the Case-Shiller National Index was 4.5% through the second quarter – more modest and rational than the double-digit increases in the mid-2000s.
- The liquidity of the housing market is supported by the Federal Reserve continuing to maintain its portfolio of agency mortgage-backed securities (MBS). However, liquidity of non-agency securities remains weak and substantially unchanged. The need for reform

of the FHA (Federal Housing Administration) loan certification requirements has reduced a typical source of liquidity for many borrowers, especially low- to moderate-income home buyers.

- Normal supply and demand dynamics appear to be at work in most regions and cities for mortgage availability, which remains constrained, particularly for low- to moderate-income families. Low equity levels limit the options for potential sellers to move up, further constraining supply. And new construction, while much improved in most regions, remains below a level needed to feed the housing stock adequately.
- While national measures are important, regional valuations vary significantly. The West continues to have the highest home-price appreciation and has recovered more fully than other regions from the 2009 lows. The South and Midwest regions' housing valuations traditionally do not accelerate or decelerate at the same pace as those in the West or Northeast, and growth is generally consistent with economic activity. The Northeast region has seen HPA (home-price appreciation) generally below 4% annually in the recovery. The disparity in the recovery rates as compared to general economic recovery may be attributable to how quickly each region worked through its shadow inventory of distressed properties and to the nonjudicial foreclosure process in the West.
- Asset valuations in individual states, MSAs (Metropolitan Statistical Areas), cities, and towns also vary considerably depending on economic activity and normal supply and demand dynamics. For example, the Denver MSA is growing 10.3% as compared to 1.1% in the Washington, D.C., MSA. Most Florida MSAs are growing more quickly than the national average, in line with underlying economic activity, but valuations remain as much as 35% below the pre-recession peaks. In contrast, in Northern California, and specifically the San Francisco MSA, HPA is above pre-crisis levels, while HPA in Miami and Chicago, although improved, remains below peaks. Housing valuations in most oil-producing regions have been reduced but remain manageable overall, as the economies are more diversified.

## **(2) Fixed-Income Markets**

- We can confirm that we notice some of the impacts of reduced liquidity in the fixed-income markets that have been the topic of much discussion. Across asset classes, we notice smaller trade sizes and longer periods to execute trades. Many believe that a liquidity conundrum in fixed-income markets exists today due to the shift in liquidity risk to buy-side and asset owners as a result of financial regulation and QE. Under normal conditions in well-functioning markets, banks will provide necessary liquidity, but under stress, liquidity shortage may be very problematic. Liquidity constraints may become more apparent as interest rates rise in the coming months and years to more normal levels.
- In judging asset valuations across fixed-income markets, the various factors reducing liquidity seem to be overwhelmed by other factors in the market, including an interest rate environment that has been stubbornly low for longer than most market participants could have imagined and global central bank monetary policies that have effectively acted as an artificial cap on credit spreads.
- For U.S. government and agency paper, liquidity is acceptable, and valuations seem high (*i.e.*, rates low), driven by central bank policy. We also think this is likely to persist and that it will be difficult for the long end of the curve to rise much in a Federal Reserve



tightening cycle, due to the technical demand for duration in the market and the relative attractiveness of U.S. rates on a global scale.

- Corporate bonds strike us as still trading too tight in credit spread in comparison to their historic volatility, potentially reflecting the impact from too-low government and agency rates, inciting investors to move into higher-risk classes to improve returns. Liquidity in this asset class, while down, is still acceptable.
- Other highly rated assets, such as municipal bonds and certain structured products, are currently fairly to slightly undervalued from a long-term investment standpoint, in our opinion, particularly if their duration risk can be offset with rate hedges. Liquidity in these asset classes, while down, is still acceptable as well.
- High-yield bonds, in particular, are prospectively the asset class where illiquidity will become most acute in a downturn. Generally, we feel that this class is fair- to overvalued, in part driven by our conviction that longer-term investors need to be compensated better to accept the fact that liquidity will probably not exist in the necessary size to exit positions smoothly in the future.

## **Item 2: Mortgage Market Credit Availability**

**The availability of credit in the mortgage market remains relatively tight. In the Council’s view, what are the primary drivers of tight lending standards (e.g., regulatory policy, risk appetite, reduced scope for mortgage funding through private capital markets)? What has been the effect on the average homebuyer and on homebuyers who face special circumstances? What changes would lead banks to expand credit availability in mortgage lending?**

**In the Council’s view, what are the primary drivers of tight lending standards (e.g., regulatory policy, risk appetite, reduced scope for mortgage funding through private capital markets)?**

- While current lending standards would be considered tight compared to the years immediately preceding the crisis, the current standards are closer to longer-term historical levels.
- There is broad consensus that the regulatory environment is the primary factor limiting mortgage credit availability.
  - It should be noted that macroeconomic factors (e.g., unemployment, income levels, and increased home prices) as well as demographic factors (e.g., delayed household formation, population growth rates) may be reducing aggregate mortgage credit demand.
- Many banks have adequate credit and interest-rate risk appetite, but stringent and uncertain regulations appear to be constraining the market.
  - Banks have increased underwriting standards for conforming loans to avoid representation and warranty risk (i.e., “put-back” risk) for loans sold to government-sponsored entities (GSEs).
  - Onerous documentation requirements have increased underwriting costs, which are often passed along to borrowers.
    - Ability-to-repay in particular has increased underwriting costs.

- The Justice Department's (DOJ) use of the False Claims Act encourages lenders to stay well within the conforming guidelines, limiting credit to borrowers on the margin.
- Many risks are unquantifiable, which the Council notes makes it difficult for banks to pass onto customers in the form of pricing or loan structure.
- Fannie Mae says traditional banks are a smaller share of the mortgage market than in the past.
- Banks composed 66% of the mortgage market in 2009 versus 49% in 2014. Conversely, mortgage banks went to 39% market share from 24% in the same period.
- Mortgage banks made up 61% of GSE loans in 2014 versus 41% in 2009. Traditional banks' share decreased to 31% from 51% during the same period. As a result, counterparty risk at GSEs may be increasing.
  - Federal Housing Administration (FHA): Many well-capitalized borrowers are reducing or eliminating their participation in the program due to risk of DOJ judiciary action. This means the FHA is purchasing qualified mortgages (QMs) from more thinly capitalized lenders.
- Reduced issuance of private-label MBS may be constricting mortgage issuance.
  - 2015 year-to-date issuance is approximately \$15 billion compared to more than \$1 trillion pre-crisis.
  - Current private-label MBS are almost entirely jumbo loans, which do not support credit creation for the average borrower.

**What has been the effect on the average homebuyer and on homebuyers who face special circumstances?**

- Average homebuyer: Despite higher fees and down payments (relative to pre-crisis levels), these buyers typically do not have issues obtaining mortgages. In particular, those who meet requirements for qualifying mortgages have good access to credit.
  - Jumbo loans: While these products are for borrowers with above-average wealth levels, prices have decreased as banks compete to make these loans for their own portfolios. This highlights that credit availability is not an issue at the higher end of the market.
- Special circumstances: Several groups of borrowers may have difficulty obtaining credit in the current environment.
  - First-time buyer: Reduction in FHA loan availability has limited credit availability, as lenders choose not to participate in the program.
    - DOJ action using the False Claims Act has caused lenders to scale back or exit the FHA market entirely.
  - Low/moderate income buyers: Increased underwriting standards and costs to conform to GSE requirements have reduced credit availability to these households.
    - As lenders pass through increased costs to customers, lower-income borrowers are disproportionately affected.
    - Banks may take a pass on the marginal lower-income borrowers for fear of put-back risk.
  - Self-employed: Those buyers who do not have verifiable income have more difficulty obtaining loans.

### **What changes would lead banks to expand credit availability in mortgage lending?**

- Clarify status of risk transfer; improved representation and warranty framework to reduce put-back risk for lenders.
  - Most banks are currently lending below their stated risk appetite due to unquantifiable regulatory concerns.
  - Consistency and clarity from GSEs around QM requirements would encourage lenders to maximize credit extension within their stated risk appetites.
- More consistent and evenhanded approach to enforcement by the DOJ may encourage lending up to the limits of QM conforming standards.
  - Current risk aversion means lenders may not underwrite loans that are close to the margin for fear of put-back or regulatory action.
- Logical, risk-based approach to allowing those with large down payments but low verifiable income to obtain QMs. This may help self-employed and low/moderate income borrowers on the margin.
- Increased issuance of private-label MBS may encourage additional mortgage credit creation.
  - Clarity around risk retention rules could spur more private issuance.

### **Item 3: Capital Buffers in CCAR**

**What are the Council's views on how CCAR (Comprehensive Capital Analysis and Review) should be revised? In particular, to what extent should revisions incorporate capital buffers on G-SIBs (global systemically important banks), and what would be the likely effects of such incorporation on these banks?**

- The Council is pleased to give additional thought to CCAR, a topic on which the Council has expressed views numerous times over the last several years, given its critical importance to the banking industry and its regulators. At the outset, the FRB should be congratulated for achieving its objectives of systemic safety and soundness: banks are better capitalized and risk-managed than ever before, and the sector's health has improved tremendously. Recent dividend and buyback approvals reinforce that banks can return capital to shareholders in a way that is consistent with earnings and does not generate outsized systemic or idiosyncratic risk. Having completed the fifth cycle, we now have experience to refine the process in a way that still ensures capital sufficiency and banks' ability to lend during periods of stress while retaining flexibility in capital planning. In considering whether CCAR's current form achieves its goals, the FRB has the opportunity to resolve previously discussed issues that remain outstanding, as well as determine the role for G-SIB buffers.
- Some Council members argue to exclude the buffers rather than change existing models for several reasons, including unnecessary duplication with the global market shock and counterparty default scenarios, increased pro-cyclicality, and inconsistency with the buffer's justification (reducing probability of default) and CCAR's policy goal (ensuring going-concern value). Others take inclusion as given. What is clear is that simply adding the buffers to CCAR in its present form yields the unintended outcome of failure for most G-SIB banks.

- This is obviously not the regulators' intent; instead, incorporation should be complemented by adjustments to CCAR that retain its fairness and balance while increasing the transparency of the process. For these reasons, the Council suggests the following revisions to CCAR that enable incorporation of the G-SIB buffer without unintended results:
  - Eliminate the global market shock, which combines one-time shocks across a large set of risk factors that affect asset prices, interest rates, and spreads without the benefit of any risk-management activity and which applies only to the six G-SIBs with significant trading activities;
  - Eliminate the counterparty default scenario, which assumes the instantaneous and unexpected default of each G-SIB's largest counterparty without any consideration of credit quality or other risk management; and
  - Enable bank balance sheets to evolve as they would in stress – with certain portions adjusted to reflect new, lower market levels and others grown to support lending – rather than the current approach that assumes total balance-sheet growth.
- Other potential revisions include changing the requirement of maintaining capital actions throughout the nine-quarter forecast period, as a bank's board approval and FRB non-objection to capital actions is limited to a four-quarter period. In any event, the board should have authority to commit to suspension of capital actions at any time during the CCAR period. The FRB should also consider modifying the sequence of submitting planned capital actions to enable banks, and subsequently the FRB, to assess capital adequacy under the Dodd-Frank Act stress test requirements prior to the banks' submitting capital actions, eliminating the unnecessary second-guessing associated with FRB results.
- Above all, the revised process must be transparent and clearly communicated to the market so that its capital implications are fully understood well before implementation. To that end, the Council suggests that the FRB publish the G-SIB capital ratios with the changes to existing CCAR relative to the new, higher capital ratios in a stressed environment. This may delay the buffer's incorporation, but clarity should be prioritized. The 2015 CCAR results indicate no immediate risks that justify trading the market's understanding of the buffer for its speedier inclusion in CCAR.
- The Council notes and supports recently proposed modifications to the regulations that exclude the supplementary leverage ratio from the 2016 cycle, eliminate the Basel I capital requirement starting with the 2016 cycle, and suspend for an indefinite period the application of the advanced approaches for CCAR stress testing.
- If the G-SIB buffers are to be incorporated, the steps outlined above should be implemented as well to avoid double-counting. As noted, this discussion offers the opportunity to resolve other outstanding issues that have been raised by the Council on multiple occasions.

#### **Item 4: Capital and Liquidity Standards for Banks**

**In general, to what extent have these standards either (1) reduced risks to the financial system overall or (2) affected the economy's long-run growth potential? What practical steps can be taken to reduce risks or support long-run growth in the future?**

The majority opinion of the Council members is that capital and liquidity standards properly calibrated can reduce risks to the financial system; however, if not properly calibrated, these standards could lower economic growth.

Council members agree that the resiliency of the banking system has improved dramatically since the financial crisis and the resultant changes in capital and liquidity standards. Whether the higher standards at banks have improved the resiliency of the financial system overall is less clear, given the migration of activity to the less-regulated shadow banking sector. The financial system's performance over a full business cycle has yet to be observed.

Similarly, the impact that the new standards for banks have on the pace of economic growth will depend on the extent to which financial activity simply shifts from banks to other institutions. Whether or not the pace of economic growth is permanently reduced, it seems clear that banks' role in funding economic growth is diminished.

Some Council members would add that some unintended consequences of the new standards may not yet have been realized.

#### **To what extent have capital and liquidity ratios reduced the risks to the financial system overall?**

- Capital ratios have significantly improved since the crisis. Between 2008 and 2014, the largest bank holding companies more than doubled the amount of their common equity tier 1 capital relative to risk-weighted assets. The quality of capital is substantially better given the reduction of capital-qualifying components. Meanwhile, the CCAR stress testing process has led to a better understanding of firm-specific risks and the capital needed to support varying business strategies at CCAR banks, and overall, to more robust capital planning processes.
- Liquidity at financial institutions has also increased with banks holding significantly larger cash positions and/or securities that qualify as high-quality liquid assets (HQLA). The liquidity coverage ratio (LCR) requirements have resulted in a reduction in short-term funding, thereby encouraging banks to rely on more stable funding sources.
- The phase-in of the LCR, the anticipated U.S. implementation of the net stable funding ratio (NSFR), and the proposed G-SIB/total loss-absorbing capital (TLAC) buffers will induce some banks to increase their capital and liquidity positions or to simplify their business models.
- Many Council members believe that the cross-effects of all of the new regulatory requirements are not known.
- Higher capital requirements in combination with other regulations (i.e., the Volcker rule) and general market factors have caused broader liquidity issues in the fixed-income

market. “Secondary liquidity” has been substantially affected by financial institutions' lack of willingness to use their balance sheets for market-making activities. Traders across the industry are consistent in their voice that almost all markets do not have the same depth that they did before the regulations became effective. The recently increased magnitude of price swings in both the equity and fixed-income markets lends credence to this assertion.

- Many Council members also pointed to the fact that some regulations have caused banks to exit certain traditional lending and deposit-taking activities, thereby pushing this business to the often less-regulated shadow banking system, creating more systemic risk. Examples of this include the sale of mortgage servicing, the rise in peer-to-peer lending, the exit of thinly priced high-quality loan classes, and the reduction of large, nonoperational, nonretail deposits.
- There are also many changes that have been implemented by the Federal Reserve that have not been tested through the cycle. Some examples include the use of reverse repos (the Fed's purchase of securities for their balance sheet, which may involve credit risk) and allowing banks to pay interest on commercial demand deposits. The most significant new tool has been the use of quantitative easing, which until now has only been used as a stimulus and will have to be unwound with unknown consequences to interest rates, credit availability, market liquidity, and economic growth.

**To what extent have capital and liquidity standards affected the economy's long-run growth potential?**

- Leverage requirements have caused banks to use their capital to hold high-quality liquid assets, thereby reducing their capacity to use this capital to lend for economically productive activities.
- The consensus belief is that higher capital and liquidity requirements have reduced certain types of lending activities, will likely increase the cost of credit and reduce credit availability in general, and will continue to lower bank profitability, thereby making it more difficult for banks to earn returns above their cost of capital.
- The cumulative effect of new regulations may reduce the economy's long-run growth potential by reducing banks' ability to extend credit to support economic growth. One Council member found the evidence of this effect to be compelling.

**What practical steps can be taken to reduce risks or support long-run growth in the future?**

- Council members agree that before any new regulations are introduced, there should be a comprehensive study of the impact of current regulations on market liquidity and economic growth.
- Consideration should be given to excluding cash and U.S. Treasury securities from the leverage ratio calculation so as not to force the use of high-quality capital to support high-quality liquid assets on banks' balance sheets.

## **Item 5: Community Development Lending and Investment**

**What are the primary factors influencing community development lending and investment decisions, and have those factors changed during the last several years? How have factors such as the availability of lending and investment opportunities, as well as the incentives for achieving a high CRA examination rating, influenced these decisions?**

The primary factors influencing community development lending and investment decisions are (1) current economic conditions, (2) increased competition for qualified opportunities, (3) changing housing trends, and (4) recent regulatory changes. Each of these factors can affect CRA ratings and influence strategies for doing business while meeting regulatory expectations:

- (1) ***Economy:*** Effects of the 2008 economic downturn are still being felt, even as market conditions gradually improve:
  - Fewer lending opportunities lead to increased competition among financial institutions.
  - Reduced confidence among businesses dampens their enthusiasm for expansion.
  - Many of the core nonprofit borrowers were significantly challenged and are now just beginning to come back to capacity, with a risk appetite more reflective of the general industry.
  - Cities and states facing budget shortfalls are less likely to provide subsidies.
  - Regulatory guidance is encouraging banks to pursue more community development outside their immediate assessment area. Banks are reluctant, in the context of safe and sound practices, to broaden their geographic reach until more economic impact information and regulatory guidance are available.
  
- (2) ***Competition:*** The increased regulatory expectations surrounding CRA and the gradual economic improvement seen in recent years have combined to effectively increase competition for community development partnerships:
  - More financial institutions – motivated to improve their CRA profiles in order to maintain a satisfactory rating that allows them to introduce new products, pursue mergers and acquisitions, add branches, and otherwise grow business – are pursuing safe-and-sound, CRA-qualified community development lending and investment opportunities.
  - Previously, organizations like Community Development Financial Institutions (CDFIs) provided an outlet for small business and affordable housing lending. Many CDFIs were financially challenged during the downturn, and as a result of their diminished capacity, are seeking high-cost, low-return sources of capital with limited payback potential. Unlike before, when they focused on hard-to-lend areas, they are now in competition for the same business as the community and regional banks. No longer is there a distinction for credit quality, since CDFI reserves for loan-loss and accounting principles are more similar to those of commercial banks. In addition, their operational costs are so high that it renders them less than competitive. CDFI lending represents a very small proportion (less than 1%) of total small business lending.
  - In pursuit of satisfactory CRA ratings, more financial institutions are bidding on investments in Low Income Housing Tax Credits, New Market Tax Credits, and Historic Tax Credits, thereby creating increased competition for a limited supply of community

development opportunities and driving down yields. This has caused banks to change their models and accept lower returns on investment, making banks question their strategies around these investments.

- To stay competitive, banks focus on volume. Regulatory language stating that “innovative” programs will be considered during CRA exams works against this tendency. The subjective nature of such consideration creates uncertainty, reinforcing a focus on volume.

(3) **Housing:** Traditionally a driver of community development lending, affordable housing initiatives continue to lag production as compared to the housing industry as a whole:

- Shifting demographics, gentrification, rising rents, and the tendency among millennial buyers to postpone purchase is affecting demand.
- Rates of homeownership are declining and causing rents to go up, since states and cities are not likely to provide deep subsidies. Opportunities to provide nonsubsidized affordable rental housing are diminished.

(4) **Regulatory impact:** The prospect of obtaining anything lower than a satisfactory rating on CRA exams, which would result in reputation loss as well as restrictions on branch expansion, product development, and mergers or acquisitions, impacts decisionmaking. Increased regulatory expectations in recent years have influenced decisions around community development involvement:

- The current banking environment expects that risk ownership is driven throughout the organization and that those in the first line of defense at the local level are best suited to understand and meet the needs of the community.
- Recent regulatory developments include:
  - The most recent revisions to the Interagency Q&As regarding the CRA (March 18, 2013) include a significant change to how community development lending affects CRA ratings. Before, such activity could have only a “positive” or “neutral” impact on ratings but can now also have a “negative” impact. This change forces banks to reexamine how they approach community development lending.
  - A regulatory focus on “current period” activity rather than a “portfolio rollup” of investments has influenced community development decisions. This has effectively pulled investments away from rural developments, where fewer current-period opportunities exist, and concentrated them in large markets and urban areas, where opportunities and competition are greater.
  - The Volcker rule has reduced the availability of earning assets, increasing demand for allowable investments such as those made to small business investment corporations (SBICs). SBICs offer a greater degree of likely repayment through their private equity and lending partnerships, while serving the needs of qualified small businesses that face challenges in obtaining loans from banks.
- Over time, as more regulations have been put into place and additional guidance has been provided by regulatory authorities, the definition of what constitutes community development has been steadily narrowed from the original intent of the CRA. Broadening the definition of community development so that more activities would positively affect the intended beneficiaries (low- and moderate-income individuals and



communities) would improve banks' ability to make life better for their customers in ways consistent with the spirit of the CRA.

## **Item 6: Monetary Policy**

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

- The Council sees the current stance of monetary policy in the U.S. as highly accommodative.
- Council members generally noted that the continuation of highly accommodative monetary policy has been accompanied by progress in the broader domestic economy and a reduction in the unemployment rate, most recently reported at 5.3%. Council members were generally optimistic about the U.S. economy, and especially the domestic financial markets, characterized by one member as "frothy." Recent economic data suggest that economic and financial conditions (based upon likely revisions) will show improvement in the second quarter, close to that originally forecast by most observers.
- Most comments related to the timing of the normalization of monetary policy and the timing and means of exit from the extraordinary measures undertaken following the 2008 market panic. As in our recent past reports, most Council members expected that conditions would allow tightening to begin before the end of this year.
- Several pointed to market expectations as reflected by capital markets, which are pricing in a gentle increase in the federal funds rate sometime before the end of the calendar year. Questions included both the terminal target rate for short-term rates and how much longer-term rates would be expected to rise, especially if the Fed were to change its current practice of replacing maturing securities held on its own balance sheet.
- The factors bearing on the decision to tighten are well known to the Fed and have been well rehearsed in our previous reports, including the relatively sluggish economic recovery, concerns about deflation and the lack of broad growth in real wages, the labor participation rate, continuing and new international troubles, and the market's uncertainty as to the timing and trajectory of the Fed's own decision to move short-term rates higher.
- Several Council members commented on the dramatic increased price volatility in U.S. equity markets, with an unprecedented series of swings last week in major exchanges both domestically and internationally following the Chinese equity market downturn and the government's intervention measures, including devaluation of the yuan. Additional comments related to the impact of the significant decrease in energy prices (as well as other basic commodities), with the conclusion that the net benefit for non-energy producers and consumers should offset concerns about the deflationary impact.
- Several commented on the importance of clear communication from the Fed regarding its decisionmaking process, ultimate objectives, and timing, noting that the level and specificity of forward guidance has diminished in recent months. The political calendar will also come into play in the next year with primary caucuses and elections beginning in February and March, perhaps further reducing the Fed's flexibility to implement a normalized monetary policy at or after that time.

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