

Record of Meeting

Community Depository Institutions Advisory Council and the Board of Governors

November 18, 2021

1. Economic Discussion:

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

Council members reported moderately stronger economic conditions across most Districts, as compared to April 2021. The Second District, in particular, showed substantial strength. The Council agreed that differences remain between urban and rural areas; however, the differences are less pronounced than they were in April. It was also observed that the more financially secure have fared better through the economic turmoil than those who are less well-off.

Most Council members reported some recovery in the hospitality sector, though not as much as was seen in other sectors and less so in urban areas. The Third District also noted improvements in hospitality, specifically in local towns and scenic areas, but added that the industry is not back to pre-pandemic levels. However, tourism had strengthened substantially in Cape May, New Jersey, and along the Delaware beaches. Tourism was also strong in the Fifth District.

Council members reported that there is a “wall of worry” over labor shortages, supply chain disruptions, and rising inflation. Labor supply is a major issue for multiple industries and is restraining business and normal operations across Districts. For example, in Denver, Colorado, school districts are facing challenges opening and operating their schools because of a shortage of substitute teachers. In addition, Council members expressed concern about new coronavirus variants and a possible surge in cases going into the winter, especially in the northern states.

Most Council members noted an improvement in inventories, but supply chain disruptions continued to impact businesses across all sectors. A key example is automobile dealers, whose sales should be off by 50%-60% because of a major drop-off in the supply of new cars. Instead, dealers are down by only 10% because they have compensated by bringing in used cars and driving up prices. (One Council member reported seeing three-year-old trucks with 30,000 miles selling for the same price as a brand-new truck.) Moreover, automobile dealers have found that it can be profitable to (1) have lower carrying costs on smaller inventories and (2) sell fewer cars for higher prices.

Council members noted similar reactions across merchandisers, especially those in inventory-heavy businesses. Many have had to adapt their business model to control expenses. (For example, restaurants have cut costs by not opening seating areas.)

Nonetheless, many merchandisers are concerned over the prospect of empty showrooms in the future.

b. *Particular Indicators:*

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

Council members reported moderate to substantial price increases for goods across Districts—and for services in some Districts—due to labor shortages and supply chain issues. Moreover, Council members noted that rising inflation expectations are influencing wage demands, and Council members do not see any sign of inflationary pressures slowing.

One Council member noted that the uncertainty of rising input costs has made producers in the Second District wary and more moderate in their risk tolerance. Inflation concerns are high in the Fifth District. In southern Virginia, diners are suffering from “sticker shock” at restaurants. Producers in the Tenth District have had manageable expenses for the most part until recently, but manufacturers are worried about the rising cost of both wages and materials. Farmers are struggling to manage the risks of rising material and labor costs. Inflation is a real issue in the Eleventh District, impacting consumers and businesses, and businesses expect the rise in input prices to continue.

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

Council members generally reported that housing prices were rising moderately to substantially in their Districts. Several Council members highlighted a lack of affordable housing as a cause for concern. The inflated market and the possibility of a housing bubble are also areas of concern.

High and rising property values are changing the housing markets, according to Council members. For example, the First District has seen a moderate slowdown in demand for housing due to rising home prices and related increases in down-payment requirements. In the Fourth District, an influx of cash investors has been outbidding others for properties, and in the Third District cash purchasers are buying up single-family properties with the intention of renting them out. Several Council members noted that first-time homebuyers, and those with less cash on hand, are having difficulty purchasing properties because all-cash buyers are winning the bidding wars.

Council members have observed spiraling home prices driving up rents across Districts. Rents have been rising quickly in the First District due to supply and demand factors. Even though property purchases by individual and institutional investors have increased rental supply, at least temporarily, rental demand has increased at least as much. Meanwhile, prospective home buyers are being priced out of properties and must remain renters for the time being. The Second District is also seeing rising home prices driving rents up, as well as frustrated

home buyers dropping out of the market. In the Fifth District, rents have doubled along the coast in the Carolinas.

Several Council members noted that high property prices, the ability to work remotely, and other factors have spurred out-migration from urban areas, including Boston, New York City, the largest California cities, and—to a lesser degree—elsewhere in the Twelfth District. Meanwhile, as reported by the Fifth District, rural areas with broadband are seeing in-migration. Thus, housing demand and home price increases are being “exported” to areas with in-migration.

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

All Council members reported mounting labor shortages in their Districts. The shortages have been attributed to the rising number of workers leaving or not reentering the labor force. Council members have heard that former customer-facing employees are reluctant to return to those types of jobs. Council members also shared anecdotes about spouses opting out of the labor force because of child or elder care responsibilities. Moreover, retirements have picked up for those aged 60 and over in many markets, including the St. Louis area. On a related note, the First, Fifth, and Tenth Districts have seen upticks in sales of small businesses associated with retirements. In the Sixth District, many workers have opted to live off government benefits instead of returning to the workforce—and while federal benefit programs have ended or will be ending soon, state and local programs are still available for those who need assistance.

Vaccine “controversies” have been reported in the Third and Seventh Districts concerning OSHA’s emergency temporary standard requiring employers with 100 or more employees to require their workers to get vaccinated or undergo weekly testing for COVID-19. OSHA’s mandate has led workers, particularly in rural areas with low vaccination rates, to shift to employers with fewer than 100 employees to avoid having to comply with the mandate. In the Sixth District, some businesses have been paying for COVID-19 tests for their unvaccinated employees to improve retention.

Council members reported that labor shortages have been driving firms to raise wages to retain or hire staff. In the Second and Ninth Districts and across most of the country, banks have also seen significant staff turnover and have had to raise wages and increase their payroll budgets in an attempt to reduce the turnover.

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

Council members reported that consumer confidence has risen moderately in most Districts and declined in some. Council members warned that recent

strength in retail sales may not imply optimism, but rather an unwillingness to defer spending further.

Consumer confidence has been undermined by pandemic concerns. The Ninth District is experiencing a pandemic spike, raising anxieties of renewed business shutdowns. Labor shortages and supply disruptions have also fostered pessimism.

However, several Council members noted that those who have money and credit have been in good shape, while those without and on fixed incomes have not. The gap seems to be widening such that the middle class is dissipating. This dichotomy is being evidenced in the Tenth District in purchases of farmland.

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

Community depository institutions (CDIs) are eager and able to lend in generally competitive markets. Council members noted that the markets vary by geography and loan type. For instance, credit markets for commercial real estate (CRE) tend to be more competitive than those for commercial and industrial loans. Borrowers, especially for business loans, are less eager to borrow, and tend to have relatively strong cash reserves. Creditworthiness is generally good, though there is more dispersion of creditworthiness among borrowers across all income levels because of differential economic effects resulting from the pandemic.

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

Council members reported that small-business credit demand remains weak overall, as borrowers remain flush with cash and lingering labor and supply chain challenges temper borrowers' appetite for credit. Demand has moderately improved, though, in the Sixth, Tenth, Eleventh, and Twelfth Districts—particularly in urban areas. Council members continued to observe an urban-rural divide. Rural lenders have faced comparatively weaker small business loan demand than urban lenders.

With fewer opportunities to put excess liquidity to work, Council members across most Districts reported an increase in loan participations among CDIs, particularly for rural lenders who are facing the weakest small business loan demand in their local market areas. Council members reported that changes in lending standards are somewhat mixed. Despite concerns about weak loan demand, lenders across most Districts did not experience significant changes to loan terms, structures, or pricing. Lenders in the First, Third, Eighth, and Tenth Districts, however, observed stronger pricing competition for small-business loan opportunities.

Small-business credit quality has remained strong or, in some cases, has moderately improved. Nearly all Council members reported that the impact of the pandemic on loan availability, and quality remains unchanged. Council members were split, however, on the outlook for small-business lending. Council members from the Fifth, Eighth, Tenth, and Twelfth Districts expect conditions to moderately weaken, while Council members from the First, Second, Fourth, Sixth, Ninth, and Eleventh Districts expect conditions to moderately improve.

- b. *Commercial Real Estate Lending:*** *Have there been any changes in the Council’s view of challenges in the commercial real estate market since the Council’s last meeting in April 2021? How are commercial real estate loans performing compared to the Council’s expectations?*

Council members largely agreed that CRE loan demand and availability either has remained the same or moderately increased. In the First and Sixth Districts, warehouse construction and multifamily housing are areas with noticeably stronger demand. Competition for CRE loan opportunities, however, has intensified. Council members observed strong competition for high-quality deals, ultimately resulting in thin margins. While underwriting standards largely remain the same, Council members reported softening terms and structures and fiercer competition on pricing. Council members also noted more strategic shifts among lenders to maintain growth in the current environment. For example, more lenders are financing speculative CRE loans. Rural lenders, particularly in the Seventh District, have partnered with lenders in metropolitan areas on CRE loan participations.

CRE loan quality remains strong, Council members noted. Lenders in the First, Third, and Sixth Districts reported stronger-than-expected credit quality with low delinquency rates. While Council members are largely optimistic about the outlook for CRE loans, some lenders reported concerns about how remote work trends could impact CRE demand in urban markets.

- c. *Construction Lending:*** *What are Council members’ perspectives on the availability of credit for construction and development projects? Have Council members seen any changes in the demand for construction loans since the Council’s last meeting in April 2021?*

Council members agreed that construction and development lending conditions remain stable and that loan performance has moderately exceeded expectations. Both credit availability and demand have moderately increased since April 2021.

Council members reported that despite facing challenges, builders are keeping up with the strong demand for new construction and development projects—particularly in housing. However, despite the demand, builders are hesitant to launch projects in the current climate because of the difficulty in sourcing labor and materials. Builders know there is sell-side potential—rental rates are rising and demand for warehouses and reconstruction is increasing—but labor and supply frictions are complicating builders’ ability to effectively price projects in a way that ensures profitability.

While builders have grown more cautious, some Council members noted an increased risk appetite among CISs. Some lenders in the Fourth, Sixth, and Tenth Districts, for example, have begun to finance speculative home or warehouse projects. A Council member from the Tenth District shared an anecdote about a second-generation lender from New Mexico whose institution previously prohibited speculative financing and now is actively seeking out developers to build speculative houses.

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

Council members across all Districts reported continuing strong demand for home mortgage loans. However, demand is starting to level off due to low housing inventory and rising prices. Council members agreed that low- and moderate-income households have been squeezed out of the housing market as a result of the highly competitive environment. Council members said that mortgage lenders are sitting on stacks of pre-approved buyers who cannot get a house under contract because of low inventory and the inability to compete with cash buyers. A Council member from the Third District noted that many cash buyers are institutional investors who are buying homes and turning them into rental properties.

Council members largely agreed that refinancing activity is slowing down and that the share of home purchase mortgages is picking up. Despite a highly competitive environment, Council members did not report any easing of underwriting standards in their markets. Loan performance has remained strong or moderately stronger than expectations, though lenders expect conditions to moderately weaken over the next year.

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

Council members reported that consumer loan availability has not changed since the April 2021 meeting. Council members from the First through Fourth Districts, along with the Sixth and Twelfth Districts, have observed moderately stronger loan demand while the other half of the Council was split between reporting level or moderately weaker demand. Council members that reported weaker demand agreed that excess savings from stimulus programs has continued to offset consumers' financing needs.

Credit card loan demand remained stable, and auto lending has increased in most Districts. Low inventories of new cars are driving higher demand for used-auto loans. A credit union in the Third District reported a 20% year-over-year increase in used auto sales at its institution. Council members from the Sixth and Eighth Districts reported strong demand for boat, RV, and other recreational vehicles—low inventories notwithstanding.

Council members in the Second and Third Districts reported that, in contrast, unsecured consumer loan demand has declined. Low consumer loan demand in the Ninth District has driven some CDIs to buy loan participations from different parts of the country. Council members also observed a decrease in the use of home equity lines of credit to finance home improvements. Instead, most borrowers are taking advantage of low rates and rolling home improvement costs directly into their mortgages.

Council members reported that consumer credit quality remains strong, with delinquency rates hovering near 20-year lows. Lenders expect conditions to largely stay the same over the next year.

- f. Agricultural Lending: Have there been any changes in agricultural lending?* Surging commodity prices and spillover government payments from 2020 supported the strongest profitability for Council members' agricultural borrowers in years. Flush with liquidity, farmers' overall loan demand declined slightly in 2021. Competition for loan opportunities grew over the period, with many lenders citing increasing competition from the Farm Credit System.

Council members noted some variability in agricultural lending by District. The Seventh and Tenth Districts reported that the growing season in the Midwest was average or moderately above average in some areas. A combination of low interest rates, moderate input prices, and strong cash flows drove up land values in 2021. In the Fifth and Eighth Districts, Council members reported that timber markets remained healthy—though rising fuel costs have started to impact the sector. Council members from the Ninth and Twelfth Districts reported that drought conditions negatively impacted crop production and that farmers and ranchers had to sell cattle earlier than originally planned due to challenges finding hay. Council members also reported a disconnect on livestock prices between retail and producers: High prices are not flowing back to producers and are being absorbed elsewhere in the supply chain.

Council members agreed that the outlook for 2022 is more pessimistic. Input costs have increased dramatically—as high as 300% in some areas—which means borrowers will be spending two or three times as much as they did in 2021 to raise the same crops. Supply chain disruptions and chip shortages have continued to roil the agricultural sector. Farmers are facing challenges getting equipment, and many inputs cannot be priced until after they have been delivered to the farm. Council members reported that producers are increasingly expected to pay 100% of the cost ahead of delivery—significantly elevating counterparty risk.

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

Council members reported that deposits are still pouring in across all Districts, with deposit growth continuing to outpace loan growth. CDIs are struggling to find ways to deploy this liquidity, and there is concern that this struggle could drive riskier lending

decisions from CDIs that are hungry for yield needed to support leverage ratio requirements.

Council members agreed that both consumer and commercial customers have sizable cash balances sitting in their accounts that are not being spent. While customers are using savings to pay down existing debt, consumer discretionary spending has declined, and Council members estimate roughly half of the Paycheck Protection Program (PPP) funds distributed to businesses remain parked in business deposit accounts at the bank.

Council members from the First, Third, and Seventh Districts reported that municipal deposits are also elevated and are likely to remain so as more fiscal support is delivered. Anecdotal reports in more than one District note that some banks have been unwilling to accept large municipal deposits without a fee structure that effectively would result in a negative rate of return.

Council members remained unsure as to when elevated deposits would begin to flow out of the banking system. However, a Council member from the Sixth District expressed concern that the velocity could be faster than CDIs expect or are prepared to handle. This could negatively impact the industry if lenders working hard to increase loan-to-deposit ratios suddenly see an out-rush of deposits.

3. Emerging Opportunities and Challenges for Community Depository Institutions:

Community banks have played a unique and an important role during the pandemic. What have we learned about the comparative advantages of community banks? In the Council's view, what are the most promising opportunities for community banks to grow and innovate to better serve their customers and communities? How should community banks pivot to take advantage of these opportunities? What are the primary barriers, and how do Council members recommend those barriers can be reduced or eliminated? What can the Federal Reserve do to help?

Council members agreed that the top threat facing CDIs are cybersecurity, particularly ransomware. A key problem is a lack of expertise, as CDIs do not always have the technology, talent, and skills to combat cyber-attacks against their institutions. Some Council members worried that cybersecurity (1) is an issue that is too large for regulators to handle and (2) is an existential problem that goes beyond what additional capital or investment could solve.

CDIs realize it is not a matter of “if” an attack will occur, but rather “when” it will occur—and they are developing incident response plans in preparation of future attacks. To help manage cybersecurity risks, Council members noted that a framework needs to be put in place that encourages cooperation and reduces the risks of transparency (which currently is seen as leading primarily to punishment and reputational damage). Such a framework would require closer collaboration between regulators and the regulated industry. Council members expressed support for “whole of government” efforts to fight ransomware attacks.

This effort includes publishing ransomware trends and taking action against ransomware operators and certain facilitators, such as virtual currency exchanges.

Providing personal customer attention for businesses is essential for CDIs and requires investment in technology and human capital, but the costs of compliance and technology—as well as the availability of qualified labor—are barriers. Some CDIs have discussed collaborating to share expenses—for example, sharing the cost of a chief technology officer—to help attract and retain talent. To make such a structure work, CDIs would need to resolve issues related to confidentiality, brand identity, and local treatment. Once again, support from and collaboration with prudential regulators will be critical to the development of workable solutions.

Recruiting and managing talent during the pandemic continue to present both challenges and opportunities for CDIs. CDIs reported having trouble attracting technology talent to rural areas—due to both the local attractions and higher wage scales offered in urban areas. The ability to work remotely has helped somewhat, but not enough to offset the disadvantages. For example, remote work allows people to live in remote markets while working for metropolitan employers, many of whom pay metropolitan wages. However, this is not the case for CDIs on the West Coast, where the cost of living is high. By enabling remote work, West Coast employers generally are able to pay lower wages to those employees who choose to live elsewhere.

Over the past couple of years, some CDIs have expanded their recruitment sphere. And although remote work has been a tool that is working for them, maintaining the CDI's culture in a remote environment is still a challenge. When enabling remote work for significant numbers of staff, CDIs need to invest more in travel, in-person planning meetings, and new management techniques to build and maintain the institution's culture. Remoteness can be a net negative if management is not careful, and the effects of remote work are not yet fully understood.

Council members stated that to stay competitive with fintechs (and neobanks in particular), CDIs some Districts have been focusing more on marketing and maintaining brand power than on technology. Council members feel that regulators could help CDIs by promoting truth in advertising by fintechs, especially when fintechs purport to be banks or offer services intended to usurp banks at the expense of safety and soundness and consumer protections.

Council members reported that both the technology firms and venture capital funds behind fintechs operate on a growth model, spending a lot of money on customer acquisition. CDIs cannot emulate that type of spending because they operate on a profitability model and maintain prudential and consumer protection standards. The lack of such standards for fintechs increases the risk of eventual consumer harm. CDIs are concerned that the inherent risks in dealing with tech start-up firms—which may lack self-sustaining business models and are dependent on ongoing capital injections—are not apparent to consumers until the firm fails or is forced to significantly reduce its service level.

Council members suggested that regulators could help protect against consumer harm by requiring fintechs to produce quarterly “mini” call reports, disclosing select information about the fintech’s profitability and business model. Such reports would inform consumers as well as regulators about the risks the fintechs present to both the financial system and the public. However, if consumers are unable to properly assess the relevant risks or are overly complacent, some Council members are not convinced that extra disclosure will sufficiently influence consumer behavior.

Regarding third-party oversight, Council members recommended differentiating regulatory treatment of fintech companies based on the channels through which they operate. Council members urge regulators to distinguish between a situation where the CDI is the customer contact versus one where the CDI introduces a fintech that is interfacing directly with the customer. Council members agreed that oversight requirements should be much simpler for the first case, when the CDI controls the customer relationship, and that more complex guidance and oversight are appropriate when a CDI is sponsoring a fintech dealing directly with customers with lesser regulation and supervision.

Council members also noted the challenge and limited value-added in performing vendor management assessments on the same vendor that numerous other financial institutions have already reviewed. Regulators could help alleviate this burden by engaging in research on means to capture the value of multiple risk assessments. Such a system would free up time and resources to better manage other pressing needs and risks.

Turning to another issue where a challenge might become an opportunity, one District raised the point that costs associated with real-time payments and Zelle are becoming a concern for CDIs, particularly rural CDIs. Council members are interested in hearing more about the timeline for FedNow, its interoperability with other systems, and the impact it may have for CDIs (in particular, whether the service could help CDIs keep up with larger financial institutions).

4. **Examination Practices:** *Have Council members experienced problems with recent examinations? Have examination practices contributed to constrained access to credit by creditworthy borrowers? What steps can be taken to address the Council’s concerns? In particular, how would the Council recommend re-balancing on-site and off-site bank examinations in light of the pandemic-related shift in the mix of these two approaches? Considering both the quality and quantity of communication and information flow, is something lost when exams are conducted remotely?*

Council members were generally satisfied with and complimentary of current off-site examinations, specifically noting examiners’ flexibility as well as the efficiencies and value of technology, and Council members expect that the process will improve over time. At the same time, they emphasized that a hybrid approach, which relies on both on- and off-site examinations, is critical to successful and effective examinations.

Council members expressed particular concern that, over time, insufficient in-person examinations and interactions will reduce examiners’ ability and opportunities to understand a bank’s culture and community involvement, identify risks appropriately, build

relationships and trust with bank staff, and communicate as insights fade and relationships fray. The impact would be compounded with waves of anticipated examiner retirements, as new examiners would have less opportunity to learn about the critical foundations of examinations in an off-site environment. For these reasons, Council members stressed the importance of a hybrid examination approach and the need to find new ways to modernize examiner training and development in a more remote environment.

In addition, Council members suggested that frequent check-ins, either by video or in person, could help facilitate better communication and understanding of expectations and requests. While many examination elements lend themselves to an off-site environment, other aspects of the process are more efficient and effective when conducted face to face, either by video or in person—as these approaches are more interactive and offer a better opportunity to establish a relationship and build trust in comparison to communicating via emails, conference calls, or phone calls.

Council members also recommended that prior to the examination, examiners and banks create a formal plan to establish the technology to be used for communication and data exchange and the circumstances of its use, with adjustments made as appropriate. Examiners should have access to a broad array of technologies, including video, that are compatible to those used by the banks.

In addition, Council members recommended establishing reasonable standards regarding the duration of remote examinations—which should be similar to the time allotted for on-site exams—with a definitive start and end date, while recognizing the need for flexibility and adjustment as events arise. Some Council members noted that off-site examinations lasted much longer than previous on-site examinations—perhaps due to a lack of urgency because the examination was not on-site.

Beyond the discussion of remote examinations, one Council member expressed concern about the turnover rate and lack of experience of newer examiners.

Council members did not identify any examination practices that contributed to constrained access to credit by creditworthy borrowers and believe that examination practices have not adversely affected creditworthy borrowers.

5. **Regulatory Matters:** *How are recent changes in the regulatory landscape affecting the ability of community depository institutions to continue providing services to their customers? In particular, please comment on the impact of the community bank leverage ratio, developments related to CRA, and upcoming changes in the payments space (e.g., proposed amendments to Regulations II and J, and account access guidelines) and provide any insights and observations on the Paycheck Protection Program.*

Community Bank Leverage Ratio (CBLR) and PPP Issues: Council members reported that many CDIs have experienced difficulty maintaining eligibility for and compliance with the CBLR because their balance sheets have expanded significantly and rapidly during the COVID-19 pandemic. Growth in deposits and accompanying growth in very-low-risk assets (such as reserves held in Federal Reserve accounts) account for the expansion of CDIs' balance sheets. Council members also noted that many CDIs were active participants in the

Small Business Administration (SBA) Paycheck Protection Program. Though CDI expectations were that PPP loan proceeds would be spent and dissipate quickly, that has not happened to the extent expected. Furthermore, CDIs have received or been offered deposits of public funds appropriated for pandemic relief, and they expect more of these deposits as further appropriations are dispersed to their public agency customers. It is unclear when these funds will be dispersed, and whether funds will remain in CDI public deposit portfolios or simply be shifted to other customers' accounts. To address some of these issues, CDIs in some communities have turned away deposits, especially from larger customers—including state and local public bodies—or have offered such customers unattractive terms, including what effectively are negative interest rates.

CDIs' balance sheet growth has been largely unplanned, and the growth reflects increased assets with little or no increase in risk to the institutions. Many CDIs face difficulty complying with the CBLR (once current temporary relief expires at year end), and some may be pushed above the maximum asset size for CBLR eligibility. Council members believe that no policy purpose is served by either requiring increased capital against low-risk assets or taking banks out of CBLR eligibility. Therefore, Council members suggest that (1) CBLR relief should be extended and (2) CDIs that grow out of CBLR eligibility should be allowed additional time to restore their eligibility.

Overall, most CDIs believe that the PPP program was a significant benefit to their customers and communities, even though significant shares of many PPP loans have not yet been spent. A number of CDIs have raised concerns about how PPP loans remaining on banks' books (and unforgiven) are going to be assessed by examiners. Furthermore, processing normal SBA guaranteed loan business is currently problematic for CDIs in many Districts, because SBA resources in those Districts are seriously overburdened. These administrative chokepoints hinder CDIs' overall ability to serve small-business customers in the affected markets.

Community Reinvestment Act (CRA): Council members discussed multiple concerns that should be addressed in a modernized CRA regulatory framework.

First, Council members stressed that updates to the CRA regulations must be forward looking. While branches play a role in the delivery of financial products and services and will remain a channel for serving customers' banking needs, that role will continue to shrink and be replaced by technological alternatives. As a practical matter, all financial institutions—including CDIs—are migrating to the digital channels that consumers demand. Council members believe that CRA cannot be truly modernized without addressing these changes.

Second, Council members highlighted that revisions to CRA regulations must (1) consider variations in bank specialization and business strategies and (2) recognize that CRA needs and opportunities in small towns and rural areas can be vastly different from those in urban centers. For example, in some parts of the country, community development projects cannot be designed for the primary purpose of serving LMI communities. The economic reality is that these projects are designed to benefit all residents in an entire area—and the projects simply cannot be designed to benefit select segments of the population. Council members

noted that because these initiatives fall within the purpose of the CRA in meeting local needs, they should receive credit in CRA reviews.

Finally, Council members emphasized the need for regulators to provide clarity and consistency regarding what counts for CRA credit as well as how CRA ratings are calculated and assigned. While quantitative performance metrics would provide much-needed transparency to the CRA evaluation process and assignment of ratings, regulators should take great care not to over-rely on performance metrics. Regulators should also take qualitative factors into account to have a full understanding of a bank's CRA performance and the impact that the institution is having in its community.

Payments Issues

FedNow Service and Regulation J

The Board of Governors of the Federal Reserve System (Board) issued a Request for Comment on changes to Regulation J that would create a new section dedicated solely to FedNow Service operations. Council members support this initiative to clarify the rules that apply to FedNow.

While Council members realize that interoperable transactions are not possible at launch, they urge the Board to adopt policies and procedures that are consistent with existing real-time payment systems, including The Clearing House's RTP network, to minimize the burden on financial institutions and ensure a uniform customer experience.

Council members expressed concerns about both Regulation E and Uniform Commercial Code 4A (UCC 4A) applying to commercial transactions as proposed. Council members urged the Board to (1) consider having Regulation E apply to consumer transactions only and (2) issue any underlying legal language needed to support this change via an operating circular instead of UCC 4A. The circular would help minimize confusion associated with applying commercial requirements to consumer transactions. The operating circular should be subject to public notice and comment.

Regulation II

The Board recently issued a Request for Comment on changes to the regulation of debit card transactions. This change would require that all debit card issuers "enable" two unaffiliated debit card networks for card-not-present transactions. When Regulation II was finalized, that was not commonly technically achievable. Council members noted that it does not appear that the Board considered the impact that this requirement would have on card issuers in comparison to any benefit that would be gained by consumers.

Access to the Federal Reserve Payment System

The Council appreciates the Board's issuance of a Request for Comment on establishing proposed guidelines for access to the Federal Reserve payment system. These guidelines will help to ensure that all applicants, whether traditionally chartered institutions or specialty charters, are held to the same standards and subject to the appropriate level of oversight to ensure the safety of (1) every individual participant in the payment system and (2) the payment system itself. This is an important backstop to ensure that entities engaging in

regulatory arbitrage to gain charters do not put other institutions or their customers at increased risk. The business models of some of these applicants appear to be focused on cryptocurrency and stablecoins, which are two areas where currently there is little regulation.

Instead of continuing to have the application review process operate at the District level, Council members would like the Board to consider further homogenizing the process by centralizing it. In addition, Council members feel that it is important for the Board and Reserve Banks to have ongoing engagement and oversight of any novel charters that are granted access to the Federal Reserve payment system to ensure that those novel charters continually meet the standards that they committed to in their application.

Special-Purpose Charters

Council members shared their continued concern about novel charters being granted to institutions that avoid traditional financial institution regulation but still provide bank-like products and services. These entities are seeking direct access to the Federal Reserve payment system. If the access is granted, these institutions may introduce increased risks to the financial system. For example, the state of Wyoming has granted two special-purpose depository institution (SPDI) charters to cryptocurrency businesses that will hold uninsured dollar deposits. The deposits will be backed by 100% reserves, and the funds on deposit cannot be loaned by the bank. This structure allows those SPDIs to avoid Federal Deposit Insurance Corporation (FDIC) and Bank Holding Company Act (BHCA) supervision. Other states are considering special charters, or, like Nebraska, have already passed a bill that would create a state bank charter for SPDIs.

The Office of the Comptroller of the Currency (OCC) delivered positive news regarding trust charters that (1) were granted to institutions and (2) do not provide traditional fiduciary duties, instead focusing on cryptocurrency services and payments. Recently, Acting Comptroller Hsu announced that those charters are under review, as are the interpretative letters that changed longstanding policy that enabled them to be approved under prior OCC leadership. However, although the review has been announced, there has been no public action yet about how to mitigate the risks that these entities pose and how to ensure that the charters are not able to avoid FDIC and BHCA supervision and compliance obligations.

Stablecoins

Council members noted that the President's Working Group on Financial Markets, together with the FDIC and OCC, recently released a report on crypto tokens pegged or linked to the value of fiat currencies, so-called stablecoins (Report). The Report identifies and makes recommendations regarding regulatory gaps associated with stablecoins that are used as a means of payment, including (1) legislative recommendations to bring stablecoins within a prudential regulatory framework and (2) recommendations for how regulators could use their existing authority to address these prudential risks to the extent possible while legislation is pending.

Council members support stablecoins regulation, viewing it as an essential element to ensure that stablecoins have the confidence of their users that is essential to making the crypto tokens an efficient payment method (unlike many of the digital assets that exist today). It is

important that oversight be implemented as soon as possible to protect against stablecoin runs, payment system risk, economic risk, and the concentration of power.

Other Issues: Bank Secrecy Act compliance burdens are still problematic for CDIs in many Districts. The Council believes that CDIs would benefit from further consideration of tailoring options. Also, CDIs in several Districts are still seeking legislative and regulatory clarity on the provision of banking services to legal cannabis businesses. In addition, several CDIs have raised concerns about the expected burden of Section 1071 reporting on small-business lending, including operational and practical barriers to adapting business loan origination systems to requirements typically associated with consumer compliance measurement. Finally, the Council refers to the comments on vendor management guidance in its responses to Question 3. Vendor management has also become a significant aspect of regulatory burden.

6. **Additional Matters:** *Do Council members wish to present any other matters affecting community depository institutions that have emerged from meetings of the Reserve Banks' advisory councils?* [The Council incorporated its answers to this question into the responses to questions 3 and 5.]