<u>Record of Meeting</u>

Community Depository Institutions Advisory Council
and the Board of Governors
November 17, 2022

1. Economic Discussion:

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

Council members reported strong economic conditions as measured by spending, though there are concerns that strong inflationary pressures may at some point undermine real spending. In addition, Council members, particularly in the Fourth District, reported that the return of production and manufacturing from offshore locations is helping the economy with significant investment in manufacturing and capital expenditure.

Despite generally strong conditions, Council members reported stark differences in economic impact between the "haves" and the "have nots." Wealthier parts of their markets are not yet slowed by inflationary pressures, while lower-income households are feeling the squeeze.

The possibility of a recession remains a concern, but so far declines in overall spending are not evident. Despite being vocal about price increases, consumers are continuing to spend.

b. Particular Indicators:

i. ***<u>Inflation</u>****: 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 generally reported that inflationary pressures remain strong, with prices rising rapidly—though some Council members reported early signs of inflation softening for some goods in certain sectors. Despite rising prices, customers and businesses have not yet pulled back on spending. Council members summarized sentiment as a lot of optimism about the economy coupled with much uncertainty about the future because there is an expectation that inflation will have a long tail that has yet to be fully absorbed.

Drivers of inflation remain mixed. Wage inflation is one key driver, particularly in the services sector, with employees expecting higher wages to keep up with inflation. Firms that want to retain talent in a tight labor market anticipate salary increases of 5-9% next year. In addition to salary expenses, Council members reported double-digit increases in insurance costs, with some insurers exiting markets along the Gulf Coast. A large insurance company has stopped selling auto insurance in California.

Supply chain issues persist and are another significant contributor to inflation, particularly in the manufacturing and goods-producing sectors. The drought in the Midwest and the low Mississippi River levels also contributed to a supply chain backup of both agricultural commodities moving downstream to export markets and raw materials moving upstream for manufacturing and agricultural production. This had a strong effect in several Districts that are reliant on the upper parts of the river. Council members also highlighted lingering effects of supply chain issues—some of which were caused by labor shortages—from the pandemic on construction. Some areas are experiencing a shortage of concrete and electric transformers (with one-year wait times). The apparent randomness of these shortages is likely contributing to further uncertainty among households and businesses.

In other cases, Council members noted that some firms have realized that they are able to maintain margins by raising prices. Council members reported that auto dealers still have strong pricing power with high prices and little negotiation. Most businesses are passing a high percentage of cost increases downstream to consumers, which generally was not the case last year. However, Council members have observed early signs of a potential shift in this dynamic. For example, market-dominant retailers such as Walmart and Target are now pushing back on vendors, seeking justification for further price increases.

The most acute effects of inflation are being felt in rural and lower-income areas, with higher gas and diesel prices squeezing the wallets of consumers and businesses, particularly smaller farm operations and other industries that use diesel-fueled equipment. While prices for some commodities (such as aluminum and lumber) have fallen, that softening has often been offset by higher transportation costs. Prices for trucking and transportation have declined but remain high—and those higher prices are being passed on to consumers.

The Council also reported that some consumers and businesses have become more focused on interest rates than inflation, which has resulted in real estate sales and development and capital expenditures being compressed by the higher interest rates.

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

Strong demand coupled with low inventory have kept home prices stable. However, price appreciation has slowed or even declined somewhat in parts of the country. Buyer activity has slowed down as mortgage rates have increased. Council members reported that the days of frenzied buying are over. Buyers are taking more time, and homes are sitting on the market longer. However, conditions have not returned to pre-pandemic levels.

The shortage of available homes continues to constrain the market for buyers. Many homeowners sitting on sub-4% mortgage rates are essentially locked into their homes and will be unwilling to sell their home if it means that their next mortgage will be near 7%. This shortage has had cascading impacts across markets. Housing remains unaffordable for many low- to moderate-income and first-time homebuyers who are now locked into the rental market. While multifamily construction has been strong, Council members reported that rental rate increases continue to exceed overall inflation in many markets. Housing shortages are also impacting the upper end of the income distribution in some markets. For example, Council members noted that some hospitals are having challenges filling vacancies because of a lack of housing suitable for higher-income health professionals.

Multifamily construction has been so strong that some Council members reported that municipalities have had to tap the brakes on new developments because municipal infrastructure cannot keep up. Meanwhile, single-family construction is slowing as builders finish their existing projects without lining up new ones because profit margins are too narrow or unpredictable to justify new builds. Buyers are choosing to purchase larger homes instead of ordering premium finishes and features that in the past have increased profit margins for builders.

There is some variability by region. In-migration from high-cost-of-living metro areas into rural areas has driven up costs in those rural areas while urban areas see softer prices. In a mixed bag, some Districts reported fewer institutional investors and house flippers buying up properties, while others continue to see an influx of investors for multifamily housing based on strong demand (and increases in rental rates.

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 that increased labor costs and the labor shortage are affecting both their financial institutions and their business customers. The labor shortage is a primary concern of bankers and a major driver of inflation. Businesses that are not raising their wages fast enough to retain workers and attract new ones are losing their employees to other firms.

There was broad consensus that several industries, such as the healthcare and daycare industries, are facing more severe shortages. Shortages in these sectors are having broader impacts. With fewer options for daycare or eldercare, more prime-age workers are being forced to remain on the sidelines. In some parts of the country, daycare now costs nearly $500 a week, which is typically much more than what many young employees with children make. The price and availability of daycare will remain a major barrier for labor force participation. Even manufacturers with capital and contracts in hand cannot find workers to fulfill the contracts.

Council members noted that the labor shortage is not transitory and will be a reality for businesses into the longer term. The decline in labor force participation has been a long-term demographic trend exacerbated by the pandemic and the transmission path of inflation to wages. Council members also noted that employers are still digesting the (1) ability for workers to work remotely and (2) increased participation of younger generations in the workforce that have different views, compared to older generations, of their relationship with work.

Several Council members noted an increased desire for immigration reform to offset the structural shortage of labor. The opioid crisis was also named as a key driver of labor shortages in some areas, and a major causal factor in many geographies with the lowest labor force participation rates.

Most businesses remain hungry for labor. In reaction to these pressures, Council members reported increased investment in equipment to make up for labor shortages across sectors. However, Council members also reported the beginning of layoffs in some markets in their region, which is a harbinger of a slowing economy.

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 a disconnect between consumer behavior and reported confidence. While inflation has reduced confidence, consumers are still spending. However, increases in spending on services has been hampered by labor shortages in that sector.

The consumer confidence divide is vast between the “haves” and “have nots.” For those on the upper end of the income distribution, folks are complaining but still spending. There is greater confidence among consumers with higher levels of discretionary income, who, as a result, feel insulated from rising prices. Holiday spending, possibly driven by pent-up demand, is expected to remain strong for these consumers. Purchasing activity may not fully reflect consumer pessimism.

For low- to moderate-income households, rising utility bills and food prices have eaten into both their savings and purchasing power. Energy prices are a major concern as we enter winter, and the cost of heating oil is a concern in the Northeast. It was estimated that for minimum wage workers, 70% of their money goes to essentials (e.g., food, energy, transportation). Lower-income households are cutting back on discretionary spending, and in many cases, they are being forced to make difficult choices about which monthly essentials they can afford.

Council members reported that consumer delinquencies remain minimal but are starting to slowly creep up. Most institutions expect losses to increase in 2023. Some Council members have observed significant deterioration in the mobile home portfolio and others have observed some weakness in auto loans. While delinquencies remain relatively low, lower used-car prices have resulted in losses for repossessed autos.

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

    a. ***<u>Small Business Lending</u>:*** *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 or prevailing economic uncertainty is slowing economic activity in this sector?*

Demand for credit was relatively stable, according to Council members, and credit quality remained strong. However, rising economic uncertainty has made both borrowers and lenders cautious about the future. Today's business owners and bank management teams have not had experience navigating a high inflationary environment of this level, and it is difficult to gauge whether businesses are adequately managing risks. The current economic environment with sequential increases in policy rate targets has not occurred in four decades. Banks are having to develop their playbooks on the go, with many Council members expressing concern about the awareness of the rate risks among their small business clients.

Many projects during the pandemic were delayed, and firms are having to adjust rapidly to the rise in financing costs. For businesses involved in commodities, Council members have observed an increase in credit line use due to the rising price of commodities, even when underlying demand has remained flat. Demand for credit in the medical field has also increased in small increments. Council members also noted a significant increase in demand for equipment purchases across all industries, as businesses continue to automate and make capital investments.

Although there have been large price fluctuations in different markets, Council members reported that banks have not made significant changes to underwriting standards, but they have become more watchful. Banks have begun to pay closer attention to the liquidity of borrowers, as well as the ability of borrowers to prepare for a potential downturn. Lenders are starting to stress test their borrowers for future interest rate hikes.

Smaller businesses with less liquidity have not fared as well, as they have less flexibility to handle disruptions. Rate increases have not significantly dampened loan demand; instead, uncertainty about the economic outlook has made firms more cautious in their borrowing. Most Council members observed an increase in demand for small business lending. Council members also reported that many small businesses tend to be rate insensitive in the sense of switching to more expensive credit card balances to meet their funding needs. Symptomatic of the generally high levels of liquidity in the broader economy, the Fifth District described how a group of businesses in a specific community have switched from bank loans to communal lending in reaction to the rate increases.

Council members from more rural areas of the country reported that they have seen national and regional banks exiting from small business lending in their respective geographies. While this opens more lending opportunities for community banks, the lending market remains highly competitive, which, in turn, causes loan rates to lag policy rate increases.

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 2022? How are commercial real estate loans performing compared to the Council's expectations?*

Council members reported that while firms have not pulled out of existing CRE projects, financial institutions have become more selective of which projects they choose to finance, and the pipeline for future projects has dried up significantly. As interest rates have risen, lenders now require more capital for each project, and many lenders—with the exception of larger lenders—have begun to pull back from the market. Lending standards have begun to tighten with rising rates, and loan-to-value requirements are rising as high as 60%. Council members also reported that appraisal values are consistently coming in lower than market valuations, which is derailing deals, especially in rural markets. In some instances when community institutions have been willing to walk away from certain deals, they have observed that some of these are being funded by out-of-state banks and insurance companies. The Third District reported that deals in Philadelphia attract funding from financial institutions in New York and elsewhere.

Multifamily housing continues to be the strongest category of CRE lending by far. Hotel performance has improved as well, while office space continues to struggle. Council members remarked that vacancies vary widely by region, with some rural markets reporting record lows, and major cities such as Los Angeles and San Francisco reporting high vacancy rates.

c. ***Construction Lending:*** *What are Council members' perspectives on the availability of credit for construction and development projects? Have Council members seen any* *changes in the demand for construction loans since the Council's April 2022 meeting?*

Council members observed demand for construction lending dropping off more quickly than demand for commercial real estate lending. Construction periods and project lengths have increased significantly due to the uncertainty of material supply and labor shortages. Council members reported that the fall in demand for construction lending has been tied more to a decreased risk appetite by firms, rather than banks' willingness to lend. Multifamily development is up, while other categories are declining.

Custom home construction also continues to enjoy growth, as the high-end options included in these projects support wider margins for builders. There is still a shortage of inventory in the housing market, and Council members are not seeing any of the weaknesses observed during the Great Recession. Carrying costs for speculative building are much higher than in the past, leading many spec builders to sit on the sidelines.

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 observed that rising interest rates have led mortgage refinancing to dry up to nearly zero. The rising interest rate environment has made adjustable-rate mortgages a more popular option. The Twelfth District observed few banks on the West Coast booking mortgage loans into their portfolios. Approximately two-thirds of homeowners currently hold a mortgage rate of less than 4%, deterring them from selling their current home and buying at a much higher rate, which is contributing to the housing supply shortage—especially for more affordable homes.

Council members expressed some concern about risks in mortgage portfolios for low-to-moderate income borrowers, as these households spend a higher portion of income on their mortgage. Also, competition for non-jumbo loans is so high in some areas that competitors are offering rates below secondary market values, leading banks to assume more risk if they remain in the market. Council members have observed an increase in home equity lines of credit, and accessory dwelling units are being built with home equity loans.

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

Most Council members reported an increase in credit card balances and noted that prepayments have been declining. Some Council members reported that credit line usage has risen approximately by a third, primarily to meet the rising costs of essential goods and services such as groceries and gasoline. Credit quality has remained relatively strong, and Council members reported delinquency rates as being practically non-existent or increasing only slightly. Council members also reported that alternative financing options such as "buy now, pay later" services have not significantly redirected business away from depository institutions.

Advance rates on auto loans have not changed, although the prices of new and used cars have risen significantly, raising the value of the average auto loan. Cars are also much more durable and reliable than they once were, and some Council members reported that terms for auto loans have been stretching out to as long as 96 months, and lenders are now lending at loan-to-value ratios as high as 120%. Despite the longer terms for auto loans in some areas, the average life of a loan is often less than three years.

f. <u>**Agricultural Lending**</u>: *Have there been any changes in agricultural lending?*

Council members reported that agricultural credit quality is extremely strong, but that credit line usage of agricultural borrowers has declined. The current concern for agricultural borrowers is land prices, as the market price of land has risen much higher than its value in production, which is a barrier to entry for new farmers. Larger farms remain more efficient and have more leverage to acquire neighboring land and consolidate operations. One District noted that, because of the market's strength, some individuals who had exited the agricultural real estate market have since returned.

Currently, farmers are generally optimistic. Even though input prices for agricultural producers are up, those prices are being offset by higher commodity prices. Council members believe that the current export market should continue to support those higher commodity prices, and farmers, moving forward, are well positioned to purchase more equipment and make larger capital investments. The high credit quality has led to greater competition for agricultural lending, as farmers are typically solid borrowers with strong balance sheets. The Farm Credit System has recently become a less aggressive competitor because it has increased its interest rates.

On the downside, Council members reported that the drought and stress on water resources will be a major problem for many farmers in the future. As an example, in southern Colorado the price of water has risen from $75 to $500 per acre-foot.

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

Some Council members reported an outflow of deposits on the commercial side, but most Council members have not yet seen a significant decline in their consumer deposit base. However, consumer deposits are expected to run off soon, following a strong growth during the pandemic. Deposits have been surprisingly sticky even as nonbanks offer higher interest rate CDs and money market accounts to attract deposits. Banks have not repriced deposit rates in parallel with the rapid rate hikes of the Federal Reserve, and Council members reported wide variability in the degree that banks have raised deposit rates. Marketing, social media, and consumer pressures are expected to contribute to an acceleration of deposit pricing pressures.

Council members noted that differences in bank deposit rates stem from how institutions managed the excess liquidity gained during the pandemic. Banks that more aggressively deployed deposits into investments are now competing for deposits to maintain liquidity, while banks that invested less aggressively are now sitting comfortably at current deposit levels.

Council members expect deposits to continue running off in the future, partly due to higher rate alternatives but also because of higher levels of spending as a result of inflation. Personal savings rates have fallen significantly and are currently below their pre-pandemic levels, though Council members did report an outflow of deposits into treasury bonds and brokerage accounts. Businesses are using their cash to pay down their lines of credit that have much higher rates now and are drawing down commercial deposit levels.

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

While Council members reported that they are not observing as much merger and acquisition activity today, longer-term market pressures for institutions and their holding companies to consolidate remain. Though competition for deals has waned, deals are still being negotiated between institutions when there is a good fit. Council members have observed more natural branching among institutions as well as an increase in loan production offices as an alternative to acquisition.

3. **Examination Practices**: *What has been the experience of Council members in the most recent examinations? Have you seen examination practices impact the flow of credit? How can supervisors improve their communications (both formal and informal) with supervised institutions?*

Council members reported that hybrid examinations have been balanced and successful. While acknowledging how challenging staffing has been and continues to be for the agencies, Council members reported that examination results have often been delayed. The Council expressed no dissatisfaction regarding—or recommendations for improving—communications.

Council members were unanimous in their expectation that, if finalized as proposed, the Section 1071 requirement that banks mix consumer compliance with business information about small business loans will greatly diminish the ability of community banks to lend to small businesses. The proposed rule requires that pricing information be included; however, the tailored nature of small business loans means that prices vary based on numerous factors that are difficult to report. The risk of legal challenges based on this complexity and the cost of compliance, along with other factors, will push rural markets to large banks, much as expanded TILA-RESPA disclosures (TRID) after the Great Recession did for residential mortgage lending.

Council members indicated that bank consumer compliance examinations are becoming longer and more burdensome, which inhibits the ability of small institutions to serve their community. Council members expressed particular concern about retroactively applied rules and the costs of identifying errors for consumer reimbursements. For example, some banks are having to identify and reimburse fees that were previously imposed for multiple re-presentments, which is a costly and manual process. Some institutions are being told that the fees should not be imposed going forward, but it is still not clear why a fee that was previously acceptable through multiple examinations is now unacceptable.

Council members reported that there are certain supervisory tools in CRA examinations that are creating uncertainty and concern. For example, examiners are using a new analytical tool that can trigger an examination process that could lead to a referral to the U.S. Department of Justice (DOJ). This raises two issues: (1) because small banks do not have access to the analytical tool, they do not have the opportunity to understand the examiners' findings or to discover anomalies on their own, and (2) the process triggered by the analytical tool delays the examination and thus the ability of banks to serve their community and expand services. Banks agree with the concept of using such tools to identify areas of concern, but they feel this particular analytical tool is creating unpredictability and causing alarm given the potential referral to DOJ and other regulatory sanctions.

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

Potential FHLB borrowing limitations:

Council members expressed concern about the ability of community institutions to continue to borrow from Federal Home Loan Banks (FHLBs) over the short term. Council members discussed current balance sheet trends, where most institutions saw a significant inflow of deposits during the pandemic and invested the funds in safe assets, such as treasuries and agency securities. Council members are also concerned about the impact the rate hikes are having on their bond portfolios, and, by extension, the increase in unrealized losses that flow through to tangible capital. Under Federal Housing Finance Agency (FHFA) regulations, banks whose tangible capital becomes negative must receive written permission from their primary federal regulators to roll over or utilize new advances. Council members noted that bank capital regulations were updated almost 10 years ago to ensure that bank capital is (1) robust, (2) reflects modern banking and markets, and (3) can withstand stress during adverse economic and financial market conditions. Council members discussed the downside of using tangible equity, rather than regulatory capital, as a proxy for a bank's health because the latter is a much more robust measure of risk. The Council requested that the Federal Reserve engage in communications with the FHFA and other banking agencies to avoid the risk of an administrative reduction in the ability to borrow from FHLBs, triggered by an exclusive focus on tangible capital, when an analysis of regulatory capital does not indicate the need to reduce FHLB borrowing.

Council members reiterated their concern that compliance regulations will adversely affect how banks are lending in their communities, both in terms of product variety and innovation and in lending volumes.

Council members discussed the continued fight against cybercrime and other scams, noting that the types of fraud are changing as criminals are getting smarter and more strategic. Council members feel that these are national issues that are not just affecting community depository institutions and large depositories. Council members believe that in addition to the fraud prevention practices they are employing, more should be done at the federal level to educate consumers.

Council members continued to recommend that efforts be made to help community institutions streamline their due diligence process for shared vendors. In addition, the Council recommended further development of federal outreach programs designed to increase customer awareness of fraud and cybercrime.

Council members reported that there have been many recent news stories related to increases in fraud in Person-To-Person (P2P) payment networks. They stressed that the fraud is real, and efforts should be made to mitigate risk and reduce depository institution and consumer losses. Council members noted that changes to Regulation E have been proposed. Currently, Regulation E provides protections for consumers for unauthorized transactions. There have been proposals to have the CFPB reinterpret Regulation E to include "fraudulently induced but authorized transactions." This would protect consumers who are tricked into paying fraudsters. The payments are then authorized by the consumer, who later has second thoughts and wants to retrieve their funds.

Expanding Regulation E in this manner would affect all consumer payment platforms, but especially P2P services where a lot of this fraud occurs. Increases in Regulation E liability could have a stifling effect on bank and credit union adoption of faster payments, including FedNow, due to the increased expense and lack of provisions for offsetting revenue to cover the risks. Financial institutions may slow down implementation, stop adoption, or even abandon existing P2P services.

Some proposals suggest shifting liability to the receiving bank in these types of transactions, but that would also have a chilling effect on faster payments adoption. Right now, joining one of the faster payments networks in "receive only" mode is considered a safe way to get involved in faster payments, without fear of fraud risk. Shifting the liability from consumers to the receiving financial institution makes it less likely that the institution would participate in a faster payments network.

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

Council members discussed recent developments in the cryptocurrency markets. There is strong interest in making these markets subject to robust regulations equivalent to what exists in the United States for securities and derivatives. Council members were agnostic about which agency—the CFTC or SEC—is authorized by Congress to conduct oversight. Many community depository institutions (CDIs) have been looking to offer services to help their customers access these products/markets, but these aspirations have been on hold pending approval from relevant CDI regulators. Council members believe that only when cryptocurrency markets are subject to formal regulation should banks be allowed to help their customers access these markets—similar to what is done now with securities and derivatives. There was also a discussion about the SEC's guidance (SAB 121) requiring banks to hold capital for cryptocurrencies they hold in custody (on behalf of their customers), which has discouraged many banks from offering these services.