Record of Meeting

Federal Advisory Council and Board of Governors

Thursday, May 11, 2023

Item 1: Economic Activity

What trends in business activity do Council members see among their clients and other contacts? Are Council members, clients, or contacts seeing any new areas of strength or weakness? Are there industries or geographic areas in which significant supply-side constraints persist? What is the Council's prognosis for the pace of economic activity across sectors for the second half of 2023?

What trends in business activity do Council members see among their clients and other contacts?

Although slowing, overall business activity continues to be solid despite the cumulative impacts of continued labor shortages, inflation, and rising interest rates—all of which are weighing upon business growth and borrower demand. These effects have been exacerbated by disruption in the banking industry, which has created greater concern regarding the economic outlook, with many companies becoming more cautious regarding expansion plans and new capital projects. This uncertainty is further compounded by the current debt limit impasse. Merger and acquisition activity remains muted. Margins are underincreased pressure but generally remain above historic levels. Commercial real estate, particularly office and senior housing, has experienced the most significant slowdowns, followed by technology and manufacturing as supply chain shortages abate and inventories rise. Meanwhile energy and commodities pricing are demonstrating some strength. Consumer spending remains resilient, especially in the areas of travel, entertainment, and hospitality among higher-income segments, but it is showing signs of weakness overall. Both businesses and consumers are demonstrating a greater preference for cash over borrowing, and line utilization remains below year-ago levels. Credit metrics continue to be good overall, although with increasing weakness—especially among lesser-quality borrowers.

Are Council members, clients, or contacts seeing any new areas of strength or weakness?

There is increasing concern regarding commercial real estate values, particularly in the office market, driven by higher vacancies and refinancing costs, and more recently accelerated by the occurrence of early lease terminations and property sales in order to get ahead of these market dynamics. Some recent weakness in home prices has been observed as higher mortgage rates have reduced purchase activity; conversely, property improvement expenditures have been higher, while rental rate increases continue to be strong due to limited housing supply. That said, there are some signs of increased residential construction activity as contractors adjust to materials supply constraints and pricing to maintain a more continuous flow of projects as strong buyer demand continues for both single family and multifamily housing.

Are there industries or geographic areas in which significant supply-side constraints persist?

Although supply chain challenges continue in some sectors (such as automobiles, trailers, RVs, and aerospace engines), the supply chain has improved significantly overall as evidenced by rising inventories and a sharp reduction in backlogs in most areas. Labor market pressures, while still a challenge, are beginning to show signs of abating, which to some degree can be attributed to lower voluntary turnover, reduced demand, and a higher incidence of layoffs (as opposed to a greater supply of workers). Skilled labor shortages are most acute in healthcare, leading to reduced capacity in the face of increasing patient volumes.

What is the Council's prognosis for the pace of economic activity across sectors for the second half of 2023?

The general consensus is that economic activity will continue to slow during the second half of 2023, although a recession is not expected until 2024 as the lagged effects of monetary policy and related stress in the banking sector continue to take hold. In addition to increased caution regarding the economic outlook among businesses and consumers, banks are tightening access to credit in the face of constrained capital and liquidity as well as uncertainty regarding future regulatory requirements. However, primarily because of the continued relative strength in the labor markets, recessionary conditions are expected to be mild.

Item 2: Labor Markets

Based on Council members' own experience and that of their clients and contacts, how would Council members describe the overall state of the labor market? Will businesses be increasing or decreasing their employment levels in the second half of this year, and in what categories? Has there been any significant shift in the size, composition, or qualifications of the available labor pool in recent months? What does the Council foresee in terms of the balance between job openings and available workers over the course of the year? What kinds of compensation increases are being planned over the next several years?

Based on Council members' own experience and that of their clients and contacts, how would Council members describe the overall state of the labor market?

Council members generally agreed that the balance between labor supply and labor demand has moved toward normalization, although the unemployment rate remains at a very low level, indicating a current bias toward a tight job market. The participation rate continues to move upward toward pre-pandemic levels, and Council members generally believe hiring will decline over the remainder of the year, which should further the normalization of the labor market and potentially lead to a rise in the unemployment rate. The actual and anticipated slowdown in economic activity, including a tightening of access to credit, is influencing some businesses to pause their hiring efforts and generally has improved employee retention. Some Council members noted that their turnover rates are currently at historic lows. Wage inflation has slowed generally with hourly rate increases below the trailing 12-month rate. An overarching wildcard in the balancing of the private sector labor market is the public sector trend, which has shown steady increases in employment since December 2022.

Will businesses be increasing or decreasing their employment levels in the second half of this year, and in what categories?

Slower growth will drive smaller employment gains for the remainder of the year. However, several segments will continue to hire based on the need for certain skills. Hospitality will likely continue to hire although at a more moderate rate, as many businesses in this industry desire to elevate service levels to pre-pandemic levels. Across many industries, technology skills are still in demand, which could absorb the reduction in staffing at some of the largest tech companies. Healthcare, specifically hospitals and residential care, is still understaffed, and compensation increases are higher than the overall market but rising at a slower pace than they did in the previous 12 months. Council members are somewhat mixed in their views of hiring in the financial services sector, and some of the emphasis placed on adding production jobs and technology skills is being offset by cost-saving efficiency initiatives. One member noted that construction subcontractors are bidding on jobs they previously declined in order to keep their crews busy. Construction pipelines generally have slowed, although that is primarily a result of the increase in interest rates and the uncertainty of the duration of the interest rate cycle. Council members did not note other industries for either a significant increase or decrease in employment levels, as a labor force balance seems to have developed in the majority of industries.

Has there been any significant shift in the size, composition, or qualifications of the available labor pool in recent months?

The overall labor participation rate continues to inch upwards toward pre-pandemic levels. It is interesting to note an increase in both the participation rate and number employed in the 16–19-year-old age group year-over-year and since January 2023, seasonally adjusted. Also noteworthy is the increase in the civilian labor force of workers with a bachelor's degree or higher of 2.2 million year-over-year and of 1.2 million since January 2023, seasonally adjusted, and that the unemployment rate for this segment is below 2%. Generally, Council members noted challenges in hiring skilled workers. This is most likely a result of higher retention rates and the low number of unemployed with bachelor's degrees or higher educational attainment. Many companies have mentioned reviewing their internal training programs to ensure they can train new hires who do not have the skills necessary for the jobs they assume, although this type of training may be less of an option for smaller businesses.

What does the Council foresee in terms of the balance between job openings and available workers over the course of the year?

In the current interest rate environment, the number of job openings generally should decline based on higher employee retention rates and slower economic growth. As the workforce participation rate continues to increase based on the need for earned income, the number of available workers should increase for the remainder of the year. This dynamic should result in the continued decline of available jobs/unemployed ratio which, in February, was at its lowest level since November 2021.

What kinds of compensation increases are being planned over the next several years?

Generally Council members see short-term compensation increases tempering compared to the previous 12 months and settling in around the 3-4% range with fewer mid-year adjustments. Longer-term projections are certainly dependent upon economic growth, inflation, and—to a certain extent—on the expansion or contraction of government programs. Exceptions are less prevalent than 12 months ago and are generally found in highly skilled positions, such as nursing, and certain technology specialties where there is immediate demand.

Additional points

One Council member mentioned an increase in employee engagement scores year-over-year, indicating increasing loyalty. Engagement scores for remote workers were significantly below the norm, which could partially explain the return-to-office trend to mitigate attrition risk. A Council member mentioned a lack of available childcare, particularly in rural areas, which is preventing some parents from returning to the workforce. Another Council member mentioned that the turmoil in the banking industry could further slow the attrition rates in the financial services sector. Lastly, one Council member noted that recently less than 5% of public companies cited labor shortages as a problem—compared to 16% one year ago.

Item 3: Loan Markets

What is the Council's view of the current condition of loan markets and financial markets generally? Are there other conditions or developments that are particularly noteworthy in lending categories such as consumer, residential real estate, construction, small and medium-size business, or corporate?

What is the Council's view of the current condition of loan markets?

Credit markets are tightening as banks focus on the cost of funding, liquidity concerns, and potential increases in capital requirements. Demand for credit is also moderating as customers react to economic uncertainty, partially due to the recent bank failures and increased costs driven by labor and higher interest rates.

Although markets are softening, they continue to function well despite increased margin and liquidity pressures. Despite warnings to the contrary, there has not been a systemic deterioration of credit quality.

Delinquency rates and overall asset quality remain strong and below pre-pandemic levels, despite modest normalization from the lows of 2022, which was broadly expected.

Consumer

Consumer loan markets are expected to grow moderately as consumer spending, particularly in discretionary goods and services, is seeing continued growth. Given the increase in consumer spending, credit card balances are expected to grow. Credit quality metrics remained strong as consumers continue to have excess liquidity. Payment rates on credit cards have decreased but remain above pre-pandemic levels. Council members noted that consumer sentiment has declined over recent months, although the consumer confidence indicator in March experienced a slight increase. It was noted that the overall decline in consumer sentiment was reflective of uncertainty about job availability and business conditions.

Automotive lending faces headwinds from higher interest rates, higher vehicle prices, and significant credit tightening. Supply chains have eased somewhat, helping to increase the level of new car inventories. Time in inventory has increased given the greater supply and challenges with affordability.

Residential Real Estate

Although showing some early signs of softening, housing prices remain high, exacerbating the affordability challenge for first-time buyers. Higher rates have greatly reduced refinancing activity and mobility for existing homeowners. Supply also continues to be tight. There has been a continued shift to home equity loans and lines as an alternative to refinancing and other more costly unsecured products.

Consumer preference has grown for adjustable-rate mortgages as a lower rate alternative. Several Council members noted downward pressure on agency mortgage-backed securities (MBS) performance when compared to risk-free rates in part driven by market disruption. Liquidations of seized bank portfolios has impacted the mortgage market as participants prepare for increased supply. This, along with originators looking to maintain adequate margins, is keeping primary note rates in the mid-to-upper 6% area.

Small and Medium Businesses

Elevated deposit balances are keeping utilization rates down; however, several Districts have seen a recent increase in applications for unsecured credit lines. Small business owners have cited labor shortages and inflation as their top two concerns. Companies, especially those in the retail sector, that traditionally were cash flow borrowers are seeking alternative borrowing structures—this change is an early indicator of changing loan conditions.

Middle Markets and Corporates

Council members agreed that there has been a slowdown in middle-market lending due to higher interest rates, a softening economy, and tighter credit markets. This slowdown is likely to extend beyond mid-2023. Bank debt has remained the primary source of capital, which is expected to continue until inflation, interest rates, and uncertainty have moderated.

In the corporate sector, the market remains available for higher-quality borrowers with modest leverage profiles. Lower new-issuance volumes are expected to persist in 2023. Within high yield, the market has been impacted by banks holding a large backlog of riskier supply (low single-B and CCC credits) provided through committed financings to large M&A transactions (mostly by private equity investors).

One Council member noted strong performance and historically low delinquency rates for agricultural loans. Although demand for farmland has decreased, demand for operating loans is expected to increase because of higher production expenses.

Inflation and uncertainty around the macroeconomic outlook continue to put pressure on pricing and deal activity. Underwriting standards and deal structures remain largely unchanged. Industries identified as being weaker than they were last quarter are healthcare, restaurants, retail, some consumer discretionary,

and general real estate contracting. Wage inflation and staffing shortages continue to have a disproportionate impact on these sectors.

Commercial Real Estate

Commercial real estate lending has slowed, due to higher interest rates, increased construction costs, and continued uncertainty around office demand. Higher rates have resulted in reduced cash flow, declining property valuations, uncertainty, and slowing transaction volume. New projects are being put on hold due to higher financing costs and uncertainty in the broader market, and very few properties have traded as valuations are unclear due to the rising cost of capital, moderating rent growth, and higher operating expenses.

Liquidity in the market has been limited, and capital providers are being extremely selective. Even smaller institutions are seeking increased economics through deposits, fees, etc. The new issuance of non-agency commercial MBS is at its lowest volume in more than a decade. Refinancing risk is increasing with both the higher interest rate environment and weakening economic outlook. Most at risk are (1) properties in urban markets and (2) class B and C properties.

Council members agreed that there is opportunity in the multifamily sector. Agency support will continue to aid the multifamily market. Extraordinary rent increases are moderating to historic norms, in line with single-digit inflationary pressures. The Southeast/Southern geographies continue to benefit from the population migration that occurred during the pandemic.

Council members noted a deceleration of the office market. Trends toward remote work have pressured collateral valuations, and current supply far exceeds the demand. Although office delinquency rates remain low, office properties have seen a rising number of loan defaults and a decrease in sales prices. Tenants continue to pay their leases, regardless of whether they use the space, but the uncertainty surrounding remote work has put pressure on the industry, making it less desirable to lend to the market.

Leases are being signed in all asset classes, but the terms are increasingly tenant friendly. Some Council members are seeing the impact of companies' space decisions accelerate. In some cases, companies are buying out their existing leases, which impairs property values and negatively impacts project sponsors.

Construction

Construction demand is lower, driven by higher interest rates, labor challenges, and inflationary cost pressures. Construction costs have normalized, relative to inflation, as supply chain issues have normalized, partly due to the decrease in demand. Contractors have begun ordering supplies in advance to avoid long delays. Deals are still getting done, but the focus lies on growth segments—such as multifamily and industrial—with favorable terms for lenders in both price and structure. Several Council members noted that loan pipelines are lower than normal.

<u>Item #4: Inflation</u>

Based on Council members' own experience and the experience of their clients and contacts, are the prices of various products and services rising more quickly or less quickly so far this year than they were last year? To what extent, and in what sectors, are businesses able to pass along price increases? Has the recent pace and pattern of price increases changed the expectations of consumers and businesses about overall inflation?

Inflationary pressures continue to ease, and prices are generally stabilizing or increasing less quickly than they were at the same time last year. Supply chains continue to recover, and core goods prices have been stable. In some instances, retailers have even found themselves with too much inventory and have resorted to discounting to clear these stocks. On the other hand, inflation in services, particularly core services and plumbing, electrical, and lawn services, remains well above its pre-pandemic pace. Although wage growth

is continuing to decelerate, wage pressure remains high and is a stubborn contributor to prolonged inflation above the Federal Reserve's 2% goal. Despite a meaningful decrease in the price of most building materials, housing and shelter costs have remained persistently high due to rising rents, low inventories, and the cost of home ownership. However, forward indicators and Council members' anecdotal evidence suggest that rents and building costs will continue to normalize, and Council members have seen some softening in home prices in certain regions and markets. Office rents have started to come under pressure, which is expected to continue as contracts mature. This pressure is largely attributed to the post-pandemic work environment. Similar to office landlords, industrial and retail landlords are expected to be less able to pass along cost increases as demand wanes. Additionally, the costs to insure commercial real estate, especially multifamily properties, has increased dramatically and will impact margins. All these factors could slow the pipeline of new projects coming online. On a positive note, at least one Council member pointed out that small business formations and originations are above pre-pandemic levels, which could help prop up demand going forward.

Until recently, businesses have largely been able to pass along price increases to consumers. Revenues are projected to grow at the slowest pace since the third quarter of 2020, and margins are starting to contract widely across business sectors, pointing to the fact that businesses are not able to pass along price increases as much as they could in previous quarters. Net income and earnings per share are expected to decrease in the coming quarters, with a few exceptions: energy, industrials, and some consumer discretionary (such as travel and entertainment). Higher-income workers continue to spend excess savings on discretionary services and self-indulgences, while lower-income consumers are trading down and shifting to non-discretionary spending. Many retailers are beginning to find it difficult to pass along cost increases as consumers start to push back. The downtrend in inflation has given businesses less cover to hike prices on the consumer.

Inflation expectations have fallen recently, which likely stems from consistent reports of slowing inflation from the various indices and reports. The decrease may also be explained by the recent bank failures. Businesses and consumers are braced for tighter credit conditions, less liquidity, and a perceived looming recession. Long-term inflation expectations continue to be well anchored for the time being and have not changed since the previous Federal Advisory Council meeting.

Item #5: Federal Reserve Policy

What are the Council's views on the stance of monetary policy, including portfolio activities?

While inflation is still above target, Council members agree that the Federal Reserve's approach to slowing it has been effective. The FOMC's actions to date have contributed to a tightening in financial conditions with substantial increases in both nominal and real Treasury yields, widening in credit spreads, and declines in asset prices—including broad equity market and housing indices. At the same time, Council members said it appears rate hikes are starting to impact growth, and inflationary and wage pressures are cooling. Price increases have slowed, wage increases are being budgeted by customers at a more reasonable level, and people are not as willing to change jobs given concerns of an economic slowdown.

Council members believe recent events in the banking sector have contributed to the inflation slowdown and will put further downward pressure on economic growth in the months ahead. Loan demand was already showing signs of slowing, and recent banking stress will likely impact supply as well. The depth of the slowdown is uncertain, however. Council members expect lending conditions to tighten in response to the banking sector stress of the last 60 days, which will put further downward pressure on economic growth. Financial stability impacts should be considered alongside the path for inflation.

Council members also said the competition for deposits has measurably intensified. To ensure liquidity in the system, it will be important to assure depositors that their money is safe. Macro deposit trends will become clearer as we move beyond tax season. The risk to watch is the deposit-to-MMF migration and the

impact on the reverse repurchase agreement (RRP) programs and reserves. Although additional declines in System Open Market Account holdings remain appropriate for now, given emerging signs of reserve scarcity, Council members believe the FOMC should explore ways to reduce reverse repo uptake via reduction in the counterparty limits or by widening the gap between the reverse repo rate and the interest on reserves. The RRP program has run in the background for the better part of the last two years without issues, but it seems prudent to consider the impact in a world where instantaneous deposit flight is a risk to any institution. Given the unusual times, the Federal Reserve should consider possible negative effects actions may have on the safety of deposits throughout the banking system. For instance, reducing the Federal Reserve's balance sheet size has meaningful implications for system liquidity and should be thought through carefully.

A pause in further interest rate increases may be appropriate to allow the cumulative effect of tightening to become evident, especially given the lag time between monetary policy implementation and the impact on the economy. The recent pressures the banking system has faced may further constrain growth when coupled with current Fed policy. A pause should allow those factors to play out and provide a clearer picture of the nature of the environment and the next steps that may be warranted.

Item #6: Stress Dynamics

What has surprised you about this episode of instability in the banking sector? How have stress dynamics changed from earlier episodes of instability? Are Council members thinking about concentration and run risks differently than before the failure of Silicon Valley Bank? What are the implications for risk management at individual institutions? Are those implications different for different-sized institutions? If so, how? How should banking, and bank regulation, change to meet the new landscape?

What has surprised you about this episode of instability in the banking sector? How have stress dynamics changed from earlier episodes of instability?

The recent episode of instability has highlighted the continued importance of strong liquidity and interest rate risk management, while also bringing to light several risks unique to the failed institutions, particularly related to their diverse business models and client bases. The biggest surprise to Council members about the bank run was the speed at which it began and how quickly it gained momentum. The speed of the bank run was driven by a combination of the implicit concentration of the client base and modern technology, which accelerated the flow of both information and funds. Social media and private messaging platforms allowed information to spread quickly among a highly interconnected client base, while online banking and digital channels enabled funds to be immediately accessed and transferred. The funding flow allowed deposits to leave the bank faster than available liquidity sources could be monetized. Unlike the Great Recession, which was a credit-driven event, asset quality was not a concern during this recent episode of banking instability, which was ultimately a liquidity failure resulting from (1) poor interest rate risk management given the business model and (2) inadequate supervisory oversight.

Are Council members thinking about concentration and run risks differently than before the failure of Silicon Valley Bank? What are the implications for risk management at individual institutions? Are those implications different for different-sized institutions? If so, how? How should banking, and bank regulation, change to meet the new landscape?

This recent episode of instability in the banking sector has brought to light how quickly poor management and failures in oversight can cause a bank to fail. While the risks facing these banks were exacerbated by unique business models, ultimately, the banks lacked (1) effective risk management frameworks and (2) limits to manage the significant balance sheet growth experienced over a short period of time—particularly resulting from large uninsured deposits. However, Council members do not think it is necessary to adopt broad regulatory changes to address the idiosyncratic risks and risk management lapses at these

failed institutions. These risks were largely known and, although not well managed, do not represent a weakness in the regulatory framework to identify, monitor, and manage risk. Banks with poor risk management can and should be able to fail without significant impact on the economy and markets as a whole.

Generally, Council members believe that the unique business models of the failed institutions, particularly Silicon Valley Bank (SVB), is what set the institutions apart from traditional financial institutions, which typically have a diversified client base and funding structure. With respect to size, it was noted that larger institutions typically have highly diversified client bases as well as the benefit of being considered too big to fail. Smaller institutions have neither and are therefore more at risk for future runs if the institutions have a significant level of uninsured deposits in their funding mix. In general, across banks of all sizes, Council members recognize a need to better evaluate and manage the factors that led to these failures—including client and deposit concentrations, overreliance on uninsured deposits, and interest rate risk in the investment portfolio.

Council members recognize that, because of social media and digital banking, deposit runs can accelerate much faster than they had in the past. As a result, banks should be reevaluating (1) contingency funding plans, (2) short-term run-off assumptions, and (3) the speed at which contingent liquidity sources can be monetized. Large, uninsured deposits may be less stable and more rate sensitive than in prior periods, especially with the relatively new potential to move outside the traditional banking system. Banks and regulators should evaluate the risks associated with material levels of uninsured deposits and ensure appropriate run-off rates are incorporated into liquidity stress testing. Additionally, the Federal Home Loan Bank System and the Federal Reserve should evaluate funding operations to accelerate and extend access to secured borrowing lines and allow banks to more easily move collateral to meet bank liquidity needs in the modern era. Online banking provides customers with the ability to access and manage funds beyond business hours, as such, and secured liquidity facilities must be updated to reflect the digital era's access and movement of funds within the banking system. Lastly, a Council member noted that as a result of the Federal Reserve defining "small banks" as banks not included in the top 25 largest banks, small institutions were left exposed to reputational risk when the media reported that small banks were losing billions of dollars in deposits to large banks.

While this episode has highlighted opportunities to enhance existing risk management practices, the recent "Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank" report highlighted the tailoring of liquidity and capital regulations as impeding effective supervision, and, therefore, contributing to the bank's failure. The shift in total asset thresholds for additional supervision potentially facilitated—or removed—barriers to the rapid growth of SVB. Establishing a more continuous approach to increasing regulatory expectations could be beneficial in removing the discrete thresholds and associated strategies to manage around them. However, the regulatory guidance and requirements that remained in effect should have been adequate to identify and manage interest rate and liquidity risks at the company under effective management and supervision. It is not clear whether the outcome would have been different had SVB been subject to a liquidity coverage ratio or additional capital requirements.

Council members shared a variety of views on potential changes to the appropriate treatment of unrealized losses and gains in regulatory capital, and they suggested that consideration be given to other elements of a comprehensive bank balance sheet, such as accumulated other comprehensive income (AOCI). Council members believe that SVB's regulatory capital would not have materially impacted capital levels because the unrealized losses were primarily on securities classified as held-to-maturity (HTM). Furthermore, continued consideration must be given to the possibility that unrealized gains could have materially, and potentially temporarily, increased capital levels due to market volatility. So, although changing AOCI rules might not have been impactful in this event—and could result in more volatile capital ratios—evaluating

regulatory treatment and strengthening the governance and monitoring of HTM investment portfolios (including the ability to monetize) could be beneficial.

More recently, Council members were encouraged by the FDIC's actions in relation to the orderly receivership and sale of First Republic Bank, actions that stand in contrast to the more expensive seizures and dispositions of SVB and Signature Bank. Council members believe it is important for banks of all sizes to support global needs and local communities. Council members also noted that in light of the recent bank failures, policymaking that discourages merger-and-acquisition activity bears reconsideration. The economy and financial markets thrive when transactional activity creates value and efficiency for stakeholders. The United States banking system is significantly more granular and less concentrated than any other major developed economy in the world, and artificially constraining market-based activity is not an appropriate role for prudential and market regulatory agencies.

Item #7: Bank Term Funding Program

The Board and Reserve Banks launched the Bank Term Funding Program (BTFP) on March 13 to make available additional funding to ensure that banks can meet the needs of all depositors. What are Council members' views on the BTFP? What are the perceived benefits and costs? Do Council members wish to share any suggestions on ways in which the BTFP could be made more accessible and easy to use?

What are Council members' views on the BTFP?

In general, Council members have found the BTFP to be a well-designed bridge financing option for firms in need of funding over the next year, and they added that it has calmed concerns in the banking industry. Participating banks were able to quickly gain access to the BTFP, and the BTFP provided an additional source of liquidity during a tenuous period in which (1) many banks experienced deposit outflows and (2) liquidity was hampered by their inability to sell underwater securities. Some Council members believe a facility such as the BTFP may have a longer-term role to play in sustaining depositor confidence, particularly as long-term rates remain elevated.

What are the perceived benefits and costs?

Benefits

The BTFP effectively provides a same-day contingent source of funding secured by assets within the liquidity buffers. Additionally, because the BTFP uses par value as the basis for borrowing capacity and has a reasonable interest cost/spread, it largely immunizes the liquidity value of these assets from the variability in interest rates. The BTFP pledging and borrowing process builds on the efficiencies of the long-standing Discount Window process, which allows member banks to leverage current Federal Reserve Bank pledging and borrowing processes, making it operationally efficient to establish and execute. The pricing and ability to pledge securities at par value (versus market value) provides borrowers advantages in comparison to other borrowing options available at this time, and some banks are likely to use this program and the Federal Home Loan Banks program interchangeably depending upon rates—especially if eligible collateral categories are expanded.

Costs

Council members believe that using a facility such as the BTFP may create a negative public or regulatory perception of an institution and may imply out-of-the-ordinary funding concerns or needs. If the intent of the BTFP is to provide a normal, course-secured funding source for banks, it is imperative to make additional efforts to change the perception of the facility.

Council members noted that a potential downside to the BTFP is the moral hazard it creates for possible future mismanagement of interest rate risk. For example, banks could use long-term securities in their investment portfolio to maximize short-term profitability, knowing full well that a program such as the BTFP is available to cushion their losses/liquidity risk if interest rates were to rapidly rise.

Do Council members wish to share any suggestions on ways in which the BTFP could be made more accessible and easy to use?

Council members suggested the program could be more useful if it were structured in a way to broaden collateral eligibility to include municipal securities, at least to the extent that such securities are eligible to pledge to the Discount Window. Many institutions that serve local markets hold a relatively large proportion of their securities portfolio in municipal issues compared to their holdings of federal and agency securities. Broadening the scope of eligible collateral would expand the practical benefit of the facility to additional institutions.

Council members noted that although the Federal Reserve has attempted to be more accommodating, the process for banks to pledge securities held in securities subsidiaries remains arduous.

Council members suggested eliminating the linkage to the Discount Window operationally and the related reporting requirements (outside of those reports required by law). Discount Window usage is reported weekly in aggregate (not attributed to any Federal Reserve District), but securities held to collateralize repurchase agreements and loans are reported weekly by each Federal Reserve District. An increase in those securities could lead to speculation as to which bank is using the facility, fueling further depositor concerns. This issue is especially pronounced in Districts that may have only one or two primary financial institutions. In addition, banks need to have securities pledged on a persistent basis to ensure "same day" access to the fund. On the call reports, banks will have to report securities to the BTFP as "pledged"—but there is no distinction between drawn and undrawn.

Some Council members recommended that this facility, in some form, should exist permanently, especially because of the role of U.S. Treasuries and agency-backed bonds in the current high-quality liquid assets framework. In the event a permanent structure was put in place, the ability to match it with an appropriate term structure (i.e., three years or five years) should be considered.

Lastly, Council members stated that BTFP reporting of pledged collateral could be improved to show par amounts more timely and accurately.