RECORD OF MEETING

Community Depository Institutions Advisory Council and the Board of Governors

Friday, November 7, 2014

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

   a. ***Small Business Lending:*** *Has credit availability for, and demand for credit from, small businesses changed significantly? Have lending standards for these borrowers changed?*

   There is ample credit available for small businesses; however, demand is weak. Strength in urban areas has generally offset weaker conditions observed in rural areas. Many Districts reported growing demand for SBA loans.

   Small business borrowers are reporting stronger balance sheets—welcome news for the banking industry. Furthermore, small business owner sentiment over the past six months has improved. However, businesses' ability to plan for future growth and expansion has been impeded by uncertainties surrounding the Affordable Care Act, other barriers, and economic prospects. Regulations and the uncertainties surrounding regulation have delayed decisionmaking and, in some cases, strangled growth for small businesses.

   Large institutions have reentered the small business lending space, "reaching down" and offering loans to small businesses that were not previously served by such institutions. This competition has driven a number of banks to loosen underwriting standards, especially the larger banks.

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

   There has been good demand for commercial real estate (CRE) loans in the past few months, especially in urban areas and near transit hubs. Improving property values and rising rents may be boosting demand for such loans. Student housing and senior housing have been areas of strength in the CRE market. Overall strength in the segment has increased the importance of prudent management of concentrations.

Competition for quality borrowers from a variety of sectors, including large institutions, insurance companies, REITs, GSEs, and HUD, has pressured community institutions' already slim margins. In addition, foreign investments in CRE properties, primarily from Europe and Asia, have picked up over the recent months, further adding to the competitive field.

c. ***Construction Lending:*** *What is the Council's view of the availability of credit for construction and development projects? Have Council members seen any changes in the demand for construction loans since the beginning of the year?*

The Council has seen improvements in construction lending, driven by student-housing and medical-facilities construction. In addition, some Districts noted an increase in lending for custom home building construction. Construction lending has been driven by projects in suburban and urban areas—leaving rural areas behind again.

Competition among builders for the dwindling supply of available lots has led to an increase in the value of these lots. In some cases, lots are being purchased for speculative reasons, with no immediate plans for development.

d. ***Home Mortgage Lending:*** *What changes has the Council seen in the mortgage market since the beginning of the year? Is a trend developing among community banks to increase, decrease, or cease home mortgage originations, and if so, what are the likely causes for and effects of this trend?*

Home mortgage lending has slowed somewhat in recent months, and refinances have practically ceased. The ability of institutions to make new home mortgage loans has been impacted by a resistance to purchase from the younger generations and a willingness to let go of homeownership by older generations.

The Council discussed community institutions' willingness to make nonqualified mortgages (non-QMs) going forward. More banks have begun to consider making non-QM loans out of necessity—despite facing heightened legal and compliance risks.

The compliance challenge associated with making a home mortgage loan has inhibited lending. Some institutions have found they are unable to price a home mortgage to cover the additional compliance costs necessary to make a home mortgage loan. The Council remarked that institutions are more focused on how to comply with new home mortgage regulations than on how to expand home mortgage lending or products.

e. ***Consumer Lending:*** *What changes have Council members seen in consumer lending?*

Consumer lending levels remain depressed at community institutions due to intense competition and, to a lesser extent, fair lending concerns. Many of the Council members noted that community institutions were concerned about being priced out of the consumer lending market by nondepository institutions or that they were exiting the consumer lending business altogether due to an inability to compete.

For example, activity was strong in the auto lending area, with strong demand and volume. However, competition for auto loans from nondepository institutions pushed many community institutions out of the market. Council members noted that indirect auto lending was “out of control.”

Some regions observed declining credit card balances as consumers deleveraged. However, this decline was not universal.

f. ***Agricultural Lending:*** *Have there been any changes in agricultural lending?*

Downward pressure on commodity prices has created uncertainty in the agricultural lending area. Overall, agricultural production lending grew over the past few months, while equipment loans declined slightly.

As prices for crops declined due to record production and yields, crop farmers depleted excess cash reserves and have turned to financial institutions for agricultural production loans. On the other hand, livestock farmers have benefited from recent price increases. For example, the Council noted that the price of cattle has increased to $2,000 per head in some areas.

Many on the Council feel that farmland values have peaked and can no longer continue to climb. In general, community institutions are concerned about the future of many farms due to the lack of young farmers and their ability to afford land. The younger populations continue to move to urban areas for a variety of reasons, leaving rural areas behind and many farms with no succession plans.

g. ***Deposits:*** *Have Council members seen any changes in local deposit markets?*

The majority of community institutions remain flush with core deposits. Many are actively planning for the outflows associated with a rising rate environment. There is also concern that new liquidity regulations will encourage large banks to compete more aggressively for deposits.

2. **Economic Discussion:**

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

The Council noted that economic conditions were improved and have remained stable, with conditions in many urban areas better than those in rural areas. Rural areas are being negatively impacted by the slowdown in the agricultural sector, declining populations as younger generations move to urban areas, and departing businesses—such as health care providers. However, economic strength over the past six months has been more widespread than in the past.

While the Council recognizes the improvements in economic growth, many remained concerned about the labor markets, especially the number of individuals who are no longer participating in the labor market and individuals who are underemployed. In addition, the Council is concerned about significant skills mismatches in the labor market.

The Council noted concerns about the effects health care reform would have on the overall economy. Many small businesses face tremendous uncertainty regarding the costs associated with the reform and have delayed business decisions and growth.

b. ***Particular Indicators:***

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

Although inflation, as reflected by standard indices, remains at modest levels, some Council members continue to report the impression that customers feel “street inflation” is higher. This impression may be a reflection of higher health care costs in combination with higher living costs. Income levels have not fully recovered from the recession, which has the effect of reducing consumer purchasing power even if inflation is stable.

The Council has not detected evidence of food prices increasing despite droughts in key agricultural areas.

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

After improving at a rapid rate, improvements in the housing market have slowed over the last six months to a sluggish rate. The improvement has been very uneven across Districts.

Many Council members noted a continuing demand for multifamily housing, as younger generations seem more inclined to rent than purchase homes. Part of this decision is the result of the debt burden of younger

Americans and their desire to remain mobile. Rents have remained strong in urban areas, while remaining stagnant in rural areas.

There remains significant concern that regulatory changes—particularly application of the qualified mortgage (QM) regulation—could restrict credit to lower-income borrowers.

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

Labor markets continue to be an area of concern for Council members. Many noted that although jobs are available, there are significant skills mismatches and a shortage of skilled labor. The Council discussed the changing definition of skilled labor as complicating the issue.

Wage inflation is becoming more problematic for positions in demand. The new "hot positions" in banking are for BSA compliance staff and commercial lenders.

The job market remains particularly tough for recent graduates. Many in the workforce have delayed retirement due to the still-weak value of their investments. This delay, when combined with efficiency gains made after 2009, means that fewer entry-level jobs are available.

iv. *Consumer Confidence: Is the Council seeing signs of improved consumer confidence? What is the outlook for consumer credit losses?*

Consumer confidence slightly improved, and in fact, recently experienced one of its larger three-month swings.

The Council discussed concern about what could happen if loan delinquencies rise due to the recent loosening of underwriting standards or when underwriting standards are again tightened.

3. **Payment Systems:** *How have consumers and business practices and preferences for making payments been changing? Have community depository institutions been able to meet the changing needs of their customers? Are there significant impediments to meeting customers' needs for payments services, and if so, how should these impediments best be addressed?*

Consumers are aware of new products that are available, and there is demand for products such as the recently introduced Apple Pay. Community depository institutions are evaluating the costs and benefits of providing these products to their customers. Institutions must balance the additional costs of implementing and maintaining a new payment channel with any potential increases in revenue. Additionally, institutions need to consider the costs of not offering the service and thereby losing customers to institutions that do. The added security of biometrics and tokenization used by these products is a plus.

Security concerns related to data breaches continue to be a top concern for institutions. Institutions absorb the costs related to breaches, while the other parties, such as consumers, merchants, and vendors, are largely exempt. There is no compelling reason for the other parties to devote resources to data security if they remain shielded from liability. The Council noted that EMV (Europay, MasterCard, and Visa, or “chip cards”) provides better security than is currently offered with conventional magnetic stripe cards but that online EMV transactions would still be vulnerable.

Generally, the Council found the cybersecurity sophistication and knowledge of examination teams to be improving. Supervisory requirements are also becoming more demanding. Technology changes and increases in cybersecurity risk are expected to present continuing challenges to community depository institutions and the banking agencies for the foreseeable future. Significant efforts with concomitant costs are currently focused on corporate account takeover (CATO) risk. Management of this risk imposes significant obligations, including extensive staff training, time-consuming visits with corporate customers to document security, and additional oversight of and agreements with vendors. While guidance for these and other supervisory requirements is available, the Council finds that the details of available guidance are not widely known or understood by some institutions or their examination teams. Increased efforts by the banking agencies to bring more clarity in this area would be welcome.

The Council recognized that customer claims connected to cyber breaches had increased perhaps 150 percent, making online detection and prevention increasingly important. In addition, smart and timely management of debit and credit card replacement and the attendant costs are a priority. The evolving nature of vendor oversight is affecting business relationships and the underlying vendor contracts in varying degrees. For instance, community depositories are increasingly seeking indemnifications, especially as supervisory efforts effectively increase agency risk for depositories. This circle of actions and reactions poses some new risks for the system, as vendors may be starting to weigh the risks that these contractual changes imply against the profitability of relationships with smaller community institutions.

The Council discussed the potential advantages and disadvantages of three separate initiatives addressing faster payments that are currently in process: efforts by the Federal Reserve Banks, the NACHA Same-Day Settlement Proposal, and the Clearing House Faster Payments Project. While these projects are heading in the same general direction, they appear to be taking different paths towards a faster and safer payments solution. The Council expressed a desire to have the Federal Reserve play a central role in any new or improved payment system that is introduced.

4. **Examination Practices:** *Have Council members experienced problems with recent examinations? In particular, have examination practices constrained access to credit by creditworthy borrowers? What steps can be taken to address the Council’s concerns?*

Satisfaction with examination practices generally has improved, though the collective increase in the complexity and costs of regulation has significantly increased costs at banks and altered their strategic business choices. The biggest gains in satisfaction have concentrated in safety and soundness areas, while compliance examination experiences have been much less certain and subject to increasing threshold requirements.

In the past, the Council has commented on inconsistencies in compliance standards from examination to examination and from examiner to examiner. However, the appearance of inconsistencies might be attributed more to the reality of ever-escalating standards. Regardless, increased compliance obligations and costs are affecting bank behavior and competitiveness. Council members also noted a continuing burden on community institutions of "trickle-down" standards from larger and more complex banks, often in the form of "best practice" recommendations that examiners treat as requirements.

The Council noted particular burdens in the following areas:

- Bank Secrecy Act compliance (see Question 6)
- heightened standards for third-party risk management that are proving very difficult to satisfy
- complex mortgage regulations that are significantly increasing the cost of mortgage compliance and limiting credit availability

In the case of mortgage regulation, many banks continue to offer only QMs as a risk-management strategy. Other banks are making non-QM loans that they feel meet their overall guidelines for risk and return. There appears to be a gradual increase in willingness to make non-QM loans, though the volume of such loans remains relatively modest.

The Council recommends that supervision should be more scalable. In other words, supervision should be risk based so that the complexity of the examination is consistent with the complexity of the institution. The current climate for supervision, particularly in compliance areas, is not one of scalable examinations but rather is a zero-tolerance regime. Supervision of BSA, third-party risk management, and now perhaps cybersecurity is focused on identifying any risk, no matter how small, and second-guessing management. This approach does not recognize or permit normal business judgments concerning risk management.

5. **Regulatory Matters and the Future of Banking:** *How are recent changes in the regulatory landscape affecting community depository institutions' ability to continue to provide services to their customers? What has been the effect on the industry generally?*

The cost and resource strain in the post-crisis regulatory landscape is a significant—if not predominant—obstacle to community institutions' ability to provide services. Rules and regulations specifically earmarked for larger institutions are softly imposed on community institutions through "best practices" or examiner suggestion with little opportunity for the institution to refuse or disagree. The aggregate burden of new regulations promulgated under the Dodd-Frank Act, as well as the resulting proliferation of new banking regulators, is yet to be fully recognized. This burden should be considered in terms of not only hard costs and resource allocations, but also in terms of lost business opportunities, staffing hardship, and the opportunity costs of managing new risks across bank operations, IT, and compliance. The net effect is to limit industry capacity and its ability to serve community needs.

From a perspective of business strategy and long-term planning, an institution may no longer consider only the credit and product needs of its community. Rather, business decisionmakers must also consider the significant compliance and regulatory costs. Many banks are exiting certain business lines (consumer and mortgage lending) or not adopting new, diverse business lines (emerging technology and niche small business lending) not due to a lack of demand or bank expertise but rather due to the accompanying regulatory expense, examination scrutiny, or compliance risk. The unfortunate result is that, regardless of their size, community-based depository institutions are no longer as responsive to their communities.

The increased cost to community institutions of hiring more revenue-negative compliance staff is well documented. However, the regulatory impact on hiring and retention is less obvious. There is an emerging trend showing that the stress of regulatory compliance and implementation on individual employees is a direct cause of retention problems. Experienced staff may retire early, exit the banking industry, or opt for higher pay and less responsibility at larger institutions rather than remain at a community institution. This loss of employees creates a talent drain and diminishes a community bank's capacity to serve diverse community needs that often are best addressed, or can only be addressed, by local and targeted institutions. This problem will grow unless supervision is made more scalable to the risks posed by community institutions.

6. **Additional Matters:** *Have any other matters affecting community depository institutions emerged from meetings of the Reserve Banks' advisory councils that Council members want to present at this time?*

Rural Appraisal Reform

Many rural areas have experienced population out-migration where business growth and job development have not kept pace with population growth. Nevertheless, these areas remain the home of many successful communities and of the agricultural and community businesses on which they depend. There is a continuing need to build, transfer, and finance properties in these communities in order to meet dwelling and business property needs. Frequently, these real estate activities are inhibited by a shortage of licensed and certified appraisal professionals, a problem that becomes more acute with population out-migration.

Title XI of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) authorized the banking agencies to issue and amend appraisal rules. The implementing regulations permitted appraisals to be done by unlicensed or noncertified appraisers when the transaction value for residential properties was less than $250,000, or when the transaction value for commercial or complex properties was less than $1 million. These threshold values have not been changed since the rule was issued.

To address in part the problems resulting from a lack of licensed and certified appraisal professionals in rural areas, and to adjust the threshold levels for the first time since they were established over two decades ago, the Council recommends the following:

- increase the residential threshold permitting appraisals to be made by unlicensed appraisers from $250,000 to $500,000
- increase the commercial and complex property threshold permitting appraisals to be made by noncertified appraisers from $1 million to $2 million

Bank Secrecy Act

BSA/AML supervisory expectations continue to rise with each exam cycle, even though there have been no new regulations in the past 10 years and bank business plans and risk profiles are fundamentally unchanged for most community depository institutions. As these expectations rise, compliance costs increase and are passed along to our customers or squeeze our margins to the point that entire business lines become financially unattractive. Examiner expectations for more controls to be applied to entire business lines such as money services businesses, which have been conducted safely for many years and have provided appropriate services to segments of our communities, are leading some Council members to exit these businesses. As a result of the ratcheting-up of reputation risk that flows from public enforcement actions for serving certain types of customers or from other agency assertions that bankers will be held liable for the activities of their customers or their customers' customers in connection with vaguely defined high-risk merchants, banks often make a prudent risk judgment to stop serving whole classes of customers. To think that de-risking is an individual customer judgment ignores the reality that the BSA exam manual and examiner criticism is all built around controls to be applied by account types and customer activities. It follows that de-risking will be similarly broad. This response naturally leads to a reduction in access to the financial system that harms the economy, harms legitimate businesses, and harms our financial and national security. Banks are responding rationally to the regulatory and reputation risk created by the regulators, who should in turn acknowledge responsibility for this counterproductive result that undermines financial inclusion.

Community depositories are more than meeting their unfunded BSA reporting obligations, and the overall insured depository industry is filing one million SARs per year. We cannot be held to be guarantors of the legality of our customers' activity. We need to get back to pro-partnership policies with the government that respect banker judgments about whom they bank with and report suspicious activity on. Law enforcement and regulators should take action against the real wrongdoers, leveraging depository information reporting requirements with their expertise and superior law enforcement resources. Banking institutions should not be either surrogate regulators or surrogate targets in this partnership.

<u>12:00 Luncheon for Council and Board Members in the Board Room</u>