

## Record of Meeting

Community Depository Institutions Advisory Council  
and the Board of Governors  
Thursday, April 2, 2020

### **1. What is being done or is in preparation to manage current and potential challenges?**

Council members have reported the following preparations being done by institutions in their Districts to manage current and potential challenges associated with Covid-19:

- Institutions are closely following CDC guidelines to reduce the risk of transmission of the virus, including social distancing, enhanced cleaning of facilities, employee hand washing, and other practices. Employees with any symptoms are directed to stay home.
- Most banking conditions have predominantly shifted from lobby operations to drive-through, ATM, online, and mobile transactions. In-person meetings are avoided unless absolutely necessary.
- Remotely working from home is encouraged when possible. Some Council members reported technology difficulties, including a lack of intranet infrastructure and cybersecurity challenges.
- Institutions are providing additional and flexible time off for employees and utilizing reduced and rotational staffing, including by dividing key operations between multiple sites to ensure continuity of operations.
- Customer-contact service centers are being fully staffed to meet demands.
- Institutions are reviewing existing portfolios to identify customers who could have the most exposure to significant business interruption in order to enact or consider loan restructuring, loan forbearance, and waivers of CD early withdrawal penalties, overdraft fees, and other customary fees.
- Multiple Council members reported increasing cash orders in order to fill deposit withdrawal demands, and one Council member noted a decrease in cash deposits from business customers due to government-mandated closings.
- Strengthened communications were noted in several Districts among institutions and their employees, customers, and directors, allowing for real-time information flow and potential streamlining of decisions.
- One Council member noted the inclusion of “pandemic” or “Covid” designations on those accounts affected that require special treatment or attention, in order to allow for reporting queries for bank and regulatory review.
- Some regional banks are beginning to close their branches in rural markets, raising concerns about an increasing lack of access to credit for rural customers. As a result, pressure is increasing for community banks to fill essential gaps in service when community bank resources are also under stress.

- Community depository institutions (CDIs) are monitoring their third-party vendor relationships. There are increased risks of vendor service reductions or failure at all levels, including from essential core processors.
- Smaller CDIs expressed difficulty in quickly adopting the technologies required for their employees to work from home, leading to other risks and challenges, including cybersecurity concerns.

**2. How are prospects and weaknesses expected to develop across consumer and client business lines in an uncertain economy and in the face of a health crisis? Business lines might be differentiated by:**

**a. *Commercial & Industrial (C&I) Lending***

- Across all Districts, the impacts to the service and hospitality industries were immediate and significant, resulting in requests for loan modifications by customers in order to combat liquidity challenges.
- Multiple Council members reported a reduction in or the elimination of new C&I lending in certain affected industries.
- Newly implemented U.S. Small Business Administration (SBA) lending programs are anticipated to be popular and beneficial, making training of staff on the SBA process a top priority.
- There has been high interest in the Paycheck Protection Program (PPP), and smaller CDIs have been overwhelmed with calls from borrowers. Many Council members expressed concern over the clarification of details of the lending program and how CDIs inexperienced with processing SBA loans can quickly implement the PPP, which could result in some banks and their customers being left behind.
- There is a significant risk that more sophisticated users of SBA products and systems will dominate access to funding, perhaps channeling resources away from many businesses most in need who may not have experience with SBA products.
- CDIs, like others, cannot see through to the long-term implications of the crisis for businesses, but it is possible that there will be significant ramifications for CDIs, including difficulties for businesses in servicing their debt obligations during an uneven recovery.

**b. *Commercial Real Estate (CRE) Lending***

- The effects on the commercial business lending sector will directly impact the many categories of CRE portfolios, including hotels, retail centers, and multifamily and office buildings.
- Prolonged business interruption will stress assumptions underlying underwriting and debt servicing capacity. Vacancy rate assumptions are likely in question, particularly for multifamily and office portfolios. Underwriting standards for sufficient levels of customer reserves are under review for new loans.

- The lower interest rate environment anticipates and encourages refinancing of existing loans.
- The effects on CRE portfolios could potentially lead to more conservative underwriting in the future.

**c. *Residential Lending***

- The majority of Council members reported a surge in residential mortgage and refinance applications due to historically low rates.
- Refinance applications outnumber the new purchase requests, and in many cases, the number of applications has overwhelmed the existing capacity of institutions to process the applications, resulting in increased interest rates to cover costs and meet demand.
- Social distancing and office closures have hampered the ability to perform appraisals, and title company and local government office closures have made it difficult to file deeds and mortgages.
- Council member institutions reported that a prolonged shutdown will likely result in decreased lending activities, a spike in delinquencies, and loans that become unsaleable to investors because of sudden borrower unemployment.
- In one Council member's District, nonbanks originate 50% of home mortgages and a vast majority of FHA loans, resulting in significant exposure to the market and economy because nonbanks are not well capitalized and lack the diverse lending commitments associated with the structure and regulation of CDIs. Other Council members expressed similar concerns.

**d. *Consumer Lending***

- Some Council members noted an initial increase in consumer lending, likely due to individuals trying to "get out ahead" of the expected economic downturn.
- Council members are expecting an increase in demand for emergency, unsecured funding as unemployment rates increase. Some institutions are tailoring products to bridge the gap between initial unemployment and the receipt of government-sponsored assistance or return to work.
- Credit card and student loans are at most risk of default, but with elevated unemployment, all consumer loans will suffer. Delinquencies will increase, as will losses, due to the economic downturn.
- Multiple Districts reported a significant drop in auto lending, in parallel with decreases in auto production and the increased likelihood that auto manufacturers will offer attractive financing in order to move existing inventory.

e. *Other Business Lines*

*Agricultural*

- The significant volatility and uncertainty surrounding agricultural commodities, coupled with large declines in oil and gas prices, has the potential to overburden an already financially stressed market.
- Low commodity prices and reduced production due to the wet conditions during both planting and harvest last season have put farmers in a weak position coming into the pandemic.
- While the pandemic may not directly impact farm production, there is concern about meat processing plants having to shut down, which will have a major ripple effect on cattle and pork operations.
- Many different sectors of the agriculture industry are under great stress due to the sudden stop in economic activity. For example, milk producers are being significantly impacted due to decreased demand from the closure of schools and their lunch programs.
- Despite the impressions that might be drawn from empty store shelves, there is no appreciable flow-through to demand for agricultural products or to income gain for farmers.

*Wealth Management*

- Wealth management is stressed due to market declines and uncertainties.
- Fee income will decline as investors go to cash and their portfolio balances decrease due to market declines.
- CDIs are staying in constant touch with customers, but customers with strong cash positions are content with cash for the time being and not ready to put their money back to work in the market.
- Many other customers are in shock from financial market drops, and that shock will increase as quarter-performance results are received.
- Not-for-profit organizations are being negatively impacted, as the market turmoil has led to diminishing inflows of funds to support their operations.
- Municipalities are a growing concern, as state and local governments will see their revenues dry up in the economic downturn.

**3. What are the expected tools and challenges for mitigation efforts by community depository institutions in a worsening economy?**

*Tools*

- Council members noted that institutions are being responsive to customer needs during the pandemic by providing flexibility, including by granting loan forbearance, waiving fees, and offering short-term loans.

- Proactive communication is essential with customers to ensure that they are aware of the resources available to them.
- Council members noted that flexibility in regulatory examinations and oversight expectations for ALLL funding, earnings, credit quality, and capital would be helpful in mitigating potential challenges facing banking customers. Additionally, waiver of the troubled debt restructuring (TDR) definition and suspension of the Current Expected Credit Losses (CECL) accounting methodology would increase the capacity of lenders to support borrowers and the economy during the crisis.
- SBA disaster lending programs and other government-sponsored relief legislation will be essential to support the economy.

### *Challenges*

- The precipitous and unanticipated decline in interest rates will significantly pressure net interest margins and net interest income.
- With the increase in potential loan forbearance, restructuring, and other loan modifications, there is confusion as to how these concessions will be classified by regulators and external accountants.
- Monitoring of credit and liquidity risks will also be a challenge. While early emphasis has been placed on loans to consumers and to hospitality, tourism, and restaurant operations, the Council's consensus is that this is a broader issue. In most Council members' Districts, loan accommodations and modifications are being used case by case rather than portfolio-wide.
- The pace and volume of change and uncertainty created by legislative actions, regulatory actions, and state and local actions has been overwhelming.
- There is a lack of clarity around availability and implementation of emergency programs and requirements to identify and document actions sanctioned under these relief programs.
- Council members also expressed a heightened awareness and monitoring of cybersecurity risks.
- Different levels of familiarity and comfort with the SBA were highlighted, as were questions about how to structure these relief program loans and whether regulators could provide greater assurance about the future treatment of these loans.

#### **4. What challenges might community depository institutions face in managing risk, liquidity, capital, ALLL, cyber breaches, and human resources:**

##### **Risk:**

- Ensuring that decisions designed to enable customers to remain solvent in the short term do not affect asset quality in a way that hampers a CDI's long-term viability.

- TDR calculations that force credits to be placed into buckets that might lead to adverse treatment for the client or the bank, impeding the ability of both to invest in growth-oriented activities and relationships.
- Interest rate margin pressure. Rising credit risk for existing assets, and identification of troubled assets versus assets in need of temporary relief.
- Management of expectations for customers' responsibilities in a rapidly changing regulatory environment based on new legislation.
- Regulatory compliance. Cybersecurity and fraud risks.

### **Liquidity:**

- While there have been no reports of liquidity runs, institutions are making sure they have access to all funding sources.
- Council members noted that liquidity tightening may be triggered by reduced paychecks, forbearance on loan payments, drawdowns on available lines of credit, and new loan growth.
- Availability of bank lines of credit and Federal Home Loan Bank advances may be necessary to meet demand.
- If the pandemic is prolonged, some Council members foresee higher demand for cash as customers hoard currency due to uncertainty and fear.
- It is critical that regulators continue to emphasize their oversight and the safety and soundness of financial institutions.

### **Capital:**

- Council members' report that capital does not appear to be a current concern for CDIs.
- However, the potential for capital erosion exists dependent on the length of the pandemic and the depth of the related economic contraction.
- A steep economic decline followed by a slow recovery would result in lower credit quality and an extended period of higher charge-offs.
- Though CECL was intended to maintain a procyclical loss allowance to buffer against future losses, CECL's dependence on economic forecasts might have the opposite effect.
- Large and volatile forecasts of higher unemployment and lower GDP growth would boost CECL loss allowances at the worst possible time, limiting CDI capacities for forbearance, mitigation, restructuring, and extending new credit. CECL may have a large negative impact on capital if it remains in effect for some CDIs, or if other CDIs are pressed for early adoption.
- CECL may have a dramatic impact on the reserves for many institutions, which would strongly encourage smaller balance sheets and less lending.

**ALLL:**

- Most Council members indicated an adequate ALLL, but there was consensus that deteriorating economic conditions or a prolonged disruption in the economy will increase their ALLL, perhaps substantially.
- Implementation of new regulatory guidance, specifically CECL, is of particular concern to institutions as it relates to a potential disincentive to make loans with the necessary provisions in the current rate environment.
- There is concern across Council members' institutions over how to determine the qualitative factors for CECL in the current environment, given the indeterminate length of the pandemic and other factors.
- Delinquencies, bankruptcies, and TDRs will increase significantly.

**Cyber Breaches:**

- Several Council members are focused on the reliability and security of their institutions' business continuity systems. There is a fear that secondary and tertiary systems that are now being used will expose new vulnerabilities that are not necessarily present under normal operating procedures.
- Concerns were noted regarding cyber events at bank service providers that could ultimately shut down or impair services by financial institutions.
- Cyber criminals utilize disruptions as an opportunity to strike as employees become distracted.
- Most cyber issues are a result of employee error on phishing emails. With employees uncertain and scared about COVID-19, these threat actors are preying on them by portraying themselves as trusted organizations.
- Additionally, there has been an uptick in consumers falling prey to cyber frauds outside of institutional breaches.
- Cyber breaches are the paramount concern regarding staff working remotely. IT staff are generally stretched to accommodate the remote workforce, thereby potentially increasing vulnerability to breaches.

**Human Resources:**

- Council members commented on employee concerns about continuing on-site work and the associated risks to their health and the health of family members. Staff are anxious but handling the crisis well and providing a tremendous service to consumers and their communities.
- Small community institutions are of particular concern, as they have limited staffing; therefore, operations could be easily disrupted if a significant number of staff are out sick--potentially resulting in complete branch closures.
- Rural communities are particularly affected due to the low number of available branches in their geographic areas.

- Multiple Council members noted challenges in preparing for the eventual first COVID-19 case among staff and establishing protocols that allow client and facility interaction to remain a priority.
- Institutions are monitoring recent changes to the Family and Medical Leave Act, along with other recent employment legislation, to ensure that proper procedures and benefits are being provided to employees.

**5. In the view of Council members, what actions could prudential regulators take through bank supervision to address economic impacts in affected communities?**

Council members and Districts appreciate the quick actions taken by the Federal Reserve and find the guidance and relief that have been provided by regulators encouraging. One Council member noted that the Federal Reserve understands the importance of having strong community banks in a “disaggregated” banking system. The Council members realize that the Federal Reserve can only do so much and that other government agencies and departments need to step in. Several Council members reported that their institutions are pleased with the “liberalizing and opening up of regulations” so that they can serve their customers. One Council member expressed how helpful it was when Federal Reserve examiners proactively reached out to offer support.

Prudential regulators have already announced a number of steps to facilitate responses to the crisis. Some of these actions are restated below because it is essential that agency leaders provide detailed guidance and instructions to their staff, including field examiners working with individual institutions. With that in mind, the agencies could take the following supervisory actions to help address economic impacts in affected communities.

- Provide regulatory guidance for examiners on the significant actions required by bankers to keep consumers out of bankruptcy and sustain businesses, such as loan extensions, skipped payments, TDR, relaxing of liquidity and capital requirements, and redefinition of core deposits and/or wholesale deposits. Overall, ensure openness and flexibility to institutions regarding the mitigation strategies being used to manage credit risk along with critical efforts to assist customers.
- Postpone CECL to enable institutions to preserve capital to allow for banks to be active lenders and aid in the recovery of the economy.
- Engage the Financial Accounting Standards Board (FASB) to obtain more relief for banks regarding CECL, TDRs, and leniency with borrowers who often run 30 days past due but do pay—it appears that only those borrowers who are current at this time qualify for any special treatment.
- Moderate regulators’ approach to on-balance sheet liquidity given the current Treasury market volatility and the ability of banks to readily obtain liquidity if needed.
- Issue further guidance on midterm examinations, including required face-to-face access to banks’ portfolios.
- Expand access to FDIC insurance to include all transaction deposit accounts.



- Consider relaxing Regulation D limitations on transfers from savings and money market deposit accounts that are made by telephone or mobile applications.
- Delay CRA compliance examinations to allow institutions to remain focused on their own direct safety and soundness and to utilize all resources and staff to deal with the current demands in this new environment.
- Encourage flexibility in external audits and/or regulatory consideration of external audits as banks provide payment relief to borrowers impacted by the crisis.
- Assist smaller banks in atypical ways by providing targeted support for technology, information sharing, and education.
- Intensify scrutiny of core provider cybersecurity mitigation and recovery efforts.
- Reconsider traditional approaches to examination and enforcement of regulations, such as the Equal Credit Opportunity Act (Regulation B). The Council strongly affirms the importance of maintaining consumer protections as community depository institutions respond to the crisis, but extraordinary response efforts will require flexibility and creativity.
- Address the significant risks that nonbank lenders pose to investors and to service continuity for their customers, as well as challenges that CDIs may face in filling resultant gaps in community financial services.
- Provide reassurance to the public from leadership that financial institutions will continue to be designated as essential and will not be closed during the crisis.
- Reintroduce a guaranty of all transaction accounts to assure CDI depositors. Though CDI deposits have been stable, some Council members feel that pandemic programs to support assets held by money market mutual funds and other initiatives might reduce retention of essential deposits needed by CDIs and the communities they serve.
- Allow drive-by appraisals as acceptable for loan origination until the crisis is contained for the safety of appraisers, homeowners, and tenants.
- Above all, prudential regulators must understand that rapid delivery of the many responses to the COVID-19 crisis will require CDIs to implement programs and procedures that have no precedent. Some community institutions will face enormous logistical and technological hurdles. Supervisors' assessments of and responses to any resulting technical problems should take account of these challenges and of the institutions' intent in serving their customers and communities. Community depository institutions are and will be critical, not only as part of the solution to the immediate crisis but also for the long-term economic recovery of the nation.