

RECORD OF MEETING

Federal Advisory Council and Board of Governors

Friday, September 19, 2014

Item 1: Current Banking Market Conditions

What is the Council's view of the current condition of, and the outlook for, loan markets and financial markets generally?

- Current conditions in the financial markets remain constructive, with a slow but steady pace of economic growth in the first half of 2014. U.S. business optimism continues to increase, consistent with generally improving U.S. economic conditions.
- The majority of investors believe that the Federal Reserve rate hike will occur in the second quarter of 2015. Although FOMC policy remains accommodative, uncertainty remains regarding how markets will respond to the end of large-scale asset purchases.
- Geopolitical risk is seen as the highest risk for global financial stability. Recent news of weaker-than-expected economic data from Europe is also causing some unease in global financial markets.
- Expanding demand for goods and services, rising business confidence, and still-low interest rates establish fertile conditions for ongoing loan demand. Overall, members believe that loan demand should remain stable in most commercial categories and in non-real-estate-related consumer categories such as auto and credit card; however, competitive pressures will continue to influence pricing on higher-quality credits.

(A) Lending to Small and Medium-Sized Enterprises (SMEs):

Has credit availability for, and demand for credit from, SMEs changed significantly recently? Have there been changes in lending standards for these borrowers?

- There has been no recent observable change in availability of credit for SMEs, which has been readily available and abundant for some time.
- Lending activity is fueled by intense competition for very creditworthy borrowers, and the desire to demonstrate loan growth has resulted in continued relaxation within pricing and structure. Both banks and nonbanks are attempting to capture additional market share in the SME segment, many of whom would not have targeted this segment in a significant way in the past.
- Demand for credit is improving but at a slow pace. While members observe positive momentum among SME customers, it is still a growth-challenged lending segment, especially as compared to consumer and commercial lending. Core business lending to support working asset growth is up, while loan requests to support real estate activities remain muted and uneven across markets.
- Results from the July 2014 Senior Loan Officer Opinion Survey (SLOOS) indicate continued easing of lending policies for C&I loans to firms of all sizes. Respondents continued to report widespread easing on the spreads of C&I loan rates over their cost of

funds. In addition, across all firm sizes, a significant fraction of banks reported having reduced the cost of credit lines and decreased the use of interest rate floors. Almost all respondents that eased their policies cited increased competition as an important reason for doing so.

(B) Commercial Real Estate Lending:

Have there been any changes in the Council's view of the challenges in the commercial real estate market? How are commercial real estate loans performing compared to your expectations?

- Commercial real estate markets have improved for quite some time and are currently stable. Members generally expect continued growth and asset quality improvement in this sector. Prices have now returned to their pre-recession levels in major markets and are nearing pre-recession levels for markets both large and small.
- Activity in 2014 continues to be defined predominantly by growth in opportunities among institutional sponsors (real estate investment trusts, pension fund advisors, fund sponsors, and national investors).
- Strong competition for financing quality projects is putting pressure on both structure and pricing. Multiple sources of financing for commercial real estate have returned to the marketplace, including commercial mortgage-backed securities, providing property owners with various alternatives to traditionally structured debt.
- By property type, multifamily developments continue to perform at very high levels and trade at very low capitalization rates. Apartment loans remain the choice product for lenders.
- Industrial demand is strong in select major metropolitan markets, with vacancy rates at levels that have spurred new construction activity, particularly for buildings designed as large distribution facilities.
- Office and retail loans remain bifurcated, with Class A properties viewed very positively and lower-quality properties priced dramatically higher by lenders.
- Hotel lending is viewed as more attractive as room rates and occupancy move towards record levels.

(C) Construction Lending:

What is the Council's view of the availability of credit for construction and development projects? Has the Council seen any changes in the demand for construction loans recently?

- The supply and availability of credit for commercial real estate construction projects remain abundant but vary by both property type and location. Loan terms continue to become more aggressive. The intensity of competition to finance high-quality projects has accelerated over the past six months, as lender demand is exceeding market supply.
- Demand for construction loans in general has remained consistent over the last several quarters, with multifamily projects accounting for the majority of the demand. Large multifamily construction loans for experienced developers in major metropolitan areas regularly attract multiple lenders competing for their business.

- Conversely, the availability of credit for speculative office or retail development remains subdued in the Mid-Atlantic and Southeast regions. Investor demand for this type of credit is also limited, given that both of these property types are lagging the recovery.
- Members report a modest amount of new construction activity and loan demand for large bulk industrial facilities in port cities and major transportation hubs, as the outlook for this sector has continued to improve.
- Loan availability and demand for hospitality projects continue to improve, as property performance metrics have returned to pre-recession levels.
- There has been an increase in both demand and credit availability for single-family construction loans with mid-sized local and regional builders. However, this sector, post-recession, continues to be dominated by the national builders, as many of the smaller builders failed in the downturn.
- Quality subcontractors seem to be in high demand and, consequently, construction costs are on the rise. Compounded with higher land costs, the development of new projects is becoming more difficult to justify, which is putting pressure on the development community's ability to source cost-effective equity, particularly for multifamily housing.

(D) Agricultural Lending:

Have there been any recent changes in agricultural lending?

- Members indicated varied growing conditions depending on precipitation levels. Heavy rains improved soil moisture levels in the Atlanta, Chicago, Minneapolis, Kansas City, and Dallas Districts, although there were isolated reports of hail and flood damage. While widespread rains improved prospects for Texas row crops, especially cotton, they came too late to aid the Texas wheat crop, which is expected to be down 20% this year. Persistent drought in the San Francisco District led some producers to curb new planting in order to conserve water for permanent crops.
- Competition for agricultural lending among financial institutions remains strong. Most syndicated facilities are greatly oversubscribed, and, in general, pricing of facilities is falling and loan terms are less restrictive.
- The largest factor for lending in this sector has been the significant drop in commodity prices for the primary crops of corn, soybeans, and wheat over the past year, which has translated into higher loan demand and lower repayment rates among grain producers, whose upcoming fall harvest season is likely to produce a record yield. The generally lower commodity prices for cash crops continue to stress those producers, resulting in increased watchlist credits. Producers, in general, began the year with strong equity and working capital positions to weather lower prices.
- Lower prices of feed, combined with strong livestock prices, have been beneficial to livestock producers during the year and appear poised to persist for several months.
- While members report few signs of substantial stress, farmland prices, along with cash rents, will be under pressure to adjust downward due to the lower commodity prices, although there remains limited evidence that farmland is overly leveraged or experiencing any cash flow constraints at the macro level.
- Major farm equipment manufacturers and dealers have announced employee reductions in anticipation of reduced capital equipment spending, which reflects a combination of lower farm revenues and current laws governing accelerated depreciation.

(E) Consumer Lending:

What changes have you seen in consumer lending?

- Consumer lending has been reasonably strong in terms of loss performance, but lenders retain a cautious eye toward the implementation of rules (e.g., fair lending), the maturation of recently created agencies, and what impact these agencies will have on this loan category. The consumer lending environment is extremely competitive as banks work to comply with tightened regulatory standards while seeking ways to increase loan growth. Total consumer loans outstanding are up 3.4% from a year ago. Almost all growth took place within the auto loan category, which was up almost 10% from the year-earlier level. Net loan loss rates remain relatively low at 2.2% for all consumer loans, 0.5% for auto loans, and 3.7% for credit card loans.
- Consumer borrowers remain generally cautious. While consumer attitudes and willingness to spend appear to be improving, the areas in which consumers are obtaining new debt remain uneven.
 - Consumers seem most willing to obtain new debt for the purchase of automobiles. Competition in the auto lending market is increasing as lenders tighten margins, extend loan terms, and expand into subprime.
 - Consumers also seem willing to obtain new debt in unsecured and deposit-secured loans and lines. Demand is increasing for variable-rate home equity lines of credit (HELOCs) due to improvements in home prices and other economic indicators. The industry is seeing a shift from equity loans to equity line production primarily due to increased rate differential, and lenders have returned to introductory rates in the equity lending market. Payoffs in the home equity line of credit product have continued to slow as a result of reductions in mortgage refinance volumes.
- There is a great deal of regulatory concern (7/1/2014 Interagency Guidance) related to a potential second housing “bubble” due to payment shock caused by end-of-draw HELOC events over the next five years. The impact will vary by institution based on several factors, including relative HELOCs outstanding, volumes entering the repayment period over the next five years, client selection (quality of borrower), and geography (market value trends).

(F) Home Mortgage Lending:

What changes have you seen in the home mortgage market in the past three months? What is happening to house prices?

- The housing recovery continues at a moderate pace but is uneven across markets.
- Mortgage rates remained stable throughout the first half of the year. Industry volume is now projected to be down 40%-45% in 2014. Purchase activity is softer than expected and relatively flat relative to 2013. Refinance volumes are continuing to decline and are just 30% of 2013 levels.
- Home prices are on an upward trend. The median sales price for existing single-family homes was \$223,300 in June, up 5% from May and 4% from the June 2013. Home values in the high-end market are anticipated to remain stable to slightly increasing.

- Over the last three months, mortgage originations continued to migrate from a refinance-dominated market to more of a purchase market, reflecting the stable/improving economy and employment.
- Mortgage lenders continue to monitor the impact of the CFPB ability-to-repay/qualified mortgage rules, particularly on their nonconforming products. A Fannie Mae survey of lenders said the new rules have had little impact on lenders' business strategies, but most expect increased operational costs as a result.
- Residential mortgage market trends have largely been driven by the broader interest rate and economic environment over the past 12 months, which, without relief on these fronts, will continue to adversely impact the mortgage lending market.
- Mortgage loan portfolio quality has improved, as measured in reduced delinquency and lower loss rates (although both are high by historical standards). The increase in house prices has appreciably increased home equity, which partly explains the increase in consumer lending volumes and reduced loan loss experience. There remain, however, a high percentage of borrowers with negative equity, which presents an ongoing challenge to an improved housing market.

(G) Healthcare Sector Services:

What advisory services and financing do Council members provide to healthcare companies? What changes have you seen in banking services to the healthcare sector this year?

- Already an important sector for large commercial banks and other financial services providers, the healthcare industry is an increasing strategic focus and strong growth market for the banking industry, despite the uncertainty created by the Affordable Care Act. The healthcare industry continues to create new business models aiming to capitalize on today's evolving regulatory and economic environment.
- Healthcare companies broadly include hospitals, health systems, senior living owners/operators, health insurers, and service providers to healthcare companies. The three largest areas of concentration and exposure are hospitals (both for-profit and not-for-profit), homes for the elderly, and service providers.
- Council members' advisory services include acquisitions, divestitures, mergers, joint ventures, corporate restructuring, recapitalizations, spin-offs, exchange offers, leveraged buyouts, takeover defenses, and shareholder relations. Financing products for these companies include tax-exempt and taxable direct-purchase bonds and term loans, working capital and equipment financing, letters of credit to support publicly issued bonds, construction/mini-perm loans, loan syndications, derivatives, treasury management, and other core banking services. Members also originate, structure, and execute both public and private placement of a variety of securities, including equities, investment-grade and non-investment-grade debt, and related products such as royalty financing.
- From a financing standpoint, members generally report seeing elevated loan demand for hospitals and clinics. Low interest rate levels, coupled with increasing M&A activity, have continued to drive strong demand for credit and capital markets solutions.
- M&A activity continues to increase as strong health systems merge with other strong systems to achieve economies of scale made even more critical by the forces of healthcare

reform. Systems are also acquiring smaller, usually weaker, hospitals to increase market share as well as bring economies and needed financial support to smaller organizations.

- Members report a significant increase in the level of new senior housing construction in all levels of care: skilled nursing, memory care, and assisted living.
- The healthcare sector's move to electronic records and technology, especially in hospitals, has also created an external shift towards managing vendor relationships electronically. The sector seeks partnership with banks to support the following:
 - electronic processing of cash flowing in and out of the business,
 - electronic storage of information, and
 - internal operating controls (dual control).

Item 2: Economic Discussion

Do Council members see economic developments in their regions that may not be apparent from the reported data or that may be early indications of trends that may not yet have become apparent in the aggregate data?

Economic Activity

- For the second quarter and early indications of the third quarter, members reported that economic growth has generally picked up from the disappointing first-quarter levels when winter-related issues were impactful.
- North Dakota and Texas exhibited stronger growth led by energy, while Miami, San Francisco, Boston, and New York City were also strong.
- On the weaker side, rural Maine, Vermont, and Western Massachusetts, along with New Jersey, Illinois, Michigan, and New Mexico, were well below national growth rates in economic activity.
- Areas with lower growth have seen less pressure on wages, slower recovery in housing prices and sales, and less commercial loan demand.

Employment and Wages

- Job growth continues to be modest, with some noticeable areas of strength and weakness.
- In most areas, the loss of jobs in the government sector seems to have abated, with only a few exceptions, particularly in the Fifth District.
- Almost every member reported a need for more skilled labor, including manufacturing and construction. Some economic growth may be held back by the lack of qualified labor. Pressure on wages in these sectors has been reported in every region.
- In the First District, some community colleges have noted a decrease in applicants and enrollments, attributed to the improved job prospects available to their typically older and lower-income pool. This segment will often choose a current job, even low paying, over a return to school for better future job prospects. This trend may reflect more hiring even for lower-skilled positions.
- Unskilled labor markets are not reporting any wage pressure, as supply remains sufficient, with overqualified applicants available for most jobs.
- The large number of underemployed and unemployed workers, particularly those with less advanced skills, is putting downward pressure on overall wage growth, but this masks

potential pressures in the more skilled areas where there may actually be a shortage of labor.

- The relatively modest growth in overall household income has not been equally shared by all. Lower-income groups, who depend the most on labor market income, have participated the least in the recovery, which could have a significant impact on consumer spending patterns.

Business Sector Growth

- Members continue to generally report strengthening in the manufacturing and energy industries, including construction within these areas as well as multifamily housing.
- C&I loan demand remains in a slow growth stage, with considerable competition for good loans. Fixed rate spreads against LIBOR-equivalent rates on loans under \$25 million have widened by 10-25 basis points over the past year, while spreads on larger fixed-rate loans have actually narrowed by about 20-25 basis points. Spreads on floating LIBOR-rate loans have fallen by about 20 basis points over the past year, in all size categories, indicative of more lenders trying to limit their exposure to rising rates.
- Livestock and dairy markets within the Ninth District look strong due to lower feed costs and higher sales prices, while those growing the feed crops are experiencing the reverse. The drought in the western part of the nation may result in some increased pricing pressure on such crops, but it is not yet evident in the markets.

Commercial Real Estate

- The commercial real estate markets generally show continued strengthening.
- Multifamily housing remains a bright spot, although some credit managers in certain regions continue to be concerned about an overheating of this market. One member expressed concern that in a number of popular metropolitan submarkets, rents are exceeding the ownership-equivalent costs.
 - This may reflect a heightened preference for renting due to uncertainty over job security or a preference for urban versus suburban living among many of those in their twenties and thirties. It could also reflect the difficulty that many in that age group face in obtaining a mortgage under the new QM rules, given their student loan obligations and the difficulty in saving for a down payment. Although the cost of renting may exceed the cost of owning, they may not be able to break through the mortgage barriers.
- A number of Districts reported that despite high demand for multifamily product and high availability of credit for the product, there is often a shortage of suitable building locations. Within the Sixth District, for example, there is very little construction despite high demand and low vacancy rates.
- The Eleventh District is showing solid growth in leasing activity and rising rents for office and industrial properties, with new construction occurring. The Ninth District reflects the opposite, with rising vacancy rates and a softening in office and retail properties, offset only partially by strong demand for warehouse space.
- Within the Eighth District, farmland prices have stopped rising and, with falling commodity prices, might actually begin to drop. The drought could do the same in other parts of the country.

Residential Real Estate

- Mortgage activity, both on the refinancing and the purchase side, has been below analyst expectations. Refinances in 2013 totaled \$1.1 billion, or 66% of the mortgage origination volume, and have fallen to about \$200 million in the first six months of 2014. Purchase volume of about \$273 million for the first six months is down 15% from the same period in 2013.
- Banks have been keeping a larger percentage of mortgage volume on their books as opposed to selling. The jumbo market, in particular, has become a portfolio play, as both the desire for high-quality assets and concerns over doing non-QM underwriting on these loans (often necessary for self-employed borrowers) makes holding rather than selling more attractive.
- First-time homebuyers seem to have disappeared. They normally account for 50% of existing home sales and have fallen to about 28% for the first half of this year. Misconceptions about the availability of mortgages for those with lower down payments, and about QM income requirements, may be discouraging certain buyers.
- Supply of houses is also reported as weak, with an inventory of about 2.3 million homes, or 5.5 months' supply, which is about half the levels seen in 2007.
- The construction of new-inventory single-family homes is likewise weak. Every District reported difficulties for developers to find suitable properties to build on, along with concern over rising material and labor costs.
- Housing sales reflect the prior comments. New home sales fell almost 5% during the first half of the year, while existing home sales grew for 3 consecutive months to end the first half of the year.
- Housing prices follow the rest of the data. Nevada and Oregon were very strong, as were coastal city luxury condo prices. The Fourth District saw year-over-year increases of 6.2%, but prices remain 18% below the peak, with 24%, or twice the national average, of homeowners underwater on their mortgages.

Consumer Spending/Borrowing

- Consumer spending was mixed. Non-auto sales were reported as moderately improved to strong in eight of the twelve Districts. Only the First, Second, Fifth, and Seventh Districts reported flat to declining sales.
- Auto sales continue to be very strong, leading to increased indirect auto lending by financial institutions. The recent increase in 60-day late payments on auto loans from 0.87% last year to 0.95% this June might reflect a loosening of credit standards to allow more lower-FICO-score borrowers access to credit.
- Home equity lending is improving but remains low except in the First District. A reluctance to assume more household debt continues to be prevalent, but improving job prospects and building confidence may reverse this trend. Lower debt-servicing ratios demonstrate healthier household financial conditions and indicate a capacity to make purchases that may have been delayed for years.
- Spending on durable goods continues to improve in most Districts.
- Members agree that the unequal participation of lower-income households in the recovery is a negative in terms of a full rebound in consumer spending and borrowing. Luxury goods continue to do well, but more basic retail items, excluding necessities such as food, continue to lag. With 12% of homeowners still facing negative equity in their home, their

capacity to borrow against that equity has been eliminated. With a large group of younger citizens faced with daunting student loan debt, options for buying a home, or spending to furnish and remodel one, are likewise limited.

Item 3: Big Banks

Some regulators have suggested that the financial services industry needs to explain how the economy and the public good benefit from the existence of large, diversified banking institutions. What are the costs and benefits of the existence of the largest banks? What are the unintended consequences of reducing bank size?

At the outset, it is worthwhile to define “large banks.” While there is no clear trigger point for size, we define “large banks” as those of sufficient balance sheet size or complexity to be termed a global systemically important bank (G-SIB).

For the record, post-crisis regulatory steps aimed at risk mitigation have materially increased both liquidity requirements and risk- and leverage-based capital requirements for the largest banks:

- Basel III and the CCAR process have driven change in institutional composition and managerial focus. This includes material investments in risk management, operational limits, staffing levels, and auditing processes.
 - The impact is tangible and evident: Tier I common equity has expanded significantly, with cash and liquid security holdings keeping pace, while leverage has been substantially reduced and is a constraining factor to further growth.
 - The Dodd-Frank Act’s enhanced prudential supervision, coupled with the industry’s fundamental structural changes and greater business diversification, has significantly reduced the likelihood of large institutional failures.
- Banks have also enhanced their commitment to building and protecting a durable runway by extending funding terms, increasing liquidity, and implementing the operational components necessary to support recovery plans.
 - G-SIBs have materially reduced their exposure to “runnable” forms of wholesale funding, and progress continues on Fed-mandated tri-party reform to address counterparty risk.
 - The Liquidity Coverage and Net Stable Funding Ratios (LCR and NSFR, respectively) will impose a binding minimum on this durability.

In aggregate, the regulatory framework governing G-SIBs has specifically addressed post-crisis concerns. Moreover, it is unclear that domestic G-SIB size is problematic either in terms of business complexity or relative to GDP. For example, the combined total assets of the six largest U.S. banks amount to approximately 65% of GDP; this compares to 145% in Germany (comprising three banks), 170% in Canada (five banks), 325% in the United Kingdom (four banks), and 435% in Switzerland (two banks). In addition, U.S. G-SIBs are no more complex than international universal banks and have the joint tailwinds of stable domestic economic growth and better earnings diversification.

Benefits of Large Banks

G-SIBs are an essential element of U.S. global economic leadership. Their products and services extend beyond deposit-taking and lending to include all elements necessary for financial relationship management for large, global companies. G-SIBs can meet such needs because of the magnitude of credit they provide, the complementary products and services they offer, and the geographic reach they wield. Large banks also foster economic growth and job creation; this is accomplished directly, through employment of workers and utilization of the services of other businesses, and indirectly, through the extension of credit necessary for economic development.

- **Large, diversified nonfinancial and financial corporations need the services of large banking institutions:**
 - *Efficiencies of scale and scope.* G-SIBs provide a suite of complementary services that enable them to deliver multiproduct solutions that are responsive to client needs. Moreover, the global transactional services provided by large banks cannot be replicated as efficiently or cost effectively by a collection of smaller financial services providers.
 - *Global presence.* Multinational corporations depend on a wide array of products and services to match the breadth and geographic diversity of their operations, which may include cash management, cross-border payments and settlement, trade finance, and management of interest rate, credit, and foreign exchange risks in numerous countries.
 - *Balance sheet strength and powerful distribution capabilities.* Large corporations have substantial credit needs that may be met by a variety of loan products or through underwriting of debt and equity offerings of significant size. Large financial institutions' balance sheet strength and distribution capabilities, backed by trading operations, market-making, and global institutional and retail distribution networks, are critical to serving these needs.
 - Small and medium-sized banks and financial institutions themselves depend upon their larger counterparts' resources and balance sheet for their funding and business needs.
 - *Technology-based service innovation.* The development of Internet and telephone banking options, ATMs, and other service-level innovations, which primarily benefit retail customers, has been driven by banks capable of absorbing the costs of research and development.
- **G-SIBs play a critical role in supporting U.S. economic activity:**
 - *Facilitating job creation.* The six largest U.S. banks employ approximately 1.1 million Americans. Every financial sector job creates and supports more than one additional nonfinancial sector job, multiplying the effects of this direct employment. Similar effects are achieved through the lending and credit support that large banks provide for globally active American companies: large corporations are the customers of many smaller businesses with whom large corporations transact.
 - *Spurring economic growth.* Large global financial institutions, which are active in many markets and countries, also contribute to U.S. economic growth and job creation by expanding the supply of credit and other financial services to emerging

- market economies, contributing to the expansion of trade flows and opening foreign markets to U.S. goods and services.
- *Primary dealer activity.* Most U.S. Treasury primary dealers are broker-dealer affiliates of large banking organizations, given the size and scale needed to support U.S. sovereign capital markets activities.
- **G-SIBs possess business strategies that enhance diversification and institutional soundness:**
 - *Reduced risk through business diversification.* Large banks are more diversified in their business mix and revenue streams, rendering them less vulnerable to the types of concentration risk which may be a source of instability for smaller banks. Adopting the lens of the financial crisis, the most troubled institutions were single-entity businesses; multientity firms faced fewer constraints in funding and were therefore likelier to weather the storm.
 - *Reduced risk through geographic diversification.* Regional downturns are less impactful on geographically diversified institutions for the same reasons that they benefit from business diversification. U.S. G-SIBs are particularly well positioned given the varying stages of economic recovery in which other regions find themselves.
 - **G-SIBs support a more efficient regulatory framework.**
 - *Large banks are uniquely capable of managing current regulatory demands.* Assembling a team that comprises the necessary operational, finance, risk, compliance, legal, and audit professionals to respond to and work with regulators requires firms to be well resourced. Given requirements in capital management and reporting, stress testing, and ongoing regulatory interactions, large banks have the scale necessary to bear these costs.
 - *Reducing bank size will increase the number of banks, exerting a significant regulatory tax.* It is far from clear that an increased number of institutions to be governed (an unavoidable byproduct of reducing size) will foster greater simplicity or less risk. Demand for the products currently offered by G-SIBs will continue. As such, it is likelier that diffuse oversight yields new regulatory blind spots. Australia and Canada offer examples of jurisdictions with large, concentrated banks that are economically right-sized and capable of performance despite adverse conditions.
 - *Inducing materially smaller institutions would guarantee that foreign institutions will become the primary financing arms for large national and global institutions.* As a matter of public policy, that kind of exposure to foreign banks cannot be a good outcome. It should be noted that most, if not all, major developed countries promote national banking champions.

Costs of Large Banks

The greatest potential cost of large banks is their risk of failure; by definition, the failure of a larger institution is costlier than the failure of a small institution, given the larger base of depositors and creditors. Just as community banks are potentially overexposed to localized and regional markets, large banks also have a diversity of exposures to markets around the world,

and severe downturns in multiple global markets may weaken a large bank's balance sheet more than a community's or regional bank's balance sheet.

Strong and effective mitigants exist for these risks, several of which are previously noted. Large banks are subject to heightened standards for capital, liquidity, and leverage through the enhanced prudential standards of the Dodd-Frank Act and the Basel-based capital and liquidity regimes. Large institutions are also subject to extensive capital and liquidity stress testing and recovery and resolution planning requirements, which foster discipline in corporate structure, preparation for adverse financial circumstances, and stronger capitalization and solvency.

Unintended Consequences of Reducing Bank Size

- *Reduced financing for the "real" economy.* A substantial portion of banks' assets consists of loans to individuals and businesses and securities issued by corporations. Reducing bank size means reducing loan portfolios and the securities market-making function of banks.
- *Higher transactional costs for cross-border activities.* Corporations attempting to execute cross-border transactions will face greater challenges arranging financing and expertise to support complex investments in multiple jurisdictions that grow the global economy and result in efficient capital allocation.
- *Reduced customer convenience and increased costs.* Clients have sought out the services of large banks given the greater convenience and potential cost savings of obtaining complementary services through a single platform. Reducing bank size interferes with clients' preferences and may lead to an increase in the cost of bank services through reduction of economies of scale.
- *Potential impairments to U.S. Treasury market access.* The U.S. Treasury Department would be forced to work with a broader range of institutions with smaller balance sheets to gain market access.
- *Smaller banks have greater exposures to local-scale risks.* Reducing bank size necessarily involves reducing bank diversity and concentrating banks' exposures in particular markets, making them more susceptible to localized or regional downturns.
- *Redirection of business conducted by large banks could weaken financial stability.* It is unclear whether activities redirected away from large U.S. banks would be assumed by foreign banks, undermining U.S. economic leadership, or by the less-regulated shadow banking sector.
- *Focus on size may be to the detriment of other risk identification.* Narrow focus on size may obscure focus on other significant risk factors, such as complexity, quality of infrastructure, and interconnectedness, and has the ability to impair benefits of scale and scope without achieving the benefit of offsetting risk reduction. In addition, the regulatory tax to be imposed by increasing the number of governed institutions cannot be ignored.

There has not yet been a compelling economic policy or risk case that larger institutions are by nature a worse alternative to smaller institutions, that they fail more frequently, or that a transition from large banks to small would create economic value and reduce systemic risk. The more appropriate distinction than size is measure of diversification. Monoline strategies, regardless of size, show the greatest exposure to disruption and potential for failure in the event of crisis.

As long as large banks create jobs, provide services, invest in projects that improve the customer experience, appropriately staff risk and control functions to meet operational requirements, and demonstrate prudence in management, should size be the dominant concern?

Item 4: Mergers and Acquisitions

Does the Council expect a trend in the banking industry toward greater consolidation as a result of increased capital and liquidity requirements, higher regulatory compliance costs, and uncertain future litigation costs? Are there factors that could mitigate increasing consolidation?

The Council sees continued consolidation over the foreseeable future, primarily due to sets of externally imposed factors and constituents (regulators and shareholders) and internal dynamics driving bank economics and management. These factors include:

- *Sheer overcapacity:* There exist roughly 6,700 depository institutions and approximately 96,000 branches within the U.S. banking system.¹ Technology advancements and changing customer behavior trends have reduced the need for banking centers on every street corner.
- *Operating challenges:* Commercial banking return on average equity (“ROAE”) declined to 9.5% in 2Q2014, down from 14.2% in 2Q2004.¹ This decline is due both to the low interest rate environment and to long-term structural changes in bank economics, including lower revenue from the Durbin Amendment, increased regulatory and compliance costs, higher deposit insurance premiums, and higher levels of common equity.
- *Potential for synergies and cost savings:* Given the operating challenges, bank mergers provide the opportunity for achieving synergies and cost savings, which can materially improve return on equity.
- *Improving credit quality and positive market receptivity:* Improving credit quality has reduced the risk inherent in acquisitions. Furthermore, immediate and longer-term positive market reactions to deals buoy buyers’ confidence.
- *Excess capital:* With strict limitations on capital repatriation, many stronger institutions continue to build excess capital in the absence of organic growth opportunities, and acquisitions are an effective way to effectively deploy capital.

With respect to factors that could mitigate increasing consolidation:

- *Regulatory cliff effects:* There exist arbitrary size thresholds (\$10 billion, \$50 billion, \$250 billion and \$700 billion in assets). The significant increase in regulatory expense at these various hurdles (stress tests, living wills, CCAR, LCR, etc.) inhibits the desire and ability of banks to consider M&A if a potential deal would cross a threshold.
- *Regulatory Approval:* Delays associated with AML/BSA and fair lending issues create significant transaction-related delays and uncertainty surrounding formal regulatory approval (e.g., MTB/Hudson and Bancorp South mergers). For deals greater than \$50 million, the average time frame for a bank transaction to close increased nearly 20% to

¹ Source: SNL Financial and FDIC. Subsequent footnotes in Item 4 cite this source.

177 days from 149 days in 2006.¹ This has a chilling effect on other potential transactions. Furthermore, many historically active acquirers are subject to enforcement orders precluding acquisitions.

- *Contingent risks:* The amount of litigation expense and regulatory exposure that a buyer may assume is unknown and may make any acquisition prohibitively expensive; additionally, a future crisis may be more difficult or costly to manage via “encouraged” mergers due to the significant legal expenses borne post-acquisition by JPM, BAC, et al.
- *Reduced interest in retail channels:* Low levels of interest rates and the ability to “desk fund” have narrowed the normal core funding advantage that branch networks provide. For example, pre-crisis in 2006, the typical cost of 2-year wholesale deposits was 5.40% compared to 2.01% for savings deposits (including money market accounts) or a spread of 3.39%. Today that spread is only 0.67%.¹
- *Large bid-ask pricing differentials:* The bid/offer spreads for potential transactions are still fairly wide.

In addition, the factors driving consolidation and the factors mitigating consolidation are dependent on the size of the banking organization. The seven largest U.S. banks (>\$250 billion in assets) have generally abstained from acquisitions as they navigate the additional capital, liquidity, and leverage rules. Their focus appears to be on organic growth and divestitures of nonstrategic, noncore assets. Banks between \$10 billion and \$250 billion (approximately 90) will examine acquisitions in order to achieve economies of scale. However, this group will be reluctant to surpass the arbitrary asset level of \$50 billion, which imposes enhanced prudential standards and CCAR, or the \$250 billion threshold, which adds Basel III capital measurement and additional liquidity rules. It is noteworthy that since 2008, there have only been 9 transactions with target assets greater than \$25 billion and only 3 since 2011. By contrast, there were 17 transactions with target assets greater than \$25 billion in the 7 years preceding 2008.¹

The predominance of transaction activity is occurring in the sub-\$10 billion sector (“Community Banks”), which account for 98% of total institutions (5,983) and 19% of total bank assets (\$2.8 trillion). In fact, the sub-\$5 billion sector has accounted for 1,183 of the 1,224 (97%) total bank transactions from 2008 to present.¹ In addition to the factors driving consolidation noted above, the following factors drive Community Bank consolidation:

- *Regulatory burden:* The regulations often designed to apply to only large banks have hefty and financially expensive unintended consequences for Community Banks. Often, as regulators demand “best practices,” rules that initially apply only to large institutions become mandatory for much smaller institutions. Examples of rules and policies intended for larger institutions that may ultimately impact all banks include the following: the Volcker Rule (TruPSs, covered funds), the Liquidity Coverage Ratio, the Dodd-Frank Act (QM, QRM, ability to repay, etc.), and the Basel Accord (MSR capital impact, risk weighting for mortgages, etc.). Additionally, the regulatory emphasis and depth required for compliance, internal audit, and enterprise risk-management infrastructure continues to expand and is increasingly costly to implement and maintain. This will drive consolidation in order to achieve economies of scale.
- *Evolving ownership base:* Previously, many Community Banks had substantial ownership from retail investors. More recently, ownership has become more concentrated with

substantial increases in ownership by hedge funds and other investment partnerships. Generally, these funds have shorter investment time horizons and encourage consolidation.

- *Older boards and management teams:* Pre-cycle, 31% of sellers had a CEO over 60 years old compared to 55% post-cycle.¹ Older CEOs recognize the difficulty in regaining peak valuation due to challenging industry economics and increased regulatory costs and capital requirements as discussed above.
- *Heavy reliance on spread business:* “Smaller Banks” (assets under \$1 billion) are much more dependent on the contribution of spread income to their profitability, with fewer opportunities for cross-selling than their larger bank competitors. For example, the Smaller Banks had net interest margins of 3.5% vs. 3.0% for banks over \$50 billion. At the same time fees/operating revenues for Smaller Banks are under 20% contrasted to 44% for the larger banks.¹
- *The need to refinance TARP/PPP:* The prospect of meaningful dilution due to the need to raise common equity will raise the cost of capital at the same time that core ROAE has declined for Smaller Banks from 11.3% in 2Q2004 to 9.1% today. Furthermore, currently only a third of Smaller Banks are earning more than 10.0% on common equity. Meeting cost-of-capital hurdles is a major reason that there have been only 5 de novo banks chartered since 2009, whereas pre-crisis 150-200 banks per year were chartered.¹

The regulatory and policy factors that limit M&A should be examined to ensure that they are being applied to specific risks rather than being applied to firms of arbitrary size.

- Stress tests are applied at arbitrary asset levels and should instead be linked to capital adequacy ratios. Regardless, the asset levels should be revised such that the \$10 billion threshold is eliminated and the \$50 billion threshold is moved to \$100 billion.
- Regulators should encourage mergers of like-size companies. This could be done by providing a one year “grace” period whereby institutions would be examined as if they are operating separately. This would provide a transition period for companies that become subject to higher regulatory scrutiny by virtue of merger.
- De novo banks can provide a laboratory for technology-driven banking solutions. Such entrepreneurial efforts should be encouraged by regulators as opposed to forcing activities into the unregulated operating sphere.
- Support should be given to H.R. 3329 that would increase the small bank holding company “threshold” from \$500 million to \$1 billion, since this would give *de novos* a greater window to achieve profitability before being burdened with larger bank regulations and capital definitions.

Item 5: Regulatory Burden

Has the Council observed instances of supervisory and regulatory expectations for larger banks migrating to medium-sized and small institutions? How are smaller regional and community banks managing, and responding to, the implementation challenges of the large volume of new rules and regulations?

- Many of the new rules and regulations that have been implemented in the last several years were designed to prevent, or at least reduce the risk of, a repeat of the failings that resulted

in the market dislocations in 2007-2009 and the financial crisis. Given the dramatic impact of the long and deep recession, it is understandable that lawmakers and regulators would seek solutions to prevent another occurrence.

- It should be noted that some of the regulatory activity in, for example, capital and liquidity should lead to an improvement in bank resiliency, which is a positive for the U.S. economy and individual financial institutions and shareholders. However, the cumulative impact of the regulations has led in many instances to overlap, inconsistencies, and unreasonable burdens, particularly where rules designed to address the activities and complexities of the largest financial institutions are impacting not only the larger regional banks but also small to medium-sized institutions.

Migration of Supervisory and Regulatory Expectations

- Despite some carve-outs or exemptions for certain institutions, the practical reality is clear: over time, the new rules become the standard by which all are measured and judged. There is definitely a trickle-down of expectations by regulators in terms of applying “best practices” gleaned from the larger banks and applied to the smaller players. It occurs at every level: \$10-50 billion banks being asked to model the practices of the largest banks; sub-\$10 billion banks being asked to model the practices of their larger competitors. It is evident throughout the examination process: safety and soundness, CRA, compliance, and stress testing. The consequence of heightened expectations for smaller and medium-sized institutions is having a dramatic impact on financial results.
- There is a certain level of fixed cost associated with compliance, regardless of an institution’s asset size, the nature of its business activities, or any other characteristic. Complying with rules and regulations requires a substantial effort to understand and interpret the rules and assess their impact on current business strategies, plans, processes, systems, and people.
- There are costs associated with implementation. Since a common theme of the new rules is increased expectations for transparency, documentation, monitoring, reporting, and robust governance programs, significant costs are associated with both human resources (compliance often requires the creation of new functional areas and expansion of existing ones) and expensive technology enablement.

Implementation Challenges Facing Regional and Community Banks

- Community banks are investing heavily in the activities necessary to comply, including the engagement of costly industry consultants to support the interpretation of rules and the design of solutions to comply. Consultants and attorneys are engaged, as many institutions do not have the ability to implement regulatory changes satisfactorily within required time frames. The cumulative effects of regulatory requirements are a diversion of money and talent that could otherwise be directed toward innovation and improving service to clients and communities. A 2013 ABA survey of bank compliance officers found that due to increased regulatory costs and risks, 58% of the banks decided not to launch, or to hold off on introducing, new products or delivery channels or to hold off on entering a new market.
- Supervisory and regulatory expectations are leading some smaller institutions to exit certain businesses after evaluating the risk/return calculation. A recent example is the QM rules, which bring substantial potential downside risk to an institution that engages in providing home mortgage financing to consumers. Lawmakers and regulators should

consider the unintended consequences of rules that, in this example, have led some community bankers to stop meeting the home financing needs of their local communities because they cannot justify the risks involved. In the same 2013 ABA survey cited above, 44% of the banks reported having reduced consumer financial products or services due to the compliance regulatory burden.

- Some boards and management teams are concluding that the regulatory burdens are simply too much to bear and are planning to sell to a larger competitor. For years, weaker community banks have faced economic challenges that threaten their survival. However, now even the strong, healthy institutions are forced to consider their long-term viability and explore strategic alternatives. This is troubling when one considers the resulting impact to the economic vitality of the clients, businesses, and communities in the markets these institutions have long supported.

Item 6: Leveraged Lending

What is the Council's assessment of current underwriting practices and risks for loans sold in the leveraged loan market?

- The majority of Council members believe that terms have become more aggressive in the leveraged loan market, characterized by increasing total leverage levels, liberal covenant packages, declining credit spreads, longer maturities, and limited principal repayment requirements. These members believe that underwriters and issuers have continued to push median leverage levels above 5x Debt/EBITDA in the broader market, to nearly 6.5x for LBO transactions, and that larger unfunded commitments and covenant-lite loan structures may be undermining the traditional protections afforded to lenders and investors. Members point to average equity contributions now in the 30%-35% range compared to the approximately 50% equity contribution in 2009.
- One member reported a belief that the market is supported by an educated and sophisticated investor base, which benefits from a floating-rate asset secured by the borrower's assets, and some members point to the improving economy, which they believe may offset the more aggressive underwriting structures and returns.
- The consensus opinion, supported by historical data, is that default rates are low. However, some members remain concerned about a borrower's ability to cover interest costs should rates rise.

Is the market overvalued relative to its economic fundamentals?

- With interest rate spreads well below historical averages for like-leverage levels, risk-adjusted returns appear to be at or near historical lows. High levels of liquidity in the market, historically low interest rates, and limited demand for funding new business expansions have combined to fuel the current pricing (valuation) levels in leveraged loans.
- Some members believe that the tighter credit spreads may be indicative of a market that is overvalued, but others who believe it is fairly valued point to credit spreads that remain in their long-term range and assets that are priced rationally relative to other asset classes.

Are possible systemic risks developing in the financial system because of leveraged lending?

- The leveraged loan market is estimated to be \$750 billion to \$1.5 trillion, depending on how the market is defined, but is small relative to the total corporate debt market of nearly \$10 trillion.
- Some Council members believe that the mix of investors in leveraged loans continues to diversify, which should lower the systemic risk.
- Several members suggested that systemic risk is building outside the banking industry as a result of nonregulated entities investing in more highly leveraged companies with looser structures. “Floating Rate Funds” offered by mutual fund complexes and others in the shadow banking space have been ready buyers of increasingly riskier assets. These nonregulated entities may fill any void and expand the pace of growth in this sector.

Do current leveraged lending practices raise regulatory concerns?

- Recent comments about leveraged lending by the Federal Reserve Chair clearly point to the existence of regulatory concerns about the growth in this asset class.
- Many members referenced the 2013 Interagency Guidance on Leveraged Lending as proof of the regulatory concern.
- The recent Leveraged Lending Guidance and the current horizontal review of leveraged lending in combination with the 2014 Shared National Credit examination results may well provide an effective tapping of the brakes on the market.
- Many members noted what they perceive to be inconsistent application and differing interpretations of the Leveraged Lending Guidance.

In summary, opinions around this topic vary depending largely on institutions’ business segment served and risk appetite. Most agree that the size of the leveraged lending market at the current time makes it unlikely that it would present a systemic risk; however, it is difficult to determine how connected leveraged lending activities in the shadow banking system are with traditional financial institutions. Unlike the residential mortgage market, where the subprime and nonconforming products in the early 2000s helped create unsustainable demand and valuations in a very large single-asset class (that nearly all financial institutions are exposed to on a direct and indirect basis), leveraged loans are dispersed across many industries, companies, and asset classes. Broad contagion risks from leveraged loans appear unlikely.

A common element affecting all corporate debt products is interest rates. A sharp increase in rates could materially impair borrower cash flows in the leveraged space and materially impact the valuations of all debt instruments, resulting in collateral calls in the short-term funding markets and accelerated investor selling.

To fully understand the risk of leveraged lending, it is important to step back and look at the root cause for the rapid growth in this sector. Economic growth remains tepid and demand for new business expansion funding is very low by historical standards. Behind this slow-growth environment is a lack of confidence by business owners and management teams due to an ever-changing and ever-burdensome regulatory environment. With a slow-growth economy and

limited opportunities for business investment, companies are seeking ways to return value to shareholders. Excess liquidity and extremely low interest rates create the environment to leverage existing cash flows and return capital to owners. New issuance in the leveraged lending market has been dominated by share buybacks, dividend recapitalizations, and LBO transactions. The degree of leverage deployed is at least partially being driven higher by the absolute low interest cost and by the length of time that rates have been depressed. As businesses gain more confidence and economic growth accelerates, the Federal Reserve and other regulators should continue to be watchful to ensure that rampant growth in any asset class generated during this period of low interest rates does not create outsized systemic risk.

Item 7: Incentive Compensation

How have firms changed their approach to incentive compensation since the financial crisis? What are practices with respect to (a) the form of incentive compensation; (b) deferral and vesting; and (c) forfeiture and clawback? Do firms treat different groups of employees differently in fashioning incentive compensation contracts or practices?

Changes in Incentive Compensation

- Bankers have broadly embraced principles-based guidelines that have reduced the potential for excessive risk-taking yet have retained the ability to recruit and motivate a competitive workforce and to effectively manage the business.
- Incentive compensation approaches are materially altered since the financial crisis and resultant guidance. Approaches vary among banks as there is no one solution for all.
- The most uniform and broad-based changes are seen in the areas of governance and oversight. Banks have created oversight committees with cross-functional, senior-level representation reporting to the compensation committee of the Board of Directors. These oversight committees ensure that plans are risk balanced, are in compliance with regulatory and legal requirements, are in conformance with corporate policies, and meet the strategic needs of the businesses. To support these changes, banks have increased spending on incentive compensation management tools to facilitate control, modeling, and simulation abilities, as well as additional levels of documentation and reporting.

Mix of Compensation

- Mix of compensation has changed materially, as firms have placed less emphasis on short-term cash incentives and moved more pay into long-term incentives, particularly for more senior positions that have a greater impact on risk-taking activities.
- Upside potential in both short-term and long-term plans has been reduced by both lowering maximum opportunity as well as creating performance scorecards focused on multiple, balanced metrics to protect against outsized payments based on performance against a single financial metric.
- As a result of decreasing the amount of upside opportunity in both their short-term and long-term performance plans, firms also find themselves in the position of increasing base salaries. Lower incentive opportunity coupled with the higher resulting base salaries has

the effect of decreasing the risk profile of compensation at a firm, but also serves to increase its fixed costs for talent.

Deferral and Vesting

- Long-term incentive plans have seen a dramatic shift from the use of stock options towards restricted stock and performance share grants. Many firms still utilize 3-year vesting schedules in long-term plans, but the trend at some firms has moved towards lengthened vesting schedules, up to as many as 7 years. Firms are also strengthening their equity retention policies, sometimes implementing hold-until-retirement requirements to impact risk-taking.
- The practice of requiring mandatory deferral of a portion of incentive compensation is also increasing at levels below the senior officer level, although this practice is still evolving.
- Vesting schedules have shifted beyond simple time-based vesting to include performance requirements. An increased use of balanced scorecards to measure performance includes both financial and risk-based metrics.

Forfeiture and Clawback

- Firms have strengthened and expanded the authority for forfeitures and clawbacks in their processes. Circumstances that trigger such provisions can include financial losses, financial restatements, inappropriate oversight of risk, violation of risk policies, and personal misconduct.

Treatment for Different Groups of Employees

- Though incentive compensation principles are generally consistent among groups of employees, employee groups are treated based on the different jobs they occupy in the organization.
- Senior officers generally have more significant deferrals, longer deferral periods, more performance-based vesting conditions, and broader clawback provisions. In addition, senior officer incentives are generally driven by corporate performance while employee incentives are based on business unit and/or individual performance.
- Employment contracts for incentive guarantees are limited in use. Guaranteed incentives are used on an exception basis when necessary in the case of new business lines or business lines with long sales cycles, or to recognize time needed for new associates to build a customer base.
- Regulatory requirements in different international jurisdictions can impact employees in similar jobs. The resultant variety within incentive compensation programs may inhibit market-based activities and result in loss of talent to other industries or other geographic markets.

Item 8: Monetary Policy

How would the Council assess the current stance of monetary policy?

- The posture of monetary policy continues to be highly accommodative, with the primary goal being to foster recovery in employment and, to a much lesser extent, ensure an optimal

inflation level (which has remained below the 2% nominal target). Open market operations adding to the Fed's balance sheet continue in the so-called QE3 program, which began in September 2013, but incremental purchases are widely expected to conclude next month (October).

- The Council is generally comfortable with both the current posture of monetary policy and prospects for a future transition to “normal.”
 - Member comments in support of continued accommodation in the near term pointed to the relative weakness in the recovery, continued uncertainties in the size and makeup of unemployment, and low/acceptable risk of above-target inflation.
 - Other comments included questions on how to gauge the real effectiveness of the Fed's market interventions in bringing about economic recovery and the appropriateness of the extended use of extraordinary measures.
 - Several comments touched on the “when” and “how” of the expected normalization in open market activities, with consensus that short-term rates will be moved up from zero next year, but noted a lack of clarity from the Fed on the form of monetary tightening, the “terminal” federal funds rate, the disposition of funds from maturing assets, the overall timing, and the method for reducing the Fed's balance sheet, etc.
- The Council is interested in the commentary from the July FOMC meeting regarding the use of interest payments on excess reserves (IOER) as a primary tool to adjust the federal funds rate. In addition to monitoring the impact of IOER as a new monetary tool, attention should be given to the impact on the liquidity, structure, and returns for banks as bank liabilities (deposits and money market obligations) also shift and reprice.
- As in past reports, several members call for attention to clarity of communication as the FOMC considers shifts in monetary policy.

12:00 Luncheon for Council and Board Members in the Board Room