AGENDA

Meeting of the Federal Advisory Council
and the Board of Governors

Friday, May 13, 2011

<u>Item 1</u>: <u>Current Market Conditions</u>

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

Overview
Financial markets have shown steady improvement over the last year, reflecting in part continued accommodative monetary policy and the impact of the Federal Reserve's second round of large scale asset purchases. Since August of last year when Chairman Bernanke signaled that the Federal Reserve was willing to do more to support the economic recovery, equity markets have risen by close to 30% and market-based measures of inflation expectations have rebounded. Credit spreads have also eased and willingness to lend has improved.

The level of uncertainty surrounding the economy and the various challenges posed by rising energy prices, on-going issues in the Middle East, the sovereign debt-crisis in Europe and the conclusion of the Federal Reserve's asset purchases are likely to lead to continued market volatility. However, financial conditions are not expected to pose a material threat to the economic recovery. Going forward, we expect the U.S. economy to continue to gain traction with real GDP growth of around 3.0% this year and next.

Moreover, in discussions about current market conditions at our meeting on Thursday, the Council discovered a unanimous concern about a significant deterioration in lending terms and conditions that is unprecedented so early in a cyclical recovery, including:

- Re-emergence of covenant-lite loans,
- Hold level and concentrations,
- Aggressive behavior among new entrants and weaker players in the industry, and
- Inconsistency of regulatory oversight and examination of such deteriorating lending standards.

(A) ***Small Business Lending****:*
Has credit availability for, and demand for credit from, small businesses changed significantly over the past three months? Have there been changes in lending standards for these borrowers?

- Several Council members have reported that demand for credit is increasing.

- Several Districts are seeing an increase in application volumes over the past three months and significant increase year over year. In spite of the increase in application volume, current application levels are about 45% below pre-credit crisis levels.

- Overall lending standards are unchanged.

- Council members believe the increase in application activity is the result of banks competing on rates, stabilization of the economy and business owners borrowing for growth initiatives.

- Specific to Louisiana, Alabama, Florida, Arkansas, Tennessee, Texas, Nevada and California the availability and demand for quality credit has not changed significantly over the past three months.
- Based on the fourth quarter results from the *Federal Reserve's Senior Loan Officer Opinion Survey*, there was a strengthening of demand for C&I loans. About 5 percent of banks reported strengthened demand from small firms. In addition, compared with third quarter data, a larger number of banks reported an increase in inquiries from business borrowers for new or increased credit lines. Of the banks reporting stronger demand, more than half noted reduced borrowing from other banks or nonbank sources. Somewhat less than half of the banks also noted increased financing needs for inventories, accounts receivable and investment in plant and equipment.

***(B) Commercial Real Estate Lending*:**
Have there been any changes in the Council's view of the challenges in the commercial real estate market in the past three months? How are commercial real estate loans performing compared to your expectations?

- With some limited variations across Districts, the CRE market has shown signs of stabilization during Q4 2010 and early 2011. After a 40% decline in values from the 2007 peak, valuations are beginning to firm.

- Several Council members report risks remain in high vacancy submarkets limiting landlords' ability to raise rents. Real estate fundamentals remain under stress.

- A consensus view among Council members is 2011-12 appears to be the beginning of a long recovery period. Certain districts (New England, Washington DC and NYC) are seeing a rebound of activity and values. These areas are expected to experience a faster economic recovery.
- Generally, market conditions remain fragile. A fairly large inventory of properties is still working its way through foreclosure and has yet to hit the market. The pipeline of maturing debt in this sector is also significant. Both remain meaningful risks.
- Several Council members feel there is a significant refinance risk for any loan originated from 2006 through 2008, which appears to have been the top of the commercial real estate market.

- Generally, private real estate companies continue to face pressure as they have little access to capital, struggle to find buyers of their properties and are more likely to incur financial distress due to balance sheet/income statement weaknesses.

- While the worst appears to be behind us, we note that CRE is typically the last segment to heal in an economic recovery, and as such, we expect we will still experience some bumps as we move forward. Above normal losses are likely to be with us for some time.

***(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 in the past three months?

- Several Council members report that credit availability for properly structured new construction and redevelopment loans is adequate and improving, particularly for multi-family rental projects. Competition has increased among lenders, impacting pricing and structure.
- Some are seeing signs of improvement with certain projects that were forecasted coming on line. New construction has generally been confined to multi-family rental projects.
- Several Council members report construction levels remain very slow, though sources of capital are returning to the market for strong and viable projects. These infrequent opportunities often result in aggressive and competitive bidding by a number of banks.
- Losses continue to accumulate in the construction sector, but the number of troubled construction loans is declining as a percentage of overall problem loans.
- There is an expectation that demand for construction financing is expected to continue to be slow throughout 2011, as companies are not expanding their need for office and industrial space, retailers are not opening stores at the pace they were in the early to mid-2000s, hotel/motel construction is not needed in virtually any market and the economy and foreclosure activity continue to negatively impact home building.

***(D) Agricultural Lending*:**
Have there been any recent changes in agricultural lending? Are the rising prices of farmland a concern?

- Council members active in agricultural lending have reported that most operators have had very solid year, with commodity prices being at or near all-time highs.

- A report from a Council member reflected that agricultural loans overall are down from just 6 months ago. With high commodity prices, the farmers and agri-business dealers are flush with cash and pay downs on operating, equipment and real estate loans are running ahead of schedules.

- Increasing land prices are something to keep a close eye on due to increasing volatility in commodity prices and input costs and the fact that many outside investors are investing in farmland, creating an environment of greater risk to land prices and corresponding cash rents.

- Loans related to fruit and produce distributors and growers in Southern California have been favorably affected by current positive price changes and weather patterns [favorable to CA versus FL and Mexico].

- In the short run and with the present weakening of the US dollar, food prices and incomes for many farmers have increased materially, and in turn, caused a short-term spike in U.S. domestic farmland prices. This has especially been true for U.S. Midwest cereal and other primary crop growers (corn, soy & sorghum) where, for example, corn prices have gone from $3-4 per bushel to over $7 in just the past year and underlying land values have increased at close to a 10% 'year-over-year' rate in many of these same regions.

- One Council member reports the biggest change has been clients moving to multi-year crop and hedging plans. This continues to challenge smaller (and less well-capitalized) operations. In addition, operators are holding onto crops longer if they have storage capacity.

(E) Consumer Lending:

What are the Council's views of consumer sentiment and the willingness of households to borrow? Has borrowing by consumers increased or decreased during the past three months?

- According to the *Senior Loan Officer Survey* for April (Q2), consumer lending standards have continued to improve. In fact, banks are reporting a higher willingness to make consumer installment loans today than at any time since 1994. However, on the demand side, evidence for a recovering credit market is mixed. Twenty-five percent of banks reported demand for auto loans had strengthened over the last three months, but demand for credit card loans remained little changed. Indeed, over the last several months, revolving credit, mainly credit cards and personal lines of credit, and non-revolving credit, auto loans and student loans, have followed vastly different growth trajectories. Revolving credit began contracting in September 2008 and has yet to return to a positive growth rate (except for a single month in late 2010). Non-revolving credit, on the other hand, has fared much better. It troughed in May of last year and has been growing steadily ever since. As of February, non-revolving credit outstanding was up 2.3% from a year ago, while revolving credit outstanding was down 6%.
- Generally, Council members report that aside from mortgages, where credit trends are mixed, consumer credit is clearly improving, despite the still-weak macro-economy.
- Card losses have improved steadily over the past year. Delinquency flow rates, bankruptcies and recovery trends all point to further improvement. Some of the improvement in Card losses is tied to portfolio seasoning and improving economic trends, although tighter underwriting standards on recent originations are also a factor.

- Some Council members report favorable credit trends are most pronounced in auto lending, where losses peaked two years ago and have been improving, on a seasonally adjusted basis, ever since. Today, we are seeing the lowest auto losses in many years.
- Council members state they are closely monitoring a range of economic factors that could slow the recovery or even spark a double dip, including energy prices. While there are regional differences in degree, members report that higher energy prices are adversely affecting consumer behavior, hindering the economic recovery.

Item 2: Housing and Mortgage Markets

What changes has the Council seen in the housing market, including changes in house prices, during the past three months?

- The majority of Council Members reported continued stress in the housing market, as fewer existing homes were sold in the first quarter of 2011 relative to the same period of the prior year.
- In addition, the majority of Council Members reported lower prices for existing homes sold in the first quarter of 2011 relative to the same period of the prior year.
- Reported pockets of strength include Texas, Oklahoma, D.C. and the San Francisco Bay Area. Homes located near each coast have rebounded more quickly.
- Nationally, year-over-year sales of existing homes declined in two of the three months in the first quarter of 2011, and the median year-over-year sales price for existing homes declined in every month of the first quarter of 2011 (Source: National Association of Realtors).

What changes has the Council seen in the pace of mortgage foreclosures during the past three months?

- The majority of Council Members reported declines in foreclosure activity relative to both the prior three months and the same period of last year.
- The majority of Council Members state that the decline in foreclosure activity is due to delays in initiating foreclosures as mortgage servicing processes are reviewed and reengineered.
- Many Council Members report increases in the length of time required to resolve foreclosures.

What reforms are needed in the mortgage servicing business?

- Appropriate written policies and procedures that comply with all applicable federal and state laws that address how to conduct, oversee, and monitor mortgage servicing, loss mitigation, loan modification and foreclosure operations.
- Staffing levels adequate to meet current and expected workload demands, and staffs that are appropriately trained and supervised by qualified personnel.
- Establishment of an easily accessible and reliable single point of contact for each borrower so that the borrower has access to an employee of the Bank to obtain

information throughout the loss mitigation, loan modification and foreclosure processes.

- Procedures and controls to ensure that when the borrower's loan has been approved for modification on a trial or permanent basis that no foreclosure or further legal action predicate to foreclosure occurs, unless the borrower is deemed in default on the terms of the trial or permanent modification. In this process, the single point of contact needs to remain available to the borrower and be referenced on all written communications with the borrower.
- Establishment of compliance programs, with appropriate regulatory oversight, to ensure adherence to written policies and procedures.
- Lastly, we await the final results of the current horizontal mortgage foreclosure exams and the third party reviews. Likewise, the current settlement discussions with the five largest mortgage servicers and the AGs remain ongoing and will likely impact the final policies and procedures.

What is the Council's view of the recently proposed QRM and risk retention standards?

- The majority of Council Members believe that the recently proposed QRM requirements are defined too narrowly.
- The proposed QRM exemption imposes minimum down payments on purchase mortgages of 20 percent and equity requirements of 25 to 30 percent for refinancing, ignoring the fact that well-underwritten, low down payment loans have been a significant and safe part of the mortgage finance system for decades.
- These proposed QRM underwriting standards would likely favor borrowers with higher incomes and wealth, while requiring low-to-moderate income borrowers to enter the non-QRM market, which will likely have higher rates due to the risk retention requirements.
- Narrowly defined QRM requirements combined with higher rates in the non-QRM market will reduce the population of borrowers that are eligible for home purchases and refinance transactions, further delaying recovery in the housing market.
- For as long as the GSEs remain in government conservatorship, Council Members agree that loans sold to Fannie Mae and Freddie Mac should be exempt from risk retention requirements, provided this does not delay an orderly exit of the GSEs from the mortgage market.

Item 3: ALLL

What does the Council believe is the most effective and useful method of accounting for loans and lease losses (ALLL)?

- The Council believes the current discussion by the FASB and the IASB regarding allowance methodology will have significant ramifications for the industry with the potential for inappropriate procyclical implications. We believe U.S. Regulators and the Federal Reserve, in particular, should be active participants in shaping outcomes. Our concerns are that methodology will be too prescriptive, potentially less transparent and not taking into consideration the various differences in asset classes by type, risk and geography. There has to be a place in the methodology for appropriately documented judgment that considers forward looking economic factors and risks.

- Reaching agreement on the most effective and useful method of accounting for loan and lease losses continues to be discussed among standard setters, regulators, investors and users of financial statements. All participants agree that improvements to the credit impairment guidance are necessary. The primary objectives of a new model should be to ensure the adequacy of the allowance for loan losses on the balance sheet while addressing the timeliness of actual loss recognition.
- Council Members have various views of the most useful method, which include:
  - Direct write-off. Banks should recognize losses when they occur through the income statement and move the existing reserve to the capital account.
  - A two-step approach, one method for the good book and another for the bad book. For the good book, measure a range of expected losses and reserve to the low or high end of the range based on economic factors and other considerations. For the bad book, model all of the expected losses using a methodology that matches the current definition of impairment.
  - FASB's original proposed methodology eliminates the probable threshold and recognizes the full impact of lifetime expected credit losses. This would be the easiest for smaller banks to implement and is more consistent with SOP-30 and FAS114.
- There is consensus among council members that an effective method would include some of the following elements:
  - Convergence of the ALLL standards by FASB and IASB, as long as the rules are implemented thoughtfully and consistently.
  - The expectations of the regulators regarding the complexity and cost of administering the ALLL must be more in line with the complexity and size of the institution.
  - Is easily understood by users of financial statements.
  - Considers forward looking economic factors when determining the amount of credit impairment. This would enable the accumulation of reserves based on future period expected losses versus recent or historical losses. Reserves could be increased during periods of low losses and portfolio strength and used during periods of elevated realized losses.
  - Allows for the use of good judgment based on factors such as the easing of credit standards by the industry, risk associated with loan growth, consideration of historical losses throughout an economic cycle, and market and industry expertise gained from prior experiences of management.
- Council members understand the difficult issues FASB and IASB have been dealing with in their efforts to converge the accounting for financial instruments. We understand that the two Boards have approached the accounting for impairment from different directions and their proposed model represents a significant compromise. However, there are concerns with the joint proposal. The most significant concerns are that it does not adequately address the cyclical behavior of financial instruments and the lack of transparency around inherent loss events until

such events are observable. Members of the U.S. banking industry (including several members on this Council) have developed an alternative proposal that they believe will more effectively address these concerns while expanding upon the existing incurred loss concept. This proposal has significant support and is presented in summary herein.

Proposal by Multiple U.S. Banks:

- This proposal expands on existing incurred loss practices found in current accounting principles to more effectively estimate inherent credit losses by eliminating the probability threshold, incorporating expected events into the loss forecast and extending the loss emergence period. Under this proposal, inherent credit losses are estimated using a two-step approach. Although described in two steps, these components are interrelated and necessary to estimate losses inherent in the portfolio. We describe the components separately and would disclose them separately to provide clarity and transparency of management estimates. The components include:
    - A base component (the "Base Component") that represents the estimate of expected inherent losses in the portfolio that are reasonably predictable, and
    - A credit risk adjustment component (the "CRA") that represents additional credit losses that are not yet reflected in current credit risk metrics used to estimate the Base Component but are estimated using macro-level factors and are expected to emerge with more transparency as the credit cycle unfolds.

Base Component

- The Base Component is intended to capture expected inherent losses that are reasonably predictable based upon an assessment of historical and current credit information and expected events and conditions. The Base Component methodology replaces the current incurred loss model with an expected loss concept that incorporates expected events into the loss forecast and extends the loss emergence period over which losses are reasonably predictable. Uncertainty in the forecasting process, changes in loss emergence periods and other factors are not explicitly or systematically considered in the Base Component, and as such, the Base Component is by itself an incomplete estimate of inherent credit losses. The terms "Expected Inherent Losses" and "Reasonably Predictable" are defined as follows:
- Expected Inherent Losses are defined as management's best estimate of losses inherent in the loan portfolio based on a company's credit evaluation process, which takes into account all relevant current and historical information as well as expected events and conditions. This is a change from the existing incurred loss definition as the "probable" threshold has been eliminated and expectations of future events can be used to estimate the severity of losses associated with a loss event.
- Reasonably Predictable is defined as the period of time that losses can be estimated with reasonable confidence. In estimating the losses that are Reasonably Predictable, several factors should be considered including, the characteristics of the financial instrument or pool of financial instruments, the historical performance of the financial instrument or pool of financial instruments, the current and expected market conditions and a company's own credit forecasting process. The period of

time determined to be reasonably predictable will vary by asset class and may change throughout credit cycles and across companies.

Credit Risk Adjustment Component (the "CRA")

- The CRA is a separate component of the allowance for credit losses that is established to address the inherent limitations in a company's credit forecasting process and the cyclical nature of macroeconomic conditions. Past credit cycles have seen extended periods of benign activity followed by rapid parallel upward shifts in credit loss estimates. The specific economic and credit conditions that lead to the negative credit shocks often accumulate over a number of years, but often are not readily apparent in the credit metrics commonly used to estimate the Base Component. For example, underwriting standards and loan terms may be eased during benign credit environments; favorable economic conditions may mask credit weaknesses of the borrower; uncertainty regarding the sustainability of current economic conditions is often high, and loss emergence periods tend to extend during benign economic periods.
- The CRA is intended to capture those losses that are inherent in the portfolio, but due to the nature of the credit cycle, will not become transparent until credit losses begin to materialize. The methodology for establishing the CRA should consider factors including, but not limited to:
  - Current credit metrics and forecasts;
  - Historical credit metrics (including stressed loss rates);
  - Management's evaluation of the credit cycle;
  - Other important credit indicators such as borrower behavior and collateral values;
  - Current underwriting standards, loan covenant terms, and other loan characteristics;
  - Recent trends in economic conditions ;
  - Portfolio performance, concentration and deterioration relative to historical ranges;
  - Changes in loss emergence patterns over a credit cycle; and
  - The level and estimate of imprecision and uncertainty in the factors above.
- Many of the factors considered in the CRA would by nature be heavily dependent on management's judgment. These factors should be fully documented and supported by either market data, where possible, or internal data and analysis, and appropriately disclosed in the financial statements.

Item 4: Interchange Fees

What effect will the proposed caps on debit interchange fees have on technological innovation in payments processing?

Discussion

While any regulatory constraint on the pricing of payment services will inherently limit technological innovation, the Board's proposed caps on debit interchange fees are an overly restrictive application of the Durbin Amendment and will unnecessarily stifle technological innovation and undermine the integrity of payment processing.

- The proposed caps on debit interchange fees are far below a debit issuer's costs of providing debit services to consumers. As a result, debit issuers will have little, if any, incentive to invest in new or improved debit products and services (such as mobile payments, contactless debit solutions and person-to-person payments), which require substantial expenditures in research and development, procurement or modification of system hardware and software, marketing and training, among other areas—all costs that are not recoverable under the Proposed Rule.
- With fewer technological innovations in the traditional debit marketplace, consumers may increasingly turn to alternative payment products or services that are not within the scope of the proposed interchange fee caps, resulting in negative unintended consequences to consumers and the payments system.
    - Consumers may leave the banking system and migrate to substitute products that are exempt from the proposed interchange fee caps and therefore more likely to offer innovative features. Because the traditional demand deposit account serves as a gateway product for entry into the financial services mainstream, this migration will have detrimental impacts on both consumers and the economy. Further, substitute products often carry high fees that are less transparent to consumers.
    - Providers of alternative payment services often are not subject to prudential regulation (unlike financial institutions that issue debit cards), so consumer migration from traditional debit products to alternative payment services may introduce additional risk to the overall payments system by encouraging the growth of an unregulated shadow payments system.
- Under the burden of the proposed interchange fee caps, issuers may limit the use of debit as a form of payment for transaction types that expose them to increased, uncompensated risk, such as e-commerce transactions. Given the prevalence of debit cards as a form of payment for e-commerce transactions, this outcome would adversely affect consumer payment choice and could undermine the continued growth of the Internet marketplace.
- The proposed interchange fee caps will encourage issuers to reduce investment in debit system infrastructure to reduce costs, possibly increasing system outages, reducing the efficiency of debit as a payments system and compromising data protection and security.
    - Unless ameliorated by an adequate and flexible fraud prevention adjustment, the proposed interchange fee caps would reduce issuer investment in fraud prevention innovations, such as enhanced fraud detection technologies and more secure methods of authorization, ultimately reducing the safety and integrity of the debit payments system.
    - The proposed interchange fee caps will encourage issuers that outsource processing functions to use payment processors that charge the lowest fees, even where the cheapest processor is less secure or less reliable than its competitors. As a result, processors will be encouraged to focus on cost

cutting as opposed to investing in technological improvements and enhancements.

- While the Board suggested in its discussion of the proposed interchange fee caps that issuers have sources other than debit interchange fees through which to recover the costs of technological innovations (in particular through increasing customer fees), consumers are accustomed to receiving the benefits of innovation without charge. Issuers will be reticent to make significant investments in technological innovations where the opportunity for recouping such investments is limited to speculative revenue sources.
- The negative effects of the proposed interchange fee caps on debit system innovation will be even more pronounced when coupled with the merchant routing requirements. Merchants will have an incentive to direct transactions to the debit network that charges the lowest fees, even where the cheapest network is less secure, less reliable or provides fewer consumer benefits than a network that has invested more in network infrastructure. As a result, the Board's Proposed Rule will stifle innovation and infrastructure investment by both debit issuers and debit networks.
- The interchange fee caps will have a disproportionate negative effect on low-income consumers, i.e. the elimination of free checking.
- There will also be a disproportionate effect on small banks that will virtually lose all interchange fees, after having already lost most overdraft fees. They will become more dependent on credit and interest rate risk.

Recommendations

- The Board should revise the proposed caps on debit interchange fees to encourage, rather than discourage, the technological innovations that have made debit a thriving and growing payments system. It provides benefits to consumers, merchants and the economy as a whole, and contributes to the United States' global leadership in financial services. The Board has significant discretion to revise the proposed interchange fee caps to reduce the negative impacts on technological innovation and infrastructure investment by:
  - Allowing issuers to recover through debit interchange fees the full costs of such beneficial investments,
  - Establishing a fraud prevention adjustment that fully compensates issuers for their costs of implementing desirable security features and fraud prevention controls, and
  - Using the same fee regulation for both large and small banks.

<u>Item 5</u>: <u>Regulatory Balance</u>

What are the Council's views on the appropriate balance between consumer rules and enforcement and safety and soundness?

- In July, the new Consumer Financial Protection Bureau will formally assume responsibility for the country's consumer financial laws. Regulatory cooperation and coordination will be critical as this transition occurs. Throughout the legislative debate, many noted that creation of a fully independent Bureau to oversee consumer protection was likely to add a new dimension to the coordinating challenges facing regulators.

- Recently, both Houses of Congress have focused on those challenges, with particular emphasis on finding the proper balance between protecting consumers and safeguarding the stability of financial institutions.
- While these legislative proposals raise important issues, the Council chose to focus on solutions achievable through the existing regulatory framework. As the July transfer date approaches, the Council urges the Board and other banking regulators to establish robust mechanisms for communication and joint action with the new Bureau. These recommendations operate within the parameters of the Dodd-Frank Act and are consistent with its governing principles.
- The Act included a number of tools to help ensure that the Bureau will pursue its mission in full coordination with prudential regulation and the systemic safeguards built into the law. Notwithstanding the tools available to the agencies to support cooperation and coordination, Dodd-Frank presents potential gaps and risks that need to be carefully considered:
    - Rule Writing: Dodd-Frank provides that the FSOC may review and set aside a Bureau final rule but can overturn a rule only with a two-thirds vote. In addition, the standard for voting to overturn is extraordinarily high and thus unworkable. A given rule would have to "put the safety and soundness of the United States banking system or the stability of the financial system of the United States at risk." Putting at risk the stability of one institution, or even a group of them, would not meet this test. This gap must be addressed through greater emphasis on pre-consultation among the agencies.
    - Supervision: Dodd-Frank calls for coordinated consumer and prudential exams, but the procedure for resolving potential disputes is impractical. The examined bank may petition for a coordinated supervisory action, but if that is denied, the dispute is sent to an untested "Governing Panel" that is to be created under terms provided in the Act.
    - Enforcement: Dodd-Frank does not explicitly provide a mechanism to assure consultation, coordination or agreement among regulators. The Act's silence on this critical score has given rise to understandable anxiety within the industry.
- The Council has identified four key opportunities for regulators to utilize existing structures to create balance between protecting consumers and assuring the stability of the banking system:
    - <u>Rule Writing</u>: The Council believes that the FSOC should establish a standing functional committee on consumer and prudential coordination. The FSOC has already established five new standing functional committees. Dodd-Frank requires that the FSOC issue procedural rules for challenging consumer rules. The additional standing functional committee would write those rules and, once they are finalized, provide an ongoing forum in which the Bureau may coordinate with prudential regulators prior to issuing rules.
    - <u>Supervision</u>: The Council believes that the Federal Financial Institutions Examination Council (FFIEC) Task Force on Supervision provides a valuable

forum for coordinating supervisory activities. The Bureau will become an FFIEC member and should leverage that structure to coordinate consumer compliance exams and actions with the prudential exams and actions of the Federal Reserve and other regulators, as mandated by Dodd-Frank.
    - Enforcement: The Council believes that the Bureau should engage the existing FFIEC Task Forces on Supervision and Consumer Compliance to coordinate with the prudential and consumer compliance regulators to ensure that enforcement of consumer law is both fair and uniform.
    - Leadership: The Council believes that cooperation between the Federal Reserve and the Bureau must be a paramount objective. Therefore, we would therefore propose regular interactions between the Bureau's Director and the Board's Vice Chairman for Supervision.
- The Council urges the Board and other banking regulators to act quickly to fill the gaps with both formal and informal mechanisms of dialogue and coordination.
- The Council notes that the debate in Congress about the Bureau is at a high level of intensity. Given that climate, the agencies should be seeking to take all available steps to create an enduring consumer protection system and ensure the Bureau is tied meaningfully into the overall framework of thoughtful prudential regulation, supervision and enforcement.

Item 6: Payments Competition from Non-bank Providers

What role do nonbank providers (e.g. PayPal, Google, Facebook) play in providing payments services? How do such services compare to those traditionally provided by banks and by traditional network providers?

- Technology innovations in online and mobile payments have greatly increased the number of payments options available to consumers.
- Continued adoption by consumers and merchants of these emerging payments options allows non-bank payments providers to play a larger role in transactions that were previously the responsibility of financial institutions.

    - Online purchasing is mainstream and using alternative payments is becoming more accepted by consumers. Per Javelin Research:
        - Nearly three quarters of adult consumers shop online (up a significant 14% since 2009) and 62% have made an online purchase in the past month.
        - For online purchases, 46% of online consumers have used an alternative payment within the past year, and 25% have used an alternative payment within the past month.
        - Total online alternative payments volume (e.g. PayPal, Google Checkout, Amazon Payments) is expected to experience 15% CAGR from 2010-2015, resulting in a 20% market share for the alternative payments by 2015.
        - Approximately 91% of consumers who have made an online purchase have used PayPal.

- Non-bank or “alternative” payments providers are defined as companies other than a financial institution which receive the primary economic, customer relationship, or brand equity benefit from participating in a payment transaction.
    - These non-bank providers of payment services share similar objectives as regulated financial institutions. They work to provide a low cost payment delivery with low perceived risk to the consumer while making a reasonable profit margin for the company.
        - For instance, PayPal has become an online merchant / merchant acquirer, network, lender (Bill Me Later), mobile player and potentially a point-of-sale (POS) payment solution within brick and mortar retail.
    - While non-bank players are often considered online providers (e.g., PayPal, Google, Facebook, Apple and Amazon), mobile network operators (MNOs) and utilities should also be considered potential participants.
        - For instance, cellular networks and cable television providers could perform many of the same services being offered by PayPal.
        - MNOs are allowing users to bill small transactions to their phone bills, in essence extending credit.
- Non-bank and alternative network providers typically participate in payments differently than the traditional payments participants. Examples include:
    - A smaller ecosystem containing fewer points of acceptance, customers and network offerings.
    - Linkage to “captive” merchants or customers (e.g., eBay, Amazon, Facebook).
    - Usage of existing payments mechanisms for new purposes.
        - For instance, leveraging ACH as the “rails” for payment transactions (not the intended functionality of the ACH infrastructure).
    - Much higher transaction tolls.
        - For instance, iTunes and Facebook have or plan to have rates as high as 30% of transactions and Square takes 2.75% of transaction value (the average interchange is ~1.8%).
    - The costs of financial services to customers and / or merchants may be cross-subsidized by other revenue streams (e.g. advertising).
    - Lack of access to liquidity and capital.
    - Fewer customer protections.
    - Less oversight for non-banks / alternative networks increases payments risk
        - Fraud / security breaches
        - Service disruptions / system outages
        - Incomplete “paper-trail” for payments through decoupling of transaction information from account issuer (e.g. PayPal)
        - Sponsorship of large nonbank providers by small FIs (e.g., MetaBank) whose reserves may not be proportionate to risk exposure

Does the Council believe that the current regulatory environment gives non-bank providers competitive advantages in providing payments services? If so, can the Council describe the advantages, assess their materiality, and suggest ways to ensure a level playing field?

- Nonbank providers are not regulated / supervised as bank holding companies. They do not have regulated bank affiliates or bank service companies that are subject to examination.
- Nonbank providers are not subject to Office of Foreign Asset Control (OFAC), Anti Money Laundering (AML)/Bank Secrecy Act (BSA) and other regulations, which effectively creating gaps in security and controls in the system.
    - Thus, nonbank providers are not subject to capital requirements, deposit reserves, restrictions on transactions with affiliates, operational and risk management supervision and other regulatory requirements (and the associated compliance costs).
    - There are some consumer protection requirements that apply exclusively to financial institutions, e.g. Gramm Leach Bliley Act (GLBA) privacy rules.
- New Dodd-Frank restrictions on bank payment service providers.
    - Dodd-Frank was intended to reduce the risks to the financial system from failures or activities of both bank and nonbank financial entities.
    - The law was intended to harmonize the consumer protection regime applicable to all covered entities. E.g., the CFPB is directed to enforce consumer laws "consistently" to promote "fair, transparent and competitive markets."
    - It is not yet clear which Dodd-Frank provisions will apply to nonbank payment service providers.
        - e.g., the Financial Stability Oversight Council will establish enhanced regulatory, capital and other standards for systemically important entities. Applicability of these standards to nonbank payment system participants has not yet been established.
        - Also, it is unclear if payment systems that do not provide financial services directly to consumers will be regulated and examined by the CFPB as "services providers," and what the extent of that regulation and associated compliance costs might be.
        - If neither the FSOC nor CFPB regulatory / enforcement regimes are applied to nonbank providers of payment services in a manner similar to how they are applied to banks, another differential regulatory impact will be created.
- Changes in consumer behavior and their acceptance of emerging technologies, combined with the rapidly evolving nature of payments technologies, warrant an evaluation of whether the regulatory environment is adequately aligned with the payments marketplace. The Council believes that the questions raised by the Board about nonbank payment system participants are important ones that merit further study. Other issues:
    - Do regulatory disparities encourage further migration of payments services to the nonbank sector?
    - Does such disintermediation impair the safety and soundness of depository institutions, the Federal Reserve's oversight of the payments system, or its access to information to inform monetary policy?
    - Should participation in the payments system be limited to regulated entities?
    - Do the Dodd-Frank caps on debit interchange fees create incentives for payments to migrate to platforms not subject to price regulation?

- Are there specific consumer protection requirements that pertain only to financial institution payments, and not to those effected by nonbanks, that create competitive inequalities or reduce consumer protections for those who deal with non-banks? (Examples: AML/BSA, Reg E, Reg CC, GLBA privacy, FFIEC Authentication Guidelines, OFAC).
  - Are billing aggregators (e.g. mobile networks, cable companies) that, in effect, extend credit subject to the same consumer protection regimes as bank lenders?
  - Do consumers using nonbank payment services, including person-to-person payments, understand their rights and the differences that may apply versus payments made via credit, debit card and check?
  - What is the impact on bank payment services providers of the differential in regulation for entities providing similar services under state money transmitter licensing laws?

Item 7: Economic Discussion

(A) What does the Council believe to be the reasons for the pace of the economic recovery?

Overview

All FAC members agreed that the pace of the current recovery is slower than typical, though several members also noted that, due to the nature of the recent recession, involving massive de-leveraging and the bursting of a credit bubble, a slow recovery should not be completely unexpected.

While there are numerous signs of a likely sustained, though slow, recovery, FAC members consistently describe several factors contributing to the slow recovery, including: continued weakness in the residential housing markets, continued low consumer and business confidence and high levels of uncertainty, state and local (and potential Federal) fiscal constraints and increased gas and other commodity prices.

Continued weakness in residential housing markets

- The tremendous wealth destruction during the financial crisis in the residential housing markets has resulted in de-leveraging by consumers and increased personal savings.
- New housing starts remain at historically low levels.
- While credit remains widely available for qualified borrowers, less qualified borrowers are having difficulty securing mortgages.
- Home price levels generally continue to deteriorate.

Low consumer/business confidence and high levels of uncertainty

- Business confidence has improved but remains at historically low levels.
- A significant portion of small businesses are not seeking credit due to concerns over future sales levels.
- Private sector hiring is starting to recover but only very modestly.

- One member noted that the movement of jobs overseas, due to lower labor costs, may be slowing the job recovery.
- Concern over the potential for inflation is creating uncertainty and limiting expansion and re-leveraging.

Government Spending

- Several FAC members noted the negative impact of reductions in state and local government spending and employment.
- One FAC member noted that since the end of the recession, employment in state and local governments has dropped by 445,000, or an average of 20,000 per month.
- The collapse in housing prices has contributed to the fiscal pressures on state and local governments.
- Several FAC members noted the potential negative impact of Federal government spending through some level of anticipated fiscal restraint by Congress.

Increased gas and commodity prices

- While generally not viewed by FAC members as a major impediment to growth, several FAC members noted that the recent modest increases in consumer spending are tempered by increased oil and other commodity prices.

How would you assess overall economic conditions in your region? Are there significant differences across sections or regions?

Overview

- The regional distribution of growth has been impacted by the severity of the regional housing downturn, the sensitivity to export growth, and the share of energy and agriculture in the regional economy. While New England is normally a growth laggard, that is not currently the case due to the milder housing cycle experienced in the region. In contrast, growth in the "sand" states (California, Arizona, Nevada, and Florida) remains depressed by the severe housing bust. The low-population grain-exporting states have been strong due to high agricultural prices and strong export demand. Even with the impact of the deep water drilling moratorium, the energy sector and regions are strong, led by the development of unconventional gas in a number of states.
- In New England, labor markets have been improving, and home prices and real estate conditions appear more stable than other parts of the country. The Mid-Atlantic, however, has been slower to gain traction. Job creation has accelerated, but remains below forecast (particularly in New Jersey.) Also, home prices are falling and there has been little easing in residential and non-residential delinquency rates. Among South Atlantic states, there are signs of improvement. Up until now, the D.C area economy has been the region's strongest, but as public sector spending restraints increase, growth is likely to decelerate. Meanwhile, in Florida and the Carolinas, job growth has been improving and coming in above forecast. However, the jobless rate remains well above average in these states, and renewed home price declines and foreclosures are a particular challenge (especially in Florida).

Regional Overviews from FAC members:

- In Massachusetts, the economy is doing reasonably well, but housing has not yet turned the corner. State fiscal issues continue to weigh on the economy, but there is little chance of a significant backslide. The most recent Associated Industries of Massachusetts Business Confidence Index revealed that while Massachusetts employers are generally positive about the situations of their own companies, they have doubts about the overall economic health of the state and nation.
- In Midwestern markets, the perception among small and mid-sized businesses is that economic conditions are improving, though they are not yet charging headlong into expansion mode. While most owners expect sales growth, some are planning to raise selling prices to preserve profits in the face of widespread higher non-labor costs. In Pennsylvania and New Jersey, cautious optimism is replacing the fear of falling sales that plagued business during the depths of the Great Recession. Florida, however, is feeling the after-effects of the recession more than most other areas. This is consistent with the greater concentration of construction employment in Florida compared to most other states.
- Washington D.C. remains stronger than the nation as a whole with lower unemployment rates and stronger retail sales and housing market. An unemployment rate of 5.7% is well below the US level of 8.8%. Employment growth is relatively flat as government-related hiring slows. In 2010, employment growth in the Washington metropolitan region averaged 2,100 per month, but in the first 2 months of 2011, it has average 1,600. Employment growth has fallen 5 of the last 7 months. Overall, the Fifth District is on par or better on most economic metrics than the US as a whole.
- Manufacturing for the Chicago region is very strong and has caused business outcomes and confidence to improve. Despite the improvement in the business sector, consumer confidence remains low.
- In the Eighth District, while employment nationally has risen by 1.0% over the last year similar to the pace for Tennessee (1.2%), there are significant differences by city. The Philadelphia Fed constructs indexes of coincident economic activity for the nation and states (based on payrolls, the unemployment rate, average hours worked in manufacturing and wages and salaries). The Philadelphia Fed's national coincident indicator has risen 2.9% over the last year, whereas the index for Tennessee has increased a slightly more moderate 2.3%.
- The Ninth District economy has expanded moderately. Increased activity was noted in consumer spending, tourism, commercial construction and real estate, manufacturing, energy and mining, and agriculture. The services sector was mixed, and residential construction and real estate activity decreased. Labor markets continued to show signs of strengthening, while wage increases remained subdued. Retail price increases were modest, but price pressures for inputs continued.
- Energy and agriculture are definitely leading the recovery in the Tenth District due to increasing commodity prices. Unfortunately, the labor markets in the region are only marginally improving. The region has seen a general slowdown in consumer spending, perhaps due to higher gas prices and other uncertainties.
- Overall, the Texas economy is still ahead of that of other regions. Home prices are reasonably stable in most areas of the State. While foreclosures are still running higher than normal, the lack of a large buildup, or price bubble, during the last decade

has provided a more moderate downturn in the Texas real estate market compared to other areas of the country. However, economic activity is showing significant differences across the State.

- In California, key urban markets are improving markedly, while inland regions (Central Valley and Inland Empire) are faced with an anemic recovery. The Nevada and Arizona economies remain very weak, and elevated unemployment continues to exert a major headwind in California and Nevada. From a portfolio perspective, the Twelfth District is seeing top line growth in many borrowers but very tempered, even reluctant, capital spending and FTE expansion. The District is seeing a leveling off in depreciation of commercial real estate values. Lease rates are still under pressure, but given such high levels of liquidity, cap rates have decreased. There is some expansion in commercial and industrial investment. Default rates have slowed. These circumstances all point to a better performing, but slow growing, economy.

Item 8: **Particular Indicators**

(A) 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 you purchase rising more or less quickly?

- Headline inflation is being buffeted by month-to-month movements in energy and food prices, but is generally trending higher. Core inflation now appears to be trending upward as well, although it remains at a benign level.
- Prices for certain raw materials used in manufacturing have been rising fairly rapidly over the past few months. Many of those costs have been absorbed by businesses, partially offset by productivity gains from labor cost savings. Ultimate costs to consumers for many products and services are seeing only modest increases. Food and energy-related products and services are exhibiting the largest price increases.
- While retailers continue to try to limit price increases due to fragile consumer demand, manufacturers have been able to push forward with higher prices.
- Prices for products and services purchased by financial institutions are stable to increasing. The upward price pressure appears to result from suppliers who are not willing to continue to offer discounts for their products as aggressively as they did over the past three years. The desire to stand firm on price seems to be maintained in negotiations. This is consistent from feedback we have received from our customers who report price hikes from suppliers.

(B) The Valuation of the Dollar: How have the recent changes in the value of the dollar affected your business or your customers' businesses?

- Financial institutions generally report little direct impact on their businesses from the low valuation of the dollar. Customer impact, on the other hand, has been significant for businesses that are significant exporters and/or importers.
- Heavy exporters have gained a pricing advantage and are using it to gain market share from foreign competitors. Much of the gains are in emerging markets where economic growth rates are significantly higher than in the U.S. or Europe.

- Importers are struggling with lost purchasing power and are having difficulty controlling costs and profitability. As the costs of imported goods have risen, it has been difficult for businesses to raise prices fast enough to offset increasing costs.
- Expectations of a weak dollar over time has made dollar funding increasingly attractive to borrowers, while customers clearing commercial payments are showing increased preference for strong foreign currencies.

(C) Labor Markets: How have the labor markets in which you operate changed in recent months? In particular, assess the degree of job loss (how much and in which industries). Has there been any significant job creation? What changes to wages have Council members observed since the last meeting?

- Job growth is continuing to firm. The Northeast, South, Midwest and West census regions all had just above 1 percent non-farm employment growth in the first quarter. Within regions, there were broad differences among states and industry sectors.
- In the Northeast, the highest growth rates were in Vermont, Pennsylvania and Delaware compared to New Jersey and New York which lagged the region. In the Midwest, Michigan, Illinois and North Dakota produced the highest rates of job growth with Kansas and Missouri at the bottom. In the South, Texas, Kentucky and Arkansas produced the best growth, while Georgia and Louisiana saw little job growth. In the West, Oregon, Utah and California showed the highest job growth rates, and New Mexico, Arizona and Nevada produced almost no growth.
- The industry sectors that provided the highest rates of employment growth were mining and oil and gas extraction, leisure and hospitality, education and health services, and professional and business services. The lowest rates of growth were in government, financial activities and information.
- An adequate supply of qualified candidates remains available in most job categories and markets providing companies the ability to continue to control labor costs. Compensation costs increased 0.6 percent for the 3-month period ending March 2011. Wages and salaries increased 0.4 percent and benefits increased 1.1 percent. Wages are not keeping pace with inflation, which is not surprising considering continued high unemployment.

Item 9: Monetary Policy

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

Overview

Current monetary policy is aggressively stimulative indicated by a low real yield measured against core inflation, a low real yield measured against reported inflation, a low real yield measured against expected inflation, a low natural rate of interest (nominal interest rate minus nominal GDP growth), a steep yield curve and a weak dollar.

FAC members have four concerns:

- Persistently low real interest rates may already be distorting activity in credit markets. Hold targets, while materially higher, have not been sufficient to prevent declining net interest income. Spreads on some weaker credits have declined too much. Already, covenant-lite high-yield bonds are being issued again and speculation has increased.
- Extremely low real interest rates may be:
    - Having some impact on commodity prices, particularly food and energy, creating a drag on disposable income for the weakest deciles of Americans. Consequently, core inflation may be an inadequate focus if commodity prices have a persistent upward trend over time.
    - Accelerating a decline of the dollar as the world's reserve currency and store-of-value.
    - Making it more difficult for U.S.-based companies to make international acquisitions .
    - Hurting the long-term international standing of the U.S.
- Greater global liquidity appears to have strengthened demand abroad, improving the prospects for exports. However, when combined with the risks and uncertainty of ongoing federal deficits and very high effective corporate tax rates, it further encourages the relative appeal of expanding capacity in more rapidly growing foreign locations rather than in slower growing domestic ones.
- Continued weak demand for credit to finance current spending combined with new and expected increases in regulatory capital requirements may be dampening the transmission of monetary ease into the domestic U.S. economy and have partially offset the easy stance of monetary policy.