

RECORD OF MEETING

Federal Advisory Council and Board of Governors

Wednesday, February 3, 2016

Item 1: Current Market Conditions

What is the Council's view of the current condition of, and the outlook for, loan markets and financial markets generally? Has the Council observed any notable developments since its last meeting for loans in such categories as (a) small and medium-size enterprises, (b) commercial real estate, (c) construction, (d) corporations, (e) agriculture, (f) consumers, and (g) homes? In particular, what is the likely impact of the recently issued Statement on Prudent Risk Management for Commercial Real Estate Lending on banks' lending practices? 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 aggregated data?

General Outlook:

- The Council believes the economy is stronger than the recent negative market sentiment would imply.
- Lenders are generally still highly competitive on rates, and looser structures are becoming more common, particularly on buyout financing.
- The demand for loans is anticipated to increase moderately through 2016, consistent with a moderately expanding U.S. economy. Soft commodity pricing may reduce some demand for working capital credit.
- More stress in the energy sector and in the manufacturing sector are to be expected going forward. To date, oil and natural gas prices remain weak and show little prospect of significant increase in the near term. Ongoing low oil and natural gas prices, combined with decreasing protection from price hedges, along with tightening credit standards, will extend the current high-stress environment for many petroleum-related companies into 2016. High-level economic indicators for the manufacturing sector are also cooling down, as recent consecutive contractionary readings in the ISM manufacturing index were the lowest since the last recession. Several regional purchasing-manager surveys have also indicated contraction over the past year.
- The financial markets will be greatly influenced by the decisions of the FOMC on monetary policy, with discussion centering on the speed of the rate-increase cycle.
- Commercial real estate and construction demand is steady, with strong competition for quality credits.
- The consumer credit market remains strong, with stable-to-improved mortgage activity and increased demand from new homeowners, supported by household formation. Auto loan volumes are robust due to record auto sales and a supportive consumer sentiment.
- The strong dollar continues to weigh on commodity prices and manufacturing activity.

(a) Small and Medium-Size Enterprises

- There continues to be a healthy availability of credit for small businesses. The desire to demonstrate loan growth in the small business segment has resulted in intense competition for the most creditworthy customers, and relaxed pricing and covenants are byproducts of this competitive landscape.
- From an industry perspective, deposits remain high for small business clients, indicating an ability to use cash in lieu of borrowing.
- Large banks continue to make fewer loans to small businesses compared to a decade ago. This has allowed alternative lenders and institutional investors to enter into the marketplace. Lending by institutional investors continues to increase, while lending by alternative lenders is starting to flatten. Although lending balances have decreased, large-bank approval rates continue to improve as the ability to service this sector becomes more efficient. There is still an opportunity to improve the customer experience for small business owners through digitizing delivery and improving responsiveness, which is an area in which alternative lenders continue to differentiate.

New Observations Since the December 2015 FAC Meeting

- Small business optimism stalled during the recent quarter after several periods of increases. Primary drivers continue to be uncertainty around long-term taxation and health-care costs. The political environment is also very uncertain, and business owners are concerned about continued tax increases and the increasing burden of regulation.
- Small businesses are beginning to make and/or plan capital expenditures but not nearly at historical levels, and any increase in borrowing remains below the capital investments.
- At this time, it is too early to measure the impacts of several external events – recent federal funds rate increase, oil price movement, impacts from late December weather-related events, and market volatility – on small business performance, though close monitoring is required.

(b) Commercial Real Estate

- Commercial real estate markets have improved for quite some time and are stable to improving in most markets. By property type, multifamily developments continue to be performing at very high levels and trading at very low cap rates.
- Banks continue offering very aggressive structures in all markets – longer tenors, higher loan-to-values, very thin pricing, and non-/limited-recourse structures.
- Activity is more balanced across public/institutionally capitalized sponsors (REITs, Pension Fund Advisors, Fund Sponsors, and National Investors) and privately capitalized sponsors. As is predictable in this stage of economic recovery, the flow of opportunities had been initially driven by investment activity in larger, coastal, and 24-hour markets, but investor interest is returning to secondary and tertiary markets due to improving health and increased competition in primary markets.
- Projects generally have such substantial equity contributions from sponsors that, despite lower-than-projected rental rates and/or absorption rates, the potential risk of loss is mitigated.
- Payoffs of interim loans continue to be elevated from historical levels. Projects are selling at historically low cap rates, and refinance opportunities are abundant.

New Observations Since the December 2015 FAC Meeting

- Continued job growth is driving office projects to exceed leasing expectations. And, the success of experiential shopping centers (lifestyle centers and power centers) has made the recovery for the more traditional retail subtypes more challenging.
- With e-commerce exponentially growing, banks are generally exercising caution around exposures in selected commercial real estate projects with tenants in certain retail businesses. Conversely, warehouse properties are gaining popularity with investors and developers, as the online retailers use large regional distribution facilities. Data indicate that a significant percentage of the warehouse/distribution sector is being built on speculation, which supports this trend.
- 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.
- At least one Council member noted instances of “froth” in the commercial mortgage-backed security market, with clients being offered 10-year, interest-only loans on commercial real estate with no recourse at relatively high loan-to-value levels.

(c) Construction

- Construction loan requests seem to have declined slightly for multifamily projects, which is likely the result of significant development of the better sites over the last few years, with many projects still under construction. Secondary sites are not as attractive to the development and investment communities.
- Competition for tenants in newer buildings is expected to be intense. Careful monitoring of the rental and absorption rates of new projects is necessary, and particular attention should be paid to concessions and effective rental rates.
- Demand for single-family tract-development financing continues to be tepid, due in most part to the dominance of the publicly held homebuilder in most major markets. Land-development financing is generally only available in conjunction with the financing of homes in the same subdivision.
- The largest single segment of growth in construction portfolios has been development or redevelopment of rental housing stock. This sector continues to benefit from the lack of new rental housing creation during the for-sale housing expansion of 2000-2008, as well as increasing demand for rental housing.

New Observations Since the December 2015 FAC Meeting

- There is a growing 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. Speculative construction is also increasing.
- With minimal new development over the recent past and now-growing enrollment, many educational institutions are focusing on incenting the development of privately owned and operated on-campus and near-campus housing.
- The current low-rate environment coupled with expectations of future rate increases continues to drive run-off in commercial mortgage books and early refinancing/asset sales in construction books.

(d) Corporations

- The large corporate environment is presently driven by a combination of factors, including lower overall market activity, continued institutional support for covenant-lite/high-yield credits, and strong commercial bank demand for higher-quality credits.
- The sector remains competitive from both a pricing and a structure standpoint, and it has not yet adjusted to reflect increased regulatory costs. Strong competition from both banks and nonbanks coupled with slow growth in the economy has made the lending environment very difficult.
- Corporates continue to refinance into current market pricing, driving down interest margins.
- Capital markets remain open and supportive.

New Observations Since the December 2015 FAC Meeting

- Softness in the industrial economy on a global basis has resulted in a negative impact on asset quality among both commodity-oriented and manufacturing-based borrowers.
- While loan demand was very strong for 2015, there was a softening of demand beginning in the fourth quarter. Loan growth in 2015 was driven primarily by one-time events (M&A, share repurchases, refinancing) and not necessarily by organic growth. In the absence of organic growth, 2016 is expected to be a marginally slower year.
- Loan spreads began to stabilize in the second half of 2015, although pressure on structures and covenants remains strong, and expectations are for that pressure to continue.
- Corporate clients continue to keep excess liquidity with banks, as evidenced by strong deposit growth during 2015. Despite uncertainty around new regulations, such as the liquidity coverage ratio, and a continued low-rate environment, deposit growth is anticipated to continue into 2016.

(e) Agriculture

- Chicken producer profits have come off of all-time highs as domestic supplies rose due to international import restrictions, driving prices lower. Cattle prices are still high but have decreased 25% year-over-year as herds are replenishing, after having been dramatically reduced due to drought in prior years. Raw milk prices declined substantially during 2015, improving processor margins but hurting producers.
- Agricultural borrowers continue to show strain at the start of the third year of low grain commodity prices, driven by high yields, reduced demand, and a strong dollar.
- The direct result of lower commodity prices is significantly reduced gross revenue for the majority of agricultural producers. These lower revenues, paired with expenses that have not reduced in kind, are having a major impact on producers' bottom lines.
- Also evident is equity erosion on the balance sheet from lower profits (or losses) combined with the significant depreciation of fixed-asset values (equipment values nationwide, as well as the correcting of land values in certain markets). This is resulting in higher leverage and weakened working-capital positions.

New Observations Since the December 2015 FAC Meeting

- Food manufacturers continue to experience steady operating performance. Niche markets for healthy and wellness alternatives continue to show consistent and stable growth, attracting both strategic and financial buyers to these businesses. Private equity firms with experience and knowledge of these industry subsectors have generally done well with these investments.
- The outlook for demand in the loan markets for the agriculture sector will be stable to increasing in light of the generally poor operating results of the last two years. But while loan demand may very well be higher, the financial profile of the borrower will likely be weaker.

(f) Consumers

- Overall demand for consumer loans is strong and expected to increase in 2016, although some pressure remains with processing under the TILA-RESPA Integrated Disclosure rule.
- Consumer loan delinquencies have remained consistently low over the last year, and FICO scores for the average consumer have improved.
- Existing consumer-line utilization reflects increases, with the consumer exhibiting nominally increased debt positions.
- Consumer demand for automobile loans remained strong in 2015 and is expected to increase in 2016, as borrowing costs remain historically low, gasoline remains cheap, vehicle-purchasing incentives are good, and buyers have plenty of options.
- Demand continues to increase for home equity lending. Drivers of the increased demand include improved home values, improved economic conditions, and consumers reinvesting in their homes via renovation/home repair/maintenance projects that were previously postponed due to the recession.

New Observations Since the December 2015 FAC Meeting

- There is evidence of increased demand for unsecured and deposit-secured lending. This is most likely due to the ease of processing and obtaining these loans compared to the requirements and length of time to close a home equity loan. Marketplace lenders are impacting the unsecured borrowing landscape by providing the convenience of broad-based online borrowing offers.
- Consumers appear to be saving much of the “energy dividend” from low oil prices rather than increasing consumption.
- Trends for 2016 that may impact consumer banking:
 - Rising interest rates with no correlated increase in savings account rates
 - Mobile payments continuing to make inroads
 - Continued mergers and acquisitions
 - Possible layoffs (particularly in commodity-stressed sectors)

(g) Homes

- Purchase mortgage originations in 2015 increased significantly compared to 2014.
- One Council member noted that the increase in originations was driven by high-quality borrowers, as only 20% of loans in a recent quarter were to borrowers with credit scores under 700, the lowest level in over 10 years.
- Refinance volume has steadily declined since March 2015, as those interested and able to refinance have largely done so.
- Inventories remain low at the high end of the market, especially in New York, Los Angeles, and the Bay Area.
- Outside of some regulatory interest in moving lenders away from interest-only home equity lines, there are no other recent developments in lending products, structure, underwriting, or pricing of note.

New Observations Since the December FAC Meeting

- The industry is expecting to be down slightly in 2016, with continued strength in purchase volume and a downward trend in refinance volume.
- New buyers are poised to enter the market as rent prices continue to increase and negative credit events from the start of the crisis (2007) move off of borrowers' credit reports.
- Generally speaking, the housing recovery continues at a moderate but uneven pace across markets.

In particular, what is the likely impact of the recently issued Statement on Prudent Risk Management for Commercial Real Estate Lending on banks' lending practices?

- In December, the federal banking agencies issued a joint statement on Prudent Risk Management for Commercial Real Estate Lending to "remind financial institutions of existing regulatory guidance on prudent risk management practices for commercial real estate (CRE) lending activity through economic cycles." The statement highlighted recent growth in commercial real estate loans and noted that examination and industry outreach activities have revealed an easing of underwriting standards, including less-restrictive loan covenants, extended maturities, longer interest-only payment periods, and limited guarantor requirements, and consequently, that some institutions' risk management practices give cause for concern.
- The statement itself is a sound one which, if adhered to, will lead to less risk in the commercial real estate market. However, several Council members pointed out that as a matter of practice, they were already following the recommendations outlined in the statement.
- There appears to be a bifurcation between banks that are adhering to the prescribed approach to risk management contained in the statement and banks that are not. Larger institutions seem to have acknowledged the need for lending strategies that are, in fact, market and product specific. However, other institutions continue to extend commercial real estate credit with looser structures, longer terms, and advance rates that may not demonstrate the same level of adherence. It was noted that the structure and pricing for term loans secured by quality commercial real estate continue to be extremely aggressive.
- It is likely that all financial institutions will begin to have a more-attuned awareness around market conditions, concentration policies, and prudent underwriting.

- While the commercial real estate lending market remains competitive as banks compete for loans, the knowledge that commercial real estate portfolios will be more heavily scrutinized might encourage some banks to begin curtailing lending.

Do Council members see economic development 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 aggregated data?

- Anecdotally, reported developments across the various Districts remain broadly consistent with trends in the aggregated economic data. Rates of job and income growth remain consistent with U.S. averages, and job growth continues to be largely driven by services, as manufacturing and energy face ongoing challenges. There are, however, marked differences in rates of job and income growth and levels of housing-market activity across individual states and metropolitan areas. It is important, from both an industry and a policy perspective, to be mindful of these divergent growth rates rather than being too reliant on aggregated data when forming views on the broader economy.
- One Council member pointed out that while unemployment rates continue to trend lower, thus far there has not been appreciable, sustained acceleration in average hourly earnings growth, indicating a still-high degree of labor market slack. This is evidenced in alternative measures of labor underutilization data released by the Bureau of Labor Statistics, which indicate large numbers of people working part time for economic reasons and also a high incidence of marginal attachment to the labor force.

Item 2: Emerging Risks

As the current expansion continues to unfold, are there particular areas in which Council members see economic or financial risks beginning to emerge? How might policymakers consider mitigating these risks?

Risk is everywhere and constant, as evidenced by the fact that risk premiums are not zero. Emerging risks can come in many forms, including asset bubbles, geopolitical, market, credit, liquidity, and even changes in consumer, investor, and business psychology. The Council believes that while all the risks above exist, a significant emerging risk is the economic reaction to policy and monetary decisions driven by forecasts that U.S. inflation will return to a 2% target while global conditions and many domestic indicators may signal significant deflationary pressures. The following summarizes these factors:

The global economy is stressed, especially in emerging markets, driven by the slower growth in China and stagnant growth in the euro zone. The two largest central banks outside the U.S. have implemented negative interest rates, and currencies are being devalued relative to the U.S. dollar. The nominal U.S. dollar has increased 23.5% since mid-2014 and remains under upward pressure. In summary, global demand is weak.

The U.S. economy experienced a sudden and unexpected loss of momentum late last year. The slowdown was fairly widespread, not just the result of declines in net exports and inventory investment. The Bureau of Economic Analysis estimated on January 22, 2016, that real GDP grew at just a 0.7% during the fourth quarter, and that nonfarm GDP only grew at a rate of 0.1%.

Also, the decline in commodity prices, especially oil, while helping sustain real income and wealth (pump savings), may also be signaling deflationary concerns. The significant slowdown in the fourth quarter also occurred against the backdrop of favorable weather. Employment remains a bright spot but does tend to lag nonfarm GDP, so it could well soften in the coming months. Auto sales are strong but have likely topped out. Given these developments, forecasters are likely to mark down their projections for real growth in 2016.

Broadly speaking, financial conditions, namely equity valuations, corporate spreads (especially high yield), and the dollar are all less favorable for U.S. growth. All of the financial conditions above slow economic growth, effectively represent monetary tightening, and are deflationary pressures. The increase in the nominal dollar is hurting U.S. exporters and S&P earnings and, all things considered, could appreciate significantly more with current stated policies combined with actions being taken by other central banks. The significant widening of credit spreads impacts business confidence and inhibits investment. Taken together, the widening of credit spreads and the decline in equity valuations represent a significant increase in cost of capital, decreasing capital expenditures, and investment.

Therefore, at a macro level, an emerging risk is that monetary policy is “tapping down” inflation and growth at a time when the world generally has negative interest rates and is exporting deflationary pressures to the U.S. In addition, maintaining inflation expectations of 2% while core inflation remains persistently low poses a risk that inflation expectations will decline instead of core inflation increasing to the 2% target. The FOMC has stated that a gradual pace of tightening is appropriate given its expectations of future growth and inflation. The so-called dots chart released in December indicates 100 basis points of tightening in each of the next three years, with a terminal rate of 3.5%. Markets do not share this view, and how these views converge represent a significant emerging risk, especially if the equilibrium interest rate is significantly below 3.5% in this global economy.

Other emerging risks identified by the Council include:

Liquidity

- New regulatory requirements have resulted in reduced bond holdings by banks, resulting in more market influence by large institutional investors. This could exacerbate financial instability and increase volatility.
- The lack of liquidity in the fixed income markets could also spill over to the equity market via exchange-traded funds (ETFs). An example of this emerging risk can be seen in this excerpt from a September 13, 2015, *Wall Street Journal* article:

“One fund hit by the dislocations was BlackRock’s iShares Select Dividend ETF, DVY -1.50 % which trades under the ticker DVY and holds shares of U.S. companies that consistently pay dividends. Its largest holdings include Lockheed Martin Corp. LMT -1.63%, Kimberly-Clark Corp. KMB -0.53% and McDonald’s Corp. MCD -1.98%. At 9:42 a.m. in New York on Aug. 24, the ETF tumbled 35% to \$48, its lowest level of the day. At the time, the combined weighted values of the stocks the ETF held were \$72.42, down just 2.7% for the day, according to FactSet.” The article further states, “Assets in

ETFs in the U.S. have grown to roughly \$2 trillion from \$305 billion a decade ago, according to research and consultancy firm ETFGI LLP. In July, U.S. exchange-traded products, a group that includes ETFs, represented just over a quarter of total stock-trading volume, according to NYSE Group. That compares with 14.9% a decade ago.”

The liquidity complexities of ETFs have not been addressed by regulators at this time.

Shadow Banking System

- Shadow banks are financial intermediaries that conduct maturity, credit, and liquidity transformation without explicit access to central bank liquidity or public-sector credit guarantees. As such, they continue to pose systemic risks to the financial system.

Operational and Cybersecurity Risk

- Operational risk is steadily increasing as banks seek to simultaneously leverage new technology, streamline processes, rationalize staffing, outsource critical activities, and partner with firms who may be unfamiliar with the new bank regulatory environment.
- Due to the increased sophistication of actors engaged in cybersecurity fraud, there will be increased losses for banks and their customers, even amidst increasing resources dedicated to protection. Evolving phenomena such as virtual currencies are enabling greater anonymity to cybercriminals to both raise funds and launder money to pay for physical and cyberattacks.

Policymakers can mitigate the above risks by:

- Signaling more strongly to financial markets that the case for four or five hikes in interest rates during 2016 is notably less compelling now than it was in December.
- Continuing to monitor the impact of new regulations and capital rules on market liquidity. Specifically, the recent proposal to increase margin requirements should be considered very carefully in the context of market liquidity.
- With respect to shadow banking, continuing to analyze risk indicators and have open dialogue regarding their implications.
- With respect to operational risks, encouraging local regulators to continue to recognize that operational risks vary significantly across institutions based on their business models. With respect to cybersecurity, there should be recognition that this is not only a private-sector issue but also a matter of national defense.

Item 3: The Outlook for Banking in 2016

- (a) What will be the drivers of bank profitability?**
- (b) What are the greatest competitive challenges facing the banking industry?**
- (c) What is the most substantial regulatory concern for the industry?**
- (d) Is the industry well positioned if interest rates rise further?**

(a) What will be the drivers of bank profitability?

- Bank profitability in 2016 will likely be challenged by escalating loan-loss provisions, continued intense pricing competition, the interest rate environment and its impact on net

interest margins, and the necessity of an institution's ability to control expenses and grow fee income.

- For individual banks, each of these drivers will impact results differently because the proportion of spread vs. fee revenue will be different, as will the exposure to changing credit conditions. More diverse forms of noncorrelated revenue will assist in the ability to maintain consistent performance if the economy falters. Similarly, a diversified loan portfolio (consumer vs. commercial; geography; industry concentrations) will provide more cushion than would portfolios concentrated in any one of the categories.
 - A highly competitive loan environment in 2016 will likely continue to impact loan pricing. Loan growth is expected to remain relatively healthy throughout the year as the economy improves, but pressure on net interest margins is unlikely to abate.
 - As deposit rates are increasing from an extended period of being close to zero and core deposit balances are at record levels, there is uncertainty surrounding deposit flows and deposit beta. New liquidity rules also increase competition for retail deposits to ensure compliance, which may result in irrational pricing and further cost-of-funds pressure.
 - While asset quality remains strong, loan-loss provisions are expected to increase as loan portfolios exhibit some modest growth, and the low level of gross charge-offs reverts closer to prior mid-cycle averages.
 - Council members believe that the challenge includes managing expenses in a muted growth environment where there are continually increased infrastructure requirements. While we expect rates to rise, we have to operate under the assumption that we will be in a low-rate environment for a protracted period. In this environment, expense management is a critical component of profitability.
 - The burden associated with an increase in regulatory and compliance costs will continue to pressure bank earnings, and while banks have focused and will continue to focus on expenses, opportunities to continue to lower the expense base will be challenging given regulatory, compliance, and technology costs.
 - Banks are expected to continue to ramp up their information security and information technology expenses in 2016 to combat cyberattacks and address technology vulnerabilities.
 - Online and mobile banking channels will be used to augment our brick-and-mortar infrastructure. Online and mobile banking continue to be growing delivery channels among the retail customer base.
 - Smaller banks in particular are unable to spread these costs over a wide asset base, so they will have a more difficult time improving ROA and ROE.

(b) What are the greatest competitive challenges facing the banking industry?

The shadow banking system continues to pose the primary competitive challenge to the banking industry, with pressure coming from nonbank entities in both the lending and payment channels.

- Retailers, service providers, and phone hardware providers are creating their own digital wallets in an effort to capture data that will allow them to deepen their relationship with clients and ultimately sell more goods and services.

- Start-up fintech companies are creating payment and financial solutions that make it faster and easier for retail clients and small businesses to borrow money and/or pay faster, and “crowdsourcing” is now becoming prevalent in the market.
- The largely unregulated fintech business model is connecting potentially unsophisticated individual lenders with individuals seeking to borrow money. This has the potential of creating a systemic risk longer term, potentially putting an individual’s financial information and well-being at risk. Many of these nonbank entities operate without the same regulatory overhead that is placed on banks, making it more difficult for banks to compete with them and putting additional pressure on already thin margins.

Secondarily, bank appetite and market expectations for growth are outstripping demand, forcing downward pressure on pricing and liberalized structures. Banking competitors are only recently facing reality with respect to liquidity and capital requirements, and no major capital provider has put a stake in the ground to increase pricing.

Additionally, bank size does not always define its business model and risk profile, so the bifurcation of regulation by size can create situations where different regulations are applied to similar institutions. This can discourage large-bank activity in certain areas where economies of scale could be beneficial.

- Regulatory pressure continues to be a drag on bank innovation, which will hurt the industry in the long term. Banks must rethink their business models to meet the increasing regulatory requirements while maintaining quality service and customer-facing activities.
- Regulatory requirements are pushing the underbanked and unbanked away from the regulated banking industry.
- The cumulative impact of rules is making it difficult for customers to get what they want.

Banks must continue to invest in talent development and improving employee retention and engagement, while responding to increasing competition from banks and nonbanks. Banks must also balance the need to provide market-based compensation while incenting the right behaviors and generating appropriate shareholder returns.

Higher U.S. capital requirements create a competitive disadvantage to overseas peers with lower capital requirements and return expectations. As the international regulatory landscape evolves, the relative competitiveness of the U.S. banking system vs. the international banking system may evolve as well. At this juncture, the outcome is unclear.

(c) What is the most substantial regulatory concern for the industry?

As it pertains to the industry as a whole, the continued growth and scope of overall regulatory complexity and reporting is a primary concern. The cost of regulatory compliance remains a chief concern of all bankers, and it is especially worrisome for community banks.

With respect to larger banks, the SIFI designation comes with a variety of correlated regulatory pressures, the greatest being LCR compliance and reporting.

- From almost every perspective, the newly imposed liquidity standards pose a bigger challenge to the industry than even the Basel III capital rules. LCR remediation requires adjustments at the corporate level, the line-of-business level, and even the product level.
- LCR constraints are forcing banks to change, or at least reassess, stable and long-held business models, as bank balance-sheet size is now effectively limited by the ability to attract funding and not the ability to find assets. Furthermore, liquidity rules have a far greater impact on commercially oriented institutions, which generally maintain larger off-balance-sheet positions and lower percentages of retail-oriented deposits than competitors. Requiring banks to put such a high amount of liquidity aside for commercial deposits will raise the cost of credit on a systemic basis, impeding long-term economic growth, which could, perversely, impact safety and soundness on an indirect basis.
- In addition, by effectively devaluing the deposits that commercial customers provide, more deposits are being pushed off bank balance sheets into off-balance-sheet funds. A lack of systemic diversification in funding and collateral could lead to numerous other concerns, including the possibility of high-quality liquid assets becoming less liquid or their pricing becoming more volatile, distorting the demand-and-supply characteristics for U.S. Treasuries.
- There are significant fixed infrastructure costs required to track, manage, and monitor liquidity as well as the significant structural balance-sheet costs to meet required standards. These are long-lasting and semi-permanent expenses that must be incurred and planned for, even in the midst of serious discussions about whether LCR standards are even necessary or will be maintained for smaller, noncomplex regional institutions.
- The new countercyclical buffer proposal, in conjunction with the conservation buffer and the yet-to-be-released requirements for the Net Stable Funding Ratio, will layer on further requirements that will substantially impact the profitability of the industry and continue to make it difficult for banks to earn returns equal to or above their cost of capital.
- The proposed changes for the loan-loss reserve methodology will require banks to reserve for expected losses, and the increase in FDIC assessment fees and other “taxes” on large banks will further exacerbate this problem.
- Concern over residential mortgage lending – particularly for smaller firms – due to QRM and the intensity of these rules, coupled with the impact on profitability, is already reducing product offerings by smaller institutions. TRID has been a confounding regulation for many mortgage providers and may negatively impact the availability of mortgage credit.
- Failure to prioritize issues/findings among prudential supervisors drives a crisis mentality about everything and creates an inability to balance costs of responses.
- Matters Requiring Immediate Attention – Working with our partners at the agencies to clarify expectations, set clear milestones, implement changes, and close outstanding MRIs is an industry focus.
- Compliance – The standards for compliance with rules and regulations have always been high. There is a perception that in some current areas of regulatory focus, the goal is perfection.
- Differing missions of the various regulatory agencies create unintended consequences. For example, consideration of CFPB actions by prudential supervisors in Community

Reinvestment Act ratings, despite no explicit link, diminishes the impact of this important legislation.

- Council members are concerned about the Federal Reserve’s oversight communication for “New Margin Requirements,” which would reach beyond banks and across the entire financial system.

(d) Is the industry well positioned if interest rates rise further?

- The industry is positioned to benefit from rising rates, but the extent of the benefit is uncertain. While banks describe their sensitivity analysis in their financial disclosures, the analysis presented is primarily based on a parallel rate shock, meaning that the shape of the yield curve is assumed to be static from one scenario to the next. In an actual rising-rate scenario, where short-term and long-term rates move at different levels, the financial benefit of rising rates could vary.
- Floating-rate loans and liabilities with contractual pricing should behave as expected in a rising-rate environment. However, deposits are an area where the estimation of responsiveness in pricing to rising rates is highly assumption based. It has been nearly ten years since the last rising-rate environment, so the quality of assumptions around how customers will behave and how banks will price are critical.

Item 4: Innovation and the Banking Industry

What are the most important innovations currently affecting bank practices and lines of business for banks and banks’ competitors outside the banking system? How have banks changed their business models in light of innovations in such areas as payment services? How significant are the challenges for compliance with safety and soundness, anti-money-laundering, and consumer protection requirements that are posed by adoption of new technologies or partnerships with nonbank innovators?

What are the most important innovations currently affecting bank practices and lines of business for banks and banks’ competitors outside the banking system?

- Last year, in particular, has seen both the proliferation and growth of nonbank technology companies offering financial services, primarily to consumers. Technology companies focused on financial services are frequently lumped together under the heading “fintechs.” However, the financial services these firms offer are rarely universal, and the typical fintech seeks to deliver only a single product line or service over the Internet. The strength of fintech firms generally is that their web-based interface is often viewed as speeding up or simplifying the transaction for the consumer. Combining ease of use, speed of operation, and the nearly ubiquitous accessibility of the Internet, fintech companies offer consumers person-to-person electronic payments, secured and unsecured loans, and financial management or budgeting products.
- Fintech firms often compete directly with services offered by banks, even if the nonbank providers frequently rely on traditional banks to help deliver their services to consumers, such as by relying on the bank-managed ACH or wire networks to settle and clear payments transactions. With regard to loan products offered by fintechs, the predominant business model is the “marketplace lending platform,” a model that seeks to match creditworthy applicants with loans that are, in turn, attractive to loan investors.

Marketplace lenders offer investment in these loans to both retail consumers and wholesale investors, including private investment funds and banks. Recently, marketplace lenders have expanded their offerings to small business lending. Financial management fintechs seek to aggregate the financial information of consumers from different financial firms into a single view and allow customers to better track their gross cash flows and savings.

How have banks changed their business models in light of innovations in such areas as payment services?

The response by the banking industry has been to revise their product offerings and delivery channels to compete with the speed and convenience of the fintechs, to acquire these nonbank providers, or sometimes to use fintechs to help deliver their own products. Some banks have active venture arms and/or accelerators focused on finding the most-promising fintech providers and investing in them to secure potential IP rights and insights. For example, some banks have acquired financial management fintechs to offer more budgeting capabilities to consumers and improve the customer experience of their own websites. In other cases, banks have used marketplace lenders essentially as correspondent lenders, investing in the consumer loans they originate either on a selective or broader basis. Additionally, banks may use the services of fintechs to better market their own loan products to existing customers through improved customer identification. However, because of the differences in their business models, regulatory requirements, and culture, banks have found themselves limited in their ability to partner in a long-term way with many nonbank fintechs.

How significant are the challenges for compliance with safety and soundness, anti-money-laundering, and consumer protection requirements that are posed by adoption of new technologies or partnerships with nonbank innovators?

- Some of the larger and more mature fintechs have compliance regimes focused on meeting basic consumer protection standards. Independent fintech companies are less focused on the prudential management of their businesses than banks because they are not subject to prudential supervision. As noted, the fintech business model focuses on the delivery of services and is not dependent on the long-term safety and soundness of the firm's activities beyond losing customer confidence.
- When fintechs facilitate lending, they rarely have any stake in the long-term performance of the loan. In that sense, fintech lenders have business models similar to the "originate to distribute" mortgage lenders of the last decade, although they rarely rely on securitizations. As the scale of these operations increases, particularly in small business lending, it is increasingly possible that they will facilitate a pro-cyclical provision of credit and exacerbate the credit cycle. These risks pose substantial challenges to bank partnerships and require extensive mitigation to avoid heightened prudential and fair lending risks.
- When fintechs offer payment services, they focus on the speed and ease of use by the consumer and rarely offer compensation to customers for fraud or loss. Indeed, some of the payment services offered by fintechs, such as those that rely on Bitcoin and other crypto-currencies, are simply incompatible with the basic anti-money-laundering and know-your-customer requirements in place for banks. The lax fraud and cybersecurity

controls of many nonbank payments providers are also incompatible with the bank payments security standards. These risks simply prevent banks from adopting many of the more-popular payment fintech solutions and have led bank consortiums to develop new real-time payment solutions that meet bank security standards, such as the real-time payments initiatives of The Clearing House and clearXchange.

- Similarly, financial management fintechs often require consumers to hand over the website log-in credentials for all of their financial accounts, making fintechs rich single points of vulnerability where hackers and identity thieves can obtain a consumer's financial information and data. Where banks have noticed that some consumers appreciate the more-advanced budgeting tools offered by fintechs, some banks are offering these solutions within the more-secure web environment of the banks' own online channels. Because of (1) the cybersecurity and fraud risks posed by fintechs using a customer's log-in information to access their bank account data and (2) the lack of control that banks have over the standards fintechs use to protect their customers' data once pulled from the bank website, banks are incredibly reluctant to partner with or facilitate the dissemination of these data to financial management fintechs.

Item 5: Mergers & Acquisitions

What do Council members foresee for M&A activity in the banking industry over the next several years? What factors will affect the pace and pattern of M&A activity? Does the Council consider these developments to be beneficial for the industry?

What do Council members foresee for M&A activity in the banking industry over the next several years?

- M&A activity in the banking sector is likely to continue, with banks evaluating whole-bank acquisitions as well as nonbank transactions:
 - On the topic of whole-bank acquisitions, announced bank transactions declined to 281 in 2015 from 287 in 2014; however, in 2015 there were 5 deals valued at greater than \$1B compared to 2 transactions each in 2012, 2013, and 2014. Total deal value was considerably higher in 2015 at \$26.2 compared to \$18.7 in 2014.
 - Consolidation is likely to continue, with much of the activity among buyers under \$10 billion in assets and sellers under \$5 billion in assets. The Council feels consolidation will continue at least at its current pace, while a few Council members expect the pace to increase. The number of banks continues to decline, as new-charter activity has been slow while merger activity continues. The total number of FDIC-insured financial institutions declined from 6,509 at the end of 2014 to 6,190 at the end of 2015, a decline of 319 bank charters.
 - Larger acquirers (\$10 billion in assets and up) will continue to evaluate possible acquisitions, but these acquisitions have slowed, with recent transactions having been sidelined because of regulatory concerns.
- On the nonbank side, banks are continuing to look for ways to diversify revenue streams and meet additional customer needs. Specialty lending businesses and technology companies that offer strong value propositions to selected customer segments, such as small businesses, are attracting potential buyers.

- Several notable key drivers for consolidation are in place:
 - Challenging interest-rate environment for spread-dependent banks.
 - Difficulty growing top-line revenues in a slow-growth economy, putting increased focus on operating efficiencies.
 - Technological innovation reducing reliance on traditional branch channels.
 - Inability of some smaller depository institutions to navigate a more-stringent regulatory environment.
 - The relative age of CEOs, paired with a lack of qualified successors within the industry.
 - Improving credit quality allows buyers to better assess the risk of acquisitions, with the possible exception of oil-related loans.
 - The expectation of higher rates should lead nontraditional niche lenders to seek more stable sources of low-cost funding (i.e., insured bank deposits).
 - Inability to gain wallet share could lead more traditional spread lenders to seek a premium for their core customer relationships.
 - In certain instances, private equity investors are looking for an exit strategy, which could include selling.

What factors will affect the pace and pattern of M&A activity?

- There are also several notes of caution for M&A activity – especially for larger banks above \$50 billion in assets:
 - While the pace of transactions has been steady and some larger transactions are beginning to be announced, continuing uncertainty in the regulatory environment makes both buyers and sellers cautious.
 - The current disparity in pricing multiples between larger and smaller banks has led to high seller-price expectations that make many transactions challenging to justify from an economic standpoint.
 - While showing signs of recovery, the pace of economic recovery is still slower than desired. Furthermore, uncertainty on future rate actions leads to challenges in valuing deals.
 - In today’s environment, both buyers and sellers are likely to conduct more extensive due diligence. A fair amount of recent M&A activity is the result of direct one-to-one discussions between the buyer and seller or limited auctions.
 - Target banks may have credit portfolios that are heavily weighted in certain concentrations. Acquiring banks must be able to rationalize these portfolios with their existing concentrations.

Does the Council consider these developments to be beneficial for the industry?

- Given the relatively large number of banks, the Council views the current pace of M&A activity healthy for the industry. Consolidation of the industry does potentially have the risk of limiting services in smaller communities. Overall, the Council considers the improvement in M&A activity to be beneficial to the health of the industry, but the lack of new bank charters is concerning, as we do believe communities need banks of all sizes.

Item 6: Monetary Policy

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

The current stance of monetary policy continues to be accommodative and can be assessed by comparing the outlook for the economy to the Federal Reserve's objectives.

- Employment has progressed very well over the past two years. The “headline” unemployment rate has fallen to 5%, and the broader unemployment rate (which adjusts for part-time workers and those marginally attached to the labor force) has dropped by more than 7 percentage points from its peak.
- Inflation remains below the targeted level of 2%. The inflation outlook depends critically on the performance of currency and energy markets.
 - While many economic forecasts predict a return to the 2% inflation level in the near term, this runs counter to financial markets, which view this as unlikely.
- The December increase in short-term interest rates was well justified and well received by markets; monetary policy remains extraordinarily accommodative and well below the 3% - 3.5% neutral funds-rate range.
 - However, financial conditions have deteriorated in recent months, with the Bloomberg Financial Conditions Index falling from 0.58 in early November to - 0.37 presently.
- Fixed-income markets currently expect the federal funds rate to rise 0.28% to reach 0.64% over the next year.
 - Previous Fed guidance indicated that it expects to increase rates by 100 basis points over the same period, highlighting a notable disconnect between the Fed and the markets.
 - Economic growth will need to accelerate and financial markets will need to experience lower volatility to enable the Fed to raise rates materially above current market expectations.
- Equity markets and other risk assets can adjust to a rate rise provided the pace of increase is generally in line with market expectations.
 - While the business and financial community will likely view the rate rise as corroboration of a healthier U.S. economy, a rate rise will also be attributed to a view that the Fed no longer believes zero interest rates are constructive.
 - The risk of collateral damage from rate hikes is higher than in prior cycles due to the extended period of low interest rates and the resulting increase in duration and credit risk that some investors have taken.
- We believe the Fed should continue to make its policy decisions that are informed by economic fundamentals, avoiding undue influence from short-term market volatility and expectations. Looking forward to 2016, we believe the Fed has four main policy paths to consider. These are shown below in order of most to least attractive, based on the current state of the economy. As 2016 unfolds, evolving economic conditions will influence the appropriateness of these options.

(1) Raise rates two times in 2016, in line with market consensus

- Given current conditions, we believe this is the optimal path.

- However, the Fed's future decisions must be supported by data and remain in line with prevailing economic conditions and interest rate expectations.
 - To minimize the negative impact of rate increases on financial markets, we believe the Fed should look to adjust rates modestly above the market consensus.
 - It may also be beneficial during 2016 for the Fed to continue communicating its plans for balance sheet management.
- (2) Hold rates constant**
- While a better alternative than the others below, the market may interpret this to mean the U.S. economy is weaker than the data are reflecting.
- (3) Follow the “Dot Chart” – Raise four times in next eight meetings**
- Given the current state of the economy and uncertainty surrounding future U.S. and global economic events, this route may prove too aggressive and have a meaningfully negative impact on U.S. financial markets, with a negative knock-on effect to the real economy.
- (4) Lower rates**
- This is the least optimal of the options, as it signals a weak U.S. economy and extends the period of near-zero rates, which may no longer be constructive.

12:00 pm – Luncheon for Council and Board members in the Board Room