RECORD OF MEETING

Federal Advisory Council and Board of Governors

Friday, February 10, 2017

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? 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:[1]

- The Council believes there has been a modest positive change in the current condition of, and outlook for, loan markets and financial markets in general.
- While not yet seen in the numbers, post-election there has been a palpable rise in consumer and small business confidence.
- Employment continues to improve, and consumer optimism is reflected in spending.
- The mortgage market continues to be healthy, although the increase in interest rates has significantly slowed refinances.
- Commercial real estate markets continue to experience strong growth without evident deterioration. Multifamily construction is showing signs of moderation.
- The pace of growth for corporate loans has slowed as asset quality has weakened.
- Agricultural markets continue to be stressed due to persistently low commodity prices and high input costs.

(a) Small and Medium-Size Enterprises

- According to the National Federation of Independent Business, small business optimism increased after the election, jumping 7 points in November and continuing to increase in December to the highest level since December 2004. Continued optimism will likely translate into additional spending.
- Council members report that current loan demand remains generally unchanged, with demand over the last six months of the year lower than that of the previous six months. However, demand for micro loans (under $250,000) has increased sharply since the election.
- For both small and medium-size enterprises, banking competition remains fierce, causing loan pricing and structure to remain under significant pressure. Noncurrent loans have remained relatively stable over the past year.

[1] *Data cited in this response refer to general banking conditions.*

(b) Commercial Real Estate (CRE)

- CRE portfolios continue to experience strong growth, but the Council is not expecting growth to continue as many current construction loans mature. The loan portfolio has grown at a year-over-year rate of over 10 percent the past five quarters (through September 2016), with totals exceeding the peak seen in 2008. In particular, construction and land development (CLD) loans have grown by over 10 percent (year-over-year) each quarter beginning in June 2014. Growth has been particularly strong in banks with over $10 billion in total assets. Noncurrent levels continue to decline from the peak in 2010, decreasing from 0.86 percent in September 2015 to 0.63 percent in September 2016, the lowest noncurrent level since 2006. There is a sense that CRE lending will be constrained soon.
- Property prices remain strong. The combination of low cap rates and peak rents continues to propel values to historically elevated levels in many markets – far in excess of the vast majority of CLD loan amounts.
- Demand for industrial properties is strong, as its pro-cyclical nature continues to support expansion. Nevertheless, there also seems to be a very robust pipeline of new, very large (600,000 to 1 million square feet) speculative developments occurring in the Inland Empire of Southern California and the greater Dallas/Fort Worth markets. Over time, this could lead to increased vacancy rates.
- Apartment fundamentals appear to be slowing after years of positive rent growth, and there are concerns about some particular market segments. Markets with greater amounts of supply and exposure to areas of the economy that are under pressure are being scrutinized. However, the underwriting in place at loan origination allows projects to provide more than ample debt service or a value cushion. The market has demonstrated a clear tightening of multifamily underwriting, and the recent deceleration of activity in start-up developments is a positive. Multifamily completions are expected to peak in 2017.

(c) Construction

- New home construction continues to be constrained in many urban markets.
- Financing demand for single-family-tract developments continues to be tepid, due mostly to the dominance of publicly held homebuilders in most major markets.
- Credit availability for the development of office and retail projects is heavily dependent upon pre-leasing and/or substantial equity contributions. In most markets, demand and/or rental rates have not returned to levels that justify the cost of building these property types on a speculative basis. As a result, supply and demand seem to be in balance.
- Construction of new retail and office developments continues to be tenant driven, and there is very little speculative activity.

(d) Corporations

- Total commercial and industrial (C&I) loans in the third quarter of 2016 were $1.9 trillion, according to the FDIC. While the pace of growth has slowed, growth in C&I lending continues. Total C&I loans in that quarter increased 0.6% from the previous quarter and 7.8% from the previous year.
- On balance, bank lending standards for C&I loans were largely unchanged, according to the October 2016 Senior Loan Officer Opinion Survey. The survey also noted that a

modest net fraction of banks reported weaker demand from large and middle-market firms, while demand from small firms was little changed, on balance. Banks reported that they generally expected C&I loan demand from firms of all sizes to remain basically unchanged, on balance, over the next six months.

- Asset quality for C&I loans weakened modestly from a very favorable level. Loan balances in nonaccrual status increased, rising only slightly from the previous quarter but more than doubling from a year ago. Approximately $24.8 billion of C&I loans are in nonaccrual status, the highest level since the end of 2010, localized to the energy sector. The portion of C&I loans that are 30 days to 89 days past due (30-89 days past due) has remained relatively steady over the past two years.

(e) Agriculture

- Total outstanding loans secured by farmland rose to $94.7 billion during the third quarter of 2016, up 7.2% from the previous year—the slowest growth rate in the past two years. Agricultural production loans also increased in the second quarter, rising 1.6% from a year ago, to $80.6 billion—the slowest rate of growth observed since mid-2013.
- Asset quality for agricultural production loans, while remaining at historically high levels, deteriorated during the third quarter, as both the 30-89 days past-due loans and the noncurrent loan rates increased—11 basis points and 36 basis points over the year, respectively. Farmland loans followed a similar pattern, rising from historical lows as the 30-89 days past-due rate rose 4 basis points over the year, while the noncurrent loan rate rose 23 basis points over the same time frame.
- According to the Kansas City Federal Reserve's Survey of Agricultural Credit Conditions, declining repayment rates and lower farmland values have contributed to a weak financial outlook for the farm sector. Despite strong exports for most commodities in 2016, prices remained lower than year-ago levels for all major commodities except soybeans. Bankers' expectations for repayment rates across all categories have become much more pessimistic.

(f) Consumers

- Consumer lending has continued to increase, up 7% over the past year. This increase has been strongest in credit card spending, up 8% over the last year. Noncurrent loan levels have remained relatively low and stable, with some Council members reporting those levels gradually increasing, but from a very low point.
- Auto loans outstanding in the third quarter of 2016 increased 1.7% from the previous quarter and 7.4% from the previous year. The share of auto loans 30-89 days past due increased slightly to 1.63%, up 1 basis point from the previous year. The net charge-off rate rose to 0.75%—the highest level since the inception of the measurement in 2011.
- The volume of home equity applications has remained strong, with no "end-of-term issues," in spite of the recent rise in rates.

(g) Homes

- Residential real estate loans have picked up at an increasing pace since 2014, with year-over-year growth through September 2016 of 7%, the largest increase since 2009. Noncurrent loan levels have continued to slowly decline, currently at 3.4% compared to 4.6% in September 2015, and are now at the lowest level since 2008.

- Due to rising interest rates, a decline (primarily in refinance applications) in conforming secondary-market mortgage applications has been experienced. However, despite rate increases, several Council members report that there has been no decline in demand for portfolio jumbo mortgages.

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?

- Comments from the Tenth District suggest a possible modest recovery underway in the energy sector, including rig counts and hiring trends for service companies. These developments may also be a factor in rising manufacturing activity.
- All members report a growing sense of optimism among consumers, small businesses, and middle-market companies.

<u>Item 2</u>: <u>Economic Growth and Emerging Risks</u>

> **What is the Council's expectation for economic growth in 2017? Are there particular areas in which Council members see economic or financial risks beginning to emerge? How might policymakers consider mitigating these risks?**

What is the Council's expectation for economic growth in 2017?

- The Council forecasts GDP growth between 2% and 2.8% in 2017. Increases in consumer spending, housing-sector activity, and business fixed investment are likely to drive economic growth over the next twelve months. This potential growth could be offset by some softening of the economic picture due to relatively weak global demand, potential new trade policies, and a strong dollar.
- Fiscal stimulus under the Trump administration and the new Congress is not clearly defined. The Council believes that the unusual degree of uncertainty surrounding new fiscal and trade policies can either fuel or stall economic growth. Personal and business tax cuts, along with increased spending on infrastructure, may stimulate even stronger growth over the next two years. However, the economy is close to full employment and that may lead to higher inflation.

Are there particular areas in which Council members see economic or financial risks beginning to emerge?

- **Lagging productivity growth continues to restrain growth of aggregate national output.** If fiscal stimulus drives up the demand for goods faster than goods-producing sectors can respond, because those sectors are restrained by slow growth in productivity and the workforce, then the excess demand will lead primarily to higher inflation. The slow improvement in productivity may be due to many factors: weak R&D and capital investment; incremental advances in IT; stagnation of quality education attainment; misallocation of resources due to overregulation; and/or income inequality.
- **Labor availability.** The Council notes a shortage of skilled workers who are adequately qualified to fill available positions. This shortage is putting upward pressure on compensation.

- **Higher inflation and rising interest rates.** These circumstances have the potential to diminish long-term growth**.** With the economy close to full employment, federal tax cuts and increased infrastructure spending are likely to fuel inflation, which could lead the Federal Reserve to raise short-term interest rates more aggressively than currently expected. Moreover, higher inflation and larger federal deficits will likely drive long-term interest rates higher, and are doing so already.
    - A drop in the market value of fixed-rate assets (loans and securities) that are held in portfolio is a threat to the banks.
    - Strong property performance and low interest rates over the past few years have made commercial real estate attractive and caused investors to bid up property prices. Over the near term, higher interest rates will raise borrowing costs for investors and could lower the value of commercial properties.
- **Weakening exports.** International trade is certain to restrain U.S. economic growth in the near term and could be a significant drain if the appetite for U.S. export goods further erodes. The smooth flow of goods and investments globally is critical to economic growth in the United States. The incoming Trump administration is proposing a number of policies that risk increased trade friction with major trading partners, including China, Mexico, and Canada. Disruptions in trade and investment flows can limit growth.

How might policymakers consider mitigating these risks?

- The Council believes policymakers should consider the effect of any fiscal stimulus coming from the new Trump administration and Congress.
- Local regulators should engage in ongoing discussions with management about how each regulated institution is measuring and monitoring exposures and should adopt best-practice models, including the consistent assessment of concentration and credit limits for various institutions, sectors, and regions.
- We recommend that policymakers closely monitor trade friction and currency valuations resulting from increasing global tensions.

Item 3: The Outlook for Banking in 2017

(a) What will be the drivers of bank profitability?
(b) What are the greatest competitive challenges facing the banking industry or, as applicable, segments of the banking industry?
(c) Is the industry well positioned if interest rates rise further?

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

Council members noted that there is a fair amount of consensus and conviction among bankers on this topic and the two related questions.

It's important to start with what will likely *not* be the drivers of improved industry profitability in 2017. At this point in the cycle, loan-loss provisioning, albeit always uneven, is at a favorable level. Further, bank management teams have done a very good job of reducing expenses over the last many years. Holding these loan losses and expenses down will still require attention. In fact, many bankers point to investments in new delivery channels, other customer-facing technologies, and information security as major programs that will consume resources in 2017. Nonetheless,

reduced loan-loss provisioning (except perhaps for those getting relief from the recent energy-sector crisis) and expense management will likely not be significant drivers of improved performance in 2017.

The strong sense from bankers is that profitability improvements in 2017, and in the near term beyond that, will come first from net interest income improvements and, to a lesser extent and likely later, from potential regulatory relief and tax reform. Net interest income improvement would be the result of a steepening yield curve (already occurring),GDP growth that would come from enhanced spending as a result of improved consumer and business confidence (already occurring), and any concrete fiscal stimulus programs that may come from the new Trump administration and a more politically aligned Congress in Washington.

Fee-income growth will likely be a less-certain contributor to the industry's performance in 2017. An overall stronger economy will help, as will specific secular trends like the growing needs for wealth management services for baby boomers, but these gains will be offset by fee compression. Fee-income growth will also likely be partially offset in the short term by reduced fee income from mortgage banking, as a result of rising rates leading to less refinance activity. Capital markets and trading activity has started strong in 2017 and is expected to continue.

(b) What are the greatest competitive challenges facing the banking industry or, as applicable, segments of the banking industry?

All of these dynamics have been well discussed in recent Council responses that are in the official meeting records. To synthesize and reiterate, bankers see the following factors as the biggest competitive challenges facing the industry in 2017:

- intensifying competition from nonbank lenders (including the shadow banking system, nonbank mortgage lenders, and in some locales, the Farm Credit System and credit unions);
- continued competitive disruption from fintech companies and platforms, especially in the payments arena;
- significant investment needed to keep up with evolving digital-delivery demands and to address increasing security and fraud threats; and
- continuing uncertain and uneven regulation.

Also presenting challenges, but less so, are the continued intense competition on both pricing and terms in the commercial lending market and continued increasing competition for talent.

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

Many bankers feel that the last two and any future federal funds rate increases have had or will likely have little effect on deposit flows and rates. After that, deposit attrition and deposit betas will likely show up in a gradually increasing way. Most bankers believe that their natural business model is well positioned for rising rates. After a very prolonged period of near-zero rates at the short end of the curve, as well as the narrowing of net interest margins, many banks have positioned their loan portfolios and their funding for rising rates. Variable-rate loans and core funding have grown significantly over the cycle and have been augmented by some off-balance-sheet strategies that will likely also benefit from a rising-rate environment. Most banks describe themselves as being "asset sensitive" (with the potential exception of some very small banks).

However, the unknowns around deposit attrition and deposit betas in a rising-rate environment are commonly expressed concerns. It's been a decade since banks have faced this rate dynamic. Competition has changed (from traditional banks and new entrants), customer behavior has changed, and the political and public relations environment for banks has changed. Most banks are using models that are rooted in data from 10 years ago or more, and those models have been adjusted to reflect best estimates of the impact of these new dynamics. However, the full effect of a rising-rate environment remains to be seen, particularly which deposits will be lost from the industry in total, how customer balances may shift to less-liquid, higher-rate products, and how much bankers will have to "pay up" to retain deposits to support balance sheet growth.

Furthermore, an offset to the benefit from rising rates will likely be a reduction in mortgage banking activity and in other more rate-sensitive lending, as higher rates price out certain borrowers and transactions from the market. Additionally, rising rates will reduce the recorded value of trading and held-for-sale investments, which will have an accounting impact on a banking organization's capital.

Nonetheless, most banks would welcome a slow, measured, well-communicated rise in interest rates as a return to historical norms and regard such a rise as good for both the economy and the industry.

Item 4: Regulation of the Banking Industry

> **Regulation of the banking industry has again become part of the national debate. What changes in regulation seem most likely? What is the Council's view of such changes, and what principles should guide those changes?**

What changes in regulation seem most likely?

On February 3, 2017, President Trump signed an executive order delineating six Core Principles that will guide financial regulation during his presidency. The executive order also directs the Secretary of the Treasury to identify the extent to which existing laws and regulations promote these principles. As a result, the Dodd-Frank Act and its associated regulations will be reviewed and potentially revised.

Those aspects of the Dodd-Frank Act and its associated regulations that touch on community banks and affect small to medium-size businesses are the most likely to be addressed in the immediate future. Additionally, the portions of the law and associated regulations that set forth the requirements for the larger, so-called systemically risky firms are likely to be revised by scaling the rules to match the particular risk profile of covered entities. Opportunities for making regulations more risk focused include adjustments to the requirements and timing of resolution-plan submissions; exemptions from Volcker Rule restrictions; relief from CCAR supervisory-run stress tests, including the allowance of capital planning independent of the annual CCAR exercise; and modification of liquidity coverage ratio and net stable funding ratio requirements.

New leadership at federal agencies is likely to be a major driver of change. It is also likely that the structure of regulatory organizations, particularly the CFPB, will be considered. A number of members of Congress and other policymakers have suggested that the CFPB's single-director structure should be changed to a multimember commission and that the organization's budget should be subject to the congressional appropriations process. There are also many aspects of the Basel III standards that are likely to be reviewed or revised in 2017. Pending CECL (current

expected credit loss) accounting changes may have significant impacts on bank loan-loss reserves, capital levels, and lending capacity. Implementation details will need to be carefully considered.

President Trump also signed a presidential memorandum on February 3, 2017, delaying implementation of the Department of Labor's Fiduciary Rule. Other recently proposed or finalized regulations will likely be reviewed and possibly revised or eliminated in 2017, including the following:

- the CFPB's Arbitration Rule;
- the FDIC's Record Keeping Rule; and
- the interagency Incentive-Based Compensation Arrangements Rule (proposed).

Additionally, cybersecurity protections for the financial services sector and the Nation are necessary; however, in the past two and one-half years, the financial services sector has been subject to 30 different regulatory proposals from over a dozen regulatory agencies. The recent Advance Notice of Proposed Rulemaking, "Enhanced Cyber Risk Management Standards," will further complicate the already fragmented regulatory space and dilute cybersecurity resources. It is necessary for the public and private sectors to collaborate to establish a more unified and risk-based framework that is useful across all sectors and that aligns to the existing federally endorsed NIST Cyber Security Framework.

While not specifically a regulatory matter, there is a chance that comprehensive corporate tax reform will be enacted in the next 6 to 18 months. It is likely that the tax rate before deductions could be significantly reduced, and a number of structural changes could impact banks and their customers. Key provisions for banking, such as the deduction for business interest expense, the mortgage interest deduction, and the low-income housing and business development tax credit programs, could be significantly modified or even eliminated. There is also the possibility that bank taxes, financial transaction taxes, or other "pay fors" affecting banks could become part of the tax code.

What is the Council's view of such changes, and what principles should guide those changes?

In addition to the principles enunciated by President Trump, the Council proposes the following principles to guide regulatory reform:

- No bank should be so big, complex, or concentrated that its potential failure would put the economic or banking systems at risk.
- Regulation should move from a one-size-fits-all regime to an approach that is risk-based and individually tailored to take into account a wide variety of factors, including an institution's size, complexity of operations, and other factors relevant to the riskiness of its activities, products, and services.
- Any legal or regulatory change should be evaluated on the basis of whether the proposal achieves the optimal outcome for short- and long-term economic growth and short- and long-term financial stability.
- Every regulation should undergo a cost/benefit analysis.
- Regulations should prescribe the boundaries within which financial institutions can take measured risk and facilitate the efficient allocation of capital.
- Financial regulatory agencies should increase coordination and reduce overlap to produce more effective regulation.

Since the enactment of the Dodd-Frank Act and its statutory size thresholds, banking regulators have relied heavily on the asset size of financial institutions, creating regulatory "cliffs" whereby all institutions over a certain size are regulated and supervised in the same manner. The unintended consequences of making size the sole determinant of risk are regulatory classifications and duties that can be highly limiting and destroy market value. ROE for the industry has still not recovered sufficiently to overcome the hurdle posed by the cost of equity capital, and the number of U.S. commercial banks continues to dwindle. Although size-only regulation may be a simple shortcut for supervising financial institutions, it is needlessly burdensome for many financial institutions with noncomplex operations and business models and results in increased costs and reduced products and services to bank customers. The Basel Committee regards size as only one of five equally weighted factors in considering whether to designate a particular institution as a GSIB. Far more important than simple size is the aggregated weight of other factors, such as cross-jurisdictional activity, interconnectedness, substitutability/financial institution infrastructure, and complexity.

Item 5: Card Payments and Fraud

> **Now that the EMV (Europay, MasterCard, and Visa) chip is being rolled out in the United States, the level of in-person card fraud might be expected to drop, similar to the lower levels of in-person card fraud observed in countries that had adopted EMV sooner. However, online card fraud is already at high levels and not addressed by EMV. What has been the Council's experience with the EMV rollout in reducing in-person fraud in the United States? What steps are card issuers, acquirers, card networks, and other payments processors taking to address online card fraud?**

The move to EMV was made several years ago in part as a response to data breaches at large, well-known merchants. Globally, EMV has proven to be effective against card-present counterfeit fraud, the type of fraud involved in these breaches. U.S. results are mixed, but generally EMV seems to be having a favorable impact on card-present fraud.

- One study reported an 18% reduction in U.S. card-present fraud in the first quarter of 2016.
- As of year-end 2016, nearly 50% of U.S. merchants had activated EMV terminals, with industry sources estimating a 50% lower card-present fraud at these merchants.

Given the incomplete rollout of EMV, especially given that many U.S. merchants have not yet fully implemented EMV, a broader perspective can be gained by looking at mature EMV markets. A June 2014 Aite report provides results from the United Kingdom:

- Total UK card-present fraud (in GBP millions), 2005, £97; 2013, £43 (believed to be primarily due to implementation of EMV).
- Total UK card-not-present fraud (in GBP millions), 2005, £183; 2013, £301 (significant increase as online sales grew faster and as fraudsters shifted their focus).
- Total UK lost/stolen fraud (in GBP millions) 2005 £89; 2013, £59 (improvement due to chip and PIN implementation) (Note: No improvement is expected in the U.S. due to chip and signature implementation.).

As indicated by the question, and as supported by the experiences in the UK post-EMV migration, there is reason to shift focus to card-not-present fraud in order to identify vulnerabilities. There are three strategies to protect, or "de-value," data that could be stolen by hackers:

- Encryption. Encrypted data cannot be used without the decryption keys.
- Tokenization. The use of tokenized data is limited to a specific transaction, transaction type, or time frame.
- Variable Data. Variable data, like EMV, include cryptograms and counters that vary after each use.

Card-Not-Present (CNP) Fraud

Merchants have traditionally borne the fraud liability for card-not-present transactions, and they were making significant investments in security prior to the announcement of EMV. CNP sales are concentrated heavily amongst a few dozen large retailers. These innovative companies have strong technical capabilities, and many augment their internal capabilities with third-party security solutions, including the following:

- Solutions to link a username and password to a specific computer, phone, tablet, or other device. These "device fingerprinting" solutions compare log-in credentials with characteristics of the device being used for the transaction (type of device, operating system, clock time/time zone, keyboard language, etc.).
- Solutions that monitor the purchaser's navigation on the site for unusual behavior, such as measuring the time spent on each page to detect that a computer, not a human, is on the other side.

Card networks have deployed 3 Domain Secure (3DS), which is a protocol that enables CNP merchants to obtain stronger authentication for transactions.

- 3DS is evoked by the merchant, typically for only the higher-risk transaction types, including large-dollar or unfamiliar "guest" checkouts.
- 3DS interrupts the transaction between the purchaser and the merchant to call out to the card issuer and provide a code to the cardholder.
- 3DS provides "two-factor" authentication for web transactions. Two-factor authentication means "something I have" (a physical card) and "something I know" (a passcode from a text).
- Anecdotally, many merchants are as concerned about lost sales from abandonment due to the extra steps of 3DS as they are of fraud.
- A new version of 3DS, 3DS 2.0, was announced in the fourth quarter of 2016. This new version offers better messaging and supplementary information that may improve performance.
- Card networks offer services to alert merchants that recently placed CNP orders have been reported as fraudulent.

Reported CNP losses and fraud attempts in the U.S. post-EMV are mixed. Most Council members reported increases in attempts, and many reported higher losses in absolute dollars.

- One Council member reported a 46% increase in online fraud attempts and a 146% increase in absolute dollars due to online fraud losses.
- ACI Worldwide estimates a 43% increase in online fraud attempts in 2017.

- One Council member reports an increase in absolute dollar losses due to online fraud over the past several years but a steady reduction in the fraud rate, due to increases in both good sales volume and efficacy of the various fraud prevention tools.

The Way Forward

Continue the deployment of EMV cards and terminals, 3DS/3DS v2.0, and mobile payments

- These technologies are showing early promise and offer a more secure alternative to magnetic stripes and traditional online authentication.

Petroleum implementation by 2020

- Issuers, acquirers, and petroleum retailers should work to identify and deploy solutions to secure pay-at-the-pump transactions. Complexities with the EMV upgrades for these terminals have caused the industry to delay the compliance date until 2020.

Stronger authentication and digital identities to combat account takeover fraud and other growing fraud types.

- Nearly all Council members mentioned the need for continually improving technical capabilities to accurately authenticate online users for the purpose of purchases, customer service, and responding to other inquiries.
- There are many emerging authentication technologies: facial recognition, voice recognition, device fingerprinting, and location services. All show some promise.
- Sharing successes among industry partners will accelerate the pace of security improvement (EMV-Co, FS-ISAC & Secure Payments Task Force, Auriemma for issuers; Merchant Risk Council for merchants/acquirers).

Item 6: Monetary Policy

How would the Council assess the current stance of monetary policy? Some critics have argued that the Federal Reserve's communications about its strategy for monetary policy are too opaque. What suggestions does the Council have for making such communications more transparent and informative?

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

- Monetary policy remains highly accommodative with a continued level of very low short-term interest rates. Looking forward, the Federal Reserve has broadly reset interest rate expectations consistent with market anticipation for three 25-basis-point increases to the range for the federal funds rate in 2017.
- Given general forecasts for further gradual declines in the unemployment rate and further gradual increases in inflation, the Council supports steady and continued increases in the federal funds rate and migration back to normalized levels.
- As 2017 progresses, the question of the Fed's balance sheet strategy will become more pressing. The Council notes that it would be helpful to have clear and consistent forward guidance from the Federal Reserve on this topic.

What suggestions does the Council have for making such communications more transparent and informative?

- Transparency in monetary policy communication can promote an informed discussion of policy options and helps to hold monetary policymakers accountable for achieving the Federal Reserve's mandates.
- One unintended consequence of a full-transparency policy is that forward guidance, unless straightforward and explicit, can lead markets to misinterpret the objectives or intent of any particular action and can, in practice, obscure transparency.
- For example, while the FOMC has noted that rate decisions are "data dependent," the interpretation of what that may mean, and what data the decision is dependent on, can appear to evolve over time. Policy transparency could be increased by explicitly highlighting the specific data used to make rate-oriented decisions and to what degree that data is "weighted" by the FOMC.
- The Council further noted that the pending Financial Choice Act would require more and very explicit communication from the FOMC regarding monetary policy, in particular forcing the Federal Reserve to rationalize policy decisions versus what result the Taylor Rule would prescribe. The Council, however, suggests that it would not favor a strict formula-driven approach to setting target rates, which was described as "too confining and inflexible."

<u>12:00 pm – Luncheon for Council and Board members in the Board Room</u>