RECORD OF MEETING

Federal Advisory Council and Board of Governors

Friday, February 9, 2018

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-sized 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:

- Overall, loan growth moderated over the last year. Most recently, H.8 data showed the pace of loan growth slowed from 3.9% annualized in the third quarter of 2017 to 3.4% in the fourth quarter of 2017.
- Initial indications are that recent tax legislation is a positive, improving optimism across many segments. Many small and medium-sized businesses are still evaluating the potential impact, although the expectation is that increased optimism will translate into more investment and higher loan demand.
- Extra cash flow in companies' accounts could reduce the need to borrow.
- The impact of recent tax reform is discussed in more detail in later questions.
- Credit quality continues to be strong.

(a) Small and Medium-Sized Enterprises

- Loan demand appears mixed: certain Council members report strong demand, while most others report stable to flat growth despite increased optimism.
- Indications are that tax reform is a positive, but businesses are still working through "what it means to me."
- Underwriting standards are accommodative, driven by terms from nonbank lenders and increased competition.

(b) Commercial Real Estate

- Fundamentals on the whole continue to be very strong in most major markets. Equity-capital-raising activity across the industry remains robust, as do the permanent debt markets.
- Initial indications are that the recent tax reform will be mostly positive for the commercial real estate industry.
- With the expectation of rising interest rates, more borrowers are looking to hedge their floating-rate loans or lock in a fixed-rate balance sheet loan.

(c) Construction

- Construction lending is available, but bank lenders continue to be selective.
- Concerns about overbuilding multifamily inventory seem to be self-regulating new construction in many markets. This limiting of new supply is helping to keep prices in many metro areas stable to higher.
- While multifamily construction seems to have slowed overall, there are pockets of growth, including Philadelphia (PA), Jacksonville and Miami (FL), and parts of the Midwest.

(d) Corporations

- Corporations have a renewed interest in large acquisitions.
- Debt markets continue to be very strong and supportive of higher leverage. Private equity firms have not yet reduced appetite for leverage, despite the new tax law's deductibility cap on interest. Some Council members believe that the cap on interest deductibility could slow debt issuance in 2018.
- Paydowns and payoffs continue to be heavy and indicative of a strong economy and strong liquidity in the market.
- End markets in oil and gas, building products, and general industrials are robust.
- One Council member reports that the energy sector appears to have recovered and is very strong in some areas after three years of depressed commodity prices. Big energy companies have resumed activity in most areas, and smaller independents are now starting to resume activities.

(e) Agriculture

- Specific segments, such as dairy and select crops, continue to face prices that are below historical levels, presenting some performance challenges and leading to strategic and, in some cases, distressed exits from these businesses. Grain markets have stabilized, while cattle and hog markets have improved.
- One Council member has a pessimistic outlook for agriculture, as political uncertainty and global trade agreements are difficult to predict. Another Council member believes recent cold weather and a healthy global economy have the potential to improve pricing trends in 2018.
- Low leverage has allowed operators to survive, even after several years of price pressure and losses.

(f) Consumer

- Expectations of a strong economy are projected to support a healthy consumer credit market in 2018. Consumer sentiment remains solid overall.
- Alternative financing options from fintechs and other nonbanks are creating additional competition in the consumer credit space.

(g) Homes

- The outlook for the residential mortgage market is stable.
- Some Council members report that a shortage of affordable housing in their markets is a continuing and growing issue.

- Refinance activity continues to contract in the rising interest rate environment. The purchase market, while healthy, remains significantly constrained in some markets by a lack of housing inventory.
- One Council member expects to see increases in first-mortgage refinancings and in unsecured fixed-rate loan volumes due to the elimination of interest deductions for equity-secured products and consumer expectations of higher interest rates. Conversely, another Council member expects home equity balances to stabilize and return to growth as consumers invest in their homes, given the strength in home prices.

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?

- A common view is that companies could grow faster, but they are restrained by the limited number of qualified employees available for hire.
- There are some idiosyncratic, but no major economic or market, trends that are not apparent in the data. Borrowers are cautiously optimistic about the impact of tax reform and prospects for economic growth.

Item 2: The Outlook for Banking in 2018

(a) What will be the drivers of bank profitability?
(b) What are the greatest competitive challenges facing the banking industry?
(c) Is the industry well positioned if interest rates rise further?
(d) How is deposit pricing evolving?

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

Council members noted that in 2018, bank profitability will likely be driven primarily by solid macroeconomic conditions, rising interest rates, continued economic expansion, and lower tax rates. The Federal Reserve has alluded to three rate hikes this year, and many banks are positioned to benefit from rising rates through the expansion of net interest margin (NIM), as asset yields will likely continue to reprice more quickly than deposit costs. Continued economic growth is expected, driven in part by lower tax rates creating higher cash flows. This economic expansion may drive higher loan demand (both business and personal), as companies take advantage of the capital-spending incentives and consumers have increased spending capabilities.

Modest growth in fee income, driven by overall economic growth, may also help boost profitability. Several Council members noted that fee compression due to strong competition and reduced mortgage banking income due to higher interest rates will likely offset some of this growth. Finally, Council members noted the potential for a positive impact from greater efficiency, transparency, and simplicity of bank regulation.

As in recent years, loan loss provisions and expense control will likely not be large contributors to profitability in the industry. Charge-offs are expected to trend toward mid-cycle averages from historic lows and provisions may increase if loan portfolio growth picks up. While expense management has been a driver of bottom-line growth over the past few years, it is becoming increasingly difficult to continue trimming expenses. Expense discipline remains high, and banks continue to develop technology-driven efficiencies, but large expense reductions are unlikely to drive bank profitability.

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

The banking industry faces several competitive challenges, including changes in consumer behavior and competition from financial technology companies and the shadow banking system. Consumers continue to increase their digital usage and demand high-quality end-to-end technology solutions from their banks. As Council members note, banks will continue to invest to keep up with these demands and create secure and user-friendly solutions. Financial institutions that are able to meet consumer demands and create digital offerings will be advantaged in the long term.

Council members see competition from financial technology companies as creating a competitive challenge. Disruption in the payments area is notable, with fintech companies and platforms evolving to capture more customers and deepen existing relationships. The shadow banking system is largely unregulated or less regulated than financial institutions that offer similar products and services, creating a competitive disadvantage and often pushing potential customers into an unregulated space. In addition, core commercial loans are being supplied in increasing amounts by bank loan funds that are sponsored by hedge funds and private equity funds.

Other competitive challenges Council members mentioned include: cybersecurity and the investments needed to address increasing security and fraud threats; the impact of competition for qualified borrowers on fees and, for some, underwriting standards; and the ability to attract, develop, and retain talent.

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

There is a consensus among Council members that the industry is positioned to benefit in a rising rate environment. The industry is generally asset sensitive, which would result in increased profitability as rates rise, especially for the larger deposit franchises that have greater asset sensitivity.

After a prolonged period of near-zero rates at the short end and overall NIM compression, many banks have positioned their loan portfolios and funding structures for rising rates. The extent of the financial benefit for banks is also somewhat dependent on how rates move. Many banks have modeled a parallel shift in the rate curve. If short-term rates were to continue to rise without a similar move in longer-term rates, creating a flat yield curve, the gains may be more muted, depending on the timing and response of deposit betas. Conversely, if long-term rates were to rise without a corresponding move in short-term rates, mortgage activity would likely be impacted, with reduced business and income.

(d) How is deposit pricing evolving?
The evolution of deposit pricing has taken two distinct paths depending on the account type. In general, there has been little to no movement in deposit pricing for retail checking and core savings accounts, with the exception of a few regional banks. However, wealth management and select commercial accounts have seen incremental repricing as the federal funds rate and LIBOR have increased. These accounts are less sticky and have larger cash positions that are seen as investments. Repricing is done to minimize customer movement from cash to investments such as short-term bond funds. Conversely, cash in retail consumer accounts flows in and out regularly as it is used for everyday purchases, and customers tend not to view it as an investment.

While Council members' views diverge as to the timing and extent of future deposit-rate increases, there is agreement that there will be industry-wide pressure to increase the deposit rates paid as short-term rates rise further. However, this increase may not be uniform. One Council member noted banks that are using technology to deploy more sophisticated pricing algorithms, allowing them to adjust deposit rates at the local level. In addition, many retail accounts are driven by factors other than the deposit rate, including the customers' assessment of the full value of the relationship, such as the convenience and services provided by the bank (e.g., technology and innovation).

Finally, deposit betas may be affected if there is particularly strong loan growth in 2018 driven by tax reform and overall economic expansion. Banks will need to fund the additional loan growth, creating a higher demand for deposit growth and thereby possibly causing deposit rates to rise industry-wide.

Item 3: Tax Law Changes

(1) Are Council members seeing signs that their business or consumer customers are changing their current spending or their future spending plans in response to the recent tax law changes?

- Overall, the Council members are seeing a positive response to tax reform from their customers.
- Many companies have already announced plans to pay bonuses and increase compensation, especially at the lower end of the wage scale; invest in other capital and technology projects; and increase investment in the United States and repatriate cash currently held internationally.
- Numerous examples have surfaced of commercial and small business customers revisiting previously tabled capital projects, acquisitions, or other investments because of increased cash-flow expectations and the clarity that the passage of the tax law generated.
- Other specific examples of changing behaviors include businesses revisiting acquisitions they had previously evaluated and chose not to proceed with and private capital groups stating plans to more aggressively invest accumulated capital.
- The Council is seeing evidence of more foreign companies investing in the U.S. due to tax reform.

- In general, the sentiment is that companies will be more aggressive with their investments compared to the "wait and see" tone of previous years. The Council expects growth in business investment to accelerate. While businesses were the first to see such positive changes, consumer optimism is growing, as evidenced by recent polls.
- Many companies have announced wage increases which, along with less federal tax withholding, have produced bigger paychecks.
- Consumer spending levels (excluding auto) have been increasing and their savings rates decreasing in recent months, which is likely linked in some degree to the tax law.
- The Council is seeing many businesses increasing their community donations due to tax reform.
- The Council fully expects the tax law change to increase economic growth by 0.5% to 1% this year.

(2) What bank customers will benefit most from these changes?

- Customers that will benefit the most have high effective tax rates and strong earnings. The average S&P company's effective tax rate is expected to drop by 6 percent.
- Large corporates, especially those in capital expenditure oriented industries, will also likely benefit from higher retained earnings and having more capital available for investment.
    - Recent announcements by companies such as Apple signal more investment in the United States and a willingness to repatriate cash held outside the U.S. at a lower tax rate.
- The impact on the commercial real estate market is expected to be modestly positive, with the effect of lower taxes partially offset by higher interest rates. It is important that tax credits for affordable housing were retained in order to encourage investment in this sector.
- The majority of consumers should benefit from higher wages and lower marginal tax rates, as we are seeing net take-home pay increase $100-$200 per wage period.
- A survey conducted by the Mid-Size Bank Coalition of America (MBCA) summarized the viewpoints of 26 bank CEOs and concluded that middle-market (77%), small business (54%), and large corporate (46%) banks will benefit the most from tax reform.

(3) What will companies do with their new earnings or capital?

- In the weeks since tax reform became law, many businesses have increased wages, announced increased investment, and committed to lowering prices for their customers. As businesses fully incorporate the tax law's effects into their plans, they will pass on the benefits in some mix of these forms.
- The Council fully expects business to increase net investment in physical plant, equipment, and technology, all of which have been lacking or slower during this current economic cycle.
- In the MBCA survey, 56% of CEOs surveyed believe companies will increase

dividends to shareholders and increase compensation, 48% expect them to accumulate additional equity capital, and 40% say companies will invest in corporate initiatives or infrastructure.

- Share repurchases are also expected to accelerate.
- Several Council members believe the pace of M&A will increase and more businesses will look to expand in the U.S. rather than overseas due to the new corporate tax rate.

In summary, the Council believes that tax reform will increase investment, spending, and wages and that it will be very positive for the economy by adding the fiscal stimulus that has been lacking for the past several years.

Item 4: BSA and AML

In what ways does the Council believe that the current anti-money laundering/Bank Secrecy Act (AML/BSA) framework can be reworked to deliver better outcomes more efficiently and effectively?

Financial institutions understand the important role they play in achieving the critical U.S. national security objectives of combating money laundering, preventing financing of terrorism, and blocking use of the payment system for illicit purposes. The Department of Treasury and its Financial Crimes Enforcement Network (FinCEN), federal law enforcement agencies, and financial institutions must collaborate to ensure that the legal and regulatory regime produces the optimal results for achieving these critical national interests. We believe modification of the AML/BSA regulatory regime for more effective and collaborative participation by financial institutions could enhance national security and law enforcement activities.

A fundamental disconnect is that the current AML/BSA program is a risk-based law enforcement process administered through an examination model focused on policies, procedures, and compliance with metrics. The focus of the regulatory regime for anti-money laundering and combating the financing of terrorism (AML/CFT) should be focused on achieving functional outcomes rather than compliance. The present regime, which involves multiple regulatory agencies examining the policies, procedures, and governance programs of financial institutions, places greater emphasis on examination compliance. Instead, the focus should be on the effectiveness, timeliness, and quality of information provided to law enforcement, which in turn should be keyed to national AML/BSA priorities. Rules and requirements should be structured so that financial institutions can provide high-quality information in a timely manner to assist law enforcement agencies in the successful execution of their duties. Similarly, law enforcement agencies should provide appropriate feedback to ensure that financial institution reporting remains effective and targeted.

Recommendations for enhancing and refocusing the AML/BSA regulatory regime include increased coordination, enhanced information sharing, reevaluation of existing guidance, and increased feedback:

Increased Coordination

Treasury's Office of Terrorism and Financial Intelligence should more actively lead coordination of AML/CFT policy and oversight. FinCEN should increase its collaboration with law enforcement to ensure that AML/CFT detection and enforcement priorities are continuously monitored and adjusted and that these priorities are formally and periodically communicated to financial institutions.

Information Sharing

FinCEN should collect and monitor all transactional information from financial institutions, with law enforcement input. This arrangement would efficiently allow monitoring to be performed consistently and nimbly, using state-of-the-art technology designated by FinCEN, and would allow the best experts to work together, subject to FinCEN's direct control and governance. FinCEN would have a comprehensive and immediate view of the entire financial-transactions landscape in order to track money flows and more easily detect and prevent money laundering. Financial institutions' individual, redundant, and uncoordinated infrastructures for AML/BSA compliance would be reduced, freeing resources to be more fruitfully invested in other financial intelligence operations. Short of a consolidated FinCEN database, financial institution protections should be expanded to facilitate greater information sharing related to illicit finance activities beyond money laundering and terrorist financing, including fraud and cyber crime, both of which can predicate crimes to money laundering.

Reevaluate Requirements and Guidance

The current Suspicious Activity Report (SAR) and Currency Transaction Report (CTR) regimes should be reevaluated and revised to reflect overall trends and emerging threats, and revised for greater efficacy in supporting law enforcement. The reporting under both SAR and CTR regimes should be streamlined, perhaps by consolidation, by reducing the frequency of reporting, increasing the reporting threshold, or using a combination of these approaches. Or, if all transactions are provided to FinCEN for monitoring, CTR reporting should be eliminated and SAR reporting should be confined to activity that is more readily discernible by financial institutions. FinCEN should clarify SAR reporting requirements by providing specific transaction-monitoring guidance by product and client type, to clarify where financial institutions should be focused and to ensure these institutions are checking for "red flags" according to consistent methods and standards, based on AML/BSA priorities.

Enhance Feedback

Financial institutions need additional, consistent communications with government entities to better inform and direct institutions' monitoring and detection activities. Without clear guidance or regular feedback, many institutions take a conservative approach to filling out reports, resulting in more SARs that may not be of value to law enforcement. Enhanced feedback should also address whether continuous reporting can be terminated under certain circumstances or should inform financial institutions when reporting has been leveraged in an investigation or determined to be unnecessary. With enhanced feedback, financial institutions would be able to tune their systems based on validation from the actual users of the reporting, and institutions would produce higher-quality, more useful information.

What are the potential benefits and limitations of approaches such as establishing a beneficial ownership database for financial institutions, expanding information sharing with law enforcement, and revising current SAR/CTR processes?

While there are concerns regarding data privacy and security, as well as the responsibility for managing such a database, the Council believes the benefits of a database outweigh its risks. Legal entities should be required to provide their beneficial ownership information at the time of entity formation and to update it for material changes. This information should be maintained in a central database, whether at the state or federal level (e.g., FinCEN) and be accessible to law enforcement, FinCEN, financial institutions, and other relevant stakeholders. A database is simply the most efficient means of giving direct, immediate access to those who need it to support national AML/CFT objectives. This centralized, more transparent, and coordinated management of information would tend to deter those seeking to create shell companies for illicit purposes. In addition, a centralized system would provide comprehensive visibility into overall patterns, improve data integrity, and eliminate unnecessary duplication of efforts and burden on clients across institutions. Financial institutions should also be able to rely on the beneficial ownership information in the central database.

The challenges to implementing a database are greatly outweighed by the direct, efficient access to beneficial ownership information by those who need it to combat money laundering and terrorist financing. The repository governmental entity would have to be vested with the authority and responsibility to collect and maintain beneficial ownership information and permit access by FinCEN and others. An enforcement mechanism to require legal entities to report initial and changed information is needed.

The Council further recommends that a "commission," consisting of Treasury's FinCEN, federal regulators, and the banking industry, be formed and have a clear mandate to reform the system, with a focus on effective outcomes, usage of technology, continuous learning, transparency, cooperation, and clarity of enforcement.

Item 5: Online lenders

The activities of many online lenders may be subject to consumer protection laws and regulations, such as fair lending laws. But some of these lenders may not be subject to the same level of federal regulatory oversight as banks. Is this a significant gap in public policy that Council members should be addressing and if so, what approach does the Council recommend?

In general, the Council supports a competitive environment in which consumers and businesses have choice in financial services, for both products and providers, and can benefit from technological innovation and other advances to conduct their bank activities securely, efficiently, and effectively. The Council also desires a level playing field that allows traditional banks, financial technology (fintech) firms, and other market participants to compete fairly and be held to the same operating standards. Regulation should be based on activity, not the type of entity engaged in the activity. In the aftermath of the financial crisis, an underlying principle of the

Dodd-Frank Act was to extend regulation and oversight to follow the activity and broaden the entities under oversight in order to address risk beyond the banking system.

The public policy debate regarding online lenders was brought to the forefront by the December 2016 white paper from the Office of the Comptroller of the Currency (OCC), "Exploring Special Purpose National Bank Charters for Fintech Companies." Through this paper and subsequent documents, the OCC and other regulators continue to explore how fintech companies that offer banking services should be regulated. The Council believes that any proposed regulatory framework should clearly define to whom the regulation applies, as well as how it will be applied. Further, the Council believes this framework should apply to all lenders--both banks and nonbanks--and should be uniform, clear, and consistent to ensure robust consumer protection and prevent regulatory arbitrage. Tailoring the framework to the nature and scale of a lender's activity is also appropriate.

At present, the Council believes that, in some instances, online and nonbank lenders are not subject to the same level of federal regulatory oversight as banks, which affects competition, advantages nonbanks, and raises issues about consumer protection and the overall integrity of the financial system. While not exhaustive, the following areas are central to further policy discussions if the scope of regulatory oversight expands to address online lenders.

Consumer Protection

Consumers, individual or commercial, are entitled to the same protections from all financial services providers, whether the providers are banks, online lenders, or other entities. In addition, a consumer's trust and confidence in his or her respective financial institution is fundamental to the operation and success of our national banking system. Robust consumer protection laws and enforcement are instrumental to building and maintaining trust. To this end, it is important that lenders be subject to consistent consumer protection regulation and enforcement.

Fair Lending and Financial Inclusion

The nature of banking provides institutions with the opportunity and responsibility to meet the credit needs of the communities they serve. Banks have developed comprehensive programs that facilitate monitoring and reporting for fair lending compliance for all their consumer products. In addition, banks conduct robust redline monitoring/reporting and dedicate significant resources to addressing any areas of emerging risk. The Council believes all lending institutions, regardless of corporate form, should be held to the same fair lending standards. Regulatory oversight should also be based on the nature and scale of activity.

Further, as the administration and Congress evaluate the Community Reinvestment Act for modernization, the Council recommends that similar requirements be applied to online lenders. In determining standards, the Council recommends that online lenders be required to set measurable and enforceable financial inclusion goals and to monitor their lending with respect to the demographics of the communities they serve.

Data Protection and Privacy

In a world that is increasingly reliant on technology to facilitate day-to-day activities, the security and protection of bank customers' account data and personally identifiable information is of paramount importance. The responsibility and obligation to maintain a customer's privacy and protect his or her information should be applied uniformly and consistently across lenders.

Banks invest heavily in protecting customer information from cyber criminals--customers expect and deserve this protection when they share their confidential data with a lender. The financial sector is estimated to have spent $16 billion on security-related hardware, software, and services in 2017 alone.[1] Banks typically maintain multilayer cyber protections, including firewalls, monitoring, access management, and malware detection. Most banks also maintain a cyber defense center that continuously monitors and protects the bank's environment. The Council believes all lenders should utilize strong cybersecurity practices with effective controls. Any breaches, including those involving nonbank industry participants, could undermine consumer confidence and trust in the overall financial system.

Integrity of the Financial System

An outgrowth of the 2008 economic crisis was a renewed focus by regulators on ensuring the stability and resilience of the financial system, including prevention and mitigation of emerging risks. Since that time, online lenders have established and grown their market share. Regulators should consider the potential market impact these lenders may have, individually and collectively, in times of an economic downturn, deteriorating credit, or constrained market liquidity. Also important is the increased coordination among regulators to share information, ensure regulatory consistency, and prevent regulatory arbitrage. To this end, the Council recommends careful consideration of the following in terms of consistent regulatory treatment for online lenders.

Coordinated and Consistent Risk Management and Regulatory Oversight

Providing credit to individuals and small businesses is subject to a host of regulation, dictated by the lender's business model (insured depository or marketplace lender) and the type of borrower to whom credit is being extended. This complex regulatory framework includes at least ten federal statutes enforced by seven federal regulators, in addition to the applicable state law where the lender is licensed. The Council believes that regulatory oversight should be based on the underlying activity (e.g., lending), rather than the type of entity engaging in the activity, and appropriately tailored to the scale of the activity.

AML/BSA

As a matter of consumer protection and national security, financial institutions are required to monitor, identify, and report suspicious activity relative to customer transactions. The administration and Congress are actively examining relevant statutes and regulations to ensure that banks and law enforcement are deploying resources effectively and efficiently. The Council believes there should be consistent enforcement of AML/BSA regulations across all lenders.

[1] Source: https://www.idc.com/getdoc.jsp?containerId=prUS43165817

Conclusion

In summary, the Council supports a competitive environment in which consumers and businesses have choices in financial services, while preserving fair competition between banks and nonbanks. As regulators continue to evaluate and consider the appropriate framework for online lenders, a few main factors should guide their thinking: robust protection for consumers: uniform application of regulation; and consistent oversight and supervision. Regulation that is based on the type and scale of the underlying financial activity will ensure a level playing field that benefits borrowers, lenders, and the financial system.

Item 6: Economic Growth

Please discuss the Council members' observations regarding economic growth in the companies' borrowing from banks and what considerations may have dampened or enhanced the pace of growth in recent months.

Council members' overall sentiment regarding economic growth is positive. Evidence of a resilient economy includes GDP growth at a 3% annualized rate in the second half of 2017, robust growth in domestic demand fueled by strong holiday retail sales and increased spending on equipment, strong labor markets with 4.1% unemployment, and inflation that is still below the Federal Open Market Committee's (FOMC's)objective of 2%.

Consistent with this positive backdrop, overall demand for corporate lending is stable to improving, with some variation across industries and customer segments. Council members generally noted positive developments in their institutions. One Council member reported growth in all markets and across industries, while another observed "modest increases" in borrowing from the bank's customer base. Two Council members cited the improvement in oil prices as a contributing factor in the rebound in many E&P (exploration and production) companies within their portfolios. Another noted that growth is expected in most industry segments with the exception of healthcare. Within manufacturing, a Council member highlighted that companies are continuing to look for efficiencies through technology enhancements and that they have the cash flow or borrowing capacity to continue making technology investments. Within commercial real estate, economic growth remains positive in the short term, driven by expansion in industrial distribution/logistics and strong fundamentals in the office and multifamily segments. One Council member highlighted that middle-market companies remained fairly cautious on the whole, tending to focus internally on operation and execution of their business plans and on organic rather than acquisitive growth. Finally, two Council members highlighted that small business clients appeared to be more optimistic than in recent years. However, a Council member noted that this optimism has not yet led to a meaningful acceleration in small business lending.

The Council believes that corporate loan demand will build over the course of 2018, given the positive impacts from tax legislation and fiscal stimulus. Competition from the institutional loan and bond markets will continue to be a partial headwind. If consumer demand increases as a result of recently passed tax reform and also leads to higher confidence levels, companies should experience faster sales growth, which will require borrowing to support growing inventories and

receivables. There is also optimism for increased M&A (merger and acquisition) activity, though one Council member noted that there has not yet been a noticeable uplift in transaction activity.

The Council conveyed several considerations supporting enhanced economic growth: passage of the Tax Cuts and Jobs Act and the subsequent boost in business investment; the prospect of additional regulatory relief for businesses; higher levels of consumer and business confidence; macroeconomic factors such as oil-price stabilization and relatively stable geopolitics; the rise in employment and modest wage gains; continued growth in overseas markets; low real interest rates relative to historical standards; continued growth in online shopping; and development activities spurred a lack of affordable housing.

Considerations dampening growth, as conveyed by the Council, include shrinking unemployment, making it more difficult to find high-quality, skilled labor; trade disputes arising from NAFTA negotiations and punitive tariffs; increased federal budget deficits and national debt; a potential sell-off/correction in the equity and bond markets; tighter liquidity constraints and stricter leverage requirements within the energy sector; and the impact of higher interest rates.

Item 7: Monetary Policy

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

Monetary Policy Considerations

Events since the Council last met indicate that U.S. economic activity has significantly improved, the labor market continues to strengthen, and core PCE inflation has gradually but unevenly begun to move toward the policy goal of 2%.

The Federal Reserve has a dual mandate to foster maximum employment and price stability. In our evaluation of monetary policy in terms of the dual mandate, in the last four years, the unemployment rate has fallen from 6.7% to 4.1%, the latter below measures of full employment, and core PCE inflation has increased to a level just short of the FOMC's 2% goal.

On the whole, monetary policy remains accommodative, with the real federal funds rate approximately 0% after subtracting year-over-year inflation of 1.5%, and below 0% after subtracting three-month annualized inflation of 1.9% (both using core PCE).

We would expect core PCE inflation to progress toward the 2% goal in the near to medium term, given favorable financial conditions, tightening labor markets, stronger and more synchronous global growth, and fiscal considerations, such as the stimulus provided by tax cuts and the strong potential for increased federal discretionary spending.

Considering these factors, the Council supports further gradual normalization of policy interest rates, as well as continued reduction of the Federal Reserve's balance sheet. The current and expected environment supports additional rate hikes in 2018, beginning with a March increase, although future rate increases should be viewed and tested through the filter of data dependency.

Given the impact of recent fiscal stimulus from tax legislation, along with potential increases in budget spending and infrastructure investment, it is important that the Federal Reserve monitor economic data carefully to ensure it does not fall behind on the appropriate level of monetary tightening.

Economic and Market Considerations

The U.S. economy ended 2017 on solid footing, with advance fourth-quarter GDP growth of 2.6% versus 3.2% in the third quarter. While the headline figure was below consensus, GDP growth was constrained by weakness in inventory investment and net exports, in contrast with a stronger performance for final sales to private domestic purchasers, which grew at a 4.6% rate--the best performance since 4.9% in the third quarter of 2014. Though volatile, current forecasts, such as the Atlanta Reserve Bank's GDPNow (4.0% 1Q18 GDP) and New York Reserve Bank's Nowcasting (3.2% 1Q18 GDP), point to stronger GDP growth in early 2018.

As described in the preceding section, another factor affecting monetary policy is that tax reductions have been legislated and additional fiscal expenditures are being considered. These actions are occurring *after* the U.S. output gap has closed, which is supportive of inflation views at a higher level of resource utilization. As productivity growth slowly bottoms and supply-side factors propelled by business investment improve with a lag, inflation may increase as growth remains favorable.

The strength in U.S. GDP is also increasingly in sync with other economies. The IMF recently noted that global economic activity continues to firm and is remarkably consistent across geographies, with notable upside surprises in Europe and Asia. Global GDP growth forecasts for 2018 and 2019 have been revised upward to 3.9%, reflecting increased economic momentum and the expected positive impact of the recently approved changes to U.S. tax policy.

Financial conditions have eased despite three federal funds rate increases and the beginning of balance sheet reduction in 2017. The S&P 500 advanced by 19.4% in 2017 but is down 3.5% in 2018 (as of the 2/8/18 close) as bond yields have increased. Housing continues to improve, with rising home prices, new construction, and increased homeownership, while inventories of existing homes remain supply-constrained.

Despite higher U.S. rates and yields, strong global growth has caused the U.S. dollar to weaken relative to other currencies, including the euro and yen. The broad trade-weighted dollar index has declined to $1.16 as compared to $1.26 a year ago, largely because stronger economic growth in other regions has raised market expectations for terminal real interest rates abroad--thus strengthening foreign currencies versus the U.S. dollar.

The bond market has taken note of stronger growth, high asset valuations, and the declining dollar, with the ten-year Treasury yield increasing to 2.83% from its most recent summer 2017 low of 2.04% on 09/07/17. The yield curve has also steepened; the two- to ten-year spread is 0.70%, up 20 basis points from its recent 01/04/18 low, and the (effective) federal funds to ten-year curve has similarly increased 39 basis points in the same period.

With respect to equity markets, considering the recent increase in the ten-year yield and equity investors' adverse reaction to that factor, it is useful to examine the implied equity risk premium. The current "consensus" estimate of 2018 S&P 500 earnings is $155.36, and the index price is 2,581 (2/8/18 close), producing a 2018 forward earnings yield of 6.02% ($155.36 / 2,581). Subtracting the ten-year yield of 2.83% produces an equity risk premium of 3.2%, a level we consider both normal and warranted.

Inflation and Inflation Expectations

Core PCE inflation has been running below 2% since June 2012. We do observe, however, that market-based measures of inflation compensation have increased in recent months, and survey-based measures of longer-term inflation expectations show signs of firming. For example, in the January University of Michigan Consumer Sentiment Survey, near-term inflation expectations were unchanged at 2.7%, while long-term five- to ten-year inflation expectations rose to 2.5%, an increase of 0.1%.

The disinflationary environment that has existed since early 2017 appears to be shifting to a moderate reflationary view. A year ago, the focus was on the disinflationary factors of dollar appreciation and oil-price declines. Today, the dollar is depreciating, and oil prices are increasing. Of note, labor markets also continue to firm, a harbinger of moderate inflationary pressures.

Labor Markets

Labor market conditions warrant special mention due to low inflation readings that have made achieving the Federal Reserve's dual mandate problematic.

Employment data began 2018 on a stronger note, with payrolls advancing by 200,000 and upward revisions to prior months. The U3 unemployment rate was unchanged at 4.1%, but the U6 underemployment rate increased slightly to 8.2%. Labor force participation failed to improve, remaining at 62.7%. Wage growth received special attention after having underperformed in recent payroll reports, as January hourly earnings advanced by a more-robust-than-expected 0.3%, for a year-over-year gain of 2.9%. January payrolls followed on the heels of the fourth-quarter Employment Cost Index (ECI), which continued to gradually accelerate. ECI private wage growth was 2.8% year over year, the fastest annual growth since the recession ended and an uptick from 2.6% in the third quarter.

The Council believes that continued labor recovery and more synchronous global growth should enable the Federal Reserve to achieve full compliance with the dual mandate in the near term, and sustainably so in the medium term, underpinning the gradual normalization of policy.

Risk Considerations

There are several risks to the economic outlook that bear monitoring, including the following:

- The Federal Reserve, while not the reserve bank *to* the world, is the leading reserve bank *of* the world. In that role, we believe it is necessary to consider U.S. policy in the context of global economic and monetary developments, which have significantly lagged the U.S. expansion.

- The current stance of accommodative monetary policy may have to be more quickly adjusted to neutral accommodation if the fiscal stimulus provided by tax reform and additional discretionary spending meaningfully increases inflation pressure or expectations.
- Given the low levels of interest rates outside the U.S., including significant albeit shrinking negative yield debt abroad, the risk associated with rising U.S. short-term rates is that the U.S. yield curve may abruptly flatten as longer-term U.S. yields remain constrained by international factors.
- The Federal Reserve's quantitative easing programs had expected *and* unexpected effects on real economic activity and asset prices. As the Federal Reserve proceeds to roll off its asset holdings, essentially quantitative tightening, the effects cannot be forecast with certainty and should be monitored closely.
- Household net worth relative to disposable personal income is at a 55-year high, and the personal savings rate is low. Households appear to be saving less as their net worth has grown. If financial asset prices weaken significantly, there could be an adverse wealth effect for the U.S. economy.

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