Record of Meeting

Federal Advisory Council and Board of Governors

Friday, May 11, 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-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

- Overall, loan growth remains steady. Most recently, data from the Federal Reserve's H.8 report ("Assets and Liabilities of Commercial Banks in the United States") showed the pace of loan growth had accelerated to 4.0% year over year (Y/Y) in Q1-18, exceeding that of Q4-17.
- Tax reform is raising both business and consumer income. In Q1-18, corporate-earnings growth was up nearly 24% Y/Y for 443 of the S&P 500 companies that had reported. Disposable personal income was up nearly 4% Y/Y in Q1-18, a 2-1/2 year high.
- The impacts of higher interest rates have been limited. The Mortgage Bankers Association (MBA) estimates a 14% Y/Y decline in mortgage refinancing originations in Q1-18.
- Credit quality continues to be healthy, with delinquency rates below their 10-year averages; however, the delinquency rates for agricultural loans are close to their 10-year average.

(a) Small and medium-size enterprises

- Small businesses continue to experience highly accommodative underwriting standards.
- Small business commercial and industrial (C&I) loans outstanding have continued to rise, up 24% from the trough of Q4-12, while growth has been relatively stable in the last few years, averaging 4% Y/Y (Federal Deposit Insurance Corporation (FDIC)).
- Future C&I lending growth is likely to be supported by small business sentiment that reached a 24-year high in February and has remained elevated since then (National Federation of Independent Business).
- Banks reported the strongest (net) C&I loan demand from small firms in 10 quarters in Q1-18 (SLOOS, the Federal Reserve's Senior Loan Officer Opinion Survey), but demand declined in Q2-18 and indicated net lower demand.
- Federal Reserve Board call reports show that C&I loan delinquency and charge-off rates at banks remained low by historical standards as of Q4-17.

(b) Commercial Real Estate

- The commercial real estate (CRE) sector remains healthy, but growth is slowing.
- Growth in CRE loans outstanding (H.8) moderated to 5% Y/Y in April, a four-year low.
- CRE asset prices may have started to decline, with Green Street Advisors reporting a 1% Y/Y decline in commercial property prices in March.
- Vacancy rates have risen only slightly from cyclical lows, and retail vacancy rates remained in line with their 10-year average at 10% in Q4-17, despite elevated store closures in the retail industry (Real Estate Investment Services).

- CRE delinquency rates also fell to the lowest level in 27 years at the end of 2017 (Federal Reserve).

(c) Construction

- Construction lending has been mixed, with single-family residential activity leading growth.
- The balances of construction and land development loans at banks (H.8) were up 7% Y/Y at the end of April, the slowest pace in at least a few years.
- Loans secured by multifamily properties (H.8) continue to grow under 7% Y/Y in April, below the averages of recent years.
- Both residential and nonresidential construction face labor shortages and higher material costs (National Association of Home Builders).
- Delinquency rates on construction loans have declined to the lowest in more than a decade (FDIC).

(d) Corporations

- The corporate loan market remains healthy, with corporations continuing to experience highly accommodative underwriting standards (SLOOS).
- C&I loans outstanding (H.8) were up over 3% Y/Y in April, an acceleration from 2017's full-year growth of 1% Y/Y, and are increasing at the fastest pace in a year.
- With capital-expenditure plans at over-decade highs and delinquency rates on C&I loans below their decade average, C&I lending growth is likely to reaccelerate over 2018.

(e) Agriculture

- Growth in loans secured by farmland (H.8) may be recovering after bottoming out near 5% Y/Y in March, but growth remains near 2017's level, under 6% Y/Y.
- Recent weakness has been due to weak agricultural income (U.S. Bureau of Economic Analysis (BEA)), which declined for the fourth consecutive year in 2017 due to weak prices for agricultural products.
- The delinquency rate for real estate loans secured by farmland moderated from a four-year high of 2.0% in Q3-17, while the delinquency rate for other agricultural loans moderated from a four-year high of 1.6% (Federal Reserve).
- One support to agricultural loans is that farmland prices have recently shown some stabilization after declining in previous years.
- Proposed tariffs create further risk to prices.

(f) Consumers

- Consumer lending is healthy, supported by rising disposable income.
- Consumer loans at commercial banks (H.8) grew almost 6% Y/Y in April 2018, just above 2017's full-year growth of 5%.
- Consumer confidence measures are near multi-decade highs, and a tight labor market has provided strong job growth and moderately accelerating wages.
- Delinquency rates overall remain historically low but have been rising for auto loans (Federal Reserve Bank of New York).
- Disposable income remains on an upward trend even as personal spending growth slowed in Q1-18 (BEA).

(g) Homes

- Demand for residential mortgages has been limited by weak refinance activity in recent periods.
- Residential real estate loans on bank balance sheets (H.8) were up nearly 3% Y/Y in April 2018, remaining at a seven-year high of \$2.22 trillion.
- Banks eased residential mortgage underwriting standards for the 16th consecutive quarter in Q2-18 (SLOOS).

- Purchase originations have continued to advance despite low inventory levels, affordability concerns, and rising mortgage rates; however, consistent with higher average mortgage rates, refinance activity has been declining since mid-2017.
- Mortgage delinquency rates rose to a 10-quarter high of 5.2% in Q4-17, but have increased only 93 basis points from the Q2-17 trough (MBA).

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?

- Q2 pipelines feel strong, particularly with respect to small and middle-market commercial and industrial lending, and it is likely we could see some acceleration in growth despite tough market competition by both banks and nonbanks. One Council member noted draw-rates were at an all-time high, implying middle-market companies are about to start spending – either for growth or mergers and acquisitions (M&A).
- Another Council member had observed middle-market M&A activity increasing from an already robust level, while noting the competition is intense and the worst seen in many years. For example, previous covenant-lite deals were principally limited to the larger market sectors; these types of deals have now found their way into smaller and niche markets as well.
- With respect to consumer spending, reported economic data may be lagging the strong spending patterns being observed. Some Council members are observing consumer spending patterns, measured through credit card transaction flows, as being up over 10% Y/Y. Specifically, this increase may be a newer dynamic that BEA data are not showing and could be the result of higher take-home pay stemming from the changes in tax laws.
- Visa, for example, had the following observation in its Q1 earnings report:
  - U.S.-only spending increased 10.2% Y/Y in Q1-18, in both credit card and debit card activity.
  - Visa's CFO commented: "Every aspect of the debit business looked very good this quarter. It attests to a pretty strong consumer profile in terms of propensity to spend."
- MasterCard saw similar trends, with Y/Y increases in spending of 10%.
- Several factors bode well for the spending outlook: strong employment trends (including a 48-year low in job claims); tax law changes that are now favorably impacting take-home paychecks; consumer confidence at generally high levels; and banks remaining accommodative.
- Council members have noted that despite the favorable changes to consumer tax laws that were implemented earlier this year, tax payments in April 2018 were substantial -- thus deposit outflows were larger than normal relative to prior years.
- Council members also pointed out, with respect to mortgage lending and C&I lending, that substantial portions of these loans continue to be made outside the banking industry. Thus, it is hard to fully assess the conditions or risks associated with those markets. Specifically, in the case of mortgage activity, Council members understand that 55% to 70% of the market is now conducted outside of traditional banks.

Item 2: CECL Implementation

> **Banks and bank regulators continue to discuss the various challenges that the current expected credit loss (CECL) accounting standards pose to operations, supervision, interaction with stress testing, and the treatment of regulatory capital. What does the Council see as the highest priorities for the banking industry and its regulators for successful implementation of CECL?**

The Council sees three top priorities for the banking industry and its regulators to ensure successful implementation of CECL.

1. **Ensuring consistency in CECL implementation practices.**

   Implementation of the new CECL standard allows for variability in the interpretation of how financial institutions employ life-of-loan forecasting methodologies. This variability could lead to a wide range of practices and make financial comparability for similar levels of risk exposure difficult. As an example, analyses performed by some banks in the industry have concluded that CECL reserves can vary dramatically depending on the bank's choice of a time horizon for a "reasonable and supportable" loss forecast before relying on long-term historical information. Similarly, a recent benchmarking study of several banks from various nations subject to IFRS 9 accounting standards published by *The RMA Journal*[1] found that credit loss estimates varied significantly by a factor of 12 to 15 times, on average, for a 12-month expected credit loss (ECL) "for the same hypothetical borrower." These differences occurred due to variability in different methodologies, data sources, and assumptions, even though the banks based their estimates on common macroeconomic forecasts and used a common estimation method. To help narrow the potential variability in implementation and results and to ensure easier financial comparability for similar levels of risk exposure, the Council encourages regulators to consider providing interpretative industry guidelines that will help narrow the range of potential practices, while recognizing the industry's desire to limit pro-cyclical impacts when possible.

2. **Providing clear supervisory expectations and guidance for how CECL will intersect with regulatory capital policies and how it will be incorporated into the CCAR process.**

   Transitioning from the current incurred-loss approach to CECL, under which banks must immediately book reserves for estimated losses over the entire life of the loan, poses unique challenges as common equity tier 1 (CET 1) and tier 1 capital levels will be reduced without any underlying change to risk exposure or economic conditions.

   Regulators have acknowledged the potential negative impact on capital related to the rule change, and as a result, recently issued a joint proposal to provide banks with the option to phase in the "day one" regulatory capital impact of the CECL accounting methodology over a three-year period. While this phase-in can temporarily soften the regulatory capital impact, experience with previous regulatory phase-in periods suggests that key stakeholders (i.e., investors, rating agencies, etc.) typically presume the fully phased-in outcomes when analyzing banks. While the Council is supportive of the phase-in, it believes more must be done.

   One concern conveyed by the Council members is that, with respect to pro-cyclicality, the "day one" regulatory impact of CECL is not an improvement over the previous incurred-loss methodology. As an example, several industry CECL back-tests performed prior to and during the Great Recession showed that using base economic forecasts at the time of reserve-setting did not generate a materially

[1] *The RMA Journal*, "Credit Loss Estimates Used in IFRS 9 Vary Widely, Says Benchmarking Study," May 2018.

different timing of "reserve build" than what actually occurred under previous accounting methodologies. Furthermore, the timing issue was exacerbated by reserve peaks, which resulted in levels 50% to more than 100% higher than what occurred under the prior methodology. In these modeled scenarios, the significantly higher levels of the allowance for loan and lease losses during a downturn would strain regulatory capital ratios, which would be countercyclical and adversely affect the availability and affordability of credit to key constituents.

The Council believes that, without a regulatory capital adjustment, CECL will have significant and adverse impacts on the pricing, terms, and supply of credit for longer-dated credit products (mortgage loans, student loans, project finance) and will provide an incentive for banks to reduce lending to riskier customers. The role of maturity transformation that banks provide will be negatively impacted by the adoption of CECL, absent regulatory capital adjustment, and the new accounting around CECL provisions would in effect be driving credit allocation decisions by banks and for the economy.

The Council believes that the solution to this issue is for bank regulators to either recalibrate downward regulatory capital minimums or to allow a CET 1 credit for the additional loss absorbency on banks' balance sheets resulting from the CECL provisions. These higher reserves are more closely related to unexpected losses (i.e., capital). Making this type of adjustment would leave banks in a comparable place, in terms of capital available to lend and their lending risk appetite, as they are in today. The measurement and methodology for such an adjustment could be somewhat tricky and complex and would therefore require analysis and study.

Council members also noted how the intersection of CECL and the Comprehensive Capital Analysis and Review (CCAR) could amplify losses and, in all likelihood, bring losses forward in CCAR stress tests, based on the reserving methodology described in the Federal Reserve's 2013 "Range of Practices and Expectations" document. The Council is hopeful that CCAR will optimally include CECL in a manner that promotes transparency and comparability, represents firm-specific credit risk, and is consistent with how the allowance would work in an actual stressed environment. The Federal Reserve Board staff has held two meetings with the industry to discuss this issue, and has asked the industry to make methodology proposals for how CECL should be modeled in CCAR. As this work is being done, the Council believes it will be important for the Board to communicate, as quickly as possible, its expectations for appropriate methodologies, guardrails, and assumptions for CECL-reserving in CCAR 2020.

3. Conducting a study to understand both the impact of CECL in different economic environments and the differences in global provisioning standards (CECL vs. IFRS 9).

Council members noted that CECL implementation may create higher costs for banks, which could lead to unintended consequences for borrowers of longer-tenor products (for example, home mortgage, home equity, student, and selected consumer finance loans). Potential consequences include higher rates, lower loan availability, or structural changes to loans that would shorten their tenor. This potential negative impact on customers could make it more difficult for banks to play their important role as financial intermediaries. Although it is difficult to fully anticipate all of the unintended consequences CECL could have on loan markets and products, a Council member highlighted how Canada is already noting changes to its residential mortgage renewals due to the IFRS 9 implementation in January 2018. Although the Canadian residential mortgage market is different from the U.S. market, the effects in Canada could serve as a potential case study for the United States, as part of a larger effort to fully understand how CECL will impact borrowers in the U.S. loan market.

A second issue raised by the Council is whether U.S. banking entities that have global footprints would be disadvantaged relative to their U.K./European counterparts, given differences in global provisioning standards (CECL vs. IFRS 9). Considering the potential real-world impacts of CECL and potential differences in global provisioning standards, Council members believe further study would be constructive.

Item 3: CRA Modernization

Federal regulators are actively discussing the possibility of updates to the Community Reinvestment Act (CRA) and exploring ways to revise their CRA regulations and their approach to examining for CRA compliance in an evolving financial marketplace. What does the Council see as the key elements in enhancing the efficacy of the CRA?

The Council is strongly in support of the goals and mission underlying CRA. The Council also believes the 1977 law has become outdated for today's market dynamics, including the needs of communities, institutions, digital delivery channels, and regulatory usage.

Background

- On April 3, 2018, the U.S. Department of the Treasury released a memorandum (the Treasury Memo) directed to the three financial regulatory agencies accountable for supervising bank compliance with CRA – namely, the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), and the Federal Deposit Insurance Corporation (FDIC) (collectively, the Agencies).
- The Treasury Memo summarized findings and recommendations from its assessment of aspects of the CRA, given emerging consensus that the regulatory framework has not kept pace with developments in how banks serve low- and moderate-income communities and clients.
- Policymakers from the Agencies, including senior OCC and FRB officials, have also addressed the question of CRA reform in recently published public comments. The OCC has indicated its intention to publish an advance notice of proposed rulemaking to revise the CRA examination regulation applicable to the banks it supervises.
- With these developments in mind, Council members respectfully submit key principles that should apply in any process to reform and update the CRA and its implementing regulations.

Principles for Effective CRA Regulatory Reform

- Any revisions to implementing regulations need to be consistent across the Agencies and provide for all regulated financial institutions to be subject to the same CRA crediting, examination, and remedial standards.
- Regulations should recognize the pro-active and encouraging framework of CRA remedial tools and thereby include specific limitations on the practice of imposing CRA-rating downgrades on the basis of unrelated legal or regulatory issues.
    - CRA is a uniquely pro-active regulatory framework, in which the Agencies encourage financial institutions to find ways to benefit low- and moderate-income constituencies in ways that are responsive to market conditions and business opportunities.
    - The statutory framework provides only that the agencies will take a bank's CRA record into account when considering applications for new branches, mergers, or consolidations.
    - In recent years, the Agencies have expanded the basis for imposing CRA-rating downgrades by reference to regulatory actions involving consumer protection laws.
- The CRA examination cycle should be faster – ensuring that institutions receive actionable feedback promptly following an examination.

- It has become commonplace for banks to wait more than a year or two to receive feedback from completed CRA exams. This delay is compounded by the fact that CRA performance assessment exams routinely cover a two- to three-year time period and may commence more than a year or two after the conclusion of the examination period.
  - Banks are thus given a public grade on activities that may have transpired more than four or five years earlier than the date the grade was released.
  - Bank boards, management, and the public need more timely feedback. By streamlining exam procedures to simplify the evaluation process and by shortening the written assessments, both public and private, the Agencies could achieve this principle.
- Rules for providing CRA credit should be revised and broadened to encourage bank activity and innovation rather than administrative complexity.
  - Financial institutions struggle with the complexity of the regulatory rules determining whether lending, services, and investments will be deemed creditable under the CRA regulations during the exam process.
  - For example, financial institution employees pride themselves on providing service to the communities in which they live and work. But the rules for what service counts under CRA are restrictive and discourage a broad range of service opportunities.
  - Financial education programs are revolutionizing the ability of banks to help enhance the financial well-being of clients with modest incomes. However, requiring intrusive personal-income information from clients would be the only way a bank could currently attempt to report these programs for credit.
  - Teaching financial literacy in low- and moderate-income schools *sometimes* counts, depending on the precise percentage of students meeting certain criteria and the government designation of the school's population.
  - These line-drawing exercises inhibit the willingness of bank employees to pursue their passion for volunteer service. Banks engage in elaborate recordkeeping to demonstrate that a volunteer activity counts, thus distorting the types of community service available from banks because the activities must conform to regulatory strictures. Creating a more flexible definition of volunteer service would create a strong incentive for bank employees to do even more.
  - Other examples exist for lending and investment activities.
- The broadening of Assessment Area designations should *reward* institutions for extending their services beyond the retail branch network and not force them to provide CRA programming or have a retail presence in the extended area**.**
  - Technological advancements and customer preference have expanded the ways in which banks can provide loan and deposit products to more customers.
  - Nonetheless, a bank's ability to engage in meaningful community development efforts continues to require a meaningful knowledge of and presence in local communities.
  - The proposed expansion of areas in which a bank would have CRA accountability to include geographies where "the bank accepts deposits and does substantial business" may result in significantly expanded CRA obligations, depending on how "substantial business" is defined.
  - While banks would welcome the flexibility to direct CRA activities to communities where they are most needed, the expansion of traditional CRA obligations to emerging areas where substantial bank business occurs could have a dampening effect on competition and innovation. Thus, activities occurring beyond a bank's retail network should be treated as additive to a bank's total CRA performance assessment and not be viewed as creating new baseline obligations.
- Agencies should coordinate and incorporate more objectivity into the assessment process and measurement.

<u>Item 4: Regulatory Reform</u>

> **Congress and bank regulators continue to make efforts to streamline and tailor bank regulation. Beyond the changes already under consideration, what further specific actions do the Council members think regulators should take to reduce regulatory burden without impairing the safety and soundness of individual financial institutions or the resiliency of the banking system?**

Council members support recent legislative and regulatory proposals that would reduce regulatory burden while preserving safety and soundness. These efforts include the bipartisan Senate bill – Economic Growth, Regulatory Relief, and Consumer Protection Act (S.2155) (the Crapo bill), the Department of the Treasury's report – *A Financial System That Creates Economic Opportunities: Banks and Credit Unions*, and the Federal Reserve's recent regulatory proposals.

There are opportunities, involving legislation or regulatory interpretation, to reduce costs to the financial sector while simultaneously achieving economic and policy benefits. Council members note that the topics of CECL implementation and CRA modernization have been addressed in items 2 and 3. Therefore, in the following discussion, we note five areas that could benefit from further action. Specifically, clarifying the Volcker rule and streamlining its enforcement would reduce the burdens associated with firms seeking to engage in desirable market making and hedging to mitigate risk. Second, Bank Secrecy Act/anti-money-laundering (BSA/AML) provisions create the most compliance costs for community banks, and certain reforms could yield more beneficial outcomes. Third, the CCAR process should be more transparent. Fourth, improved rule clarification and coordination, as well as consistency in the application of rules, among regulatory agencies would maintain rigorous analyses of bank activities, but at a lower cost to banking institutions. Fifth, some regulatory "tailoring," whether by size, business line, or materiality, would increase the efficiency of regulatory exams by allowing the regulators to conduct more focused, relevant exams.

<u>Volcker Rule</u>

The Volcker rule is made increasingly complex because it is administered by five co-equal regulatory agencies, each with separate mandates and interpretations that hinder efficient compliance by institutions. Appointing a leading regulator to supervise compliance with the Volcker rule would streamline the process for banks.

The enforcement of the Volcker rule has inhibited risk management and market-making activities, which are separate types of activities, as opposed to FDIC-insured firms taking unduly speculative risks through proprietary trading. Council members believe a modified Volcker rule would incorporate a simple definition of proprietary trading, rely more on existing bank-defined risk limits, and apply to fewer banks.

More precisely, clarifying key terms would help distinguish between productive activities and the proprietary trading targeted by the Dodd-Frank Act. Specifically, proprietary trading should be defined as short-term trading operated by a business unit that is wholly unrelated to financial intermediation, risk management, or asset-liability management.

Reversing language that assumes all trades are proprietary unless rigorously proven otherwise would be substantively beneficial. Classifying trades through an intent-based standard has resulted in the need for a substantial compliance infrastructure at banks. Within the underwriting and market making exemptions, the RENTD (reasonably expected near-term demand) provision effectively reduces liquidity. Eliminating this requirement would enhance liquidity in the capital markets, especially in corporate debt instruments.

A proposed modification to the Volcker rule is using bank-defined risk limits as a guide for regulatory examinations and for determining if improper proprietary trading activity has occurred. Additionally, the concept of inventory aging can be used to create risk weightings or stress loss factors (for firms subject to Dodd-Frank Act stress testing).

Establishing a minimum asset threshold for Volcker rule compliance would help smaller banks. The Crapo bill would exempt community banks with under $10 billion in assets and with less than 5 percent in trading assets from the Volcker rule.

The definition of covered funds should only encompass funds that engage in proprietary trading. Traditional private banking or family wealth investment vehicles should be excluded, and the foreign public fund exclusion could be simplified. The Volcker rule should also remove the limitation on employee and director ownership of covered funds.

Bank Secrecy Act/Anti-Money-Laundering

The Council recognizes the importance of BSA/AML in combating narcotics and terrorist financing, but banks incur substantial compliance costs in these efforts. Proposals to improve the BSA/AML framework include having states collect beneficial ownership information for all legal entities when they are incorporated. This would assist banks in conducting due diligence and drafting suspicious activity reports (SARs).

Many false positives are cited, as banks utilize various software and processes. The Financial Crimes Enforcement Network (FinCEN) should consider centralized software capabilities. The $10,000 threshold for requiring banks to file a currency transaction report (CTR) was established in 1972. Adjusted for inflation, this threshold is equivalent to $60,000 today, but the threshold level remains unchanged. The Council recognizes that increasing this threshold would need to be weighed against FinCEN concerns.

The House of Representatives is currently considering legislation that aims to more effectively target money laundering and other criminal activities. Legislative goals include being more outcome driven, improving enterprise risk management, refining FinCEN's process for administrative rulings, tracking anonymous shell companies, and exploring new technological capabilities. Any BSA/AML proposals would need to survive committee, and the House bill would need to be reconciled with the Crapo bill.

CCAR Transparency

One of the challenges the industry faces in dealing with CCAR's impact on capital management is the lack of transparency and industry input in the setting of the economic scenarios, as well as the lack of transparency in PPNR and credit loss modeling.

As CCAR results would inform each company's stress credit buffer under the Federal Reserve Board's recent proposal to simplify the capital rules, the matter of increased transparency should merit greater consideration.

Regulatory Clarification, Consistency, and Coordination

There are opportunities for regulators to achieve efficiencies without sacrificing rigorous enforcement. By standardizing reporting for all agencies and establishing the same reporting deadlines, much less burden would be placed on financial institutions. Information could be viewed by all regulatory agencies within a central repository. A joint regulatory (compliance) examination process could replace the separate reviews conducted by different agencies that financial institutions are now subject to. The Federal Financial Institutions Examination Council coordinates joint information technology examinations, and applying this concept to compliance examinations would assist financial institutions.

Finally, changes to capital requirements are generally more topical for global systemically important banks (G-SIBs) than for regional and community banks. Among the firms subject to CCAR, estimates indicate the proposed stress buffer requirements will on average increase capital requirements for G-SIBs and decrease capital requirements for non-G-SIBs. Holding U.S. Treasury securities and central bank deposits is rewarded in the liquidity coverage ratio but essentially penalized in the supplementary leverage ratio. G-SIBs based in the United States are facing regulations with respect to risk capital, counterparty risk, and modeling standards that could meaningfully increase their capital requirements. Additionally, U.S. regulatory requirements differ from international standards concerning capital surcharges and loss absorption, so U.S. requirements and international standards should be more closely harmonized.

Regulatory "Tailoring" Giving Greater Respect to Size and Business Complexity

Much of the current regulatory structure is characterized by standardization and a "one size fits all" approach. Giving more recognition to tailoring regulations to a bank's specific size or business model would produce better outcomes for both regulators and banks. While this concept is already acknowledged in some regulations (chiefly, in the CCAR thresholds, but there are a number of other examples), the Council believes several other areas deserve further consideration.

Many banks currently face burdensome regulations that do not apply to their business lines or activities, and compliance with these regulations diverts resources from a bank's core competencies. By giving more respect to establishing regulatory parameters aligned with the size and business lines of banks, grouping banks into the appropriate categories, and making regulatory evaluations using "best practices" based on those used by comparable companies, regulators could increase their efficiency and effectiveness. Regulators could perform very specific analyses and compare a bank's performance against that of other banks with similar profiles. This approach would allow regulators to better prioritize their time and resources during examinations, provide more customized expertise and commentary to banks, and thereby enhance the safety and soundness of the entire banking system. Regulation still needs to operate within a general, consistent framework, but in the spirit of re-examining the "one size fits all" approach that seems to have predominated since the crisis, Council members offer these areas to review.

Horizontal Reviews

Banks currently encounter horizontal reviews by regulators, whereby a given area or activity at a bank is evaluated across several institutions, without accounting for that bank's risk profile and business model. Even if an institution with a variant business model is in compliance with a regulation, applying a rigid standard may result in a supervisory finding when comparing it against other (dissimilar) firms. Understanding a bank's mission and culture would be helpful to supplement quantitative metrics. Receiving examination results in a more timely fashion would also allow banks to better respond to findings and effectively adjust to changing regulatory expectations, if necessary.

Certification

Increasingly, firms must certify to having met their responsibilities and the certification process involves multiple employees and layers of sign-offs. A firm's resources may be better prioritized toward activities that more directly support training, compliance, and risk management programs.

Eliminating or reducing certifications, while maintaining objective and transparent compliance requirements, could be constructive.

New Bank Formation

Along with strengthening existing banks, regulatory simplification may help spur innovation in the sector. Reduced regulatory requirements, especially at the start-up level, would help entrepreneurs who are considering the banking sector. Coincident with a generally rising interest-rate environment, the formation of new banks could be a beneficial byproduct of tailoring. Banking start-ups could inject new ideas into the marketplace and develop new approaches to, for example, the delivery of financial services. Crucially, new banks would be subject to regulatory review and would therefore be easier to monitor than companies outside of the banking system. In addition, it may be easier for existing banking companies to adopt innovations developed within the banking system.

Item 5: Trade Policy

Have recent changes in trade policy changed Council members' views or the views of business customers on the economic outlook? More generally, what are the members' views on globalization and the costs and benefits of financial openness?

The United States has announced several actions in response to international trade practices considered to be unfair or a national security risk, but the actual imposition of tariffs has been fairly limited. If the various tariffs and trade restrictions proposed are implemented, they could have significant impact on specific sectors of the economy.

- Increased tariffs and quotas have been imposed on imports of washing machines and solar panel components under a statute that is designed to protect these U.S. industries from increasing levels of imports.
- Penalty tariffs have been imposed on imports of a wide range of steel and aluminum products, pursuant to a finding that imports threaten U.S. national security. Certain countries and products were exempted from these penalty tariffs, subject to the discretion of the Administration. The next date for country-suspension decisions to be revisited is June 1. The Administration has stated that if agreements are not reached for quotas by June 1, then the penalty tariffs will be imposed until further notice and further exemption "rollovers" will be ended.
- A three-part action has been proposed against China by reason of unfair acts, policies, and practices of the Chinese government regarding intellectual property rights, piracy and protections in China, and the forced localization and/or transfer of technology for U.S. investors in China –
    - Increased tariffs proposed to be imposed on $50 billion of Chinese imports, with a yet-to-be-announced subsequent additional amount of $100 billion, all of which would be imposed at a time yet to be determined after a public comment period ending at the end of May.
    - Initiation of consultations and dispute settlement proceedings with China under the auspices of the World Trade Organization.
    - Imposition of investment restraints on Chinese investment in U.S. technologies.
- North American Free Trade Agreement (NAFTA) renegotiations have been pursued for over a year. An announcement of an agreement in principle between the United States, Canada, and Mexico may occur sometime in May, after which a formal process of notifications and consultations with the U.S. Congress must take place in order for Congress to approve or disapprove the new agreement. The President has continuously threatened withdrawal from NAFTA if a new agreement is not achieved.
- After withdrawing from the Trans-Pacific Partnership (TPP) in 2017, President Trump proposed rejoining the TPP in April 2018.

- Negotiations were initiated and completed with South Korea to improve certain terms of the United States-Korea free trade agreement.

Trade Policy and the Economic Outlook

- Council members report that the recent announcements and discussions surrounding trade policy have not generally affected current or near-term economic prospects. While announced tariffs on steel and aluminum have induced increases in their prices, there appears to be no meaningful impact on overall inflation, according to Council members' clients.
- Concerns about intermediate impacts of trade policy are on customers' minds, and if the uncertainty persists without resolution, there could be some impact on economic performance.
- If tariffs were enacted, the economies of all trade partners would be adversely affected to some extent. For example, $50 billion in U.S. and Chinese tariffs would reduce the level of real GDP in the United States by an estimated 0.3% and in China by an estimated 0.4%.
- The core strength of the U.S. economy and the positive impact of tax reform and deregulation are of far greater significance for current economic performance.
- In short, while the ongoing trade negotiations bear watching, their economic impact is not relatively strong at this point.

Globalization and Financial Openness

- The Council believes globalization has been, and will continue to be, a source of greater economic potential and participation for all economies. The Council also recognizes that globalization is a potential source of dislocation and volatility.
- Accordingly, the Council believes that achieving a global marketplace characterized by more fair and open trade is of considerable long-term benefit to the U.S. economy as well as the global economy.
- Key elements of creating such a marketplace include open access to each nation's markets for all suppliers; elimination of subsidies to suppliers from their national government; and protection of the ownership of intellectual property.
- The Council recognizes that the process of negotiating the framework for such a marketplace is creating some uncertainty that may affect the economy in the near term.
- The Council also recognizes that strategies pursued in this process risk causing significant disruptions to international trade, with deleterious effects on economic performance.
- Consequently, the Council expresses hope that the negotiation process will be well managed and ultimately successful.

Item 6: Economic Growth

Please discuss the Council members' observations regarding economic growth, based on the companies that borrow from your banks. What considerations may have dampened or enhanced the pace of growth in recent months?

Consumer expenditures continue to be the main force behind the current economic expansion. Small business has begun investing in capital expenditures -- seemingly fueled by tax cuts, the promise of deregulation, and businesses simply being forced to take care of deferred maintenance -- and appears to be supportive of growth through 2018 and 2019. Small businesses report expectations that their capital expenditures will increase, and they anticipate having excess cash on hand. Investments in real estate, new factories, additional equipment, tools, and services should spur economic development.

One Council member expects some near-term temporary weakness as a result of various factors, such as a retreat in vehicle sales from the high pace set in the fourth quarter of last year, as well as economic activity related to hurricane damage repair. Recent data suggest that growth rates of household spending and business fixed investment have also moderated from their strong fourth-quarter readings, related to idiosyncratic factors, including delayed tax returns, tax withholding tables that were only updated in mid-February, and residual seasonality. Housing activity in particular has weakened due to cold weather and higher mortgage rates.

Even though consumption in some areas has been weaker than in previous quarters, business investment spending continues to expand. “Soft” data such as the ISM surveys suggest the underlying pace of growth remains robust.

Global growth remains strong. For example, JPMorgan forecasts 3.4 percent global growth in 2018. The United States is expected to grow at 2.5 percent, Europe at 2.4 percent, Japan at 1.7 percent, and China at 5.1 percent. This backdrop provides an encouraging view, which one Council member reports is consistent with observations within the customer base in the member’s District. The euro zone and other advanced economies may see somewhat weaker near-term growth prospects, probably due in part to temporary factors. But some respondents foresee rising downside risks to global growth.

Council members noted that lending competition is high; however, problems in underwriting that would contribute to overheating in some lending segments were not apparent. Commercial real estate has experienced a recent spurt in activity. Strong economic growth, combined with robust employment, is having a continued positive impact on the multifamily, office, and industrial-logistics segments. C&I loan growth has picked up recently, and that growth has historically been associated with increased growth in nonresidential fixed investment. However, it is too early to draw any significant conclusions that would suggest something materially different than these observations of recent trends.

Reactions from consumers have been broadly positive, and while everyone realizes economies are cyclical, there is no current sign of a slowdown or of any causes of a potential slowdown. Even if consumers have put a large amount of the recent increase in their after-tax income into savings, the boost to consumption could push second-quarter growth in U.S. real GDP above 3 percent.

Customers generally remain positive about prospects for 2018. However, one source of concern is increasing interest rates. After years of being a non-issue, the cost of capital, while still attractive, is now a topic, and further increases could dampen growth. Additionally, the shortage of skilled and unskilled labor, combined with increased mobility and wage pressure, could dampen profitability, and political rhetoric on trade and changing Administration priorities could dampen the impact of tax reform.

Item 7: Inflation

Does the Council see any evidence that inflation is picking up?

Council members' reports indicate that inflation is gaining some traction. The real question is whether inflation will accelerate sharply or gradually "normalize" in alignment with the Federal Reserve’s target. Most Council members believe inflation will follow the latter course, rising to, or slightly above, an annual rate of 2 percent over the next several years.

Council members cited several factors contributing to a pickup in inflation: the declining slack in labor markets; late-cycle fiscal stimulus, rising oil prices; and rising costs of other inputs resulting from a weaker dollar; and the imposition of tariffs. However, they also noted some mitigating factors, including: the prospect of some additional increases in labor-force participation rates and in labor productivity; an apparent weakening of the link between labor market tightness and inflation pressures; and well-anchored inflation expectations.

Most Council members report that low unemployment is putting pressure on real wages. While most businesses report annual salary increases in the 2.5%-3.0% range for 2018, many indicate that the competition for new workers is fierce and that hiring-salary requirements have increased significantly. The Council believes continuous vigilance on the part of the Federal Reserve is appropriate.

Salaries are also climbing for workers in specialized fields. For example, at one Council member's bank, salaries are growing for wealth advisers and small business officers at branches and for specialists in cyber security and digital technology, data scientists, and agile coaches. Salaries for risk audit and compliance staff are also seeing significant increases. One Council member also reports that rhetoric about immigration has also curtailed the availability of entry-level workers.

The ADP Q1 1028 Vitality Report states, "Over the last year, wages for U.S. workers grew 2.9%, increasing the wage level by $.57 to $27.36 an hour. The information industry saw an overall wage bump of 5.6%, while the construction industry experienced big wage growth for job holders (5.6%), job switchers (7.3%) and new entrants (6.8%)."

Oil prices are at a 3-1/2 year high. Energy prices are on a path of consistent and steady increase, as evidenced by rising gasoline prices. A significant weakening of the U.S. dollar and the imposition of tariffs have many commodity prices on the rise. The recently announced import tariffs on steel and aluminum will allow domestic producers to raise prices, which will have downstream effects on automobiles and other consumer durables. Foreign retaliation for these tariffs could put additional pressure on the prices of a range of imports and import substitutes.

Item 8: Monetary Policy

> **How would the Council assess the current stance of monetary policy? Does the Council foresee any impact or significant disruptions to the financial system if interest rates continue to rise? Has the increase in interest rates thus far had any impact on banks' assessment of their credit risk?**

The Council considers the current stance of monetary policy as modestly accommodative and believes that further removal of accommodation is called for. However, the force of events has shifted over the last four months, with passage of the tax and budget acts. The economy is getting a large dose of fiscal stimulus while already at or past full employment. Inflation is arguably already rising through the Federal Reserve's 2% objective, and the unemployment rate is likely to dip to the mid-3s. With this, the Council suggests the FOMC can be more confident (less cautious) about removing monetary accommodation.

Council members have noted that while broader measures of financial conditions remain quite accommodative, conditions have recently become more volatile. There appear to be a number of disconnects between the real economy and financial markets. Tighter monetary policy, both through rising interest rates and the reduction of the Federal Reserve's balance sheet, is therefore more likely to be associated with some further unpredictability in financial conditions.

However, given the existing disconnects, a delay in tightening raises the threat of faster and more disruptive tightening in the future. In addition, the transmission of higher policy rates to higher borrowing costs for consumers and households is gradual, as the majority of loans (including mortgages) are at a fixed rate. The Council does not foresee any significant disruptions to the financial system in the near term if interest rates continue to rise in the gradual manner signaled by the FOMC. The key is that if interest rates are rising, it is because the economy is strengthening.

With a strong labor market and rising wages, consumers should continue to be able to make payments on loans and meet financial obligations, thus keeping delinquencies at low levels. Moreover, margins continue to expand, as has been the case for banks, which have experienced increased net interest income in tandem with rising interest rates. Banks have been able to increase the rates charged on the loans they make, while hiking the rates paid to savers at a slower pace. Additionally, the Council notes that banks considered such rate increases when underwriting loans; therefore, rate increases have not changed the banks' assessment of credit risk.

In summary, the Council supports the FOMC's continued removal of policy accommodation but also stresses that the path of gradual rate increases must balance the risks: rates should be raised slowly enough to avoid pushing the economy into a recession-- but not so slowly that inflation accelerates beyond the targeted range.

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