Record of Meeting

Federal Advisory Council and Board of Governors

Thursday, February 3, 2022

Item 1: Economic Activity

Based on Council members' experiences and expectations and those of their customers and contacts, what is the Council's assessment of the strength and sustainability of the current recovery?

a. **Are there conditions under which consumer spending is likely falter or ramp up in 2022? What factors are likely to shape the categories of strength or weakness in consumer spending?**

b. **What are businesses' inventory rebuilding and capex spending plans for the year? How tentative are these plans?**

c. **How are state and local governments managing their spending in their current fiscal year? In the year ahead?**

Summary

Due to the $2 trillion in excess savings of consumers and the accompanying robust balance sheets of businesses (because of the federal stimulus), the strong economic recovery is expected to continue, although at a slower pace, through 2022 and into 2023. The labor market continues to recover with solid job growth, quickly rising wages, and historically strong labor demand. Additionally, household wealth is at a record high with strong growth in stock prices and home values. Council members anticipate that consumer spending growth will shift from goods to services in 2022 due to (1) the expected further reopening of the economy and (2) pent-up demand for experiences such as travel. The biggest negative for consumer spending in 2022 is high inflation, which is eroding real incomes.

The outlook for business investment was also solid. Profits are rising, providing a source of internal financing. Because of robust demand and supply shortages, many businesses were able to maintain profit margins by passing along higher production and labor costs to customers. However, the ability to pass on costs varied by company based on their market position and size. Small businesses have experienced more margin squeeze than larger competitors due to the former's reliance on a smaller populace of suppliers. Additionally, because they have relied heavily on the stimulus programs, it is unclear whether small businesses will be prepared for a more normalized environment once their liquidity declines.

The strength of the recovery is dependent on the pandemic fading over the course of 2022, which is not a given. Other risks to the recovery include higher-than-expected inflation—which could weigh on consumer spending—and labor supply growth that is weaker than expected, constraining the supply side of the economy.

Are there conditions under which consumer spending is likely to falter or ramp up in 2022? What factors are likely to shape the categories of strength or weakness in consumer spending?

Nominal spending is expected to increase significantly in 2022, driven by labor market improvements in both employment levels and wage growth, along with excess savings. This growth is on top of 2021 personal consumption expenditures, which were 9.16% higher than 2019 levels per the Bureau of Economic Analysis. Based upon consumers' increased "pandemic fatigue" and comfort being in public places, much of these savings could convert into spending in 2022 and 2023. Conditions that could ramp up consumer spending in 2022 include the following:

- No new variants emerge that are resistant to existing vaccines
- Inflation rates, particularly for food and energy, stabilize and begin to recede

- Asset prices (housing and equities) remain stable when the stimulus is removed
- Availability of credit continues to increase
- Labor force participation continues to recover

Council members noted that the pace of real spending growth will likely depend on the rate of inflation, which continues to outpace wage gains, eroding real wages, and the supply of goods and services available for purchase. The availability of durable goods and construction materials has continued to be disrupted by supply chain issues, while services—such as dining out, travel, and events—remain limited in certain locations because of pandemic-related restrictions and concerns. In addition, as monetary policy is normalized through both rate increases and reductions in balance sheet purchases, asset prices may become volatile, which could impact asset valuations (i.e., wealth effects) and consumer confidence.

Meanwhile, continued strong consumer spending could be negatively impacted by additional unexpected COVID variants, the severity of those variants, and the efficacy of vaccines to those variants. Additional headwinds to consumer spending are (1) the expiration of many payment moratoriums (such as rent and student loans) and (2) the reduction in the child tax credit. Those changes could reduce the purchasing power of many consumers, especially those who live paycheck to paycheck with the moratoriums and stimulus still in place. The child tax credit—which studies indicate was spent as opposed to saved—was a $330 billion benefit to lower-income households in 2021. This reduction in spending power combined with rising prices for essential goods such as food, gasoline, and rent (all of which will make up a larger portion of consumer budgets in 2022 compared to their 2021 budgets), could affect other consumption spending. Continued wage gains could offset the impact of higher prices on spending power.

What are businesses' inventory rebuilding and capex spending plans for the year? How tentative are these plans?

Relative to sales, inventory levels and capex spending remain depressed. This is largely a supply-side issue, as businesses would like to rebuild inventories and invest for growth now that they have the capital and more confidence in the economic outlook to make long-term investments. As a result, inventory investment will be a source of growth as supply-chain disruptions are expected to fade during the year. According to the Institute for Supply Management's Semiannual Economic Forecast, which surveys manufacturing and service supply executives, the expectation for capex growth in 2022 is 7.7% for manufacturers and 10.3% for services.

Unfortunately, supply is limited by various well-documented factors (such as technology, labor, and transportation). As a result, businesses are diversifying and nearshoring supply chains to increase resiliency. In this environment of high demand and limited supply, prices are naturally rising. Although the price hikes and long lead times will dissuade some companies from buying more equipment, as soon as these problems ease, demand should rise. Businesses that sell capital equipment will remain well positioned. Due to the challenging labor markets, some companies are shifting capex focus to automation and digitization to reduce future reliance on labor supply. Companies are concerned that the lower labor force participation rate is permanent.

How are state and local governments managing their spending in their current fiscal year? In the year ahead?

Despite seeing higher expenses for state and local governments because of pandemic-related expenses in fiscal 2020 and 2021—including Medicaid costs and unemployment benefits—many states ended fiscal 2021 with large surpluses due to government stimulus; controlled expenses; and better-than-expected sales, property, and wage tax revenue collections. Additionally, twenty-seven states reported growing their general funds and rainy-day funds in fiscal 2021. State and local governments have also taken advantage of this excess liquidity to reduce debt burdens or refinance existing debt to lower rates. While still a significant concern, unfunded pension liabilities have also decreased due to strong investment returns.

State and local government spending is expected to increase in 2022. However, Council members cautioned that the increase is uncertain given that there is no expectation of further government stimulus. On the other hand, in certain states, much of the stimulus money has not been spent, and there are now fewer impediments to how the money can be spent. For example, states could use the funds to help consumers and businesses offset the headwinds from (1) the expiration of payment moratoriums, (2) childcare expenses, (3) COVID mandates, and (4) other impediments. A large area of focus for spending is expected to be on education: specifically, increasing teachers' pay and adding resources to reverse educational losses stemming from school shutdowns. Other areas of targeted spending will be on environmentally focused projects and efforts to combat homelessness.

Item 2: Labor Markets

How would the Council rate the overall strength of the labor market at this point?

a. **Do Council members foresee labor shortages in their own institutions or in those of clients and other contacts increasing or decreasing in the year ahead?**

b. **What kinds of compensation increases are being planned for 2022?**

c. **Are there other strategies that have been particularly successful in attracting or retaining employees recently? Are there new strategies that Council members foresee being tried in 2022?**

Overall, the demand for labor remains strong as indicated by elevated job openings, but labor supply continues to be constrained by pandemic-related issues (such as childcare availability and health concerns), early retirements, and dampened immigration.

Do Council members foresee labor shortages in their own institutions or in those of clients and other contacts increasing or decreasing in the year ahead?

Based on 2022 forecasts for declining unemployment, Council members expect the labor market to remain tight, which will continue the trend of upward pressure on wages—though this pressure may be partially offset by a return to work on the part of the estimated 4.8 million people who left the labor force during the pandemic and have not yet returned. Labor shortages, especially for frontline and high-demand roles, will increase over time, as (1) workers focus on reskilling themselves through their current employers' training programs or through other channels and (2) more employees are able to retire because of their growing retirement balances. Council members stated that labor shortages have been exacerbated by a high level of new business formations, which is creating additional demand for accountants, attorneys, and compliance personnel. Council members expect drops in overall applicant volume, continued levels of higher-than-typical turnover, and sustained pressure for salary increases.

The labor challenges are particularly acute for technology, skilled technicians, frontline services, healthcare, accounting, and hospitality. Global unrest, increased cybersecurity risks, and pandemic impacts have resulted in the "onshoring" of some functions historically performed offshore, while continued immigration restrictions have limited the ability of employers to meet the additional staffing demand through net immigration of skilled workers.

Logistics are also under stress due to the short supply of drivers and the inability for transportation businesses to secure a sufficient pool of qualified drivers. Currently, there is no anticipated relief for this shortage, which is one of the most significant issues businesses are facing in 2022. In addition, the Omicron variant is likely to increase labor shortages because infected employees are temporarily unavailable to work.

What kinds of compensation increases are being planned for 2022?

For broader workforce pools, annual merit increases are ranging from 3 to 4%. However, the constrained labor market is driving higher labor costs for frontline workers, as well as a broader variety of roles spanning from technical and digital jobs to other specialized roles. With increased attrition, new hires are demanding higher wages, creating compression with the current employee base. Overall, inflation in labor costs can range from 3 to 5% for traditional roles, and up to over 20% for high-demand skills. More than one bank has raised minimum hourly wages to $18 an hour.

For other roles, banks are still encountering wage pressures as employees at all levels are faced with an abundance of options. Council members are focused on being selective in where they outcompete, and they are continuing to plan shifts in their company's compensation structure where the market is indicating that a permanent shift is required. Compensation will always be a factor in the attrition equation, but it is not sustainable to overcorrect to an "always higher" compensation strategy.

Are there other strategies that have been particularly successful in attracting or retaining employees recently? Are there new strategies that Council members foresee being tried in 2022?

Workplace flexibility has become a "currency" for employees, and, at times, more valued than actual compensation. Employees expect flexibility and autonomy more than ever before. Employers find that allowing employees to work remotely on a full- or part-time basis and being flexible about the hours they work is crucial to employee retention. Likewise, banks are finding the same flexibility is critical as they look to hire and retain talent. It also allows banks to cast a wider geographic net when looking for the right talent. Overall, the more flexible banks can be as employers, the more successful they will be when it comes to attracting and retaining talent.

Employers introduced several strategies to address, from a compensation perspective, both turnover and a reduction in applicant volume. Wage pressures are acutely felt across all employee levels and job types. Levers being deployed related to compensation—the use of retention incentive programs, sign-on bonuses, base pay investments, counteroffers, etc.— are not necessarily "new," but the pace and reach of their application has increased dramatically. Employees also have higher expectations regarding the benefits they receive from their employers, from traditional medical coverage to non-monetary customized perks and experiences, such as sabbaticals and increased vacation time.

In addition, employees are focused on acquiring relevant and high-demand skills, which in return will make them more marketable, enabling career progression. Some banks seek to align their learning and development programs with their corporate strategy by offering skills enhancement programs in key areas such as digital and technology, data analytics, and managerial/leadership to address the rapidly changing, technology-driven demands of the financial services industry.

Beyond enhanced total reward strategies, many organizations are deploying creative tactics to acquire and retain talent, such as hosting learning sessions with keynote speakers, hosting roundtable sessions that include access to executive leadership, touting their social impact and diversity initiatives, reinforcing the importance of networks throughout the organization (e.g., employee resource groups), marketing an employee value proposition to their candidates, and focusing on more intentional onboarding of new employees to help them feel connected to the organization's mission and brand. Members believe a combination of any number of directed, intentional experiences created for candidates and employees is critical in this environment.

Item 3: Loan Markets

What is the Council's view of the current condition of loan markets and financial markets generally? Are there other conditions or developments that are particularly noteworthy in lending categories such as consumer, commercial real estate, residential real estate, construction, small and medium-size business, or corporate?

Summary

The commercial loan markets remain active, healthy, and strong. Loan demand has improved for medium to larger corporate clients, driven by increased capital expenditures and working capital levels related to the continued improvement in economic activity, as well as acquisition financing. This has also driven an increase in line utilization from historically low levels. At the lower end of the market, credit remains readily available, but only recently has demand for credit begun to increase from lower levels, as many clients have cash on hand. The market remains competitive in terms of its structure and pricing, but within reasonable limits by historical standards. Council members observed that the volume of loans outside of the regulated banks remains high, with recent reports showing more than 50% of almost all loan types in the hands of non-traditional banks. The growth for loans in non-banks has been reported to be 14% (in comparison to pre-pandemic levels) versus 1% for the regulated banking industry.

Consumer Credit

As the economy continues to improve, consumer asset quality remains strong, driven by unprecedented levels of liquidity and clients paying off debt. Concerns around increasing inflation, decreasing government support, and supply chain disruptions have been noted. Council members have continued to monitor credit demand and have seen strong increases in consumer spending levels, but there are notable drops in travel and entertainment, which have been attributed to concerns about the recent increases in COVID cases.

Collateral values for real estate and auto remain strong, as product demand outpaces inventory levels. However, as some Council members pointed out, mortgage lending looks challenging from a volume perspective given rising rates leading to reduced refinancing, a high-priced residential market, and a lack of inventory for sale. If used car prices dislocate significantly due to a combination of supply chain normalization or demand destruction, new car loans from 2020-21 could be challenging.

Some Council members observed the increase in "buy now pay later" installment loans, which remain a watch item because of their potential to increase consumer levels of indebtedness. This lending in its current form is creating risks that could result in increased pricing for consumers.

Commercial Real Estate Credit ("CRE")

Commercial real estate borrowing has begun to stabilize in many sectors as the economy has reopened. However, certain sectors, including hospitality, while showing signs of improvement, continue to be negatively impacted by the pandemic. Moreover, many real estate markets, while also improving, are still experiencing some disruptions in demand, supply chain challenges, and tenant difficulties. Current and future office demand is uncertain and a rising risk as companies evaluate space needs with employment models that include a mix of remote and conventional office use.

Some Council members noted that, historically, CRE has been viewed as a hedge to inflation, as rent levels are generally able to grow with the increasing cost structure. However, in the current environment, office and retail are unlikely to have the pricing power to move rents in concert with increasing inflation. The opposite is likely true for multifamily and industrial, as supply chain, labor, and inflationary conditions will limit new construction, permitting greater pricing flexibility in these areas. Multifamily will be further assisted by the shortage of single-family alternatives and the price increases in the for-sale markets, further enhancing the ability to respond to pricing pressures. Multifamily demand is, in part, driven by the underlying job and population dynamics. Council members noted demand differences even within discrete metropolitan areas within the same Federal Reserve District driven by the type of job growth in the market—with technology, biotechnology, and related industries driving heavy demand for multifamily housing.

CRE construction has been measured and appropriately focused on the growth segments of multifamily and industrial, with only the existing pipeline for office at moderately concerning levels. Labor and supply chain issues are considerations for construction of all property types. These constraints should help keep new construction at lower levels and may even assist in repurposing existing underutilized properties. Members expect to see multifamily expansion more in the moderately priced secondary markets rather than in the elevated gateway markets. Liquidity for construction debt also remained ample, with terms and conditions competitive, but still reasonable.

Commercial Credit – Small-Medium Sized Borrowers / Corporate

The loan market remains liquid and strong, and overall asset quality ended the year particularly strong. The health of Council members' clients improved significantly over the last 12 months, and their clients' liquidity levels remained robust. With that being said, key risks include the labor shortage, supply chain issues, and inflation (and the resulting increase in the cost of goods and labor). Council members expect the labor shortage and supply chain disruption to be larger issues for small to medium-sized clients that may have more supplier concentrations. COVID remains an ongoing issue for clients primarily in the travel, entertainment, and hospitality sectors. The labor shortage, which has been exacerbated by COVID, is the leading issue for many companies. Council members noted that underwriting terms continued to move to a pre-pandemic posture. High liquidity in the banking industry and strong external competition from the securities markets and non-bank lenders was noted by all, and Council members anticipate that the competitive impact on structure and covenant terms will be even more robust in 2022.

Small Business / Lower Middle Market: Several Council members noted that borrower demand remained muted and still well below pre-pandemic levels, despite banks having returned to pre-pandemic lending standards. New money financing is generally being used to fund maintenance and small growth opportunities. Business transition planning continues, and light merger and acquisition (M&A) activity is occurring as seasoned owners exit. Meanwhile, small business owners remain concerned about ongoing pandemic impacts. Planned interest rate increases could further dampen loan demand, but if the pandemic restrictions ease later this year, there may be an uptick in demand from business owners willing to make investments. Members noted the concerns their clients have about the ability to pass through commodity-driven price increases, especially agriculture clients who have experienced inflation in land, fertilizer, and related prices in the last year. The potential impact on margin, cash flow, and ultimately credit quality is worth watching.

Upper Middle Market / Corporate: Mid-market and corporate borrowers are performing well, and asset quality is quite strong. Some Council members suggested that activity remains formidable both in terms of loan closings and the pipeline. The continued strong economic growth, as well as M&A activity, is driving new volume and increased use of revolvers. The lending market remains competitive on pricing and structure, but is still within historical standards.

Item #4: Inflation

Based on Council members' own experience and the experience of their clients and contacts since the December meeting, please comment on the following:

a. **Are the prices of products and services rising more quickly or less quickly than in the recent past? Are Council members or clients and contacts starting to change pricing strategies? If so, how?**

b. **Is there evidence that supply chains are reconnecting, or do persistent supply frictions remain? Are there industries or geographic areas in which expansion is impaired by supply constraints?**

c. **Have recent levels of inflation changed the inflation expectations of consumers and businesses? In the Council's view do inflation expectations remain well anchored?**

Are the prices of products and services rising more quickly or less quickly than in the recent past? Are Council members or clients and contacts starting to change pricing strategies? If so, how?

Council members reported that prices continued to rise at an abnormally brisk pace, especially for important and visible household spending categories such as food, gasoline, housing, and rent. At the end of January, regular formulated U.S. gasoline prices were up about 40% from a year ago. U.S. rents are up about 14% on average and rising at a 30-40% year-on-year pace in some high-demand metro areas such as Austin, Texas. Meanwhile, food and beverage inflation is running at a steep 6% pace from a year ago. Though several Council members noted that the rate of increases are somewhat less severe in some categories than in the recent past, individual price movements continued to be volatile and unpredictable month to month.

Ongoing labor shortages and rising rents and housing costs are expected to keep core inflation elevated in 2022. At the same time, the rapid spread of the Omicron variant in January in the United States and abroad appears to be worsening supply chain disruptions and shortages, particularly for groceries and other goods that have the potential to reignite another wave of price increases in the first quarter. Clients widely reported robust demand and an ability to pass along price increases to their customers with little negative impact on demand or profitability. However, rising prices have helped push consumer sentiment to new pandemic lows in January, and real average weekly earnings have been declining since last April, as rising nominal wages fail to keep pace with the rise in consumer prices. Members are concerned that lower-income households may be the most vulnerable to the price increases, as food, gasoline, and housing costs make up a higher percentage of their overall spending.

Is there evidence that supply chains are reconnecting, or do persistent supply frictions remain? Are there industries or geographic areas in which expansion is impaired by supply constraints?

Over the past few months, there has been some modest reduction in supply chain disruptions and port backlogs from recent peaks, but the level of disruption remains high overall, and it is still too early to tell if improvement will be sustained or reversed. Container prices to West Coast and East Coast ports are off recent peaks and continued to trend lower in early January but increased a bit at the end of January. ISM Manufacturing and Non-Manufacturing surveys for December showed large declines in prices paid and supplier delivery time indexes; however, supply chain and port conditions remain far from being back to normal, and new lockdowns and port delays in production centers and ports in Asia threaten to reverse or slow some of the progress that has been made over the last few months. The ISM Manufacturing Index for January showed a partial reversal of the improvements in the prices paid index, suggesting that price pressures and supply chain disruptions may be slow to recede.

Semiconductor chip shortages continued to weigh on the expansion of motor vehicle production. Domestic motor vehicle inventories declined by approximately 86% over the past year, as motor vehicle production dropped by around 45% from July 2020 levels. Shortages in residential construction, transportation, warehousing, and trade services are other sources of supply chain bottlenecks that continue to hold back the expansion and kindle price inflation.

Have recent levels of inflation changed the inflation expectations of consumers and businesses? In the Council's view do inflation expectations remain well anchored?

Council members reported that consumer inflation expectations remained high and largely unchanged since December. Rapid wage inflation and increases in rent and housing prices are likely to be more sustained than inflation in other pandemic-impacted sectors, leading to more prolonged pressure on inflation expectations. Businesses increasingly view the current labor shortage as a permanent shift in the U.S. labor market that has the potential to add to inflation and inflation expectations over the medium term. Moreover, highly transmissible coronavirus variants such as Delta and Omicron have simply reinforced this perspective, as their rapid spread has exacerbated staffing shortages across a broad cross-section of industries, including hotels, airlines, health care, restaurants and bars, personal services, gyms, retail and wholesale trade, and transportation.

There has been little improvement in overall labor force participation, and Council members do not expect the participation rate to go back to pre-pandemic levels anytime soon. While inflation expectations have not yet completely untethered from previous historical norms, Council members believe it is important to take the threat seriously and act proactively to help keep inflationary expectations anchored.

Item #5: Fed Policy

What are the Council's views on the stance of monetary policy, including portfolio activities?

The members of the Council noted that financial conditions continue to be highly accommodative, though tightening has occurred in recent weeks with the widening of corporate spreads and the sell-off in equities. Despite recent tightening, equity markets are near an all-time high, though with dramatically increased volatility.

Council members reported that the market is expecting, and pricing in, three to four rate hikes in 2022 followed by two to three in 2023, as well as a balance sheet rundown starting this fall. One member expected nine hikes in each of the nine quarters starting in March to bring the upper end of the target range to 2.5%. Council members uniformly believe that inflation, supply chain, and labor market data suggest that the pace and timing of rate hikes expected by markets may be insufficient.

Given the state of the economy and trends in labor markets and inflation, Council members believe that rate hikes should occur faster, starting with a 50bp hike in March. Given the data, such a relatively aggressive stance seems justified. At the same time, Council members recognize that the data has, and likely will continue to, change rapidly. Moreover, it is unknown how fiscal actions or the absence of previously available fiscal stimuli could impact the data and financial conditions. Therefore, Council members encourage a more aggressive stance at the moment while also signaling and retaining the ability to remain nimble as conditions and data warrant.

On the topic of portfolio activities, Council members believe that purchases and reinvestments should be curtailed as soon as practicable, consistent with the interest of maintaining market liquidity. Aligning portfolio actions with other monetary policy actions will enable clear signaling and acknowledgement of what the current data are supporting. Additionally, Council members believe that the Federal Reserve should retain the flexibility to engage in portfolio sales if policy objectives and financial conditions justify doing so.

In terms of things to watch, Council members expressed that it will be important to monitor the health of repo, Treasury, and MBS markets amidst rate increases to ensure their smooth functioning. Council members also expressed the importance of threading the needle carefully in contracting the balance sheet and raising interest rates so as to keep the economy expanding at a modest pace, keep inflation expectations anchored, and, importantly, provide the Federal Reserve the degrees of freedom and nimbleness needed for future accommodation should it be required.

Council members also discussed the implications for financial conditions of balance sheet runoff versus rate increases. Research has shown that balance sheet changes from SOMA operations do implicitly translate to rate change equivalents through the effect on term premia.[1] Former Chair Yellen highlighted that QE had roughly the effect of 100 bps on term premia.[2] Thus, the QE effect should apply in reverse, and the planned QT does implicitly translate into rate rises. However, Council members acknowledged that one must be cautious in making inferences from prior research in this respect, as the effects vary due to the differences in balance sheet composition and the macroeconomic and financial market backdrop today versus during prior balance sheet contractions. In short, the lessons of QE may not symmetrically translate in reverse to QT. In particular, the size of the balance sheet and the current financial conditions may dampen these implicit effects. To the extent that the market believes that QT is a substitute for rate hikes and flattens the money market curve, this belief could have a dampening effect on Federal Reserve rate tightening (which further highlights the role of Federal Reserve rate hikes as the most effective tool for tightening money supply and controlling inflationary expectations).

Council members noted that the build of inflation expectations bears watching as the Federal Reserve plans the dual operation of contracting the balance sheet and increasing rates. Near-term inflation expectations (including the Federal Reserve`s gauge of Common Inflation Expectations) have been ranging higher. The primary drivers of these expectations are wage increases and energy prices. The concern expressed by Council members is that these near-term higher inflation expectations may become anchored and could impact longer-term inflation expectations or aggregate demand. As aggregate demand contracts with rising inflation expectations while the Federal Reserve is on its path of rate hikes, a risk exists of tipping the economy into a technical recession. Again, Council members stressed the need to maintain flexibility in the pace and magnitude of rate hikes in the coming months as new data emerge around key issues, such as supply chains and inflation.

Item #6: Outlook for Banking

For Council members' institutions and other banks in their Districts:

a. **What is the outlook for loan volumes and deposit flows in 2022?**
b. **What will be the primary drivers of revenues, costs, and profitability?**
c. **What sorts of risks and contingencies warrant particular attention?**

Loans

Overall, Council members reported a positive outlook for loan volumes heading into 2022. Commercial loan growth, led by commercial and industrial (C&I) loans, is expected to be strong; however, a lack of mortgage production may offset the growth compared to 2021, especially with respect to refinances. It is important to note that while mortgage production has been down, the banking industry is not expecting a large runoff of mortgage balances. While most Council members agreed that loan volumes will be strong in 2022, a few Council members noted that the lack of mortgage originations and the continued roll-off of the Paycheck Protection Program (PPP) loans may mute overall loan volumes.

The Council expects commercial loan volumes to be driven by C&I loans as inventories continue to improve, capex spending increases, and line utilizations begin to approach their historical averages. Additionally, some Council members expect to see the multifamily and mixed-use CRE categories strengthen, but they anticipate that weaknesses in office space, senior housing, and traditional retail will offset gains.

In general, mortgage volumes are expected to put the most pressure on loan growth, and as interest rates increase, refinance mortgage production is expected to plummet. While a strong background economy

[1] Bonis, Brian, Jane Ihrig, and Min Wei (2017). "Projected Evolution of the SOMA Portfolio and the 10-year Treasury Term Premium Effect," FEDS Notes. Washington: Board of Governors of the Federal Reserve System, September 22, 2017, https://doi.org/10.17016/2380-7172.2081.
[2] Chair Yellen has highlighted that QE had roughly the effect of 100 bps on term premia.
Speech by Chair Yellen on a challenging decade and a question for the future - Federal Reserve Board

would typically indicate continued purchase-money loan growth, the industry is expected to be hampered by low available inventory. Most published economic baselines and internal estimates have projected that mortgage production will decline approximately 25-35% in 2022.

Mortgage lending aside, Council members noted that consumer lending is expected to grow as (1) consumer spending increases, (2) consumers begin to deplete their savings, and (3) credit card volumes strengthen, which—along with a strong economy—should lead to an increase in borrowing.

Deposits

The Council anticipates that overall growth in deposit volumes will slow down, and consequently banks will not see the double-digit increases that they experienced in 2021. The anticipated slowdown is attributed to the lack of new stimulus. Deposit balances are expected to remain elevated, and Council members believe that deposit volumes will continue to increase (but at volumes closer to historical norms). The increase in deposit volume will likely be driven by new loan production, which means there will likely be a shift from consumer deposits to corporate deposits. However, a few Council members expressed that deposit volumes might come under pressure and could even decline due to the projected increase in consumer spending, capex investing by businesses, and the conclusion of Federal Reserve tapering. If balances do not decline in 2022, at least one Council member predicts that a decline would occur in 2023. There is some concern among Council members that deposits could continue to leave traditional banks as (1) interest rates increase and (2) fintechs and neobanks compete for market share. Customers have become fairly comfortable opening online accounts and using online banking, which should benefit the neobanks as the fight for market share continues in an increasing-rate environment. Banks are flush with excess deposits and currently have historically low loan-to-deposit ratios that are closer to 65% today versus 82% at the beginning of 2016 (prior to the last rate hike cycle). Council members noted that traditional banking institutions likely will not feel the need to increase deposit rates quickly as the federal funds rate increases.

Council members have differing opinions on how long the surge in deposits will remain in the banking system.

Drivers of Revenue, Cost, and Profitability

In general, Council members anticipate that the banking industry's asset sensitivity coupled with the expected increase in loan growth will help drive revenue and overall profitability in 2022. Banks' high liquidity levels—and hence their ability to control deposit pricing—should also bolster profitability. And as banks can leverage excess liquidity into higher-yielding earnings assets (loans and securities), revenue should be positively impacted. Conversely, revenue will be negatively impacted, compared to 2021, by the lack of PPP revenue and a normalized credit environment. Many banks have reversed portions of their allowance for credit loss and recognized provision income in 2021. A more normalized level of charge-offs and forward provisioning is expected in 2022. Additionally, loan pricing is expected to remain extremely competitive as banks compete to put excess liquidity to work in earning assets, and low interest rates are expected to continue to put pressure on net interest margins.

Fee income is expected to be negatively impacted by the expected decline in mortgage volumes and the resulting fee income from gain on sale. And competitive and political pressures are expected to continue to drive banks to change the way they charge for non-sufficient funds (NSF) and overdraft fees, which will be a blow to noninterest income and overall revenue, especially for community banks. Consequently, as mentioned by a few Council members, the offset to the change in NSF fees will be increased transaction fee income from increased spending and overall economic expansion, as well as improved strength in the wealth management business (trust and brokerage).

With respect to drivers of cost and noninterest expenses, most Council members cited the impact of inflation via the cost of labor and ability to retain talent. In addition, Council members noted the continued costs associated with technology required to help offset the rise in labor costs. Investing in technology has also been necessary to combat the expenses associated with increased regulatory burdens.

Risk and Contingencies Warranting Particular Attention

The most common risks discussed by Council members that warrant attention are those associated with potential new COVID variants and any sustained level of inflation—especially when it comes to labor cost and retention. Council members emphasized the risk of employee attrition as well as retention and acquisition costs. Council members are also concerned about any changes made to the tone of Fed policy that are not clearly messaged or that could be, as one member stated, "perceived as a monetary policy pivot." With respect to the announced monetary policy actions, there is also a risk of a flattening yield curve, which would in turn put pressure on bank net interest margins. Balance sheets need to be carefully managed and positioned for this environment. One Council member commented that it would be prudent to focus customers on hedging interest rates to deter swap risk beyond facility maturity. Rising interest rates could also cause asset price dislocation and further expose secular changes to asset classes, such as office CRE. In the same respect, while credit quality looks great now, banks will need to keep an eye out for hidden credit risk on their balance sheets and be proactive in managing it. An example given involved customers who are coming off short-term deferrals and have businesses that are improving, but are not yet back to pre-COVID levels.

Other common themes included political and regulatory risks and a shift in policy. Council members are concerned that there is not enough regulation around neobanks, thus creating a "regulatory arbitrage" and an uneven playing field. Additionally, any potential tax reform would disproportionately affect banks and the domestic business communities that banks typically serve.

Cybersecurity, fraud, and vendor management are other areas that banks need to stay focused on. One Council member mentioned risks associated with the LIBOR transition (which is another topic that banks need to remain focused on). While banks are subject to "no new use" laws, nonbanks could continue to add new LIBOR exposures until June 2023.

Item #7: Regulatory & Legislative Priorities

What are the three highest regulatory or legislative priorities for the banking industry in 2022? How would the desired regulatory or legislative actions impact Council members' institutions?

Climate Risk

Council members broadly support efforts for the banking industry to reduce the impact of man-made climate change and manage climate-related risks. Council members also support U.S. financial regulators' focus on addressing climate-related risk; however, they believe that more guidance on the scope and pace of requirements is needed. Given the complexity and interconnectivity of the climate and the broader economy, Council members urge regulators to avoid prescriptive regulations and hard quantitative requirements, because such measures would likely be premature at this juncture. The need for appropriate transition time for the economy to adjust to climate-related risks was also highlighted by the Council.

Council members noted that climate-related "scenario analysis" can be an effective element of an evolved supervisory approach to provide directional views on climate-related risk. Such "scenario analysis" should (1) be conducted separately from existing capital and liquidity stress testing, (2) be designed to capture risks over the long-time horizon over which climate-related risks will materialize, and (3) recognize the infancy of the quantitative modelling necessary for such analysis.

Council members welcome regulatory actions that address concerns related to the lack of data granularity, consistency, transparency, and materiality. While these issues are addressed, members would appreciate flexibility and appropriate timelines to onboard new tools or enhance existing data sources to effectively comply with new requirements.

In designing a new supervisory approach to climate-related risk, Council members believe that regulators should consider the size and scope of banking institutions to ensure smaller institutions have the time and resources necessary to satisfy expectations. To acknowledge the time and flexibility needed to support the transition to cleaner forms of energy, geographic and industry concentrations should also be taken into account.

With regard to disclosure, the Council commented that it will be important that any final rules recognize the inherent challenges banks will face in producing climate disclosures, given banks' reliance on client disclosures to calculate their financed emissions. This comment suggests that some form of phasing would be appropriate when it comes to requiring scope 3 emissions or financed emissions disclosures.

Unregulated Competition

The Council broadly welcomes and supports appropriately regulated competition for financial services. Council members believe that appropriate regulation would protect consumers by limiting fraud and other risks. The response of the federal financial regulators to the evolution of traditional banking services and products by unregulated big tech and fintech companies, or so called "synthetic banks," is important. Special-purpose charters that allow institutions to provide segmented banking services, without the expense or limitations of regulatory oversight, would introduce risk into the system and create an uneven playing field.

Council members reported that digital unbundling and rebundling of core banking functions by unregulated tech companies have taken many forms. For example, fintechs began offering payment products several years ago and more recently have expanded into other areas, such as extending credit and offering crypto-related products and services. The balances held by some of these payment providers function like deposits, but it may not be clear to a consumer whether those funds are insured.

Several regulatory and legislative priorities in this area to consider include (1) evaluating the appropriateness of new limited-purpose bank charters, (2) limiting "rent-a-bank" arrangements and use of the Durbin interchange fee loophole, and (3) limiting access to Federal Reserve master accounts and related services (e.g., FedWire, FedACH, and Discount Window) to unregulated institutions engaged in the business of banking.

The Council believes there is risk that failures, inappropriate conduct, or flawed products of unregulated competitors will be associated in the public mind with legitimate regulated institutions, and this association could undermine the public's confidence in the financial services industry. The regulatory perimeter around banking must be transparent and meaningful to promote public trust in the system and reduce risks to the financial system, consumers, and national security.

Mergers & Acquisitions

Council members noted that over the past several months, significant discussions have been held on possible changes to the bank merger regulatory approval processes. Collectively, these discussions could be perceived as communicating a shifting view of the benefits of bank mergers and signal the potential introduction of additional approval requirements that may go beyond existing laws, regulations, or historical practices. The cumulative effect may be a reduction in combinations that are economically sound and beneficial to the economy and the communities that banks serve.

Council members believe that increased scale is necessary for small, mid-sized, and regional banks to remain competitive, as scale in banking has become increasingly important in light of rising costs for digitization, cybersecurity, regulatory compliance, and unregulated competition. Strategic planning will be disrupted absent reasonably predictable and timely approval of deals that satisfy existing legal requirements for mergers. The reputational impact of non-approval and the economic cost of delayed approvals of mergers render the mergers significantly more impractical. The inability to increase scale through M&A activity will negatively affect the ability of all but the very largest banks to compete in the race to deliver competitive technology and meet the evolving needs of customers and communities served by the industry. Council members believe that any vision for the appropriate size and scale of banks should consider the broad and changing landscape of financial products, emerging financial technology, and emerging sources of competition.

Additional regulatory and legislative priorities include:

- *Implementation of Basel III:* As the Federal Reserve works to implement Basel III finalization, Council members advocate for regulations to be implemented in a manner that (1) is capital neutral; (2) is appropriately tailored to the complexity and risks of the U.S. banking system; and (3) recalibrates the leverage ratio requirements to account for increased deposits so that the risk-based capital, and not the leverage ratio, requirements serve as the binding constraint.
- *Cybersecurity:* Threats from cyber-attacks and ransomware attacks to the integrity of financial institutions' systems and operations have increased and become harder to prevent despite significant investments in detection and prevention measures. Intensified government action, including coordination with other countries, needs to be undertaken to identify, thwart, and prosecute cyber-criminal organizations.
- *Community Bank Leverage Ratio:* Community banks have seen their balance sheets grow significantly and unexpectedly, from both PPP lending and increased deposits as customers built large liquidity reserves in the face of the pandemic. Congress and the regulatory agencies temporarily addressed these issues, but extended relief is needed. Community banks may be forced to consider subordinate debt to meet the capital gap if the ratio is not readdressed for an extension.
- *LIBOR:* Congress is considering legislation that would provide a replacement framework for outstanding financial contracts tied to LIBOR, which is being discontinued. The legislation would establish a process for financial contracts that do not contain sufficient fallback language to instead reference the Federal Reserve's recommended alternative—the secured overnight financing rate (SOFR)—or an appropriately adjusted form of SOFR without the need to be amended or subject to litigation. The banking industry supports the legislation, which would help ensure that discontinuation of LIBOR does not lead to significant disruption in financial markets.
- *Digital Assets:* As financial markets shift rapidly toward digital assets, regulated financial institutions should play an important role in protecting financial stability, providing investor and consumer protection, and addressing anti-money laundering (AML) and other public policy mandates. One element of a new regulatory approach is to ensure that all firms providing digital finance services are captured in an appropriate regulated perimeter. The U.S. President's Working Group report on stablecoin is an important step forward in this direction. Equally important is establishing coordinated supervisory expectations that allow banks to fully participate in digital finance markets in a manner consistent with traditional principles of safety and soundness. The recently concluded interagency "crypto sprint" established a thoughtful broad outline for additional work by the U.S. banking agencies in this area.
- *Marijuana Sales:* Passage of the SAFE Act or similar legislation facilitating a framework for financial institutions to transparently bank cannabis businesses where the activity is permitted under state law would help banks compete with credit unions and nonbank providers already supporting this space.
- *Regulatory Compliance:* It is critical that federal banking regulators take a coordinated approach to harmonize definitions, eliminate redundancies between reporting regimes, and streamline reporting requirements with an eye toward cost/benefit analysis and the potential impact on banks' ability to serve their customers and compete in the marketplace. As one example, the Consumer Financial Protection Bureau's proposed data collection rules for small business lending would impose

additional compliance burden on banks, which is particularly challenging in the face of increased competition from nonbanks that would not face the same level of scrutiny of their data. The significant and increasing expense associated with the time spent and staffing required to meet the Bank Secrecy Act (BSA) and the Community Reinvestment Act requirements is especially challenging in light of declining net interest margins.

<u>Item #8: Stablecoins and CBDC</u>

a. **Some observers have suggested that stablecoin issuers could choose to either operate under a conventional bank charter, acquire a special-purpose banking charter designed in the future stablecoin legislation, or register as a money transmitter at the state level and a money services business at the federal level. What is the Council's view of this regulatory regime?**
b. **Some observers have also highlighted the potential for stablecoins to increase the speed of payments and to lower costs. What accounts for these advantages? Do Council members foresee stablecoins as displacing other forms of payment?**
c. **The increasing popularity of stablecoins has led many observers to question what role, if any, there may be for the Federal Reserve to provide a digital version of the dollar, or "central bank digital currency" (CBDC). From the Council's perspective, what are the most significant opportunities and risks that a domestic CBDC could pose to the effective and efficient functioning of the payment system?**

Some observers have suggested that stablecoin issuers could choose to either operate under a conventional bank charter, acquire a special-purpose banking charter designed in the future stablecoin legislation, or register as a money transmitter at the state level and a money services business at the federal level. What is the Council's view of this regulatory regime?

The majority of Council members are in agreement with the recommendations of the President`s Working Group that the prudent regulation of stablecoin issuers is required to maintain the standards of financial conduct and risk management to protect consumers and the financial system. Stablecoin issuers are engaged in taking deposits and effectuating payment for their customers, and the federal regulatory framework governing insured depository institutions are the best suited to address the regulatory requirements associated with those activities.

Today, participants (1) have little recourse for loss of funds and (2) do not benefit from the consumer protection standards and redemption rights of depositors. Not having those standards in place could create systemic risk in a time of disruption. Meanwhile, the standards of cybersecurity and monitoring of AML, BSA, and the Office of Foreign Assets Control requirements to protect against operational risk and prevent the use of stablecoins for illicit finance are insufficient. A money transmitter or money services business charter would likely solve both of the above concerns, but either solution would still fall short in addressing the capital and liquidity standards required to ensure safety and soundness. Given that, the conventional bank charter seems to be the regulatory framework that is best suited to manage the inherent risks.

There is an alternative opinion within a minority of the Council that, in the current use case, stablecoins need to be freely transferable among counterparties that have no direct legal or commercial relationship with the issuer and, as such, depository institutions and their regulatory framework are not appropriate. The proposed approach would create a special class of regulatory framework that addresses the regulatory requirements such as AML; clarifies that stablecoins are not bank deposits, do not pay interest, or receive deposit insurance; and mandates transparency along the lines of the current money market fund rules.

As innovation in the cryptocurrency space continues to unfold, it is important that the United States is a primary stakeholder, encouraging competition and innovation in the development of the market and framework. The objective of regulation should be to set a level playing field that protects both consumers and the financial system while allowing for the highest quality of innovation.

Some observers have also highlighted the potential for stablecoins to increase the speed of payments and to lower costs. What accounts for these advantages? Do Council members foresee stablecoins as displacing other forms of payment?

The improved speed that payment stablecoins afford is relative to the traditional payment rails, such as ACH and wire transfers. Historically, these systems have not been real-time and are constrained by transaction windows, which are not 24/7. These inefficiencies are magnified when sending money cross-border, where correspondent banks and foreign bank regulations often add complexity to payment processing, which leads to settlement time frames that are further delayed. It should also be noted that the lack of strong know-your-customer requirements in the decentralized finance space, in general, can sometimes give the appearance of a faster onboarding experience relative to traditional banking products and services.

It is not clear that this advantage is permanent as faster payments systems—such as real-time payments from The Clearing House—now allow for the same 24/7 instantaneous payments, which have become increasingly common. Likewise, The Clearing House, SWIFT, and EBA Clearing completed a proof of concept this past fall for "immediate cross-border payments" with success. Coupled with the implementation of FedNow, it is hard to conclude that stablecoins will have any clear advantage in speed in the foreseeable future.

The same can be said for cost, which the advent of the aforementioned improvements in the traditional money transfer system can significantly reduce. Ultimately, outside of some specific use cases—such as marketplace environments where transactions are performed on a cryptocurrency blockchain framework—Council members do not see a clear long-term advantage of—or the replacement of current forms of payment with—a crypto-enabled model. Still, because there are specific use cases where digital tokenized deposits may be better suited, and because of the constant evolution and adoption of the space, it is critical that the banking community monitor and develop the means to operate and process these transactions.

The increasing popularity of stablecoins has led many observers to question what role, if any, there may be for the Federal Reserve to provide a digital version of the dollar, or "central bank digital currency" (CBDC). From the Council's perspective, what are the most significant opportunities and risks that a domestic CBDC could pose to the effective and efficient functioning of the payment system?

While it is clear that the use of stablecoins is increasing and that a number of central banks are actively developing their own form of CBDC, Council members would be highly cautious of the introduction of a U.S. CBDC, especially retail CBDC.

If the Federal Reserve were to issue tokenized coins as its direct liability for the use of retail clients, it would extract those deposits from the existing banking system, reallocating funds from commercial banks to central banks, and drastically altering the roles of government agencies and the private sector. Furthermore, in a time of crisis, the creation of a U.S. CBDC could serve to destabilize the market as customers seek the safest haven for their deposits and move their commercial banking deposits to CBDC, exacerbating a liquidity crisis.

The Council is more supportive of the development of a U.S. CBDC reserved for wholesale payments for large-value transaction settlements between financial institutions that have accounts at the central bank. This would allow for the operational development and practical testing of a live U.S. CBDC without introducing the systemic risks of a retail-facing coin. With that, the U.S. will ensure it develops its monetary functionality on pace with the world as cryptocurrency and the financial infrastructure evolve.