Record of Meeting

Federal Advisory Council and Board of Governors

Thursday, February 8, 2024

<u>Item 1: Economic Activity</u>

In November, the Council saw economic activity continuing to slow, though still supported by a resilient consumer. What patterns or trends in economic activity do Council members see among their clients and other contacts at this point? What is the Council's prognosis for the pace of economic activity in 2024? Any sectors of particular strength or weakness?

Overall, economic activity and the trends reported by the Council at the November meeting remain relatively consistent. Economic activity continues to slow, and consumers remain resilient, helping to support the economy and moderate the pace of the economic slowdown. Generally, business strength remains stable, and companies remains fairly healthy—even as activity slows. Consumer-facing businesses are more insulated and typically are faring better than others. Both business and consumer balance sheets remain strong, both having benefited from cash buffers accumulated from pandemic-related stimulus—although this is starting to normalize. Consumer spending is still bolstered by real wage growth as aggregate labor earnings continues to outpace inflation. This is supported by a strong labor market marked by low unemployment and steady initial jobless claims. Additionally, household net worth remains near all-time highs, and monthly debt service burdens—as measured as a percent of disposable personal income—continue to hover near all-time lows, although they continued to normalize to pre-pandemic levels. Consumers previously locked in financing at historically low interest rates, leading to a relatively less-rate-sensitive consumer compared with previous cycles. Lastly, increased government spending provided support for the economy in 2023 and is predicted to continue to do so in 2024, albeit at a slower pace.

Although consumer and business balance sheets remain resilient, the lagged effects of monetary policy are becoming more apparent. More and more businesses are experiencing margin pressure and have difficulty passing along cost increases. As a result, companies are looking to slow expansion activities and focus on cutting expenses. While some of the larger businesses are better equipped to absorb higher interest rates and continue with some level of investment, it appears that the largest and most significant projects are being delayed due to the cost of debt financing. Still, most industry sectors continue to be stable. Sentiment among most business leaders appears measured with a positive bent, and it appears that businesses are prepared for a range of economic environments. Areas of strength continue to be primarily consumer-facing industries, such as those in the service sectors, as well as those industries that are benefiting from government spending, such as infrastructure-related construction. Notably, the construction industry may be stabilizing compared to previous quarters. Council members noted some strength in housing-related construction, and at least one member mentioned improving or stabilizing margins for the industry overall. Conversely, industries with the most exposure to interest rates, such as real estate and traditional manufacturing sectors, continue to weaken. With regard to the consumer, signs of strain are beginning to appear among lower-income households as evidenced by elevated subprime delinquencies and growing credit card debt. Cash balances are still slightly elevated relative to pre-pandemic levels; however, these levels continue to normalize as personal savings rates fall and consumers dip into savings. Consumers have increasingly relied on borrowings, as evidenced by consumer debt levels recently reaching all-time highs.

Looking forward, Council members expect the economy to continue to slow throughout 2024. Most Council members continued to see the probability of a recession as declining, or at least being pushed out. However, the possibility of a recession remains, as (1) past monetary policy actions continue to work through the system, weighing on corporate profitability, and (2) the strength of consumer spending weakens over time.

Item 2: Labor Markets

In November, Council members saw the labor market continuing to come into better balance. Based on Council members' own experience and that of their clients and contacts, how would Council members describe the overall state of the labor market at this point? How do Council members foresee employment levels and compensation rates evolving across sectors in 2024?

Council members said labor trends remain largely consistent with last quarter. Hiring slowed and voluntary attrition continued to decline, and although the market remains tight and finding skilled workers is still a challenge, fewer companies are reporting labor shortages. Overall, labor markets seem to be slowing down, consistent with changes in the macro-economic environment, business sentiment, and geopolitical risks. These factors that influence staffing are generally consistent across industries. However, Council members noted that healthcare, cybersecurity, digital, construction, and other specialized positions (e.g., treasury and risk within banking) remain particularly tight, leading to increased competition and a longer lead time to acquire new talent in these areas.

Employees remain highly focused on competitive pay and robust benefits. Overall, compensation has started to normalize compared with the rapidly escalating inflation period of the prior year. Healthcare costs across the United States continue to increase, however, and employers are responding with a focus both on benefits education and on limiting employee cost increases in a dynamic healthcare environment.

Some Council members have seen a significant increase in applications for open positions compared to six months ago, which may indicate more people attempting to reenter the workforce or changes in immigration activity. Employees also appear to be applying for jobs within their own organizations and seeking career progression opportunities in what they perceive to be a more stable environment.

Although companies continue to emphasize retaining their workers, Council members reported that there appears to be a greater incidence of organizations starting to reduce headcount and restructure given rising borrowing and labor costs. This is normal, cyclical behavior, and Council members anticipate the labor market will continue its current trend toward gradual normalization in 2024—although there may continue to be pockets that feel outsized pressure (e.g., small and medium-sized businesses). There is a broad trend toward efficiency in 2024, and while that may not lead to widespread layoffs, Council members indicated this trend may slow hiring or encourage companies to deploy their current resources more efficiently and leverage internal mobility more readily this year. This phenomenon may influence workers' decisions about whether to search for new jobs or remain in their current, seemingly stable roles for the time being. Most Council members expected staffing levels at their banks to be flat or down slightly in 2024.

Item 3: Loan Markets

At recent meetings, the Council indicated that credit terms continued to tighten and there was a general lack of loan demand. Moreover, banks were forecasting inordinately slow loan growth for 2024. Has the Council's assessment of loan market conditions changed in recent months? If so, in what ways? In particular, is there any update on commercial real estate? Are Council members seeing any noteworthy developments in other lending categories such as consumer, residential real estate, construction, small and medium-size business, or corporate?

Since the last meeting, trends regarding tightening credit and slowing loan demand continued. The slowdown is due to several factors. The availability of credit continues to be impacted as many banks remain focused on liquidity management, tightening credit standards, and supporting existing full relationships. On the demand side, businesses continue to reduce capital expenditures amid slowing demand and overall uncertainty about future conditions, while also struggling to digest higher debt service costs and adjusting to elevated interest rates and the lagging effect of higher costs on their financials.

In general, consumers and small businesses remained resilient and willing to spend; however, cash buffers are normalizing, resulting in more use of credit to offset cash shortages. On a positive note, there is

increasing mergers and acquisitions (M&A) dialogue, with spreads between the bid and ask narrowing. The expectation is that M&A activity will increase in 2024, resulting in more lending activity. Private equity firms have been holding onto companies longer with hopes of better execution as the year goes on. Overall, Council members predicted a continued slowdown in lending compared to the prior year, which saw a deceleration in lending activity as the year progressed.

Corporates – Overall loan demand remains soft; however, spreads have remained relatively tight, especially for higher quality borrowers that bring a full relationship (deposits and cash management, etc.). For these types of credits, banks are being competitive on pricing and structure. Overall, credit quality remains strong, which is feeding into the relatively tight spreads. Revolving line utilization is still down consistent with lower demand. One Council member noted that asset-based lending utilization is at an all-time low. Finally, syndication deals are down significantly as banks focus on full relationships. Despite the syndicated loan market's sentiment steadily improving as the year progressed, 2023 volumes were down roughly 27 percent year-over-year, driven by tightening in bank lending, decreased M&A/LBO activity, and the attractiveness of other financing markets (mainly corporate bonds and private credit).

Consumer – As noted, consumers remain resilient; however, cash reserves continue to be depleted, especially in lower income bands. This has led to continued normalization in credit card and revolving line usage back to pre-pandemic levels. Additionally, Buy Now Pay Later activity during the holidays surged 17.5 percent as consumers turned to installment purchasing to fund holiday purchases. The decrease in cash buffers led to an increase in late payment activity and delinquency as these metrics also normalize back to pre-pandemic levels. Auto lending is still challenged due to higher auto prices, although used car prices continued to decline (down 21 percent from the peak), combined with higher interest rates.

Residential Real Estate – Affordability remains under pressure with limited supply and stable-to-increasing home prices. The supply of existing homes remains low, as many homeowners benefit from having refinanced into a low-rate mortgage and are unwilling to sell out of their existing mortgages. As a result, demand continued to be tempered by higher interest rates and lower affordability, resulting in the lowest level of existing home sales since 1995. Additionally, underwriting standards have tightened at the margin, mainly for lower credit score consumers or those exposed to higher interest rates.

Construction – Demand for construction financing has decreased due to the current rate environment and the lower risk appetite for construction deals, which has forced marginal projects to be delayed or stopped One exception is financing for affordable housing, where construction requests remain steady. Another bright spot is in data center development, which is being driven by a surge in AI. Looking ahead, he AIA Deltek Architecture Billings Index, which predicts non-residential construction activity nine to twelve months ahead, hit its lowest level in October 2023 since December 2020, with only slight improvement in November. On net, the Council expects demand for construction financing to remain muted in 2024 due to elevated costs, higher interest rates, a slowing economy, and tightening lending standards.

Small and Medium-Sized Business – Although credit standards have tightened, stretch deals are still being made, and competition remains stiff, particularly in industries that lenders consider somewhat countercyclical such as institutional not-for-profits and government contractors. Additionally, there has been a focus on secured lending (equipment finance), as small business borrowers are prioritizing spending on essential equipment. The expectation that interest rates will come down during the year has resulted in projects being put on hold with the hope of getting better pricing in the second half of the year.

Commercial Real Estate – Since the last meeting, there has not been a notable change in CRE demand. Transaction volume in office was muted, making valuations of existing stock difficult. Loan markets for office mortgages continued to be largely closed in the banking sector. Debt funds provided most of the debt on the limited traded volume. This is a result of banks' unwillingness to lend in this space given current liquidity challenges and the stresses on the CRE market—specifically office—combined with borrowers' inability to line up the equity needed for a transaction. The wide gap between seller expectations and buyer offers is stalling the market. 2024 is the first year of significant loan maturities in the CRE sector. The

resolution of these loans will be closely watched. The market needs a longer period of stability with interest rates and values to fully unlock capital on the sidelines.

The multi-family market faces residual inflationary pressures coupled with the slowing economy, challenging income levels. Additionally, elevated supply is creating headwinds in some markets. In markets not constrained by supply, primarily in the Sun Belt, high delivery levels have caused some weakness in valuations and cash flows . Overall, multifamily credit quality has declined as these factors work through internal assessments. The decline in credit quality should abate throughout the year as economic pressures correct and slowing construction loan demand, permits, and starts address existing supply concerns.

Due to the lack of liquidity and activity, valuation write-downs could have a significant impact on those overly concentrated in specific sectors of CRE, specifically urban office or multi-family, where rents could not be increased. The impact will be felt not only by the banking industry—where the impact is not expected to be significant other than to those institutions with concentrations in these specific sectors—but also by insurance companies, the CMBS market, and municipalities (from lost tax revenue).

Finally, the cost and availability of insurance are of increasing concern, particularly in the coastal markets.

Item #4 Inflation

In November, the Council noted that the pace of disinflation had slowed and inflation expectations remained elevated. Have Council members observed any recent changes in these conditions? In this environment, how do Council members see their business clients and contacts approaching pricing decisions for 2024?

Since the last Council meeting, falling energy prices have resulted in headline inflation decelerating at a slightly faster pace, while the pace of deceleration in core inflation remained fairly steady. Still, headline inflation and core inflation each both remain well above the FOMC’s 2.0 percent target rate. While the pace of inflation has slowed significantly relative to this time last year, the cumulative impacts of inflation are weighing on consumers who are starting to show some resistance to continued price increases. As a result, consumers are shifting from bigger-ticket to smaller-ticket purchases and are “trading down” in areas, while their savings balances are declining and credit card usage is increasing.

Further moderation in labor costs should help secure further deceleration in inflation, particularly in the services sector, where labor costs tend to account for higher shares of final prices. Core goods prices are expected to maintain current levels in 2024, leaving them as more or less a neutral factor in terms of the path of overall inflation. Council members expect both headline and core inflation, as measured by PCE, to range from 2.1 to2.4 percent on a Q4/Q4 basis in 2024, reasonably close to the Federal Reserve’s 2.0 percent goal.

Two potential risks to the pace of moderation are the cost and time to ship goods. Disruptions in the Middle East, specifically the Red Sea routes, have forced shipping companies to reroute goods around Africa, lengthening voyages and pushing up costs. Similarly, a drought in Panama impacted passage through the Panama Canal, forcing some companies to use alternative routes, creating delays and driving up costs. If these challenges persist for a prolonged period, rising costs could slow disinflation.

Inflation is still a top concern, particularly for small and medium-sized businesses. Operating costs remain elevated as the increased cost of labor continues to erode margins. Generally, businesses have less leverage to increase pricing and instead are focused on expense management. Exceptions exist in industries such as transportation where contractual agreements provide for price escalation as costs increase.

One Council member noted that by leveraging technology, retailers have begun to implement targeted loyalty programs. These programs draw consumers in with high levels of personalization and attractive pricing, and the technology allows retailers to charge varying prices to different customers, based on loyalty to the brand. This addresses both consumer price sensitivity and maintaining margins and—most

importantly—market share. Some Council members noted that although overall numbers show inflation is coming down, anecdotal feedback from consumers is that they are not feeling much relief.

Item #5: Federal Reserve Policy

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

The Council continues to view the Federal Reserve's restrictive monetary policy as appropriate given the resiliency of both consumer spending and the labor market, and the deceleration of inflation. Although the bond markets celebrated the Federal Reserve's December meeting report with investors pricing in twice as many quarter-point rate cuts for 2024 as the median projection indicated by the "Dot Plot," with U.S. equity prices reaching record highs, Council members believe that continued vigilance remains important, especially given increasing geopolitical risks and resulting supply shocks, as well as still-unspent stimulus funding appropriated in response to the pandemic. Given the relatively strong economic activity and a relatively low risk of recession, the Council supports continued stable interest rates and cautious messaging, as well as a continued data-dependent approach by the Federal Reserve to monetary policy.

Although Council members consider reductions in the Fed's balance sheet to have been orderly and appropriate, there is broad support for slowing or pausing the rate of run-off due to the meaningful impact on bank liquidity and lending. Although it is difficult to know for certain if recent funding pressure has been driven by the decrease in the size of the Federal Reserve's balance sheet or by other factors, signs of marginal funding pressure have emerged, with SOFR rates increasing meaningfully at the end of each of the last three months—often an early indicator of increased liquidity stress. In addition, the rapid decline in reverse repo program (RRP) balances is suggestive of bank reserves becoming tight. As a result, consideration of slowing the pace of quantitative tightening and closely monitoring RRP balances and overnight funding markets seem both pragmatic and prudent. Consistent with the last meeting, Council members do not recommend any changes to counterparty limits or administered rates at this time.

Council members applaud the establishment of the Bank Term Funding Program (BTFP), which provided an important tool in helping to stabilize bank funding at a particularly tumultuous time in the industry. Although no longer broadly necessary (there are some concerns regarding the availability of replacement funding among smaller banks), it nonetheless demonstrated the need for improvements in Discount Window parameters. Features such as valuation of collateral at par, lower haircuts (particularly for high quality assets), relatively longer terms, more streamlined processes, and reduced borrower disclosure would increase Discount Window attractiveness and reduce the likelihood that temporary facilities such as BTFP would be necessary in future times of stress. Council members are also aware of discussions regarding the future use of the Discount Window and the availability of Federal Home Loan Bank borrowings, causing some concerns with respect to future liquidity sources.

Item #6: The Outlook for Banking in 2024

What is the outlook for loan volumes and deposit flows in 2024? What will be the primary drivers of revenues, costs, and profitability? What sorts of risks and contingencies warrant particular attention?

What is the outlook for loan volumes and deposit flows in 2024?

Research analysts have predicted low but abating loan growth in 2024; however, numerous Council members reported guidance of modest declines. Council members reported a mix of expectations for growth, with some focused on supporting existing commercial clients and others expecting consumer card balances to drive growth as retail clients spend down deposit balances. Declining balances are expected to continue in CRE, residential mortgage, and home equity. These trends are driven by the continued higher

interest rate environment, inflationary pressures, and tightening credit standards as banks seek to preserve capital for proposed regulatory changes.

Most Council members reported expectations of declining balances with a stabilizing trend. In addition to consumers continuing to spend down stimulus funding, quantitative tightening has continued to withdraw reserves from the system and create upward pressure on pricing. Deposits are expected to continue to shift from non-interest bearing to higher-cost deposits while flows to nonbank investment vehicles are expected to be lower than they were in 2023.

What will be the primary drivers of revenues, costs, and profitability?

In 2024, revenue growth is expected to be under pressure, but this will be heavily dependent on the path of interest rates. Most Council members expect multiple cuts throughout the year with net interest income (NII) expected to trough as rates come down. Net income margin (NIM) expectations were mixed depending on the extent to which banks have shifted their interest rate sensitivity to protect against declining rates. Regulatory and compliance expenses have increased, while overall expenses are largely expected to be flat or see low single-digit growth as banks closely monitor headcount and curb expenses. Smaller banks have seen an increase in fixed costs and have less flexibility to reduce staffing and other variable costs. Credit costs are expected to continue to normalize upward as the economy slows, consumers deplete cash reserves, and charge-offs increase.

As a result of these drivers, the Council expects profitability to decline in 2024, with lower NII and higher credit costs. However, the year could be a tale of two halves with NII under pressure in the beginning of the year and having the potential for growth in the second half of the year—depending on the path of interest rates and the economy.

What sorts of risks and contingencies warrant particular attention?

The Council reported that banks are closely monitoring several risks and contingencies for the year ahead. Economically, the path of interest rates and the rate of quantitative tightening will have significant impacts on bank balance sheets, deposit betas, and funding costs. Banks are shifting from protecting against "higher for longer" interest rate scenarios to protecting against the risk of declining interest rates; however, fewer or slower interest rate cuts than expected could negatively impact profitability. Risks related to asset quality from a slowing economy remain somewhat uncertain, and office CRE continues to be an area of particular concern to watch in the industry. Council members noted that these credit concerns could compound the impact of tightening credit as banks look to preserve capital and liquidity in advance of the Basel III endgame finalization. Other potential regulatory changes related to banks and consumer fees are also weighing on banks' outlooks. Council members view possible changes in depositor, investor, or regulator perceptions in reaction to a bank's unique negative circumstances as potential risks. In addition, domestic political polarization and uncertainty surrounding the presidential election, along with continued geopolitical instability, also present risks to the 2024 outlook.

Item #7: Migration of Credit Provision to Nonbanks

In recent years, there has been strong growth in the amount of funds raised and credit deployed by private credit funds, which do not operate under the same regulatory requirements as insured depository institutions. What are the Council's views on the drivers of this trend? What risks does this pose to the financial services sector, and how should regulators respond?

What are the Council's views on the drivers of this trend?

The Council considers the following to be the main drivers of this trend:

- **Bank regulation.** Post-crisis regulatory constraints have limited banks' ability to participate in certain leveraged deals, and nonbanks have filled the gap. Supervisory pressure on banks to

limit exposures and balance sheet size has also reduced banks' credit supply. While, in general, banks are not interested in taking on the same level of risk as private credit funds, there are certainly some types of lending banks want to engage in that are restricted by overly conservative supervisory assessments--including the application of leveraged lending guidance.

- **Nonbanks' competitive advantages.** Speed of execution, certainty to close, higher tolerance for leverage, limited payback requirements (i.e., amortization), and covenant flexibility (i.e., covenant-light features) drive the market share for private debt. Currently, the proliferation of private credit is mostly focused on the syndicated markets (i.e., large cap and the upper end of the middle market), but it will eventually creep into the middle market and lower middle market as the availability of capital for these investment classes significantly outweighs the finite number of larger loan opportunities.
- **Move from public to private**. Private equity (PE) values flexibility and leverage to drive returns. As a result, private credit is heavily linked to PE, which is more willing to pay for these advantages than regulated institutions. Publicly listed companies face headwinds with increased federal regulation and proxy activism. The number of publicly listed companies has declined 20 percent since 2000, while the number of PE-backed companies has increased sixfold.
- **Investor demand.** As interest rates have risen, there is increased investor demand for floating rate assets in credit markets. This return, combined with the above trends and advantages, has capital pouring into private credit funds. With a large amount of "dry powder" and low default rates, these trends are expected to accelerate.

Similar trends have also been observed in the consumer area, particularly in mortgages, with increased bank capital requirements and regulation, as well as technology developments, driving activity from banks to nonbanks.

What risks does this pose to the financial services sector?

Risks from nonbanks go well beyond the financial services sector and can impact companies, individuals, and the economy as a whole.

Risks to Banks

- **Disintermediation.** There is a risk that banking institutions will be disintermediated from their customers by private credit funds in their commercial lending business, including in traditionally safer asset classes such as asset-based lending, when bank customers need to turn to private credit funds for loans not available from traditional banks. While banking institutions may not want to take on the same level of risk as private credit funds, once a customer enters into a relationship with a private credit fund, there is a risk that the fund will then inherit the entire credit relationship. This could ultimately push the commercial lending market to nonbanks in the same way it has pushed the mortgage market—where nonbanks originate approximately 70 percent of home-purchase mortgage loans today.
- **Deteriorating bank profitability.** As the trend of private credit funds accelerates, traditional banks may feel forced to expand their risk tolerance or become less profitable.
- **Loss of banks' lending talent.** The success of private credit funds and their respective market shares have led to a drain on some of the banking industry's top talent.

Risk to Customers

- **Retail borrowers pay more when using nonbank lenders.** Nonbanks are more expensive because they need to justify the risk and deliver returns to their investors. For mortgages, individual consumers pay up to 40 percent more in closing costs. Additionally, Buy Now Pay Later financing continues to grow, and some of these financing providers still do not consistently provide consumer information to the three largest national credit reporting

companies. Nonbank lenders that do not provide transparency to consumers' full financial information put additional risks on consumers (as well as banking institutions) by potentially allowing consumers to take on undue amounts of debt.

- **Customer protections and service.** Nonbanks are typically efficient in bespoke, narrowly defined products and services when the availability and cost of those products and services are highly sensitive to their own financing costs and market conditions. Thus, given the purely transactional nature of some of these relationships, many nonbank lenders have limited ability to serve customers through adverse economic cycles. Additionally, nonbanks often do not have the same oversight and supervision from banking regulators and the Consumer Financial Protection Bureau (CFPB) to ensure compliance with consumer protection laws.

Risks to the Financial System

- **Downturn in broader economy.** Underwriting standards across banks are heavily regulated through leveraged finance guidelines, ongoing regulatory exams, and the Shared National Credit process. Private credit's increased market share combined with its liberal underwriting standards could exacerbate a downturn in the broader economy. In contrast to banks, many private credit funds have not experienced the effects of cyclical declines on a loan portfolio. Liquidity is critical during cycles, and private credit's responses to credit deterioration could either improve or stress market liquidity. During downturns, private credit funds must manage not only their portfolios, but also their investor pools, which focus on returns.
- **Systemic risk and interconnectedness.** Private firms (i.e., private equity and private credit) lending to each other could exacerbate systemic interconnectedness that is not currently visible to regulators.

How should regulators respond?

- **Restrict the funding sources of private credit funds, which comes primarily from banks.** Regulators would need to walk a fine line between limiting bank funding and not overly restricting other permissible and safe and sound lending, which may have, in part, led to the explosion of private credit funds in the first place.
- **Study the increasingly uneven playing field between banks and private credit providers.** Systemic risk is being pushed to the unregulated sectors of the financial services industry.
- **Determine if increasing requirements on banks are delivering the intended outcomes consistent with agencies' expectations.** These requirements include the recent Basel III capital proposal and the GSIB framework as well as interpretations of the leveraged lending guidance.
- **Recognize unintended consequences of increasingly stringent limitations on banks.** The growth in private credit demonstrates that further bank lending regulation does not protect the economy, it only reduces the relevance of the regulated universe and the visibility into market activity.
- **Increase systemic risk monitoring, including by addressing data gaps on nonbank lending activities.** When appropriate, use current authorities to expand the regulatory perimeter to oversee nonbank activities with risks similar to those of banks, including through reporting and disclosure, capital, liquidity, customer protection requirements, and stress testing.

  For example:

  - The CFPB's recent "Larger Participant Rule" establishes supervision over nonbank payment providers with 5 million transactions annually (currently 17 institutions). Nonbanks taking on the same activity and same risks as banks should have the same regulation, and CFPB has jurisdiction to supervise these entities.

- Regulators should continue to urge standardization of reporting for Buy Now Pay Later providers through the CFPB or other authorities.

- **Minimize the constraints to work with private credit.** It is imperative that regulators (1) not manage the perceived systemic risk through onerous rules or requirements on banks willing to participate and (2) work with nonbanks in a manner consistent with the framework of banks' risk policies. Many of the larger regulated banks have entered into partnerships with private credit providers to maintain market share and relevance.

Item #8: Financing Small Business

How are Council members' banks and other financial institutions partnering with CDFIs and MDIs to finance small businesses? How are they leveraging the State Small Business Credit Initiative (see State Small Business Credit Initiative (SSBCI) | U.S. Department of the Treasury)?

CDFI and MDI Partnership

There is broad recognition that community development financial institutions (CDFIs) and minority depository institutions (MDIs) play a vital role in addressing the financial needs of underserved communities. Council members said that banks partner with CDFIs by investing equity capital and supporting various aspects of CDFI's operations. For instance, Council members' banks serve on CDFI boards of directors, and when CDFIs are formed, their banks provide bridge capital to the new entities. Council members' banks partner regularly and extensively with CDFIs to support development in their communities and foster small business growth. Banks that are unable to accommodate small business credit requests leverage their partnerships with CDFIs to make referrals—enabling better service to small businesses. The Council noted that Federal Reserve Banks are valuable resources for identifying CDFI partners.

Council members' institutions also partner directly with MDIs,. This activity has increased significantly over the past three to four years. They have provided capital, loan participations, access to ATM networks, leadership training, and technology assistance, as well as white-labeled mobile and online banking development, partnership mentorship, and broad expertise in other areas to support MDI operations.

Regarding MDIs specifically, both the Federal Reserve Board and FDIC use the FIRREA definition of "minority bank," and only the OCC considers women's depository institutions as MDIs. Women's depository institutions are not included in the list of MDIs and CDFIs published by the FDIC. Currently, the OCC reports that 27 percent—or 13 out of 48 MDIs—are women owned. The inconsistent categorization and reporting underrepresent the presence of women's depository institutions generally, and may limit access to opportunities for those regulated by the Federal Reserve or the FDIC. Eliminating this discrepancy would open up opportunities for greater financial inclusion across the regulatory spectrum.

State Small Business Credit Initiative

Council members have a strong interest in the State Small Business Credit Initiative (SSBCI), but they are unfamiliar with how the program works. Council members who have had experience with the SSBIC expressed optimism about the program, but also highlighted implementation challenges. The program offers benefits such as allowing funding of loans that have limited cash flow, insufficient collateral, and lower credit scores. There are CDFI/SSBCI partnership success stories, and preliminary feedback indicates that recent SSBCI funding requests are highest for loan participation and loan guarantee programs.

However, the program requires high levels of coordination and thoughtful implementation. Ensuring an efficient framework, equitable distribution, and a transparent application process is critical for success. States must balance prompt fund deployment with effective evaluation measures that emphasize coordination among financial institutions, state agencies, and small businesses. Each state is given the flexibility to deploy SSBCI funds within their preferred framework based on the unique needs of its small

business communities, resulting in a variety of experiences. Some states have deployed the funds directly, while other states have granted the full amount of funding to community organizations or CDFIs to manage. Technology and organizational inefficiencies have created some difficulties. One Council member reported that an MDI partner that participated in the SSBCI found that the rules and requirements disincentivized participation. Numerous CDFIs have encountered difficulties in obtaining SSBCI funding, primarily attributed to the design of state programs. These challenges stem from constraints on supported financing product types, demanding reporting requirements, and various operational obstacles.

Traditional banking institutions can play a role in supporting the SSBCI by providing private match capital, potentially through the Initiative for Inclusive Entrepreneurship. Banks can also assist by highlighting the challenges that CDFIs and MDIs face in accessing SSBCI funds so that they can be addressed by state SSBCI administrators and Department of Treasury officials. Finally, banks can help create awareness of the alternative sources of capital and can direct clients to the correct solutions based on an understanding of the unique differences between funding sources. In general, the deployment challenges must be addressed to ensure the success of the program and its contribution to a more inclusive and resilient small business ecosystem.