

AGENDA
Meeting of the Community Depository Institutions Advisory Council
and the Board of Governors

Friday, April 5, 2013

1. Current Banking Conditions: *What is the Council's view of the current condition of, and the outlook for, loan markets and financial markets generally? Please describe any significant changes you are seeing in the creditworthiness of applicants for loans, loan demand, and lending standards in general.*

*a. **Small Business Lending:** Has credit availability for, and demand for credit from, small businesses changed significantly in the recent past? Have there been changes in lending standards for these borrowers?*

Loan demand from creditworthy borrowers remains weak in much of the country, leading to strong competition for lending. Many larger banks have begun competing for smaller business loans. This is spurring a “race to the bottom” in terms of interest rates, maturities, and underwriting to some degree. Smaller banks are unable to match the low rates that larger institutions can offer and are losing market share because of it.

The current low-rate environment is not providing expected incentive for businesses to make larger capital investments, especially when accompanied by other market and economic uncertainties. As rates are expected to remain low for an extended period of time, businesses believe that they can delay investments and still take advantage of low rates in the future.

The Council noted that community banks often play a large role in developing small businesses. Bankers' experience can be leveraged to help educate small business owners and prepare them to take on loans. Bankers also note that they increasingly partner with nonprofit and other development institutions to achieve such incubation goals.

*b. **Commercial Real Estate Lending:** Have there been any changes in the Council's view of challenges in the commercial real estate market since the beginning of the year? How are commercial real estate loans performing compared to your expectations?*

Commercial real estate lending appears to be picking up in a few key areas. Multifamily real estate has been among the strongest areas, and high occupancy rates are fueling new construction. There is also growing demand for owner-occupied commercial real estate financing as prices have stabilized and begun to rise. Financing includes purchases of existing buildings, new construction, and building rehabilitation. Each area shows promise of sustainable growth.

Frustration remains with the low-interest-rate environment and questionable pricing from insurance companies seeking to remain invested. In some cases, the return is not high enough to

justify the risk on the loans. One Council member mentioned a case of a bank returning funds to shareholders rather than risk funds at a low return. Also, several Council members have been frustrated by appraisal values trailing current market developments that resulted in failed transactions.

- c. **Construction Lending:** *What is the Council's view of the availability of credit for construction and development projects? Have Council members seen any changes in the demand for construction loans since the beginning of the year?*

New construction has picked up a bit; however, this is seen almost exclusively in metropolitan areas. There is almost no new construction outside of the larger cities, and when there is, it is often undertaken on a unit-by-unit basis. In a number of university towns, there has been growing demand for student housing, which has fueled construction.

Appraisals remain a constraining factor for construction lending as with CRE finance more generally. Builders are unwilling to undertake speculative construction because the cost of construction is higher than the appraised value of a project.

- d. **Home Mortgage Lending:** *What changes have you seen in the mortgage market since the beginning of the year? Is a trend developing among community banks to increase, decrease, or cease home mortgage originations, and if so, what are the likely causes for and effects of this trend?*

The housing market has picked up significant steam in recent months. Prices are beginning to appreciate across the country. As a result, home purchases have ticked up as well. Many Council members cited examples of homes receiving multiple bids and selling for well over the asking price. Home supply remains near record low levels in many areas, and in some areas, a house put on the market is sold in a matter of days.

Much of the mortgage activity and revenue is currently being generated via refinancing due to the record low rates. Some members noted that this serves to distort the sustainable volume of mortgage business. As soon as interest rates tick up, refinancing will drop off immediately and a strong source of revenue will disappear.

- e. **Consumer Lending:** *What changes have you seen in consumer lending?*

Consumer lending has been stagnant in recent months. The little activity there is comes primarily from auto financing. There is notable concern with this sector as well, as community depository institutions face stiff competition from uninsured competitors in the auto financing business.

Consumer compliance regulations are a particular concern in this area. One member cited several examples of banks exiting the consumer lending business entirely due to concerns with fair lending regulations.

f. Agricultural Lending: Have there been any recent changes in agricultural lending?

Agricultural lending has been stronger as of late. Most commodities have seen strong price appreciation in the past year. Drought conditions have severely limited supplies of most agricultural goods, pushing up their values significantly. There are a few areas that have not seen such strong improvement however. Potato prices have failed to rise. In addition, high feed costs have put pressure on the dairy industry and feed lots.

Agricultural land prices have risen as well, creating fierce competition for agricultural plots. Many Council members cited examples of hedge funds bidding against local farmers on land up for sale. The hedge funds are attracted to current land leasing opportunities that offer 5 percent investment yields.

The Council noted concern that much of the land prices reflected, in part, appreciation in crop prices due to the drought conditions across the country. There is worry that a year with strong rain could lead crop prices to collapse, undermining land value. The growing presence of hedge fund investments adds to risks of a land price bubble.

g. Deposits: Have Council members seen any changes in local deposit markets?

Banks are currently flush with liquidity. Despite lowering payments to near-zero levels on deposits, cash continues to flood in. Many banks have nowhere to put the deposits. There were some cases cited where banks had begun refusing new deposits. There are few options for investing excess cash, with high pre-pays on mortgage-backed securities and competition from Federal Reserve purchases.

2. Economic Discussion:

a. Overall Economic Conditions: How do Council members assess overall economic conditions in their regions?

The Council noted that general economic conditions have improved in most areas. There is a large degree of uncertainty that continues to restrain growth across the country; however, if this uncertainty is removed, there is potential for tremendous growth. There is uncertainty from a number of sources, including the tax code, sequestration, and state budget cuts. The Council did note a number of underlying economic strengths that can sustain growth.

The Council noted that conditions vary dramatically from region to region. Conditions in many metropolitan areas seem to be booming; however, the more rural areas are often left behind. A number of regions noted significant economic tailwinds from agriculture and oil production that has pushed the recovery. The relative strength of agriculture often has been rain dependent and varies by region.

Another overall theme was that businesses (notably manufacturing) were in better financial shape, but they had no urgency to borrow money. The low-interest-rate environment, which is

expected to continue into mid-2015, gives them room to wait until some of the uncertainty clears.

One large concern that was noted was the impact healthcare reform would have on the overall economy. Many medium and small businesses face tremendous uncertainty regarding the upcoming costs associated with the reform and have delayed major business decisions or hiring until there is more clarity. Moreover, many healthcare providers are facing imminent cuts, as payments become restricted.

The Council noted that housing market improvement has the potential to strongly bolster economic growth. The housing recovery has gained strength in recent months and may aid other areas of the economy as consumers gain confidence from the increased wealth reflected in home values.

b. Particular Indicators:

- i. **Inflation:** *Are the prices of products and services rising more or less quickly (or declining more) than in the recent past? Are the prices for the products and services you purchase rising more or less quickly?*

The Council thought that there was a “disconnect” between “prices” and “inflation.” Despite government policies focusing on core inflation, consumers pay attention to their real costs, which have seen stronger increases than core inflation would suggest. Many costs, such as education, construction, energy, and healthcare, are not fully represented in price indices but have a significant impact on the cost of living for individuals.

One Council member noted that cost-of-living adjustments and other increases in pay are simply not keeping up with the true cost of living.

The Council also noted “hidden inflation” occurs when manufacturers alter size or quality but sell for the same price. One member noted that ice cream manufacturers are reducing the size of cartons from 16 ounces to 12 ounces but continue to charge the same price.

- ii. **Housing:** *How have house prices changed in recent months? Have there been any changes in housing activity overall in your region?*

Nearly all of the Council members noted strong improvement in housing markets. In fact, many pointed to housing as one of the brightest areas of the economy. Nearly every region reported price appreciation in recent months. The pace of home sales has also picked up in many areas. Supply of homes remains extremely tight, further contributing to price appreciation. Some Council members noted anecdotes of homes selling well above their listing prices.

Adequate appraisals remain a big concern for some Council members. In some cases, there is a lack of available appraisers. The comment was also made that new construction costs were frequently more than the house could be appraised at, thus slowing new building even in areas where buyers had adequate income to support the loans.

Regulatory changes – particularly determinations on the Qualified Mortgage – could restrict credit to a number of creditworthy borrowers.

- iii. **Labor Markets:** *How have the labor markets in which you operate changed in recent months? In particular, assess the degree of job loss (how much and in which industries). What changes to wages have Council members observed in the past year?*

The Council noted that the job market, although improving, has lagged much of the rest of the economy. Much of this is due to productivity gains made in recent years, as companies invest in capital technology rather than hiring new employees. There remain significant skills mismatches, and retraining may be needed for many who are unemployed. This mismatch was affecting salaries and boosting salaries for many workers with key skills in certain sectors.

Uncertainty and costs associated with healthcare legislation may have lasting impacts on labor markets. Small businesses are incredibly creative in keeping below certain thresholds beyond which they must offer full benefits to employees. In many cases, this means retaining only core experienced staff and hiring outside help for other less-skilled duties. Many Council members expressed concern that this would result in a failure to develop the skill set of younger workers, which may lead to future problems.

One member noted that for banks, there was demand and wage pressure for information technology jobs, auditors, and compliance staff (e.g., Bank Secrecy Act (BSA) officers).

- iv. **Consumer Confidence:** *Is the Council seeing signs of improved consumer confidence? What is the outlook for consumer credit losses?*

The Council was largely impressed by the resilience of U.S. consumers in the face of adversity. Many were surprised that consumers were so upbeat despite current conditions.

The expiration of the temporary payroll tax relief in January was felt by all consumers. Many Council members noted that there was a notable decrease in ability to repay debts for some consumers.

The Council noted that demand for consumer loans was remarkably low, with almost no one reporting making new consumer loaning in recent months. In fact, many reported that consumers are reluctant to take on new debt and are paying down existing debt. Some noted that the lack of demand for new loans was being masked by growing student debt, which makes gross consumer credit appear to grow at a more rapid pace. Many Council members noted that this loan growth was unsustainable and that many graduates were unable to support their debt load upon graduation.

3. **Payment Systems:** *How have consumer and business practices and preferences for making payments been changing? Have community depository institutions been able to meet the*

changing needs of their customers? Are there significant impediments to meeting customers' needs for payments services, and if so, how should these impediments best be addressed?

The Council continues to have significant concerns regarding rapidly evolving payment innovations based on changing consumer attitudes, convenience, and nonfinancial institution competitors. A decreased role of banks in the payment system increases the risks for consumers using it. Financial institutions are subject to extensive consumer protection regulations, capital requirements, as well as stringent rules regarding consumer privacy and data security. Moreover, banks are subject to on-site examinations to ensure that they are following the rules. Nonfinancial institution entities offering payment services do not provide the same level of consumer protection or systemic strength.

Over the past six months, it is apparent that the Federal Reserve Banks are also following these issues closely. The Federal Reserve Bank of Chicago hosted a payments symposium last spring that addressed the various challenges and opportunities that emerging payments products present to the financial system. As a follow-up to that meeting, the Federal Reserve Bank of Chicago is hosting another meeting next month. The May meeting with bankers will focus on the future of the payments industry and the role of nonbanks and regulators.

One issue that will likely arise is the need for interoperability in Person-to-Person Payments (P2P). Community depository institutions see value in ensuring that similar emerging payment products be governed by consistent standards and interoperability. For example, allowing all participants to compete for P2P payments volume using a nationwide standard would benefit all financial institutions as well as consumers. Since interoperability is desirable, should the industry proactively pursue a solution or allow market forces to slowly define a standard?

The Council recognizes that emerging payment systems, including P2P, digital wallets, and new credit and debit card acquirer services such as Square, are gaining popularity. Technology is evolving rapidly, and marketplace acceptance of new products appears to be increasing as well, as more consumers become comfortable with new technologies. Community depository institutions are working to meet the demands of consumers in these areas, but they have concerns that some products offered by nonfinancial institutions may represent a risk that customers are not considering.

Community depository institutions have been able to meet consumer demand for new payments products primarily through the use of core service providers and outside vendors. Like many new products, smaller financial institutions do not have the resources to develop offerings independently. The use of third parties can be financially advantageous, but it does require the financial institution to cede some control when it comes to product features and implementation schedules.

At this point in time, there is concern that the regulation of nonfinancial institutions and financial institutions is not consistent, and the lack of established oversight over nonfinancial institutions may present them with a marketplace advantage while placing consumers at risk. Financial depository institutions are subject to federal and state regulation, examined for compliance with federal and state regulations on a regular basis, and offer insurance on funds placed on deposit. Nonfinancial institutions are not subject to this level of oversight.

4. Examination Practices: *Have Council members experienced problems with recent examinations? In particular, have examination practices constrained access to credit by creditworthy borrowers? What steps can be taken to address your concerns?*

Council members noted that safety-and-soundness examination experiences are generally improved. Bankers are also indicating that examiners are recognizing improved bank performance and in some cases spending less time on examinations. Overall sentiment, however, is that examinations are still too long and pre-examination requests for information are getting longer. Bankers are concerned that as they grow, their examinations are more focused on enhanced bank policies and procedures, all of which must be documented in writing even in noncritical areas. Community bankers continue to believe that they are being held to a higher standard and that their examination scopes are much more detailed than those in larger banks.

Bankers are continuing to note inconsistencies and differences among the prudential regulators and between state and federal regulators. For example, state regulators and federal regulators may rate or view an area of the bank differently. They also indicate a lack of communication exists among the regulatory agencies that have pieces of the examination process, such as examinations at the holding company and the bank. Thrift and savings institutions now subject to OCC and Federal Reserve examination continue to experience differences in examination culture, emphasis, and results. Bankers say these inconsistencies, changing supervisory expectations, and the multitude of new regulations that are in the pipeline all lead to uncertainty for community bankers.

Banker sentiment on their compliance examinations is the total opposite of those on safety-and-soundness examinations. Examinations are “check the box” exercises with no tolerance for errors or violations. BSA is the biggest area of concern and a dominant part of community depository institution examinations. Supervisory expectations can change from examination to examination, and what was considered acceptable last time is no longer acceptable now. Council members are increasing compliance staff and audits to keep up with new compliance rules and examination requirements. Members are concerned about the potential for examination confusion due to the number of new rules and changes in the compliance area resulting from the creation of the Consumer Financial Protection Bureau, as well as the application of the new rules implementing the Dodd-Frank Act.

Overall, banks feel that suggestions from examiners, even those not based on guidance or regulation, require action to implement. Otherwise, they could face scrutiny at the next examination. Bankers indicate that examiners are providing them more best practices even if they may not be appropriate at their institution or fit their business or risk profiles. They feel examiners think that if it works at other banks, it should work at their bank. The sentiment is that with all the money being spent on the examination process, by the regulators and the banks alike, bankers should feel like they have been helped to have a safer and sounder institution that can better comply with laws and regulations. Bankers also state that examiners are doing much more second-guessing of bank decisions and injecting themselves into the bank-management process.

Finally, members are concerned about the experience level of examination staffs and some agencies using contract hires to perform examination functions. Seasoned examiners are able to conduct and conclude examinations on their own, whereas less-experienced exam staffs have more communication with District or Washington personnel during the examination. Council members are burdened by educating new examiners and have little time to do so on site. They are concerned that a reduction in the experience of examination staff could result in less-robust examinations, more requirements for information before the examination, and additional inconsistency and uncertainty. While bankers are still reluctant to contact the agencies when they have examination or supervisory issues, they believe that an interagency ombudsman's office is a good idea to resolve interagency supervisory differences.

5. Regulatory Matters and the Future of Banking: *How are recent changes in the regulatory landscape affecting community depository institutions' ability to continue to provide services to their customers? What has been the effect on the industry generally?*

The Council appreciates that the agencies need to address statutory mandates created under the Dodd-Frank Act, but the avalanche of new rules, short implementation deadlines, and extremely high cost of compliance are causing community depository institutions to consider curtailing particular product offerings or exit profitable lines of business. For example, several Council members indicated that some banks may be reconsidering traditional business lines, such as consumer lending or residential mortgages, due to the inconsistent and burdensome enforcement of fair lending and consumer protection rules. The Council also is concerned that the level of regulation will encourage further consolidation of the industry. The Council notes that community-based institutions are the most active banks in a community in terms of credit outreach, charitable giving, and local leadership. A reduction in the number of community banks will have a significant impact on small business lending as well as the viability of the communities served by these banks.

There was general consensus that compliance burdens, particularly CRA and BSA/anti-money-laundering, have become increasingly tense. Regulation is not focused on a bank's complexity and risk profile, and community banks are being subjected to best practices intended for large and complex banks.

The Council is concerned that regulations are being enforced inconsistently and supervision has become overly prescriptive. Restrictions are being placed on bankers' ability to rely on experience and market knowledge when making credit decisions. Moreover, the compliance burden has forced banks to increase the number of full-time employees significantly, which increases costs and reduces performance.

Of particular concern is the impact of the new mortgage rules. The Council unanimously voiced its concern that the rules would not only restrict lending but also mimic redlining and generate statistical differences across protected classes. In following the mortgage rules, banks risk running afoul of analytical procedures being deployed to monitor fair lending and housing obligations.

The impact of regulatory burden and business uncertainty also is affecting the morale of the community banking industry. Experienced bank employees are growing frustrated and looking for work in less-stressful, less-regulated industries. Bank boards and senior management at profitable institutions are exploring mergers for the sole purpose of exiting the market. In some instances, customers are electing to pay off their loans rather be subject to additions in required documentation and questioning.

The overall environment of uncertainty also affects the Council's view of the future of the community depository institution model. The cumulative effect of margin compression, capital requirements, compliance burdens, human resource challenges, technology costs, and the aggregate impact of these factors on bank efficiency ratios calls into question the viability of the community depository institution model. Council members expressed concern that the long-term survival of community depository institutions in the United States is less certain today than it was six months ago. The Council identified the following factors affecting competitive fairness for community depository institutions.

- Excessive margin compression resulting from current interest-rate policies
- Simultaneous pressures on several key community depository institution business lines
- Excessive proposed increases in capital requirements
- Substantial increases in regulatory burden not justified for typical community banking business models
- Competition from an unfairly advantaged farm credit system
- Commercial real estate lending competition from insurance companies operating under different regulatory regimes
- Reduced investment yield resulting from abnormally large security purchases to implement monetary policy

The Council suggests a need for a dialogue among the regulators as to the public policy importance of community banking institutions. If there is a need for community banking institutions, then the regulatory landscape needs to encourage a viable industry. An unintended and artificial contraction of community banking institutions will dramatically reduce the nation's economic diversity and growth. The fact that community banking institutions frequently are the only suppliers of banking services in smaller communities and rural areas only underscores the compelling need to recognize and address the risks to the industry.

6. Additional Matters: *Have additional matters affecting community depository institutions emerged from meetings of the Reserve Banks' advisory councils that Council members want to present at this time?*

I. Regulatory Capital

Council members are deeply concerned about numerous aspects of the recent Basel III proposals. These proposals fundamentally change every aspect of regulatory capital: narrowing what counts

as capital, changing risk-weight calculations, and establishing new required levels of capital. The Council supports the notion of capital reform to help ensure capital adequacy and better alignment of capital with business risks and incentives. However, the Council believes the current proposal falls significantly short of these objectives and would be particularly detrimental for the community banking segment. The following matters are of particular concern.

Mortgage treatment: The Standardized Approach NPR assigns different risk weights to residential mortgage exposures based on (i) whether the mortgage is a first-lien “traditional” mortgage as redefined by the rule (category 1) or other loan (category 2) and (ii) the LTV ratio of the mortgage. Risk weights for category 2 mortgages range from 100 percent to 200 percent, with higher risk weights depending on higher LTV ratios.

The Council believes the categories are inappropriate because they do not focus on an appropriate and necessary consideration of all essential and compensating facts essential to underwriting decisions, whereas community depository institutions excel in this area. If the proposals were to be finalized in current form, the regulators would be encouraging a check-the-box approach to mortgage lending rather than allowing community depository institutions to exercise their judgment about compensating risk factors and the relationship they have built with a potential borrower. The Council feels that the proposals would hurt, rather than help, the residential mortgage market because they do not accurately reflect the actual or relative risk of certain types of residential mortgage loans.

Moreover, the treatment of second mortgages is highly inappropriate. Under the proposal a junior-lien mortgage extended by the same institution that holds a first-lien mortgage on the same property would increase (possibly dramatically) the required capital for the first-lien mortgage. Finally, the Council would like to emphasize that most community depository institutions do not have the data in their systems to apply the complex mortgage treatment. As a result, the Council does not feel it should be adopted as proposed.

Unrealized gains and losses flowing through capital: Under the proposed rule, unrealized gains and losses on available-for-sale securities will flow through to regulatory capital. Unrealized gains and losses occur in an available-for-sale portfolio primarily as a result of movements in interest rates. This change would bring interest rate risk into the regulatory capital standards and greatly increase the volatility of capital ratios. In addition to bringing volatility into the capital calculation, allowing unrealized gains and losses to flow through could create profound risk-management issues (both liquidity and interest rate) and complicate management of lending and investment limits. As a result of the volatility and the potential risk-management issues, the proposed rule should be revised so that unrealized gains and losses on available-for-sale securities do not flow through capital.

Phaseout of Trust Preferred Securities (TPS): Inconsistent with the intent of the Collins Amendment, Basel III does not maintain grandfathered-status for TPS for institutions between \$500 million and \$15 billion. Instead, Basel III requires the phaseout of these instruments for bank holding companies having between \$500 million and \$15 billion in total consolidated assets. In light of the costs of the Dodd-Frank Act and this NPR, all community institutions face greatly reduced alternatives in raising capital. This is particularly true for privately held banks,

mutually owned institutions, and Subchapter S Corporations. Phasing out this source of capital especially burdens community depository institutions in their capital plans. As a result, the proposed rule should be revised to fully recognize the intent of the Collins Amendment by permanently grandfathering outstanding TPS for institutions between \$500 million and \$15 billion.

Issue of concern flagged for future discussion - Leverage Ratio: Increasingly, the debate on regulatory capital has centered on a higher leverage ratio. Generally, Council members are deeply concerned about where this debate will lead. The leverage ratio is an extremely good backstop to the risk-based standards but should not be set at a level where it becomes the dominant regulatory capital standard. As this debate develops, Council members may have additional concerns.

Issue of concern flagged for future discussion - Basel Liquidity Standards: In addition to the Basel capital standards, the Basel Committee has developed liquidity standards. Although the Basel capital standards were developed for internationally active banks, U.S. regulators proposed the standards across the industry. Council members are concerned that the upcoming U.S. liquidity proposal could have a similar scope. Council members feel that community depository institutions should not be subject to standards that are not designed for them. As this issue develops, Council members may have additional concerns at a future date.

II. Impairment of Loans and Debt Securities

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have issued different proposals on impairment accounting. As part of the convergence process, the IASB and FASB initially worked together to develop a common model that would be used under U.S. Generally Accepted Accounting Principles and International Financial Reporting Standards (IFRS). However, FASB found the IASB model inappropriate for the United States. The IASB did not participate in FASB's process, effectively ignoring FASB's views. U.S. constituents have been engaged with both FASB and the IASB and have been in regular communication with FASB, the IASB, the SEC, and banking regulators regarding concerns about both models. At this point, FASB's model appears to address many banking industry concerns related to loans by providing for adequate loan loss reserves, while the IASB provides inadequate loan loss reserves. However, significant concerns remain about requiring estimates of losses over the entire life of healthy loans. The Basel Committee has written to FASB and the IASB to express its support for basing impairment on the entire life of healthy loans. U.S. constituents have told FASB and U.S. banking regulators that estimates should be based on losses that can be estimated with a reasonable level of confidence. Some District Councils have expressed strong support for impairment accounting standards that provide for adequate loan loss reserves, that are based on losses that can be estimated with a reasonable level of confidence, and that are not overly complex and costly to maintain.

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