

Record of Meeting

Community Depository Institutions Advisory
Council and the Board of Governors

Friday, November 16, 2018

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 in the creditworthiness of applicants for loans, loan demand, and lending standards in general.*

Overall, the Council reports that banking conditions, which were good in the spring, are even better now. General lending standards have been neutral for banks and improving for consumers. Competition for good credits remains high, but the flattening yield curve and tightening spread are playing more into lending decisions in certain loan categories and markets and has flattened asset growth. As discussed in the "Overall Economic Conditions" section, there were differences between urban and rural areas, which will inevitably influence credit decisions. The general sense was that now is the time for more caution.

- a. **Small Business Lending:** *Has credit availability for, and demand for credit from, small businesses changed significantly? Have lending standards for these borrowers changed?*

The majority of Districts reported that the demand for small business loans has been moderately stronger since the last meeting in April. Competition remains intense, with fintech firms and credit card companies being aggressive in the market. Loosening underwriting standards, such as not requiring personal guarantees, were raised as a concern. Some Council members note there is an oversupply of Small Business Administration lenders.

Council members contrasted their existing customers with newer startups, noting that the former were much more cautious about expanding, while new businesses were more optimistic and excited to have access to funds. Small business lending has been strong to service businesses, particularly in the hospitality and technology fields. However, lending in rural areas has been lagging behind that of more-dynamic urban centers. One Council member noted that it was easier to make profitable commercial real estate (CRE) loans to smaller businesses than commercial and industrial loans. Also, reductions in business tax rates have resulted in more self-funding by businesses, which has reduced loan demand from what it might have been otherwise.

- 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 last Council meeting in April? How are commercial real estate loans performing compared to the Council's expectations?*

Council members reported a mostly solid CRE market but noted that conditions are slightly less favorable than in April. The First and Seventh Districts noted that CRE demand is high and that it is easy for banks to find business. A number of Council members cited the strength in multifamily and warehouse projects as driving CRE

lending. One Council member described activity related to warehouses as “red hot.” The Sixth and Seventh Districts reported that large national real estate buyers have entered local markets to buy large tracts of land and then lease it back out, a trend that has reduced CRE lending opportunities for banks in favor of financing by private equity and other institutional investors.

One Council member expressed concern that an economic slowdown would cause pain in the multifamily market and serious pain in industrial lending. The structure of the credits, the Council member suggested, would not hold up in a stress scenario. In some Districts, the slowing demand for multifamily lending is characterized by differences in the absorption of multifamily inventory in urban markets, which are increasingly neighborhood specific.

- 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 last Council meeting in April?*

Many Districts reported that demand for construction lending has cooled somewhat. Much of the decreased demand is attributable to a slowdown in homebuilding. Builders are facing labor constraints and rising material costs, which have led many to build fewer, more expensive homes with higher potential profit margins instead of entry-level homes. But demand for more expensive homes is weaker, limiting construction loan demand, and capacity has not switched to the less profitable entry level. Just as the millennial generation is aging and starting families the supply-demand imbalance at the entry level may be increasing, and the process to secure building permits has also been hindering the supply. Multifamily construction, though, has helped make up for the lack of lower-cost starter homes.

One Council member reported that some businesses have turned to focusing solely on building in catastrophe areas. Given the number of damaging storms over the past year, the demand has grown for builders in storm-affected areas. The Council member noted that these businesses are performing very well using this specific business model.

- d. ***Home Mortgage Lending:*** *What changes has the Council seen in the mortgage market since the last Council meeting in April? 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?*

Mortgage lending demand has been steady across most Districts. So far, there has not been a meaningful effect on originations due to rising interest rates. However, a significant decline in the volume of refinancing’s, and to a lesser extent a limit on the growth of purchase-money mortgages resulting from a low inventory of houses for sale, is leading to layoffs in the mortgage business.

Council members expressed concern that smaller banks are being pushed out of the market due to competition from nonbank players and the inability to scale. Also, many community institutions are finding it more difficult to compete in the mortgage-servicing business, increasing the likelihood of selling mortgages on a servicing-released basis. This forced exit from servicing has reduced the attractiveness of mortgage lending for many community institutions, whose business model often depends on maintaining customer contact both in origination and servicing. Several

Council members noted examples of banks that are exiting mortgage lending altogether. The Fifth District recounted that some banks are laying off mortgage staff for the first time in memory.

Council members feel challenged by the need to invest in technology that allows them to compete with those nonbank lenders that have gained market share. Several Council members expressed the view that “alternative lenders” do not have the same regulatory obligations or supervisory oversight and can move much faster with lower overhead than banks can. One Council member expressed concern that the growing market share of nonbank lenders, who as a group tend to be thinly capitalized compared to depository institutions, makes them susceptible to market disruptions in a downturn. Should community banks and credit unions continue to reduce origination and servicing capacity, they would not be in position to step in as was the case ten years ago when nonbank lenders retreated from the market.

e. Consumer Lending: What changes have Council members seen in consumer lending?

Consumer lending demand was positive across most Districts but varied by type of product, partially attributable to increased consumer confidence and improved credit scores. Multiple Districts reported that community banks are generally leaving the consumer lending space due to its very low margins. The threat from nonbank competition has grown, as these lenders do not face the regulation and costs that banks do. Credit unions reported relatively stronger markets, especially in auto lending, though competition has increased. However, both credit unions and banks noted that the growth in credit card portfolios was mostly stagnant.

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

Council members generally describe the underwriting environment as “unfavorable.” Multiple Districts reported that the outlook for crop prices is not good. Moreover, there are major concerns related to agricultural lending due to weather problems and tariffs. Land prices have mostly remained stable due to low inventory. It was also noted, however, that pricing may be somewhat distorted by demand for land for non-agriculture uses. Numerous Council members noted a growing trend in farm consolidation, as big corporations are taking over smaller family farms. Some farms that focus on dairy are struggling, as costs are rising while prices are not. The Fifth District reported a strong increase in the number of new wineries. One Council member noted that wineries usually sit on good land, which helps back the loans. Environmental risk concerns are also weighing on agricultural lending.

Another concern for community banks is that they are increasingly unable to compete with the lending terms offered by the Farm Credit System (FCS), particularly as the FCS expands its product range and target markets.

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

Council members reported that access to deposits has become a prime issue over the past year. One Council member stated that the competition for deposits poses the greatest threat to his bank. Deposit competition was the most-discussed topic among banks in the Fifth District, many of which reported high loan-to-deposit ratios (e.g., 95%-105%). Council members expressed that it has become increasingly difficult to

find sources of funding and that it is now more challenging to retain deposits, even as short-term interest rates continue to rise. Another problem cited was that as the population ages and money is passed from one generation to another, deposits often leave a financial institution with the younger generation.

The Liquidity Coverage Rule was also cited as being damaging to the ability of community banks to attract and retain deposits. Some Council members noted that large banks have a technology advantage and offer more convenience for customers, drawing in a greater share of the market.

2. Economic Discussion:

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

The overall economic outlook is positive for Council members. However, they see a difference in the economic strength of urban and suburban versus rural markets. Business conditions across metropolitan areas are solid but are much less so elsewhere.

The Tax Cuts and Jobs Act passed last year has noticeably increased business enthusiasm and spurred business investment. However, concerns over escalating labor costs and rising tariffs, along with potential retaliations by trade partners, have raised uncertainty.

While start-ups and younger firms are expanding, several Council members noted that established businesses are becoming less ready to take risks and are holding off on expansion projects, hiring, and capital expansion over concerns that economic growth may have peaked.

Agriculture has been hit hard in recent months. Workhands have become hard to find and costly. Too much rain in the East and too little in the West have hurt production. Tariffs have dried up the markets for some crops. For example, some soybean farmers in the South-Central region are not harvesting their crops, which they cannot sell. In the central Atlantic region, farmers are concerned about the effect of tariffs, but crop values have not yet been affected. Dairy farmers in the North-Central region are seeing unfavorable changes in demand for their products.

b. *Particular Indicators:*

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

The steady measures of inflation nationally mask the differential price changes Council members are seeing across many markets, as price hikes in some markets are becoming noticeable.

All Districts report that they and other businesses are facing rapidly rising costs for wages and employee health care. Firms are trying to hold down price increases by substituting technology for labor.

New tariffs on foreign goods are also driving prices higher, particularly for materials. For example, steel producers raised their prices ahead of rising tariffs in

anticipation of the effects. Some agricultural prices are also rising, especially for seeds. On the other hand, moderate inflation numbers reflect deflating energy and telecommunication costs.

Consumers are avoiding rising prices by price-shopping on the internet—but this does not help them dodge the rising costs of services.

ii. Housing: How have house prices changed in recent months? Have there been any changes in housing activity overall in Council members' regions?

Housing is in short supply across the nation, according to Council members. Homebuilding is being held up in many areas due to a dearth of labor resources. However, many homebuilders shut down in the last recession and have not come back, masking the deficiency of construction workers to some degree.

With rising material costs and labor scarcity, builders are optimizing projects by concentrating on higher-priced homes. Several Council members noted a critical shortage of lower-priced housing. There is a malicious cycle: housing is scarce and expensive for lower-wage workers, so they are going elsewhere. This movement increases the shortage of labor available to build homes in the areas workers have left, thus exacerbating the housing shortage and price escalation.

Young and other first-time homebuyers have become a larger share of home seekers—but they are experiencing more difficulty finding homes. Demand has outstripped supply, and existing stocks of lower-cost homes have been drawn down in several Districts. Moreover, there is little construction of new housing in lower price ranges.

Some Council members noted activity in home improvement, but there has been a slowdown in construction of multifamily properties in some areas.

Council members in general noted that housing prices continue to rise, with no evidence at this point of any effect from rising mortgage interest rates. The largest price gains have been for lower- and mid-priced homes, as more homebuyers are avoiding large homes. The prices of new homes are rising because of the shortage and rising costs of construction labor, as well as higher material costs. New homebuyers are more concerned about rising interest rates, as many are already strapped with education debt.

Some Council members are observing migration across jurisdictional lines to lower-tax areas. Demand is strong in suburban areas where there is access to public transportation.

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

The strong business environment has led to robust demand for labor; all Council members reported very tight labor markets and rising wages.

Employers are finding it difficult to replace or add staff who are capable and drug free. Competition to find workers is strong, and employees are ever ready to change jobs, so labor-force-turnover rates are high. Replacing workers in senior, skilled positions is especially difficult and expensive; firms are having to pay up and offer perks.

The urban/rural paradigm is reflected in the labor markets, as the challenges of housing and labor are interlinked: there are no jobs where housing is affordable and vice versa.

Some Council members noted a contraction in higher education enrollment (especially among foreign students) at public and private colleges, some of which are cutting back or closing. There are concerns that this trend will forestall development of human capital.

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

With the economy growing and labor in demand, consumers generally are confident about current conditions but somewhat guarded about the future, according to Council members.

Consumer credit quality remains quite strong. However, lenders are wary of the potential effects of rising interest rates on consumers who have adjustable-rate mortgages and other loans.

3. **Faster Payments:** *Over the past few years, the Federal Reserve and the payments industry have been focused on pursuing ubiquitous, safe, and faster (real-time) payment capabilities in the United States. The Federal Reserve and the industry have worked together on the Faster Payments Task Force and other efforts focused on governance, directories, and rules/standards. At the request of the industry, the Federal Reserve is also assessing possible operational roles, in particular enabling 24x7x365 settlement, to support faster payments in the United States. Given these past years of learning, how important strategically do you think faster (real-time) payment capabilities and related technologies are to your banks and the long-run evolution of the banking industry? How do you envision end users making use—now and over time—of such capabilities and technologies? Do you believe that the payments industry is advancing sufficiently in its adoption of faster payments and related services to end users?*

The Council affirms that faster payments capabilities are essential to the success of their individual financial institutions. Financial institutions rely on deposits. If consumers and businesses cannot meet their demand for faster payments at one institution, they will move to one that can meet that need.

The Council sees the demand for faster payments being addressed today in many ways, both inside and outside of the banking system. There is clear support for a “bank-centric” solution because the regulatory oversight that banks are subject to will result in a better, safer solution for community institutions and their customers. As regulated entities, financial institutions must meet substantial requirements regarding the protection of personal data from security breaches and the prevention of data being used unknowingly for marketing purposes.

The Council supports having the Federal Reserve become a provider of a faster settlement service, as outlined in the recent proposal issued in October 2018. Several reasons were cited in the discussion, including:

- The addition of the Federal Reserve would increase competition with the current private-sector operator, resulting in better pricing and customer service.
- Offering two solutions would increase the resiliency of the marketplace for faster payment systems, similar to what exists in the check and automated clearinghouse (ACH) markets today. The resiliency of the payment system is a national security issue that will only become more important as the volume of payments migrating to this new services channel increases.
- The Federal Reserve is connected and has existing service relationships with financial institutions across the country, and there are policies and procedures in place to ensure compliance with requirements related to the Gramm-Leach-Bliley Act, vendor management, data security, privacy, and more. Many financial institutions would prefer to expand an existing relationship with the Federal Reserve instead of having to create a new vendor relationship.

To mirror the successful model of private/public-sector competition used in check and ACH clearing, it is essential that any new Federal Reserve service be interoperable with private-sector solutions. Transactions need to be able to start with one provider and end on another, just as checks and the ACH operate today. If the Federal Reserve created a new but isolated solution, the result would be fragmentation of the marketplace and slow adoption by consumers.

Any new faster-settlement system created by the Federal Reserve must continue to operate in the same manner as existing systems, that is, only chartered financial institutions have direct access. The integrity of the system relies on having regulated and regularly examined entities as counterparties to financial transactions. Entities that do not meet the requirements established for chartered institutions pose an unacceptable risk to the system.

Finally, the Federal Reserve should act--and act quickly--to implement a solution for faster settlement. The idea of Federal Reserve participation in such a solution has been considered for several years, without any result.

The private-sector solutions have been very slow to roll out, especially to smaller financial institutions. The Federal Reserve should move forward as rapidly as possible to provide a faster settlement system that is interoperable with private-sector solutions and restricted to chartered financial institutions. The Council believes that Federal Reserve intervention and participation will:

- Help to level the playing field for institutions of all sizes;
- Ensure adequate competition with one or more private-sector operators;
- Stimulate more innovation and competition from private-sector providers that leverage faster payments systems, as outlined in the proposal issued in October 2018;
- Ensure appropriate controls around customer privacy, and
- Provide sufficient liquidity, ensuring transaction completion.

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 the Council's concerns?*

Council members generally find that examination practices and the tone of examinations have improved, continuing a trend with respect to safety and soundness examinations and more recently for compliance exams. Recent exams have been fairer and more accurate and collaborative, and examiners have been knowledgeable. Council members agree that the risk-based approach to safety and soundness exams has resulted in meaningful improvements. Council members did identify a need for greater interagency consistency on liquidity risk management.

Council members' experience with cybersecurity and compliance examinations is not as positive as for safety and soundness. Council members report that cybersecurity exams are not tailored but rather appear to follow a checklist from the Federal Financial Institutions Examination Council Examination Handbook. In the areas of Bank Secrecy Act/anti-money-laundering (BSA/AML), Community Reinvestment Act (CRA), and fair lending, many concerns remain, despite the improved tone of these examinations. Council members report frustrations with inadequately trained examiners, unnecessary escalation and disproportionate scrutiny of issues, a lack of transparency around the formulas used to identify and resolve issues, the reliance on small data sets to draw potentially adverse conclusions, and examiners' insufficient understanding of banks' business strategies based on safety and soundness.

In the BSA/AML area, several Council members reported that institutions were frustrated by inadequately trained federal or state examiners. One Council member described a bank in a high-risk geography receiving disproportionate exam scrutiny relating to a technical error in a new reporting system that the institution had self-reported and self-corrected.

In the fair lending context, several Council members noted that examiners drew unfavorable conclusions and identified exceptions based on very small data sets that did not reflect statistically significant loan samples. Council members also find that some issues appear to be routinely escalated for review in D.C., leading to an extension of the exam process. Further, these escalated issues are resolved without explanation. Council members observe that the lack of transparency about the analysis of escalated issues means banks cannot be confident that their practices will be deemed compliant in future examinations.

Council members report cases of examiners recommending approaches that would be inconsistent with a bank's business practices based on safety and soundness considerations. For example, an examiner asked an institution whether it would open a branch in a certain market for CRA compliance purposes, without an apparent appreciation for the business considerations that framed management's branching strategy and options. Another institution with very high levels of CRA lending reported being pressed to also make certain CRA qualified investments, even though the bank had determined that the particular qualified investments were highly priced and would be a poor investment.

Council members reported that while there has been improvement in these areas, some examiners continue to press institutions to follow best practices that are not required or to adhere to standards based on a threshold that the institution has not yet crossed (for example, the \$10 billion asset threshold).

Council members observe that the shift toward doing more compliance and fair lending examination work off-site has not reduced the overall burden on institutions. While examiners may spend less time on-site at the institution, pre- and post-examination information requests cause the institutions to spend much more time -- in some cases, as long as seven months -- in “examination mode.” The problem is exacerbated when an institution is subject to joint exams and the examination teams do not coordinate to share information the institution has provided.

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

The Council notes that, across Districts generally, three regulatory issues are of particular concern and that progress on these issues seems to be minimal or nonexistent: compliance with expanded Home Mortgage Disclosure Act (HMDA) requirements; implementation of “current expected credit loss” (CECL) accounting requirements; and compliance with FinCEN’s beneficial ownership/customer diligence requirements.

Additional HMDA data collection requires banks to hire additional staff. In addition, it appears to the Council that the additional data collected offer no apparent benefits (in terms of a clearer picture of mortgage lending activity) that would justify the additional costs. Also, the regulatory exemption from additional data reporting for lenders that make fewer than 500 mortgage loans annually is not practically useful in some cases. Most automated systems for data collection include the expanded data fields, and the systems cannot generate reports unless borrowers provide all requested data and all fields are completed in a particular manner. Moreover, management of some community depository institutions feel that the additional reporting can be problematic for smaller institutions that have small mortgage portfolios: If the size of the loan sample is too small to eliminate statistical anomalies and sampling errors, there may be more likelihood of an appearance of disparate impact even though there is no evidence of disparate treatment.

The Council notes, however, that the U.S. Department of Housing and Urban Development (HUD) has issued an advance notice of proposed rulemaking on fair housing, including HUD’s disparate impact standard that may ultimately offer some beneficial clarification on practical use of disparate impact analysis. Finally, the Council has previously noted that an anticipated review by the Consumer Financial Protection Bureau of its HMDA filing requirements could eventually lead to a meaningful burden reduction, which would likely expand customer access to credit and improve maintenance of customer privacy. The Council continues to recommend such a reduction.

The process of CECL implementation is also requiring significant additional staffing and has highlighted the need to reconcile CECL requirements with regulatory capital requirements. Absent an adjustment to the latter, community depository institutions may experience a significant misalignment of capital and allowance for loan and lease losses.

Finally, the experience to date with implementation of FinCEN’s beneficial ownership requirements reveals uneven responses and burdens across the industry: Community depository institutions that conscientiously seek to comply with beneficial ownership due-diligence requirements continue to experience negative reactions from customers, especially long-established customers well known to an institution’s management. Often,

these customers report very different and uneven experiences in similar transactions with other institutions, who reportedly do not require such extensive information. The Council feels that one positive adjustment would be allowing depository institution personnel to complete some customer information reports using dependable public sources of public information rather than insisting that customers resubmit information packages merely to add, for example, a missing zip code for an address. The Council believes that such adjustments would ease the burden on and frustration of customers without compromising the integrity of the reports.

Beyond these developments, the Council notes a number of areas of progress, in many cases tied to implementation of the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA). For example, the proposal for a simplified capital treatment for qualifying community banks is a welcome option. The Council notes, however, that more specificity is needed for the proposed capital standard and additional clarity is needed concerning how banks that fall below the applicable standard will be treated.

Also, the EGRRCPA's change to brokered-deposit rules to exempt reciprocal deposits is positive for community depository institutions' funding and liquidity. The Council notes, however, that it is still necessary to update other aspects of limitations on brokered deposits and national rate caps, which in the latter case means that affected institutions in some markets cannot cover the marginal cost of incremental deposits. These institutions may face material constrictions on what otherwise would be stable deposit sources in highly competitive local deposit markets.

Furthermore, changes to regulatory approaches to "high-volatility commercial real estate" (HVCRE) include improvements, for example, to valuation requirements (such as recognition of appreciation) and reductions in the scope of assets subject to the HVCRE policy. Other aspects of the proposed new approach, however, are confusing or counterintuitive, such as the inability to consider project cost and appraised value in relationship to loan-to-value when assessing credit risk. Simply said, a project with a lower leverage ratio is a lower risk project, *ceteris paribus*.

Finally, the EGRRCPA provided relief for appraisal requirements for portfolio loans in rural areas, but the approach that examiners actually take in practice will be a critical factor to realizing the potential benefits of this provision. A related concern is that, even under a more flexible regime, large-volume national mortgage lenders may still be able to compete more effectively for appraisers' services in many cases because they can offer a larger, more dependable business volume than local community depository institutions are able to. The most sensible remedy would be a relaxation of restrictions on and the bias against the use of in-house appraisers, provided appropriately rigorous quality control and internal review standards are in place. The Council believes that this approach would result in appraisals of significantly better quality than appraisals produced by automated valuations. The projections for a relatively low number of new appraisers entering the field and receiving training and qualification in the coming years will make this issue increasingly important.

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

State Authorizations of Cannabis Businesses

Three states approved medical or adult use of cannabis during the mid-term elections earlier this month. As a result, 33 states have now authorized the use of cannabis in various forms. This result expands the number of problems facing the banking industry across geographies and populations. The Council wishes to reiterate concerns expressed at past meetings about the problems faced by banking as a result of differences between federal and state laws governing cannabis. The Council encourages the Federal Reserve to initiate discussions among stakeholders about the untenable situation facing the banking industry as a result of this dichotomy.

Bank Secrecy Act/Anti Money Laundering Compliance

The Council strongly encourages further engagement of the Federal Reserve with other stakeholders to:

- Provide relief from BSA/AML compliance burdens. In particular, the Council encourages the banking regulators to provide information on how they plan to review compliance with new beneficial ownership requirements.
- Raise the current \$10,000 threshold for filing CTRs.
- Increase meaningful dialogue between stakeholders to better connect compliance data and law enforcement actions.
- Encourage better and more consistent feedback from law enforcement to help bankers focus on the most critical or essential elements needed to fight financial crime.
- Better define how banks might streamline or expand information sharing within the bank and/or among banks to help fight financial crime.

Cybersecurity

The Council encourages the Federal Reserve Board to engage stakeholders to provide the banking industry, in particular community depository institutions, with better guidance and strategic direction for their cybersecurity activities. This might include more commentary on a variety of alternative best practices, emerging technologies, and approval of risk management techniques that focus on effective compliance efforts rather than emphasizing technical but less material compliance.