<u>Record of meeting</u>

Summary of Discussions Among Members of the Community Depository Institutions Advisory Council

April 11, 2024

1. Economic Discussion:

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

Council members noted that the economy remains surprisingly resilient despite persistent challenges, such as inflationary pressures driven by strong consumer demand. However, there is a bifurcation in the economy between upper- and lower-income groups—with lower-income households experiencing more difficulty keeping up with the rising prices. Council members discussed the growing variations in economic conditions across regions and industries. Overall, the Council expressed cautious optimism regarding the economic outlook, given stable consumer confidence and the slow return of small business capital investment.

b. Particular Indicators:

i. <u>Inflation</u>: 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?

Council members reported that inflation has moderated from its peak but remains stubbornly high, driven by both labor costs and strong consumer demand that continues to surprise to the upside. Council members added that inflation is hurting low- and moderate-income families the most. Many households are spending the same amount of money but, where possible, are purchasing more affordable products (e.g., generic brands). This trend has raised concerns about the financial strain among vulnerable populations. For example, several Council members shared that there have been significant increases in requests for food assistance in their communities.

The industries driving inflation have shifted since the Council met in November 2023. In general, goods inflation seems to be slowing, but services inflation has persisted due to the associated labor costs. Stable construction prices illustrate this trend: rising labor costs are offsetting the decreasing prices of raw materials, leading to a net-net zero change in construction costs. Prices are also moderating in the auto space. More cars are sitting unsold on lots, and transportation firms are seeing a pullback on the valuation of semi-trucks that they purchased during the pandemic. Manufacturers that were burdened by just-in-time inventory strategies during the pandemic have built up more inventory than in the past, which may be contributing to the moderation in goods pricing.

Council members discussed the rising cost of insurance and technology. Insurance costs have risen for most forms of business, and the availability of insurance products has diminished, contributing to inflation in unexpected ways. Meanwhile, depository institutions have been

facing higher technology costs, which until recently had helped to moderate overall cost increases. Technology firms have been more aggressive in pricing. Year-over-year increases, which previously averaged 2-3 percent, have increased by as much as 10 percent in 2024.

Finally, Council members discussed businesses' pricing strategies and their ability to pass on increased costs to consumers. While some businesses were reluctant to raise prices pre-pandemic, that mindset has shifted in the current environment. The manufacturing sector has been more comfortable passing on input cost increases to sustain profitability, and the airline industry—which has been experiencing very strong demand--is also more easily passing on price increases. Sectors that are not passing on the complete cost increase to their consumers are turning to other strategies, such as making labor cuts, to absorb margin reduction. Council members expressed doubts about the near-term feasibility of the 2 percent inflation target in the current economic environment.

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

Inflationary pressures have been particularly pronounced in the housing market. Council members noted that although housing price increases have moderated, prices across the Districts are still restrictive for most consumers. Costs of supply inputs for houses continue to increase, forcing builders to increase prices, placing more upward pressure on housing prices, and further restricting the supply of affordable housing. In some instances, the housing market has become so restrictive that there is concern consumers are being priced out of their local markets entirely. Additionally, some regions have seen an influx of out-of-state buyers—some of whom are purchasing second homes—which has further placed the supply of housing under pressure, making it more difficult for local residents to find affordable housing.

In other areas of the country, Council members noted that housing supply issues are becoming increasingly regionalized, with some areas demonstrating a loosening of the tight supply conditions seen in the past.

The discussion around multifamily housing painted a different picture than the conversation around single family housing. In the recent past, Council members noted the upward trend in multifamily housing permits. This year, however, some Council members noted that there have not been new permits issued in their Districts. In other regions, the issuance of multifamily construction permits has remained high, and those Council members have seen little evidence of softening. While the factors contributing to the affordability and availability crisis in the housing market vary by District, there is broad agreement that the rate of increase in housing costs is slowing.

iii. *Labor Markets: How have the labor markets in which Council members operate changed in recent months? In particular, please assess the degree of job loss or gain (and, in which industries). Please comment on the changes to wages that Council members have observed over the past year.*

Labor market conditions varied by region and industry. Council members generally agreed that finding nonskilled and blue-collar labor remains challenging, especially in the manufacturing and trade sectors. By comparison, the talent pool for skilled, white-collar workers is larger—but companies need to offer higher salaries to fill middle management and executive positions.

In the manufacturing sector, many firms have the capacity and desire to expand but are limited to do so due to an inability to fill positions. Immigration is helping to fill the vacuum to some extent. In one District, an anecdote was shared about a large Japanese manufacturing plant that hired more than 100 immigrants, and language interpreters, to fill their labor force. In another District, one firm spent a significant amount of time exploring how to relocate a small village of 150 people from Mexico to Ohio to meet their labor needs before abandoning the effort due to challenges implementing the plan. .

The healthcare sector is also facing challenges filling positions. Hospitals are increasingly turning to travel nurses, which has significantly increased costs. In the Third District, rising costs have led to consolidation among hospitals.

Banks and credit unions are facing their own challenges filling entry positions, such as bank tellers. Banks shared anecdotes of having to increase their hourly rate just to get feet in the door. However, because technology firms and large banks have been shedding jobs, community banks are discovering highly qualified talent in the labor market. Labor costs have moderated somewhat. Last year, pay increases averaged around 6–7 percent, and this year they will be closer to 4–5 percent.

Meanwhile, labor markets are becoming a little more balanced between employers and office workers. While many employers continue to face pressure to offer hybrid work arrangements, some employers are having success implementing return-to-office policies without experiencing attrition.

iv. <u>Consumer Confidence</u>*: Are Council members seeing any signs of improved (or declining) consumer confidence? What is the outlook for consumer credit losses?*

Council members discussed consumer confidence, and analyzed its impact on recent economic trends. Despite the prevailing inflationary pressures, Council members noted consumer confidence remained reasonably strong in many regions.

A notable divergence between consumer sentiment and actual spending behavior has been raising questions about the sustainability of current consumption patterns. Across various regions, consumers are spending the same amount, but they have shifted consumption patterns to cheaper substitutes.

Council members emphasized the importance of monitoring consumer confidence, and the public perception of confidence, as those metrics serve as key indicators of economic resilience and future spending trends. Council members noted that some consumers hold a false expectation that as inflationary pressures ease, prices will return to their pre-pandemic levels. Council members noted that a consequence of those expectations was an uptick in consumer loan losses.

The discussion underscored the need for policymakers to focus on potential discrepancies between consumer sentiment and economic realities to ensure long-term economic stability and growth.

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

Council members observed regional differences across the various loan categories, but generally agreed that despite elevated interest rates, underlying loan demand from borrowers has remained strong for most categories. However, both borrowers and lenders are experiencing constraints in this area. On the demand side, increased regulatory guidance from examiners has led to some borrowers being unable to meet a bank's qualifying criteria for a loan, leading borrowers to shop around for a lender. This has been exacerbated on the supply side, as some banks are constrained by the liquidity requirements, even if they have the availability to service loans. These liquidity constraints have led banks to tighten their lending standards to keep their powder dry for higher quality borrowers, thus pushing customer traffic to lenders who have more ample liquidity. While there is a strong pipeline for loan growth for banks who want it, lenders are limited by their available liquidity and increased regulatory requirements.

a. ***Small Business Lending:*** *Has credit availability for, and demand for credit from, small businesses changed significantly? Have lending standards for these borrowers changed? Do Council members see evidence that prevailing economic uncertainty is slowing economic activity in this sector?*

Council members generally reported sustained demand for small business lending. The pipeline for demand has remained strong, but lenders are increasingly scrutinizing credit risks and quality in their approvals. Denials are rising as some banks are constrained by liquidity, and they have become more conservative in the loans they take on. Whereas previously, the economic outlook drove trends in small business lending, now the trends are driven by liquidity underlying small business loan demand—and in some cases, uncertainty over interest rate trends have affected demand.

Council members reported that economic conditions are mixed both within and between Districts. For example, in the Tenth District, small business loan demand has been depressed, but in recent months has shown signs of ticking up. Meanwhile, in the Sixth District, loan demand peaked in mid-2023, and is now ticking down as higher rates have weighed on demand. The Twelfth District reported that they are also seeing a decline in the number of new small business start-ups.

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 Council's last meeting in*

November 2023? How are commercial real estate loans performing compared to the Council's expectations?

Commercial real estate (CRE) lending conditions varied by geography and sector, and Council members concurred that urban office spaces have stood out as the weakest sector. CRE in downtown urban markets remains under pressure, while suburban office spaces and industrial manufacturing seem to be performing relatively stronger. Owner-occupied businesses are also performing well. Council members reported that a growing number of office spaces are being converted to multifamily housing within their Districts; however, these projects require significant infrastructural investment, such as for the conversion from commercial to residential plumbing.

Council members noted that lending standards have tightened significantly for CRE, with some banks requiring up to 50 percent equity for CRE loans related to warehousing, multifamily, and strip centers. Some institutions are also reaching their limit due to regulatory guidance capping construction and CRE loans at 100 percent and 300 percent of capital, respectively, limiting banks' capacity to participate. For banks that are starting to realize maturities in their loan portfolio, they are changing requirements—such as extending the amortization period or asking for higher collateral on new deals.

Council members also noted that because of the term length on CRE loans, many companies have not fully realized the effects of interest rate hikes, as 40–50 percent of loans are awaiting repricing. The Sixth District anticipates that maturity repricing will increase significantly in 2025 and 2026. In addition to repricing, many leases in metropolitan areas are set to expire soon. In some areas, firms are continuing to pay on active leases, but the firms are no longer occupying the property and do not plan to renew, which will lead to higher vacancies and lower valuations.

As interest rates have risen, the cap rates used in appraisals have increased as well, leading to reduced property values, and stronger investors have taken advantage of those declines to buy properties. The Sixth District was an outlier, noting that members in their District are anticipating higher cap rates, but that they have not yet materialized, and property valuations remain strong.

c. ***Construction Lending:*** *What are Council members' perspectives on the availability of credit for construction and development projects? Have Council members seen any changes in the demand for construction loans since the Council's November 2023 meeting?*

While Council members generally agree that the commercial side of construction lending has slowed, the outlook for the residential side remained mixed. Council members from the First and Eleventh districts reported strong demand for residential construction, driven by the low inventory of existing homes. They also noted that prices of raw materials have risen, and borrowers have depleted their existing capital. In contrast, the Tenth District reported that 1-4 family residential construction loans have begun to pick up from a low base, primarily in rural markets, while the Eighth District reported that 1-4 family residential construction has been cutting back. In the Twelfth District, community banks have seen a slowdown in demand in

California and Utah, while in Hawaii there has been an increasing presence of government and philanthropic spending to support construction, as developers have been unable to complete the projects on their own.

The largest issue in residential construction has been affordability, as builders working on tight margins are motivated to build larger, higher-end properties that are more profitable, leaving little inventory on the lower end of the spectrum. Council members also pointed to the low availability of developed land as a headwind for construction lending. In the Seventh, Eighth, and Eleventh districts, Council members reported that developed lots are now almost nonexistent in their regions, and that builders are now turning to undeveloped land for new properties.

d. ***Home Mortgage Lending:*** *What changes have Council members seen in the mortgage market? How, if at all, is regulation impacting the participation of community depository institutions in this market?*

The pipeline for mortgage lending is larger today than it has been over the past two years, as inventory that has been historically tight has shown recent signs of loosening. In addition, Council members observed that some borrowers are becoming acclimated to higher mortgage rates and are entering the market because they can no longer wait on the sidelines for rates to decline. Council members also observed an increase in HELOC loans because borrowers now think it is a good time to draw on their home equity, but total advances remain below the levels experienced during the great recession.

There was broad agreement that regulatory restrictions are negatively affecting banks' ability to compete with nonbank mortgage lenders that are not subject to the same regulations. Community bankers noted that the majority of home mortgage loans are now originated by nonbank financial institutions, and this has negatively impacted CDIs ability to build local mortgage and deposit relationships with borrowers. Members also noted that a surge in mortgage lending in 2021 made certain banks subject to additional regulated standards for fair mortgage lending, to which they had not previously been exposed, and that significantly increased compliance costs. Council members noted that CDIs engaged in the mortgage space are facing a choice to either scale up or exit the market to stay competitive.

e. ***Consumer Lending:*** *What changes have Council members seen in consumer lending? Please comment specifically on credit card and auto lending.*

Council members largely confirmed that consumers have been spending down their accumulated savings, and that credit card utilization is on an upward trend. They noted that households—primarily lower- to middle-income households—have been turning to credit cards to maintain their spending. Council members from the Third and Eleventh districts reported that credit unions have seen a rise in both delinquencies and charge-offs, with a significant rise in auto loan delinquencies resulting in repossessions. Although auto loan delinquencies are on the rise, they are coming off a historically low base, and the recent uptick is more of a normalization to pre-pandemic levels. In addition, bankers noted that prepayment activity on mortgages has slowed materially, and that mortgages are staying on their portfolios longer.

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

Council members expressed broad agreement that agricultural lending remains strong, including for land sales. The Ninth District reported seeing more land sales to fellow farmers rather than to outside investors. At the same time, Council members remarked that farmers were flush with cash from strong yields and prices in recent years; hence, the use of operating lines of credit has been down. Council members also noted that cattle prices, in particular, are fairly strong and are benefiting ranchers. In contrast, commodity prices have softened in recent months, and farmers have had record-high input costs going into this growing season, which will challenge profitability in the coming year. Council members in the Sixth and Eighth districts reported that the poultry industry is performing well in their local markets. The Eighth District, following the exit of large poultry producers from the region, has seen a rise in smaller poultry and egg operations, as well as some egg producers converting to other production facilities such as for mushroom farming.

g. ***Deposits****: What changes have Council members seen in local deposit markets? Describe these changes by segment (retail, small business, and corporate). What are Council members' expectations with respect to deposit levels?*

Council members were in broad agreement that deposit pricing pressures remained elevated, increasing the cost of funding and compressing net interest margins for banks. Council members commented that although in the months after the closure of Silicon Valley Bank smaller banks experienced deposit outflows—especially business deposits—to larger banks, this is no longer a factor. In the context of other sources of deposits, such as municipalities and local governments, Council members shared that the inflows into these accounts from government stimulus programs are still in the system. Two Council members described some of the challenges community banks faced when competing against state-run programs for such deposits.

The sentiment among Council members was that managing deposit flows is the "name of the game" for banks. The Council is concerned about an undue focus by regulators on uninsured deposits members are concerned about the lack of any movement to reform deposit insurance. They noted that some of the focus by regulators on uninsured deposits is a consequence of the failure to fix known flaws in the current deposit insurance framework, including a mechanism to index for inflation is maintain the real value of insured deposits Council members acknowledged the absence of consensus among banks of different sizes on the path forward for reform, which is important for an industry working toward determining feasible alternatives.

h. ***Mergers and Acquisitions Activity****: What trends are Council members observing with respect to mergers and acquisitions among depository institutions and their holding companies?*

Council members reported that current market conditions have been unfavorable for mergers and acquisitions (M&A), but added that they expect consolidation will pick up toward the end of 2024 and through 2025. Community bankers see considerable pent-up demand for M&A but anticipate that activity will not materialize until rate and price accounting changes are more conducive to deals. Council members stated that the buyers will likely be banks that are trading at higher multiples with better earnings. Banks with larger valuations and market caps enjoy higher profitability than smaller institutions in the current market, and the scale for profitability will drive deal-making. In the Tenth District, Council members observed a growing number of credit unions acquiring banks, possibly due to a faster approval process through the NCUA and the absence of shareholders criticism. There is a large presence of mutual banks in the First District, where Council members have seen a significant amount of shared service model deals in which the acquirers keep the individual bank charters under a shared holding company.

> *3. **Third-Party Service Providers**: What issues are top of mind for Council members in connection with their relationships with major third-party service providers? Are there unique issues if a third-party service provider performs consumer-related services or other functions (e.g., BSA/AML)? In thinking about outsourced services, do Council members have a view on the current balance of the regulatory framework for depository institutions compared to the regulatory framework for service providers? Are there changes to the status quo that members believe would better promote safety and soundness and compliance?*

Council members discussed top-of-mind issues in connection with their reliance on third-party service providers (e.g., core service providers, fintech partners, and cloud service providers).

Council members stated that (1) reliance on vendors is one of their biggest risks and (2) the cost of relying on technology providers is increasing. Council members noted that core service providers are more concentrated, which diminishes the ability of community banks to negotiate terms with them, including access to data to monitor risk exposures. Council members added that community institutions have no leverage with major service providers and cannot negotiate customized contracts. Core providers often charge excessive termination fees to exit contracts and are slow to share information about computer security incidents, which makes it difficult or impossible to comply with incident notification requirements to federal banking agencies, banking customers, and—in some cases—the public.

Council members discussed how artificial intelligence (AI) could exacerbate these risk management and compliance challenges. Community banks face challenges with procuring the necessary expertise to evaluate AI technologies, and service providers provide inadequate information about “black box” algorithms and data sources. Collectively, this limits the ability of community banks to innovate and comply with regulatory expectations.

Council members believe that the updated guidance that the federal banking agencies issued in June 2023 is vague and does not provide adequate guidance to community banks. Council members added that regulators are focusing more on “nth party” risk (i.e., understanding the risks posed by the service providers that third-party service providers use). This is an issue with the major core service providers, large fintechs, and cloud service providers, and creates a burden on community institutions in that they do not have clarity as to how bank examiners will evaluate compliance, especially for more complex and nth party exposures. Council members observed that there is a persistent gap between the capabilities of community institutions to oversee core service providers and the expectations of federal banking agencies. A potential solution is a more collaborative relationship between community banks and the federal banking agencies on the examination of major third-party service providers. Council members discussed how regulators might “tailor” examination requirements based on underlying business model, size, and complexity.

Council members suggested that federal banking agencies provide more information about their examinations of significant service providers, such as the major core service providers, and the ongoing status of unresolved issues that could pose risks to community institutions. Council members discussed whether the Bank Service Company Act should be updated to reflect changes in the market and the increasing importance of third-party providers to the financial sectors. Council members explained that they routinely access the reports of examination of service providers that the federal banking agencies compile. Council members added, however, that when community banks ask service providers for information on how they are responding to negative examination findings, there is often silence or “canned” responses. Council members also noted that the reports of examination are often stale. Council members suggested that examiners share more information on the risk management practices of core service providers with community institutions. Some Council members want the federal banking agencies to examine the core service providers more intensively. Council members also noted that there is no centralized repository of examination information for trending third-party risk management issues at community depository institutions. Council members suggested that federal banking agencies share more information on expectations to make examination processes more predictable.

> *4.* ***Examination Practices****: What has been the experience of Council members in recent examinations? In particular, what has been the experience of community depository institutions in the aftermath of the bank failures in March 2023? Have you seen examination practices impact the flow of credit? How can supervisors improve their communications (both formal and informal) with supervised institutions?*

Overall, Council members felt that recent safety and soundness examinations were productive. They reported examiners were focused on liquidity risk exposure and management, including policies and procedures, governance, and setting and adhering to risk limits.

Council members also reported examiner focus on funding concentration and volatility, and analysis of deposit stickiness, particularly with respect to large demand deposits. Council members reported a decreased focus on uninsured deposits in and of themselves as the Spring 2023 crisis is reconsidered in context.

Council members noted an increased emphasis on stress testing and examiners probing to ensure that “you know your algorithm.” Council members reported that examiners were trying to ascertain if the board of directors understood its role. Additionally, many Council members noted that examiners discussed the need to monitor social media.

Council members also discussed examiner expectations with respect to the Federal Home Loan Bank (FHLB) system and discount window (DW). Council members noted that it is much easier to do business at the FHLB, explaining that the DW’s cumbersome setup and administrative process is “archaic and painful.” Council members also noted that they had a *de minimis* amount of collateral placed at the DW for “regulatory”—as opposed to business—purposes. (See the expanded views on this topic under Additional Matters.)

On the compliance side, Council members reported that compliance exams continued to be much less efficient, and that there often is considerable lag in reporting on compliance results.

A Council members also discussed HMDA data and the review process. While Council members reported productive conversations with examiners regarding their mortgage pricing engines, there was concern about a lack of transparency for some model benchmarks or targets applied during the supervisory process. Examination staff were not always able to adequately explain the relevance or applicability of certain “black box” targets to the institution being examined.

Council members generally agreed that hybrid examinations (those held both on- and off-site) are working well. Other Council members reported strains from experiencing multiple examination types at the same time.

> *5.* ***Regulatory and Payments Matters****: How are recent changes in the regulatory and payments landscape affecting the ability of community depository institutions to innovate as well as continue providing services to their customers?*

Overall, Council members felt that the current regulatory and payments landscape presents significant challenges for community depository institutions. The Council expressed concern about the layering impacts of seemingly uncoordinated regulations from multiple agencies related to basic banking services, such as checking accounts—all of which are putting pressure on the economic viability of the community bank business model. There is significant frustration among these institutions on the use by the current administration and certain regulatory agencies of the term “junk fees” to refer to fees that are clearly disclosed, compensate banks for valued services, or help banks prudently manage their risks.

Council members believe that regulators have failed to fully understand the costs incurred by banks providing basic banking services such as accepting deposits from and making loans to households and businesses in their communities. Council members noted that like any other commercial business, banks should be allowed to recover their costs.

Unfortunately, the proliferation of regulations in the last 15 years and the growing market power of technology providers have increased the costs of providing banking services. Council members reported two key challenges to the industry: (1) skyrocketing technology costs that outpace inflation and (2) the lack of competition among a limited number of essential vendors.

At the same time, actions by bank regulators are hurting banks' ability to cover these costs. Council members fear that the net impact will be to cause community depository institutions to withdraw from various product and market segments, leading to consolidation in the banking industry. The ultimate price will be paid by the end customers, who often may be left at the mercy of non-depositories operating outside the regulatory perimeter.

The Council, which has previously suggested the Federal Reserve's proposed reduction in the Regulation II debit interchange cap be withdrawn and reproposed following a fulsome cost-benefit study, noted again that the proposal's purported exemption of CDIs under $10 billion will not shield them from the rule's effects—just as the current regulation has not shielded them. Further, the current proposal, which relies on 2021 data, does not take into account the pricing and fraud impact of new debit routing rules that went into effect for all banks, including CDIs, in July 2023.

Although complete data to measure performance of debit businesses is difficult to access through core providers, one Council member explained that over the last year, though the institution saw a 36 percent increase in debit card volume, interchange income fell by 3.5 percent, and fraud-related costs surged by 75 percent. Falling income and rising costs, despite higher volumes, illustrate the negative effects of regulation and market dynamics on CDIs' debit business model. In practice community depository institutions have not been able to operate outside of the effects of the relevant regulations.

Council members believe that regulators may be too narrowly focused on definitions of direct costs of services, such as how much a returned check costs in terms of loss, and failing to account for the infrastructure, labor, time, and opportunity costs of returning a check. All Council members affirmed that their institutions had seen similarly increased fraud-related costs over the past year, likely driven in part by the new routing rules that allow merchants the option to send online transactions over less-secure networks.

Council members described the challenges they face in obtaining relevant information from their core providers, who are also their payments processors. Council members expressed skepticism regarding the ability of bank regulators to conduct impact analysis when the banks themselves are struggling to obtain the data.

Council members agreed that limiting non-interest income will lead to costs being passed to consumers in a movement toward "banking as a service." Interchange fees, in particular, offset

costs associated with free checking and debit card offerings. With a significant reduction in interchange revenue, products must be financed differently, such as by charging consumers account maintenance fees. If sources of non-interest income are limited and institutions are directed to move pricing toward cost, they will have to charge more for essential and basic banking services. Council members noted that many institutions may simply opt out of offering key products altogether.

Also of concern for Council members is the impact of increased costs on rural and low-income consumers. The regulatory impact on revenue will likely disproportionately affect rural areas, potentially creating banking deserts and reduced services for low-income consumers as higher fixed costs will be spread over a smaller customer base.

Small institutions pursuing simpler business models may have trouble offsetting lost revenue and cannot as feasibly distribute the total loss across their smaller consumer base as large banks can. Additionally, as the costs of fraud and risk continue to skyrocket, Council members are concerned that customers deemed "risky" may lose some of their already limited banking access as banks decrease their risk tolerance and willingness to take on less financially stable customers. Council members are concerned that increased costs to consumers and the reluctance of banks to retain risky customers will push customers away from the banking system toward potentially predatory services, such as payday lenders, cash checking agencies, and unregulated fintech.

> *6. **Additional Matters**: Do Council members wish to present any other matters affecting community depository institutions that have emerged from meetings of the Reserve Banks' advisory councils?*

Council members raised two additional matters of interest to community depository institutions.

Pre-positioning collateral at the discount window

The Council discussed concerns expressed by community depository institutions on ongoing policy discussions related to requiring depository institutions to pre-position collateral to cover 100 percent of uninsured deposits. While community banks have been testing their ability to post collateral and borrow from the discount window, there was consensus within the group that the institutions should not be required to post collateral on a permanent basis. Council members discussed numerous unintended consequences of any such mandate.

Based on press reports, Council members understand that the current thinking is to impose this requirement among banks with total assets of $10 billion and higher. While community depository institutions might be outside the scope, there is broad expectation that the requirement will be made applicable to them through the supervisory process.

Council members' views about any expansion of the discount window are informed by their experience with the Bank Term Funding Program (BTFP). At the last Council meeting in November 2023, Council members speculated on whether the BTFP would be extended beyond March 2024. In the months leading to March 2024, members had been evaluating their plans to either roll over or take new loans from this program. But the sudden re-pricing of the loans,

while arguably justified, negatively impacted their planning. Members mentioned the numerous changes to the Paycheck Protection Program—and the ensuing confusion and uncertainties from those changes—as another example of potential arbitrariness in the implementation of such programs. If the expectation is that community depository institutions will regularly use the discount window for their funding needs, then institutions would want to avoid the risks of unanticipated changes to the discount window terms by the Federal Reserve.

There is a strong preference among all Council members for the more predictable policies and procedures of the Federal Home Loan Banks (FHLBs). Over the decades, community depository institutions have developed highly robust, reliable operating procedures to incorporate the FHLB system into their liquidity and funding management systems. Council members are unsure if the discount window, given its current design, can serve the same purpose as FHLBs.

Relatedly, Council members speculated on policy makers' thinking around FHLBs, and if the intent was to shrink their footprint. Council members believe that shrinking the FHLBs would have significant negative implications for community depository institutions. In addition to the operational efficiencies offered by FHLB advances, banks take advantage of the rich set of loan products offered by the FHLBs. Although smaller institutions typically do not hedge their interest rate risks directly using derivatives, they transfer these risks through appropriately designed FHLB advances. It seems unlikely that the discount window would be able to meet such needs in the same manner.

In the context of the potential requirement for posting collateral sufficient to cover all uninsured deposits, Council members described scenarios that might cause bottlenecks, including shifting collateral to cover anticipated advances from the FHLBs.

Council members were also concerned about the deadweight cost of leaving collateral at the discount window for long periods of time. Among other things, this would leave less collateral with the banking system for advances from the FHLBs, causing the FHLB system to shrink in size, thus leaving big gaps in the sources of funding for the U.S. banking system. Council members speculated on the end goal of the policy makers. Is the intent for the Federal Reserve to basically step into the role of a regular, business-as-usual source of funding for banks?

If the answer is "yes," Council members believe that a number of changes to discount window operations would be necessary. Council members believe a name change should be considered in order to counteract the deeply ingrained view of the discount window being an emergency lending facility. The current operations of the discount window would need to be modernized to achieve the operational efficiencies of the FHLB system if it were to address day-to-day needs of the industry. There was also an acknowledgment among Council members that as emergency lending facilities typically are designed to address a specific systemic issue, their terms and conditions may not be appropriate for daily operational needs of the banking system.

Finally, Council members commented that even if the discount window is adapted to be an improved funding source for banks, it cannot adjust to fill the other roles FHLBs play for the affordable housing market. Originating mortgage loans is an important product offering that

many community depository institutions want to continue to offer, and they rely on being able to transfer associated risks to the FHLBs.

Payment fraud

Council members described that community depository institutions are facing difficulties resolving fraudulent payments via check, ACH, or wire transfers. Council members discussed examples of the long delays in communications and eventual resolutions these institutions face with larger banks. In many instances, despite receiving timely alerts, large banks will process the fraudulent payments; in other instances where the matter is resolved, it sometimes takes eight to nine months for the large banks to remit the funds back to the community depository institution. Council members believe that there is little incentive for large banks to resolve issues in a timely manner.

Council members are of the view that this is a systemic issue for the banking industry—especially community depository institutions. The Council believes that current rules, policies, and procedures are outdated, and the delays and challenges associated with resolving fraudulent payments are symptoms of a breakdown in the industry's ability to efficiently resolve customer grievances.

Council members recommend that the Federal Reserve play a leading role in coordination with other relevant bank regulators to improve the current system.