Record of Meeting

Community Depository Institutions Advisory Council and the Board of Governors

Friday, April 10, 2015

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.*

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

      Credit is abundantly available at low rates, and although loan demand has been good and improving, it is not in line with supply. Small businesses have been improving their balance sheets and are becoming more confident, but there is hesitation due to uncertain healthcare costs, regulatory costs, environment issues, competition from companies with greater scale efficiencies, and, to a lesser extent, economic conditions. This hesitance is causing businesses to postpone hiring, capital expenditures, and expansion into new markets. Small businesses in the metro areas have been more successful than those just outside the metro areas and in rural areas.

      Small business loan portfolio growth is centered more on market-share shifts rather than on new business growth; some current customers are not renewing loans or expanding borrowing as they consider changes in strategies, business structure, or ownership.

   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 the Council's expectations?*

      There has been new investment in commercial real estate properties, especially in multifamily, student, and senior housing, keeping up with the increased demand by consumers for housing in metro and metro-accessible areas. Conversely, many Districts are seeing a decrease in new office building construction.

      There is an oversupply of credit in this market, but demand is starting to pick up. Loans are performing well with little indication of stress. Council members are noticing increased competition from large banks, insurance companies, and the

GSEs. Borrowers are shopping around for loans, pushing competitive rates even lower. As market pressures lead banks to loosen standards, examiners are pushing for standards to tighten.

CRE portfolios at community banks are growing as it becomes more difficult to remain profitable in consumer lending businesses because of compliance burdens.

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?*

Construction lending is stable; demand has improved but there have not been large portfolio shifts. Lenders often find that the increasingly competitive market for permanent financing means that construction lending is a standalone business line, not an entry to longer-term financing.

In densely populated areas, land for development is becoming increasingly limited, driving up the price of available land. Some Council members are seeing builders buying and flipping land as the demand for building sites has picked up.

Districts with high concentrations in energy industries are seeing a pause in construction activity. There seems to be an unlimited demand for multifamily buildings, and they are often completely leased out before construction is completed. There is also often a quick change of ownership, with developers removing their equity interest before completion of the projects.

d. ***Home Mortgage Lending:*** *What changes has the Council 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?*

Many Districts are experiencing an increase in home-purchase mortgages, more so than refinance loans. Volume particularly picked up in January when mortgage rates declined below 4 percent. Most Districts saw more purchase loans than would normally be typical in the winter, even in parts of the Northeast where the weather was particularly bad. The inventory of available homes has not been sufficient to meet demand, leading to higher prices and, in some cases, bidding wars. Lower-priced and properly priced homes are selling faster than mid-range-priced homes.

The District representatives agree that the millennial generation has been slow to enter the housing market, with many feeling the weight of student loans and the slow labor market. The lack of first-time homebuyers is hindering homeowners wishing to move up into their second homes.

The increase in compliance costs in the home mortgage business has made it unprofitable for many banks, forcing them to leave the business. This is particularly true for smaller and marginal lenders. Institutions have found it challenging to transition staff and system resources to comply with the new, complex TILA-RESPA rules becoming effective in August.

Council members have concentrated on qualified mortgage (QM) loans as the result of TILA rules that were effective January 2014. New survey evidence reports that 10 percent of mortgage lending by community institutions was for non-QM loans, down from 2013 lending that occurred before the Dodd-Frank Act rule changes. Most of the non-QM lending was held in portfolio because of the lack of secondary market options, reflecting investor perceptions of associated legal risk. Non-QM loans were so classified for a variety of reasons, including loan terms, lender characteristics, and property type.

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

Consumer demand is finally increasing after prolonged stagnation. Auto loan demand has increased, and there has been an increase in volume. However, low rates and longer terms on these loans often make them marginally profitable.

Demand for student loans has increased, particularly in the private sector. Some Council members are avoiding these loans because of high default rates and political risk.

Banks that are not primarily consumer lenders are increasingly exiting the market due to increased regulatory and compliance costs. It has become increasingly expensive to keep up with regulations for multiple products, leading banks to specialize in a few select products. The movement of consumer lending to the nonbank sector is increasingly worrisome.

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

Districts with high concentrations of agricultural businesses note that farmers are having a difficult time making money due to falling commodity prices. Farming equipment businesses are highly exposed to falling commodity prices, which reduces demand for agricultural implements. Weather is increasingly concerning, especially for those experiencing drought. Farmers with mature operations have been living off of working capital, in the hope that trends and cycles will level off over time, but there has been an increase in the trend of approving negative cash flow loans.

Many Council members do not engage in agricultural banking, finding it difficult to compete with the tax-subsidized Farm Credit System (FCS). However, the FCS is “cherry picking” loans, diverting its focus to other markets such as real estate and commercial and industrial lending, rather than lending to traditional and weaker agricultural businesses.

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

Deposit availability is strong across the Districts. The cost of funding has been low, but many Council members are waiting for the anticipated federal funds rate increase. Some are concerned that the stability of their balance sheets will be threatened by the possible volatility in rates.

Many Council members expect increased competition from large banks aiming to raise core deposits as capital market funding becomes less attractive in a changing rate environment.

2. **Economic Discussion:**

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

Expansion is on solid footing. Last year was the best since the crisis, and 2015 is likely to be stronger. Business investment is strengthening, confidence is improving, and labor market conditions have been improving. However, data are mixed, and there are some concerns.

While consumers have benefited from low energy prices, those areas concentrated in energy production have begun to struggle. Council members that engage in energy lending are seeing losses, but they can be absorbed for the time being.

Council members feel that last month's low jobs report was a blip attributable to the harsh winter.

b. ***Particular Indicators:***

i. <u>*Inflation*</u>*: 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 Council members purchase rising more or less quickly?*

Widespread inflationary pressures appear to be low. Most Districts have observed evidence of wage inflation, particularly in construction, healthcare, and technology sectors. Food-price inflation may rise if harsh weather conditions in some Districts continue, especially in the 12^{th} District.

Although gas prices are at their lowest level since 2009, consumers are sensitive to the recent increase in prices relative to prices last December and January.

Council members note that inflation will be an indicator to watch as the Federal Reserve prepares for rate liftoff.

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

Home prices are increasing in the Districts. This is particularly true for metro areas.

Demand for and construction on multifamily properties has increased, driving up prices. Some Council members expect that, as the price of renting becomes exceedingly high, consumers will be more attracted to homeownership.

Council members expect a rise in HELOC refinances, mainly from consumers with interest-only loans from before the crisis.

iii. *<u>Labor Markets</u>: 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?*

Labor conditions have improved over recent months, but Council members find this to be true only for skilled and specialized workers. Businesses are having trouble filling mid-level skilled labor positions, such as welders, electricians, and plumbers.

Council members are finding that the skill level and education required for their employees has been increasing. There has been an increase in demand for compliance and IT security positions. Banks are having trouble attracting young talent.

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

Confidence among consumers has improved, but they are still not completely happy with conditions. The job environment is more stable and credit losses are trending down, but Council members feel this is part of the credit cycle. Possible future losses will stem from auto lending and loosened lending standards.

3. **Payment Systems:** *In January, the Federal Reserve published the Strategies for Improving the U.S. Payment System paper. From the perspective of community depository institutions, what should the Federal Reserve and other governmental agencies understand as work begins on the new strategic payment initiatives? Which strategies are community depository institutions particularly interested in advancing by working closely with the Federal Reserve and the rest of the industry? To what extent do any of the strategies or tactics outlined pose unique opportunities or challenges for community depository institutions?*

Payments are at the very core of community financial institutions' business models. As such, Council members feel potentially threatened by payment innovations and practices that are being developed outside the traditional regulated banking system by lesser-regulated or unregulated shadow banks and service providers. In essence, community institutions could be on the outside -- left out and left behind -- of a rapidly evolving payments environment. This has practical implications for customers in rural areas and for smaller business owners in all geographies, where businesses depend on their local institutions for access to the payments system. And, if community institutions eventually are able to enter this new environment, will they be able to do so at competitive costs?

Council members also pointed out that the banking system's regulatory regime does not encourage payments innovation. This innovation gap is perhaps most acute for community institutions' service providers.

Community institutions view themselves as at risk of becoming silos for money -- the equivalent of becoming "dumb" pipes in the payments system. Participants recommended that the Board be forward-looking in terms of the payments system, especially since its proper stewardship is a matter of national and economic security. The Federal Reserve has to be engaged as the "owner" of security policy, rules, and regulations for the payments system. It should have a role as a cop on the beat and should coordinate with the CFPB to support its role in consumer protection.

While members applauded the Federal Reserve for engaging on payments issues, it should be more deeply involved in this quickly evolving space. That may point to a need for a special congressional mandate regarding whether the Federal Reserve should serve:

- as a directory of directories;
- as a policeman/regulator of the payments system; and
- as an operator/facilitator for community financial systems.

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?*

Satisfaction with examination practices generally continues to be positive. The Council identified no process issues in safety and soundness examinations, but Council members expressed serious concerns about an examiner mentality of zero tolerance for Bank Secrecy Act (BSA) and consumer compliance regulatory issues. Additionally, compliance examination expectations have been much less certain and subject to increasing threshold requirements, regardless of overall risk to the bank or to consumers. The collective increase in the complexity and costs of regulatory compliance has significantly increased institutions' costs, indirectly increased costs to consumers, and altered institutions' strategic business choices.

The Council continues to comment on inconsistencies in examination standards from agency to agency, examination to examination, and from examiner to examiner. These examination inconsistencies could be the result of (1) ever-escalating and diverse regulatory requirements; (2) agency guidance and uncertainty about whether institutions are required just to consider rather than implement that guidance; and (3) examiner reliance on requiring "best practices" that trickle down from larger, more complex institutions -- when "one-size supervision" may not fit institutions of differing size, complexity, and market footprints. Regardless of the real causes, Council members were unanimous in concluding that the current regulatory environment and supervisory expectations are significantly increasing compliance obligations and costs, which impact bank behavior and competitiveness.

The Council noted particular burdens in the following areas:

- BSA compliance
- BSA requirements and their negative impact on ability to continue serving existing customers, maintaining correspondent relationships, and providing vital services in low- and moderate-income areas within their market areas
- Heightened standards for third-party risk management, including monitoring and audit, are proving very difficult to satisfy as expectations keep changing
- Complex mortgage regulations that are significantly increasing the cost of mortgage compliance and limiting credit availability
- Fear that current mortgage product strategies could be considered to have fair lending implications
- The vast volume of documents institutions are required to provide to examiners that they neither review nor use
- Length of examinations, number of examination staff, and their experience level
- Regulatory appraisal requirements and the ability of small and rural community banks to continue making sound consumer and commercial loans secured by real estate

In the case of mortgage regulation, many community institutions continue to offer only QM loans as a risk-management strategy. Other institutions are making non-QM loans that they feel meet their overall guidelines for risk and return. It appears that the number of mortgage products community banks are willing to offer may be gradually expanding.

The Council recommends that supervision should be more scalable. In other words, supervision should be risk based so that the complexity of the examination is based on the complexity of the institution. Supervision of consumer compliance, BSA, third-party risk management, and now perhaps cybersecurity, is focused on identifying any risk, no matter how small, and on second-guessing management. This approach does not recognize or permit normal business judgments concerning risk management.

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 burden of post-crisis regulatory changes continues to adversely affect the service levels community institutions can maintain and the level of credit intermediation they can provide. Numerous community institutions have been forced to make fundamental decisions to withdraw from business lines that now present too great a regulatory cost burden, too great an exposure to compliance risk, or both. In many markets, this withdrawal either significantly restricts service and credit levels or leads to increasing concentration in the hands of the few remaining providers, which sometimes drives the business into the shadow banking system. Most examples fall within consumer financial services, with institutions in many Districts withdrawing from or significantly contracting in areas such as residential mortgage lending. The Council anticipates that institutions intending to maintain a presence in such business lines may reconsider as the examination cycles progress. Some Council members noted that the April 6 FFIEC FAQs prevent institutions from addressing refinance demands from their customers with perfect credit histories in the most efficient, low-cost, and consumer-friendly manner without triggering an unacceptable increase in asset risk weighting. Among other challenges, institutions expect the phase-in for new rules on truth in lending and real estate settlement procedures to be difficult, complex, costly, and a likely source of consumer complaints and dissatisfaction. While the new forms may be more understandable, the complexity of rule requirements and systems changes are likely to cause delays that result in unanticipated changes in closing dates.

Similar concerns have grown in anti-money-laundering compliance. Upstream correspondents are terminating long-standing service arrangements, such as wire transfers, because of their inability to manage the identification process for downstream correspondents' customers. The result is often a serious constraint on service to internationally active small business customers. The emergence of a "near-zero-tolerance" approach to the examination process has exacerbated the burden, since it necessarily implies a much lower number of errors for small institutions than for large institutions with much larger business volumes. The Council acknowledges that anti-money-laundering risk is not a simple function of institution size, but it urges the Board to consider tailoring the examination approach in this area (as well as others) to the nature of activities and the attendant risks of the specific institutions, rather than applying a "one-approach-fits-all" examination regime. Similarly, in areas such as residential lending, regulators should adopt tailored approaches based on institution size and risk profile for the activities in question.

The underlying common concern is the massive shift of talent and resources away from services that clearly create value for bank customers and the general economy to activities that, however theoretically desirable, reflect no sound cost-benefit analysis. One Council member cites 87 regularly tested statutory compliance requirements, administered by 19 government agencies. Another Council member pointed to a requirement for expensive outside validation of financial models on a regular cycle, even when neither the model parameters and assumptions nor the parameters for the business line have changed since the previous validation. Though no one regulatory topic or area accounts for a material portion of the problem, the cumulative changes since the passage of the Dodd-Frank Act have increased both compliance costs and, especially, the burden on staff who must be reallocated from various roles in which they interact directly with customers. The damage in terms of cost to community institutions, the concentration of risks in other institutions (e.g., shadow banks), and the overall reduction in services and credit intermediation available in the economy is not self-correcting and deserves urgent attention.