Record of Meeting

Community Depository Institutions Advisory Council
and the Board of Governors

Friday, November 18, 2016

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.*

The condition of financial markets is generally good, as is loan demand. However, rural areas are much weaker across the board. Economic growth, confidence, wage pressures, construction activity, and other indicators are demonstrably higher in urban and higher-population areas. Challenges in lending to energy-sector firms have abated. Creditworthiness among borrowers remains good, but competition has eroded underwriting in several market segments.

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

Small business loan demand remains strong in most urban markets, with some businesses moving ahead of anticipated Federal Reserve rate hikes. However, loan demand is tapering in some regions where there is little appetite for risk, with firms' concerns over the impact of the Fiduciary Rule (for the treatment of exempt vs. nonexempt staff), the Affordable Care Act, and other factors. In most rural areas, outside of certain agriculture credits, demand remains weak in the face of sluggish economic growth and job losses.

Competition among lenders is intense; it is a borrowers' market. Pricing is competitive, leading some banks to loosen credit standards. Council members expressed concerns over competition from loans guaranteed by the Small Business Administration (SBA) and from marketplace lenders.

The SBA is aggressively pushing its guaranteed loans. A number of lenders appear to be "cherry picking" in strong sectors. Moreover, in the East and West, some SBA lenders have lowered credit standards to lend where other banks would not.

Marketplace and person-to-person lenders, which are not subject to the regulatory restrictions and supervisory oversight of banks, may be relatively small players in the small business market, but they are leveraging their advantages and ability to process loan applications expeditiously in order to grow rapidly. There is a lot of pressure on banks to expedite processing to be competitive.

Banks' small business credit quality remains strong. However, many marketplace lenders have seen high delinquency and default rates on loans. Clearly, they are learning and getting better at credit underwriting, often in response to investor concerns. However, the robustness of underwriting, especially over full business cycles, raises questions about loans to less-creditworthy borrowers and potential disruptions from delinquencies and bankruptcies to the broader markets in which these lenders operate. Moreover, there are concerns about potential economic ramifications if marketplace lenders are not a steady source of credit when the economy weakens.

***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?*

Commercial real estate loan demand and credit availability continue to be strong in many metropolitan markets. Some Council members have concerns about overheating. Borrowers have considerable leverage and often obtain looser underwriting covenants, longer amortization schedules, lower pricing levels, and decreasing capitalization rates. Other Council members feel that growth may have peaked, noting the duration of the current economic expansion, rising borrowing rates, and tightening lending due to increasing supervisory attention.

Outside of the urban markets, demand is much weaker. In rural areas, economic indicators, such as declining school enrollments and falling nursing-home occupancy, show trends of falling numbers of younger families and an outmigration of wealth, deterring CRE investments.

Nonetheless, credit quality remains high, although some Council members have observed, and are concerned about, cash-out refinancings.

Multifamily lending has been strong across the country, to the point that some Council members are seeing stressed absorption rates and have become wary of potential overdevelopment. For multifamily lending, HUD and the GSEs continue to provide attractive terms and pricing for purchases, and guarantees are raising competition in this market. Additionally, some urban markets reported the emergence of more active lending, both acquisition and refinancing, for office buildings.

***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?*

Except for rural regions, demand for construction loans remains robust. As with CRE, strong competition has affected credit standards.

Credit quality remains strong. However, borrower caution is rising, and there is a general sense that multifamily construction lending is at the top of its cycle. Concerns for a possible bubble have led traditional lenders to proceed carefully.

Construction costs have risen sharply due to the escalating cost of materials and scarcity of construction workers. Moreover, rents appear to be stabilizing – even declining in some markets. These trends are raising questions about loan-to-value ratios for construction loans.

Council members note that, in densely populated areas, much of the increase in multifamily lending was driven by changing demographics. Older millennials have started to move into the suburbs, which may impact the urban, multifamily rental market.

Prices in office and retail space have also increased since the beginning of the year but are not considered to be a bubble. Retail spaces within center-city areas shared in the price gains.

High-volatility commercial real estate (HVCRE) guidelines are constraining some lending. However, many lenders with long experience in this sector have not felt constrained by the 100 percent and 300 percent thresholds, due to their conservative underwriting, risk-management practices, and capitalization. Some community banks are picking up loan participations that allow larger institutions to stay under the thresholds. The supervisory focus appears to be more on recent market entrants and rapidly growing market participants. However, Council members have concerns that standards are not being applied evenly across regulators and regions and that well-managed institutions have been inhibited from implementing strategic plans to grow CRE exposures.

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?*

Council members see continuing demand for home mortgages in the purchase market. However, they suspect that demand may taper with rising mortgage interest rates and other factors. In particular, rising construction costs (discussed above) and regulatory-driven constraints on the “credit box” are straining the affordability of homes for first-time homebuyers. The burden of student loan debt and desire for mobility among millennials are well-documented contributing factors. Moreover, TRID, the TILA-RESPA Integrated Disclosure, has hampered use of a popular loan product that combines both construction and permanent financing in a single product to reduce consumer uncertainty. To date, the Consumer Financial Protection Bureau (CFPB) has not been able to address adequately the disclosure conundrum for such products.

The trend is continuing for community lending institutions to curtail or exit the mortgage origination business due to increased compliance costs and regulatory uncertainty. Domination of the market by the GSEs and major banking organizations, as well as growing competition, has challenged the feasibility for some community lenders in this business. Those leaving were more likely to have had more-marginal mortgage operations, although some institutions made larger-scale, strategic business changes.

In addition, many community institutions have scaled back underwriting predominately to qualified mortgage (QM) loans, which can have a disproportionately negative impact on rural areas that have higher proportions of nontraditional credit needs and on first-time homebuyers everywhere. However, non-QM lending appears to have partially recovered in 2015 and 2016. Also, some institutions are offering jumbo mortgage loans with non-QM features, which continue to be in strong demand.

The national shortage of appraisers is hampering home finance, especially in rural areas. Some Council members have observed a frustrating cycle where housing prices are rising and bids are coming in over asking prices. Nevertheless, appraisers have not been willing to factor the price escalation into appraisals so the loans have not been approved. In areas where home values are falling, appraisers have factored this into appraisals.

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

Consumer confidence, retail sales, and loan demand remain robust, particularly for automobile finance, home equity lines of credit, and credit cards. However, many community lenders are leaving the market, as they are no longer able to compete against large banking firms and marketplace lenders. Council members noted that credit unions' balance sheets are concentrated in consumer loans and that auto lending – both direct and indirect – has expanded significantly due to low gas prices and pent-up demand.

Credit quality also remains strong. However, Council members expressed concern in regards to the easing and lengthening of auto lending terms, by noting low recoveries in defaults. Additionally, the CFPB's impact on indirect auto lending has been driving an increased number of borrowers to direct lending by credit unions and banks.

Council members also noted that student loans have become more difficult to underwrite and that more institutions are exiting this business line due to an increase in regulatory burden on student loans and the aggressive entrance of financial technology (fintech) companies in this marketplace.

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

Overall, Council members see 2016 as a year of stabilization in agricultural credit. Commodity prices are low, but crop production is near record levels (although a water shortage has hurt production in central California). However, low commodity prices and the strong dollar continue to negatively impact the sector, forcing farmers in some areas to file for crop insurance support this year. Livestock, dairy, and farm equipment have been hit hard, and low energy prices have reduced demand for ethanol and hurt corn producers. In contrast, fish and poultry have remained stable, and loans in this area have fared well. Council members have observed a relatively small but growing entrepreneurial industry in organic farming.

Against this background, farm rent prices remain high, even as land and equipment values weaken. Economic incentives for more consolidation in farming and agribusiness remain strong. Also, agricultural lenders face strong direct competition from the Farm Credit System, especially on long-term loans.

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

Council members report stable deposit growth. However, major banking firms are offering strong competition, in part to satisfy new liquidity standards. They have invested heavily in fintech portals and advertising and are offering teaser rates for new depositors. A particular frustration for community lenders is that millennials increasingly choose uninsured fintech services to hold their deposits, and they appear insensitive to the risks of holding deposits that are not federally insured. Fintech firms such as PayPal and various prepaid cards now hold significant balances of uninsured deposits.

There is significant disparity for deposits between rural and urban institutions, with rural institutions seeing little to no growth. For example, in rural areas, estate settlements often result in funds being passed on to heirs. Since they often live in a different locale, funds exit the rural institution. Furthermore, rural areas have seen little to no wealth growth, thus hindering rural banks' ability to grow their deposits.

2. Economic Discussion:

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

Incremental economic improvement has been observed across the Districts, although the dichotomy between urban and rural regions continues to expand. Inflation has been mixed, but housing prices continue to increase across urban regions. Labor conditions have generally strengthened, unemployment continues to fall, and consumer confidence remains stable. However, some Council members have concerns about the potential of shifting demographics to exacerbate economic stagnation in rural regions.

More certainty after the presidential election has led to optimism and expectations of reduced tax and regulatory burden, which may have an impact on the labor participation and employment rate.

b. ***Particular Indicators:***

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

Council members observed mixed inflationary pressures, with higher inflation in urban centers than in rural regions. However, most Districts have experienced inflation in the costs for health care wages and housing. Housing costs continue to rise in urban centers, where demand outstrips supply, while labor demand has led to increasing wage pressures in most Districts. Districts also have experienced higher IT costs.

Some Council members predict that rising economic growth combined with simulative policies from a new presidential administration may stoke inflation. However, the time it takes to execute new policies may delay any such effect.

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

Housing prices are increasing in most areas, particularly in metro areas, where demand continues to outpace supply. Demand for, and construction on, multifamily properties in particular has increased, though absorption of new supply may become a problem in some areas.

Many baby boomers are transitioning from large suburban family homes to city dwellings, further putting both upward pressure on metro housing prices and downward pressure on suburban home prices. In densely populated areas, bidding over the asking price has become standard. However, some Districts have experienced rent prices that are beginning to stabilize.

Rapid housing inflation has been observed in second-tier markets, following the entry of a large employer into those markets. Foreign capital has also contributed to the increase in urban housing costs, especially at the higher end of the market in gateway cities.

Some Council members have concerns that the growth of the housing market in urban regions may be peaking for multifamily homes as well as for single-family homes.

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?*

Labor conditions have strengthened generally, and unemployment continues to fall. Employers reported some difficulty in the procurement of skilled labor, particularly in the areas of IT, health care, accounting, and compliance. In addition, the energy industry has begun to recover.

Some Districts have experienced increased wage pressure in urban markets and diminished gains in productivity. Council members also report increased demand and wages for skilled trades in fields like construction.

Some Council members noted that health care costs are discouraging employers from adding full-time staff, and some employers are opting to only hire part-time staff to limit incurring that cost. There are some reports that companies are more averse to adding staff and are instead focusing their excess capital on alternative investments. In addition, some Council members note that initiatives to increase the minimum wage may lead to lay-offs in the future. Council members have concerns that automation may exacerbate this issue.

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

Council members indicated that consumer confidence continues to trend as stable or improving. Housing and auto sales are up, and oil prices have also strengthened. The hospitality sector is strong, and hospitality projects are progressing at a rapid pace in several areas. Furthermore, consumer credit losses are very low, and delinquencies have continued to decline.

Some Council members also noted that an increase in certainty after the presidential election has led to a tentative increase in consumer confidence, with many consumers anticipating a decrease in taxes.

3. **Innovation and Community Banking:** *What are the most important innovations currently affecting banking practices, business models, and lines of business for both community banks and their competitors outside the banking system, which are popularly known as "fintechs"? What challenges for compliance with safety and soundness, anti- money-laundering, or consumer protection regulations are presented when community banks adopt innovations or partner with fintechs? What are the barriers, such as costs or regulatory concerns, for community banks seeking to meet the needs of their customers through innovations or fintech partnerships?*

The Council believes that the most important innovations for the banking industry are those that both reduce costs and improve the user experience. One Council member notes that reduced response times are the key advantage of many fintech firms. Council members also believe that, while fintech firms play an important role, greater value is placed on the innovation itself. For example, online origination platforms enable financial institutions to decrease the cost and expedite the process of underwriting a loan; mobile payments enable customers to quickly send and receive money; mobile banking applications enable customers to manage their finances on the go; and personal financial management applications enable customers to gain a deeper understanding of their finances. All of these applications are evolving in banking companies of all sizes.

Council members believe regulatory uncertainty is a major challenge for banks seeking to adopt innovations or pursue fintech partnerships. Third-party vendor management is required for any bank partnerships with a fintech firm, and banks face much higher legal liability in the event of failure. However, the risk aversion among regulatory agencies can be reflected in costly requirements that outweigh the advantages of innovation. It is essential that the banking industry and its regulators work together to avoid this "Catch-22." Otherwise, innovation will occur outside or around insured depositories, not in them. This situation only increases concerns about the inconsistent regulation of nonfinancial institutions and financial institutions and concerns about the lack of established oversight for nonfinancial institutions that may present them with a marketplace advantage while placing consumers at risk.

The Council has significant concerns regarding emerging payments products, concerns based in part on changing consumer attitudes, demand for convenience, and competition from nonfinancial institutions. Millennials increasingly choose uninsured fintech services to hold their deposits, and they appear insensitive to the risks of holding deposits that are not federally insured. Fintech firms now hold significant balances of uninsured deposits. Financial institutions are subject to extensive consumer protection regulations, capital requirements, and stringent rules regarding consumer privacy and data security. Banks are also subject to on-site examinations to ensure that they are following the rules. Nonfinancial institutions offering payment services do not provide the same level of consumer protection or systemic strength.

Other barriers include differential entry costs that result from both scale and regulatory barriers. Community banks cannot afford to just walk away from a project that subsequently fails. Community banks face much more stringent supervision than fintech firms, restraining banks from committing resources to internal innovation initiatives. Council members also have concerns about potential future access requirements, particularly to the payment system. Simply stated, policy should require that the payment system provide equal access with equal cost to all insured depositories. Otherwise, the diversity of banking services to communities will suffer. Similarly, community banks rely on core process providers, and they cannot be allowed to become a barrier to community banks needing access to payment innovations.

The Council supports the efforts of the Federal Reserve's Faster Payments Task Force. However, there is still concern about the time it will take smaller institutions to implement any accepted solution and the unknown costs related to offering a new service. The Council has considered what role the Federal Reserve should play in any new payment system, including providing oversight or acting as an operator. However, the Council has significant concerns regarding the growing consolidation of the payment system by the card networks and the impact that may have on community bank access.

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?*

Examination practices were assessed positively, consistent with prior Council responses on this topic. The Council noted more communication during and between exams and a generally effective use of the pre-examination process to reduce examiner presence in the banks. Still, there were concerns that pre-examination disclosures had at times been unanalyzed or under-analyzed by examiner staff, leading to duplicative examiner requests and unnecessary bank burden during the on-site review. While the Council encourages pre-examination disclosures, it recommends tailoring those requests to the examined institution and full consideration of the material banks do provide. In addition, the Council welcomed any guidelines that would facilitate greater use of the off-site examination process.

The Council noted a heightened concern over fair lending issues. In particular, the Council recommends providing banks with greater transparency in the fair lending analysis undertaken by the examiners. This transparency will better enable banks to maintain compliance with fair lending requirements.

The Council also encourages more uniform application of joint agency guidance that eliminates the use of "recommendations." Some institutions continue to notice such requests in their exam reports. In addition, an interagency discussion at the FFIEC level on this guidance would be an opportunity to ensure greater consistency.

Consistent with its views on the need to more clearly identify requirements, as compared to suggestions in the examination process, the Council urges caution against examination practices that focus on “best practices” borrowed from other, frequently larger banks, as part of community bank supervision. The Council feels this approach may be at the heart of what seems to be ever-escalating examination expectations regarding compliance with the Bank Secrecy Act (BSA). The Council also notes the inconsistent application of new requirements pertaining to HVCRE and encourages further FFIEC review to improve uniformity and transparency. The Council also recommends examination of, and an increase in the size thresholds for, “large banks,” as they are defined by the Community Reinvestment Act (CRA).

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 numerous regulatory changes affecting community depository institutions has continued to increase in the past six months, impairing their response to the credit needs of their communities. New requirements applicable to residential mortgage and construction lending and other consumer protection measures present the most troublesome issues. Moreover, the revised TRID requirements have resulted in a deterioration of customers’ experience and in significantly increased negative customer reactions.

Concerning regulatory and compliance costs generally, the Council members share a concern that, over the previous five years, compliance costs have consistently grown faster than assets and returns. One recent study estimated that the cost impact to the credit union industry alone over a recent period was approximately $7 billion. This comparative trend of expense growth versus business growth is unsustainable, and even the most optimistic growth forecast, taken alone, will not adequately address the problem. Institutions must be permitted to bring these costs under reasonable control. The most profound negative impact is on the credit and other services that institutions are able to furnish to their communities. These concerns extend to anti-money-laundering and BSA compliance, where many institutions, previously urged to invest in information technology and analytical systems to capture and organize data, are now pressured to hire additional staff to analyze the data.

As the Council has noted in previous reports, concerns persist about the inconsistent application of new regulatory standards, both within a single supervisory agency and across multiple agencies. It typically takes several examination cycles for institution management and examiners to achieve clarity about specific regulatory expectations. For example, different supervisors reach different conclusions when assessing deposit production channels against brokered-deposit limitations. Some vendor services are treated differently under deposit-broker rules by different supervisors. In another (particularly troubling) example, an institution’s CRA rating was changed – retroactively, almost three years after issuance – following actions taken by other agencies that affected the institution. Significant business initiatives that depended on the institution’s CRA rating were damaged as a result. Even before a comprehensive legislative and agency review of CRA requirements and supervisory practices, which the Council believes would be timely and appropriate, the regulatory agencies should strive to avoid such divergent and even contradictory actions. Finally, an inconsistency that extends beyond the financial supervisory realm is becoming increasingly serious, as various jurisdictions legalize and even promote marijuana production. Institutions’ customers seek loans and other services as they begin operating under these new laws, raising concerns about anti-money-laundering and other compliance requirements.

The Council emphasizes that many regulatory requirements have now begun to significantly affect the customers of community depository institutions. New integrated mortgage disclosure rules and account-opening rules (i.e., customer due-diligence requirements) have meant a sharp deterioration in the customers' experience. The cumulative effect is that, with increasing frequency, customer-facing staff have "horrible conversations with good customers," often including customers who have had lengthy relationships with the institution. If the ultimate result drives these customers to alternatives, such as marketplace lenders and shadow banks that have become easier to deal with, not only will the institutions lose business, but the Federal Reserve System will also suffer in its ability to influence monetary and economic conditions.

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?*

Marijuana Businesses and Banking

The number of states that permit licensed marijuana production and dispensary businesses continues to increase. Consequently, demands for banking services for existing and potential banking customers are increasing, but regulatory guidance from regulators and a more transparent discussion of other potential legal liabilities has not kept pace with these developments. Financial institutions naturally must weigh their costs when offering banking services and deciding whether to take on new or maintain existing customers, as well as how much to charge when services are provided. When it comes to banking services for emerging marijuana businesses, frankly, community institutions are at a loss.

Council members request more guidance. Some of that should come directly from the banking regulators, but the Council believes that a broader discussion and understanding between banking agencies and federal law enforcement agencies is warranted.

Examples of some of the conflicting messages and uncertainties faced by Council members are as follows:

- Institutions have been told to go forward with opportunities to provide banking services to marijuana businesses, but will doing so result in their accounts with Federal Reserve Banks being closed?
- Are banks obligated to monitor the accounts of their existing commercial real estate borrowers who lease property to marijuana businesses?
- Are banks obligated to monitor the existing accounts of customers employed by marijuana businesses?
- Are banks obligated to treat both existing customers and new customers differently when they have marijuana-business exposure?
- Many municipalities and states tax marijuana businesses. What obligations do banks have when they are involved in collecting such payments or in maintaining the accounts into which such payments are made?