<u>Record of Meeting</u>

Community Depository Institutions Advisory Council
and the Board of Governors

Friday, April 14, 2017

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

Overall, banking conditions and banker attitudes are positive and improving, fueled by economic stability and the prospects for improvement in the regulatory environment. Urban versus rural conditions and issues remain divergent as a general matter, and rural conditions and prospects remain weaker.

Council members are seeing some pullback from commercial real estate (CRE) and construction lending due to concentrations, overbuilding, weakened loan terms and conditions, and growing concerns from bank management and regulators. In many cases, this caution is warranted, though in other cases, regulatory pressures have not adequately recognized the prudential opportunities available to well-managed CRE lending specialists.

Labor supply and immigration constraints are a growing concern, in both agricultural and general labor forces. Fintech seems to be a transitioning issue, and many bankers are focusing on avenues toward better customer-directed interfaces while retaining credit standards. Both regulators and core service providers need to adjust to accommodate these trends.

Housing markets continue to evolve and improve, and consumer lending is still robust in the auto sector. Concerns continue about student debt and the long-term impact of that debt on young people's ability to start businesses or buy cars, homes, and other consumer goods.

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

Optimism and confidence about small business lending remain strong in many states, due in part to an increase in young entrepreneurial activity. This positive outlook is particularly prevalent in urban markets, where economic opportunities continue to improve. However, rural flight has led to stagnant loan demand in rural markets, which continue to lag behind their urban peers.

Community institutions continue to experience competitive pressures from digital lenders, which often cherry-pick the most creditworthy borrowers. However, as digital lenders face funding pressures, more have begun to seek partnerships with banks and credit unions.

As demand increases in urban markets, some Districts report a degradation of market discipline regarding loan terms and rates. Young entrepreneurs, in particular, demonstrate a willingness to accept less-favorable terms in exchange for the convenience of digital loan-application processes. Regulatory requirements and the intransigence of core service providers have hampered the ability of community financial institutions to leverage technology to improve their application processes, which puts them at a considerable competitive disadvantage with regard to attracting potential customers who prefer digital processes.

Council members believe that the Small Business Administration (SBA) could help attract young entrepreneurs who seek convenience over more-favorable loan terms. However, some Council members noted difficulty approving SBA loans for young entrepreneurs, who often fail to meet SBA requirements due to generational differences – such as the lack of homeownership – which limit the ability of these borrowers to demonstrate their creditworthiness.

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?*

Generally, Council members report a tightening of commercial real estate (CRE) credit standards. CRE loan prices and commercial rents have been up in urban markets, but absorption rates and rents are now beginning to slip. Community institutions generally are maintaining good structures for CRE deals; however, some report a worrying loosening of standards in certain markets.

CRE loan demand near transit hubs is nearly as strong as in urban markets; however, that demand tapers off quickly the farther one gets from transit centers. There has also been a general pullback in multifamily development, but notably not in the Washington, D.C., area. Additionally, uncertainty surrounding potential changes to the Affordable Care Act and other market uncertainties have caused many banks to be more cautious about financing medical facilities.

Rural areas are experiencing low levels of CRE loan demand and supply. While Council members report universal appraisal challenges in the appraisal industry as a concern, the problem has been particularly acute for rural regions. However, improvements have been noted in the rural second-home construction market. Furthermore, land valuations in rural vacation hot spots remain particularly strong.

Council members noted CRE guidance issued by regulators in 2006 related to Acquisition, Development, and Construction (ADC) loans in excess of 100 percent of capital and 300 percent of capital for all CRE loans have limited banks' ability to make worthwhile loans. There is a noticeable disparity in how supervisors interpret this guidance. Some see the guidelines as suggested limits that can be exceeded as long as a bank's risk-management processes are robust enough. Others view the guidelines as hard ceilings regardless of strong underwriting standards or strong levels of oversight. The Council believes an update to this guidance would help improve the situation.

Lastly, some banks and credit unions are experiencing difficulty with the guidance pertaining to high-volatility commercial real estate (HVCRE). Council members believe clarifications, exemptions, or modifications are needed, especially to recognize the value of land that has been held for an extended period of time and has appreciated in value.

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 demand remains very strong in most metropolitan markets, which are experiencing an increase in investor activity. However, Council members note that an excess supply of student and multifamily housing has been associated with eroding lending standards in some markets. In other areas, an excess of multifamily units is being drained from the market through condo conversions in order to meet demand for more affordable homeownership.

Some Council members reported that housing developments were being built in areas thought to be less desirable economically due to excess housing demand. However, rural areas have experienced much weaker demand and supply.

Community financial institutions note that the cost of construction has risen considerably since the Great Recession. These rising costs will dampen the pace of construction to varying degrees, depending on the strength of local market demand. Lastly, Council members noted that weak supply and demand in the retail sector could have a ripple effect that affects collateral valuations.

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?*

Generally, refinance activity has decreased in most markets as a result of rising rates, but refinancings continue because rising home values provide homeowners with a source of collateral to support consumer credit demands. The loss of rate-based refinance activity has been replaced with growing activity for home purchases. Home supply is limited in many markets, which has limited the pace of gains in home-purchase markets. Some Council members noted that affordable housing supply in urban areas is being limited by rising prices and short supply.

Council members also identified two trends related to the millennial generation. First, millennials generally tend to wait longer to purchase their first home. Second, those millennials who have sought home mortgage loans generally place a premium on speed and convenience. Regulatory requirements that have lengthened the process for approving and closing home mortgage loans have led to customer complaints, especially for qualified mortgage loans; however, so far these complaints have not translated into decreased demand. Rural appraisals are increasingly difficult to attain, and the small volume of business in these markets has made new regulatory costs difficult to absorb. As a result, more rural institutions have exited the residential mortgage market. Nonqualified mortgage (non-QM) rural borrowers may face particular challenges in finding mortgages.

Community institutions are continuing to provide non-QM credit, but since there are no secondary markets for such loans, they are placed into portfolio. A build-up in banks' non-QM portfolios may begin to limit their capacity to make non-QM loans going forward.

Basel III capital costs for holding mortgage servicing assets (MSA) have resulted in large-scale sales of MSA by large banks to nonbank servicers. Some Council members report that these Basel III requirements are now affecting the ability of community institutions to hold MSA for their customers. This is particularly troubling because strong customer service is a core ingredient of the community banking business.

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

Council members reported strong volumes of consumer lending, particularly for auto loans. Consumer credit quality is good, banks have been able to increase rates without experiencing a decrease in volume, and delinquencies are low.

The price points for purchasing and leasing autos have become increasingly similar, which has led to more consumer auto purchases. Some auto lenders have begun to extend maturities to 7 years, and in some cases, even to 10 years. The split between 6- and 7-year loans is about even. In the past, 5-year loans were more predominant. Community institutions generally have avoided the more extreme terms.

Despite these positive signs, Council members did cite increases in consumers' debt-to-income ratios, particularly among millennials with high student debt, as a hindrance to consumer lending growth. Additionally, fear of declining collateral values in addition to growing consumer debt burdens have led some auto lenders to lend more cautiously.

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

Overall, Council members believe that the agriculture lending industry has stabilized, due in large part to a stabilization in most land prices. Council members also cited the rise in agritourism as a positive sign in some areas, as the popularity of wineries, microbreweries, and the like continues to rise.

However, strong incentives for consolidation within the agriculture industry remain, as large farms get bigger and small farms struggle to keep pace. Council members report that efforts are being made to enable borrowers with liquidity-to-debt-load problems to restructure their loans, to the extent possible.

Council members cited uncertainty surrounding potential immigration reform as a point of concern for agriculture lending. If certain immigrant communities decide to leave the United States or are prevented from entering the United States because of new restrictions, the labor force could be severely diminished, posing a significant challenge to the agriculture industry.

Lastly, Council members noted that the leases on many gas and shale loans – which have helped to support farming communities in some states – are coming due and could affect agricultural lending.

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

Urban areas report stable deposit growth of roughly 4 to 6 percent in most cases. However, Council members are concerned that the current growth levels will not be sufficient to keep up with loan demand, and they see deposit rate increases as a possibility.

Most banks expect to delay raising deposit interest rates, depending on competition. However, many banks are considering reinstating their old programs for rate bumps and step-ups in anticipation of rising rates.

In rural areas, deposit growth has tended to lag behind the growth seen in other markets. Council members largely attribute this stagnation to the struggling agriculture industry. Furthermore, as margins have been compressed by low interest rates, banks have compensated by growing loan volume. This strategy has led to high loan-to-deposit ratios. There are now concerns about the need for more aggressive loan pricing as deposit rates rise in order to balance those ratios.

Community institutions are also concerned about their ability to compete with major banking firms to attract deposits. Large banks have aggressively priced deposits to meet new regulatory standards, which have dramatically increased acquisition costs for community institutions. Retail consumer deposits are very competitive.

2. Economic Discussion:

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

Council members have seen remarkably stable economic progress in most Districts. They reported significant optimism and confidence among small businesses broadly across metropolitan areas, particularly from young entrepreneurs. Even markets where economic growth has lagged since the last recession have gained some momentum, but to a lesser degree in rural areas. However, non-urban markets where the local economy is based on government, recreation, tourism, or higher education are stronger.

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?*

Except for home prices and salaries as noted below, price inflation for products and services purchased and sold by community financial institutions has been low and steady in most Districts, but somewhat higher in urban areas.

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?*

Council members see short supplies of housing in many urban areas. Existing homes for sale are moving fast, and new-home construction is being constrained by high construction costs, labor shortages, and scarcity of open land – especially in long-established zones. Home prices and rents are escalating in such areas, especially in Boston and D.C. Even in rural areas, where home construction has been tepid since the last recession, home values have generally stabilized (but are down in some) and building is picking up to a degree. Near transit hubs, prices and rents for single- and multifamily housing are escalating, and construction has been strong. In some areas, high-priced homes are selling for cash, and investor activity is growing.

Council members, in contrast to media and other reports, generally feel that millennials are not as different from prior generations seeking homeownership, except they are starting families and buying first homes later due to changing social norms and student debt burdens. Correspondingly, multifamily development is slowing in many areas (but notably not in the D.C. market). This belief is breeding wide-ranging expectations for future home-value appreciation, even outside urban areas.

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?*

Metropolitan labor markets have tightened to the point that voluntary resignations are up. Financial institutions are losing commercial loan and other officers to other institutions and even to nonfinancial firms.

Council members report that it is hard to find seasoned executives and skilled staff. As a result, salaries and back-office staff wages are rising rapidly. Other wages are not inflating, but there are expectations that this may soon change. In some areas, elevation of legal minimum wages is driving wages up.

In hiring, many banks are going back to offering signing bonuses after losing applicants who were offered what were considered to be competitive salaries by other employers. Replacement staff often ask for more pay or benefits than the departing staff received. Some banks match demands for paid time off and/or reimburse hires when they would have to pay back tuition reimbursements to their current employers. Banks are finding that they must be flexible when candidates could find alternative positions that would allow for flexible work arrangements, even when the other positions pay less. In the past, community institutions would hire seasoned staff away from larger institutions, but the situation has reversed.

In rural markets, some Council members reported labor shortages. Continuing economic slack has driven away foreign workers, and new immigration policies have slowed the inflow. This has been an issue in agriculture, home construction, and other industries.

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

Consumer euphoria following the national elections appears to be waning. Nonetheless, the general outlook remains upbeat due to sustained economic prosperity, strong job growth, and rising home values. An observed jump in entrepreneurial activity exemplifies the general optimism. Confidence is not as strong in rural areas, where economic and job growth has been weak.

3. **Payment Systems:** *Although the introduction of the EMV (Europay, MasterCard, and Visa) chip is aimed at reducing in-person fraud, it does not address online card fraud, which continues to grow. What has been the Council's experience with the EMV rollout in reducing in-person fraud in the United States? How does the Council view steps taken by the industry to address online credit fraud?*

The bankers generally agreed that the migration to EMV to reduce counterfeit card fraud has been moderately successful, but it has not addressed all of the related issues. The potential reduced losses related to counterfeit card fraud are constrained for several reasons. First, many merchants have not upgraded their card readers to accept chip transactions. Second, because many merchants have not upgraded, the magnetic stripe must remain on the chip cards to ensure they can be used at all locations. The magnetic stripe is the easiest for criminals to create using stolen card credentials. Third, the bankers have seen increases in fraudulent transactions when they occur online. Fourth, when the magnetic stripe on a card is compromised, the issuer must replace it with a chip card, at considerably greater expense than replacing a magnetic-stripe-only card.

The EMV migration has created many customer-service issues as well, including confusion regarding where the cards can be used and delays in processing transactions at the point of sale.

The industry has taken several steps to address fraudulent online transactions, including tokenization, encryption, and address verification services. Unfortunately, there is not a universal standard of best practices for online sales, and many safeguards have not been put into place by the merchants operating online sites. EMV technology cannot effectively address problems of online fraud, and such fraud is accelerating in incidence and cost.

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?*

Bankers view examination practices positively overall, yet negative concerns continue to surface about compliance examinations. The Council is very concerned that the working partnership that has existed for years between examiners and bankers and credit unions is no longer working well, as manifested by increased examination time frames, less risky concerns being mentioned as matters requiring attention or documents of resolution, and a lack of exam focus on an institution's overall risk profile.

The Council strongly encourages the agencies' efforts to work off-site during the pre-examination process and to perform actual examination activities off-site when reasonable. However, one concern with this approach is that the longer time period between initial information request and the actual exam start date tends to create additional burden for the institution. Examiners have had more questions, which in turn creates the need for more data from the institution, which may or may not be reviewed. The period between the data request and the actual examination is, in fact, becoming an extension of the engagement time in the exam process for the institution. The Council continues to encourage and recommend that information requests be more tailored and risk-based to a specific institution and that all provided data be evaluated before the on-site visit.

The Council has heightened concerns about examination activities for fair lending, Bank Secrecy Act (BSA), cybersecurity, and vendor management. Fair lending examinations seem to continue indefinitely, as if examiners must continue to review until they find a problem. The Council is concerned that agencies are using statistical models and regression analyses in these examinations but will not share their methodologies with financial institutions. Community institutions want to comply, and being able to use the same tools as examiners would help ensure compliance on their own part and would provide examiners with sound, reliable data analysis, thereby reducing examination burden and allowing examiners to focus on higher-risk areas. Issues about BSA compliance and concerns about vendor management exemplify the more granular nature of the exam activities being performed and the lack of focus on the real risk issues that exist in these areas. This granular approach creates undue burden on an institution that is not warranted by its risk profile. Several Council members indicated that cybersecurity, while an increasing risk for institutions, does not receive sufficient exam attention. There are also questions about whether examiners have the expertise needed regarding cybersecurity.

The Council also encourages more coordination and consistency among the various regulatory agencies when more than one agency is involved in the regulation of a specific institution. In many cases, field examiners have to consult district staff or national experts before examination findings can be finalized. While perhaps not unusual, these efforts lead to a fractured examination process, less interaction between the examiners and the examined institution, a lengthened overall examination time frame, and uncertainty by bankers as to examination findings and outcomes. Yet the agencies continue to claim that the process is transparent. On a similar issue, the Council continues to voice concern about the trickle-down examination approach. Activities being performed by larger banks are now often expected of community institutions when their risk profile does not warrant such increased scrutiny.

Lastly, the Council is concerned with the reduction in examiner experience and expertise. Less-experienced examiners tend to focus on a routine of "check the boxes," rather than on the risk profile of an institution. This approach moves away from the risk-based premise the agencies explain in their examination procedures and guidance, creates uncertainty among financial institutions, and clearly increases the burden community financial institutions must address to effectively manage their institutions in a safe and sound manner.

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?*

Post-crisis regulations continue to impair community depository institutions' ability to service their customers and meet the credit needs of their communities. As a result of the cumulative regulatory burden imposed over the past few years, institutions must now dedicate more staff to meeting regulatory requirements, leaving fewer resources available to serve customers. Tailoring regulatory requirements and examinations to the size, scope, and complexity of an institution and its activities would go a long way to address the regulatory cost burden, which as expressed in previous reports, has resulted in many community institutions being forced to withdraw from certain business lines. Reviewing and tailoring outstanding rules and regulatory guidance would serve community depository institutions well by easing regulatory burdens and expenses in several areas, including mortgage lending, CRE risk management guidance, fair lending, BSA/AML compliance, and capital requirements. Residential mortgage lending, with the new TILA-RESPA integrated disclosure requirements, has become excessively complicated for both community depository institutions and their customers. Similarly, conflicting disclosure requirements for real estate lending arrangements that are transitioning from a construction phase to permanent financing create challenges for both lenders and borrowers without providing a measurable benefit. The Council acknowledges that existing CRE risk-management guidance containing supervisory criteria of 300% and 100% to capital may benefit from an update to reflect supervisory experience over the past decade since the 2006 guidance was issued. Clearer expectations regarding what constitutes CRE concentration risk and supervisory perspectives on expectations to help manage these risks may be helpful.

Meeting supervisory expectations for managing fair lending risk continues to be a challenge for community depository institutions, as regulators rely on opaque analyses to determine if discrimination has occurred. The Council indicates that the federal banking agencies, in their analyses of disparate impact, may consider including a review of an institution's policies and procedures in addition to statistical data regarding its lending practices.

Similarly, concerns about anti-money-laundering compliance have exacerbated. Many institutions have had to bring in additional staff and outside vendors to ensure compliance. The Council urges the Board to consider tailoring anti-money-laundering examination approaches to be commensurate with the scope of an institution's activities and the nature of associated risks. The Council recognizes that appropriate rulemaking authorities may want to revisit thresholds for filing currency transaction reports, among other compliance measures that may need updating. In addition, a national regulatory policy is needed to address widespread regulatory confusion and conflicting government policies for dealing with marijuana-related businesses.

The Council emphasizes that capital rules enacted under Basel III should be revisited. Specifically, in light of the upcoming adoption of the new current expected credit losses methodology (CECL), consideration needs to be given to adjusted capital requirements, given expected industry-wide higher allowances for loan losses. Similarly, the punitive capital treatment of mortgage servicing assets and so-called HVCRE has resulted in many community depository institutions refraining from or reducing these lines of business, resulting, in some cases, in more nonbanks performing these services.

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?*

Evolution of Payments Systems and Technologies: The Council wishes to reiterate its concerns that changes to, and new entrants into, the payments system may be weakening its necessary security or potentially limiting access to essential parties. The Council appreciates the Federal Reserve's commitment to the faster payments initiative and strongly encourages such engagement now and even more intensively in the future. A strong role for the Board of Governors and other System resources is essential to improvements in utility for the payments system, including better security in the face of new and powerful threats, robust operational capacity, and maintaining comparable ease and cost of access to all payments providers.

The Council is frustrated that no single part of the government seems empowered to address all of these critical objectives and needs. Surely, the Federal Reserve has the most significant role, but the risks of a fractured and risky payments system are all too real if we enter the future with fractured public policy and oversight. The Council believes that the hour is late to develop a structure of public policy objectives and the oversight necessary to accompany and guide development of the secure, innovative payments system that our future economy will demand.