<u>Record of Meeting</u>

Community Depository Institutions Advisory Council
and the Board of Governors

Friday, November 8, 2013

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?*

Generally, small business loan demand remains flat compared to the previous meeting. Larger urban areas are generally seeing the strongest loan demand. Any area outside of an urban center has tended to be much less positive. Certain regions are seeing improvement based on commodity performance, such as energy and agriculture.

Small businesses have been hesitant to borrow in the face of tremendous uncertainty associated with their future costs and the economic environment. The Affordable Care Act has limited small businesses' ability to predict their staffing costs, resulting in delay or cancelation of many plans to expand. These pressures are especially great in the service and hospitality industries. The government shutdown and sequestration, to a degree, struck a blow to confidence and certainty.

Competition for qualified borrowers remains strong. Larger banks are beginning to "reach down" and offer loans to smaller businesses that they had not serviced in the past. In addition, community institutions are seeing outside competition from nondepository lenders, such as online vendors. This competition has pushed pricing down and has eased terms on many small business loans. One Council member noted that credit availability is at its highest level in 25 years for quality borrowers. Smaller community institutions are often having trouble competing with larger institutions and other competitors who face lower costs of funding.

   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 lending has picked up somewhat in most regions compared to the previous meeting. Despite this pickup, competition remains fierce and community institutions face slim margins.

Many loans are refinancings, which have better borrower terms and conditions, rather than new lending. Competition has increased from large institutions, insurance companies, and REITs.

Multifamily, medical facility, and, in some Districts, hospitality have been bright points for CRE lending. Though a number of regions reported seeing strengthening multifamily demand, some regions see supply beginning to outstrip demand. Where hospitality has been strong, new construction is likely increasing credit risk for existing loans on older properties.

Competition for CRE loans remains strong, including competition from large insurance companies that are being very aggressive and offering low-rate, long-term loans. An unexpected trend was the levels of cash being used to pay down loans early. This is an indicator that businesses are too uncertain to expand and would rather use available cash to de-lever.

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 appears to be picking up, primarily in urban areas. Some bankers noted that certain urban areas were beginning to show signs of a bubble.

Many bankers noted that rising construction costs, driven by this new demand, posed a challenge in the face of lagging appraisal values.

Flood insurance remains a key concern in certain regions. Responses regarding flood insurance were mixed. However, some bankers expect a high multiple increase in insurance prices. This was posing a particular problem for Gulf Coast areas that support shipping and refining.

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?*

Home mortgage lending has fallen off dramatically since interest rates began rising in April. This has hit refinancing particularly hard, with the majority of bankers reporting approximate declines of 75 percent. Competition for good loans remains strong.

There was significant concern regarding upcoming mortgage regulations. The majority of the group noted that they planned to remain within the Qualified Mortgage (QM) definition for almost all of their loans. Despite this, some noted there would be community institutions – particularly in rural areas – that would need to make non-QM loans due to their customer base and long-term customer relationships. For urban community institutions, the choice to stay within the QM box was stronger. Several council members noted that a few community institutions they know of have already stopped mortgage lending altogether.

There is also concern that following QM will lead to fair lending violations. Despite reassurances from regulators that this will not be the case, the risk of a fair lending violation is real and will have an impact. The "zero-tolerance" approach from examiners and the impact of statistical disparate-impact analysis have created a dilemma for many community institutions.

Having sufficient documentation to prove ability to repay in a court case was a concern.

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

Consumer lending levels remain extremely low with the exception of a few categories. Auto lending and home equity loans have seen increases in a few areas of the country.

Many smaller community institutions are concerned about being priced out of consumer lending by large banks and nondepositories. Many of the Council members noted that community institutions in their area had exited the consumer lending business altogether. Members noted that the demand for consumer loans at community institutions is primarily from less-qualified borrowers due to the low rates offered to qualified borrowers by larger institutions.

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

Agricultural lending has been strong for most regions, with the exception of dairy, which remains weak. Many crops have performed well, injecting cash into the agricultural system. Many farmers have used available cash to finance crops rather than borrowing.

Land prices are at very high levels. One trend that the Council noted was that many of the land purchases had shifted from investors to farmers, who are able to afford higher prices because of strong cash positions and lack of debt.

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

Community institutions remain flush with deposits; however, the rate at which the deposits are coming in has leveled off in recent months for many regions. High deposit levels, combined with the tepid loan demand, have left community institutions with few avenues to use the deposits. In some parts of the country, loan demand related to the energy boom has kept loan-to-deposit ratios high.

Many of the community institutions noted that although they are flush with deposits, they have seen significant consolidation of deposits at larger institutions.

Some community institutions noted concern that as rates begin rising, they expect to see strong deposit outflows.

2. **Economic Discussion:**

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

The Council noted that general economic conditions have improved in most areas. There is a large degree of uncertainty that continues to restrain growth across the country.

The Council noted that conditions vary dramatically from region to region. Conditions in many metropolitan areas seem to be booming; however, the more rural areas are often left behind. A number of regions noted significant economic tailwinds from oil production that have pushed the recovery.

One large concern that was noted was the impact healthcare reform would have on the overall economy. Many medium and small businesses face tremendous uncertainty regarding the upcoming costs associated with the reform and have delayed any major business decisions or hiring until there is more clarity. Moreover, many healthcare providers are facing imminent cuts, as payments become restricted.

The Council noted that housing market improvement has the potential to strongly bolster economic growth. The housing recovery has gained strength in recent months and has the potential to aid other areas of the economy as consumers gain confidence from the increased wealth held in their homes.

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?*

Although headline inflation remains subdued, there are a number of areas where consumers are seeing price increases that will impact their spending power. One banker noted that he had conversations with a single parent in his area who was upset because they could not afford tires. The perception of inflation by the average customer, or “street inflation,” will have an impact on overall spending.

One major source of concern is increasing healthcare costs. Council members predicted costs rising 20 percent to 30 percent. This has made it difficult for small businesses to forecast their employment costs and is delaying business expansion and hiring decisions.

In addition, many bankers noted that they had seen significant increases in all costs associated with construction that may not be accounted for in the low headline-inflation numbers.

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?*

Housing remains a bright spot in the economy. Nearly all of the Council members noted strong improvement in housing markets. In fact, many pointed to housing as one of the brightest areas of the economy. Nearly every region reported price appreciation in recent months. The pace of home sales has also picked up in many areas. Supply of homes remains extremely tight, further contributing to price appreciation.

Many Council members noted that the majority of the pickup in housing was centered in the lower-end first-time buyer market. The Council saw this as a positive sign, which may indicate sustainable growth.

The length of time to resolve foreclosures was cited as a continuing problem and as making it hard to forecast supply conditions in some markets.

Prices have appreciated notably over the past year, particularly in some of the hardest-hit markets. Although it is encouraging that these markets are beginning to recover, it may be a "catch-up" effect rather than a true improvement in housing conditions.

There remains significant concern that regulatory changes – particularly application of the QM regulation – could restrict credit to a number of creditworthy borrowers.

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 markets remain a concern for much of the Council. Current conditions have made the job market particularly poor for younger people. Despite this overall weakness, the Council noted a lack of skilled labor.

The job market remains particularly tough for recent graduates. Many in the workforce have delayed retirement due to the still-weak value of their investments. This delay, combined with efficiency gains made after 2009, means that there are fewer entry-level jobs available.

Regarding the shortage of skilled labor in certain sectors, community institutions are having trouble finding qualified employees to deal with increased regulatory burden. The IT sector has struggled to find skilled engineers as well.

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

Consumer confidence has taken a significant hit following political debates in Washington. The group believes that these debates have derailed recovery in confidence. In particular, the government shutdown had a great impact on confidence in affected areas.

Much of this uncertainty has manifested itself in consumers continuing to deleverage and in an increased reluctance to take on debts. Demand for consumer loans was remarkably low, with almost no bankers reporting making new consumer loans in recent months.

3. **Payment System**: *How can the nation's payment system be improved to foster greater adoption of electronic payments and provide near-real-time retail payment options when considered from end-users' perspectives? What changes should be made to provide better choices for end-users to make cross-border payments?"*

There is a consensus among the group that the Federal Reserve should play a more active role in improving the efficiency of the payment system. Consensus was not reached on exactly what tasks the Federal Reserve should take on to improve and reform the payment system, but several options were discussed.

- The Council noted that nondepositories are not subject to as many rules and regulations and are much less risk-averse than community institutions because the negative fallout associated with failure is so low, and all of that contributes to nondepositories moving to market faster with new products. This problem is magnified because consumers are placed at risk since they are expecting bank-like regulatory protections backed up by regular examinations, while these new products and the non-depositories are not held to that high standard. This increases the risk to the consumer and to confidence in the payment system itself. The Council expressed interest in having the Federal Reserve or, in some cases the Consumer Financial Protection Bureau (CFPB), take on a more active oversight role for nondepositories.

- The Council recounted favorably that the Federal Reserve has taken a very active role in the payment system in the past through the implementation of Check 21, acting as an ACH operator and clearing conventional paper checks. The Federal Reserve should consider playing an active role in emerging payment systems to ensure that consumers are protected and that any new payment system has its integrity protected to the same degree that the legacy systems are operating under today. One item discussed, but not specifically endorsed, was the possibility of the Federal Reserve acting as the clearing house for P2P payments that rely on associating public information, such as email addresses and mobile phone numbers, to DDAs. Currently, there are several closed systems, but a national clearing house would encourage more interoperability among the consumers of all the providers of the service.

- The Council discussed how the Federal Reserve could use its influence to improve the payment system indirectly. This could take the form of encouraging NACHA operating rules changes that would increase the number of ACH settlements each day or supporting a standard to foster P2P interoperability among the payment service providers.

- The Council identified one area where more information is needed. Whether a faster, better, and stronger payment system is created from scratch, or if legacy systems can be improved upon, these infrastructure improvements will require investments. Any improvement in the payment system that will require capital investments from the participants must be rational and have a reasonable return on expected investment. Building a faster payment system that no one will use or that the banking system cannot justify economically does not make sense.

The recently enacted remittance rules put in place by the CFPB provide for more disclosures and protections for consumers making cross-border payments. These regulatory changes come at a substantial cost for those community institutions, and the costs are often passed down to the customers. Many community institutions are no longer offering the service at all or have limited the number of countries where payments can be transmitted, due to the regulatory burden.

The Council did not consider commercial cross-border transactions to be a high-priority item for their discussion.

4. **Examination Practices:** *Have Council members experienced problems with recent examinations? In particular, have examination practices constrained access to credit by creditworthy borrowers? What steps can be taken to address the Council's concerns?*

Council members noted a decline in exam problems and complaints with respect to matters related to safety and soundness. Improved credit conditions and increased capital levels over the last several years have contributed to the decline. However, community institutions are seeing continued heightened expectations and stringent approaches in compliance, risk management, vendor management, and AML/BSA examinations. Council members reported examiners requiring many community institutions to meet "best practice" standards and noted the "trickle down" of large bank regulatory rules, although community institutions are not required to comply with such rules.

Bankers are also concerned about the length and frequency of examinations, as well as the number of internal and outside audit requirements placed on community institutions. The size of the examination teams for community institutions has also increased significantly over the last several years, with many Council members noting that examination teams have doubled in size over the last year, in part due to specialization of examiners.

Community institutions are seeing inconsistencies and differences between regulators. For example, state and federal regulators may rate or view an area of the bank differently. In addition, Council members noted inconsistencies from one exam year to the next. This was particularly noted in the AML/BSA area, where a bank's program may be acceptable one year but highly criticized the next even though no changes were made to the program. Inconsistencies are leading to uncertainty for community institutions.

On the compliance side, AML/BSA, fair lending, and CRA dominate compliance exam agendas. Council members are increasing compliance staff and external audits to keep up with new compliance rules and examination requirements. The increasing compliance requirements are hampering the ability of some community institutions to focus on the needs of their customers.

Council members did find that examiners were more experienced and more willing to defer where appropriate to banker judgment, particularly in the areas of credit and safety and soundness. Regional and district offices appear more willing to address issues bankers raise regarding exam staff, increasing the comfort of bankers to raise such issues.

Overall, bankers believe that suggestions from examiners, even those not based on guidance or regulation, must be implemented, or the institutions could face scrutiny the following year. In this regard, examiners drive institution behavior. This maxim applies even for comments that centered around "best practices" that often seem inappropriate with the businesses and risk profile of the bank.

5. **Regulatory Matters and the Future of Banking:**

a. How are recent changes in the regulatory landscape affecting community depository institutions' ability to continue to provide services to their customers?

It is well known that lending by community institutions is essential to job creation and supporting the small business sector in a recovering economy. However, a community institution's benefit to the community is not limited to supplying banking services. They also fill an important role within community life. Often community institutions are the only reliable source of charitable support in the form of monetary donations and volunteers. An unintended and artificial contraction of community banking institutions will not only dramatically reduce the nation's economic diversity and growth but also harm the well-being and viability of the communities that depend on them.

Increasing regulatory burden and resulting constriction of traditional banking services caused the Council to question the future of community banking institutions as a value proposition. If the viability of community financial institutions is limited or reduced, so too will be the value they bring to the community-at-large. The focus of resources on compliance and examination results in less focus on growing the business, serving the customer, expanding products, and being active in the community.

The Council continues to voice its concern about the volume of overwhelming new rules and the high cost of compliance, particularly those caused by the new mortgage rules. In direct response to the new QM and Ability to Repay (ATR) rules, several Council members indicated that community institutions will be significantly restricting – or terminating – their traditional business focus on consumer lending and residential mortgages, due to the lack of clarity surrounding the consumer protection rules and fair lending expectations. Moreover, the impact of the QM rule makes it exceedingly difficult to serve first-time homebuyers or those with significant student loan debt. With the risks of non-QM loans not yet understood, community institutions are much less likely to make non-QM loans to potentially good borrowers. Rather, the Council recounted that many community institutions are tightening underwriting beyond the QM standards to ensure a non-QM loan is not made by mistake. The unintended consequence of the rule remains that qualified borrowers who should get a loan will be unable to get funding. When a mortgage loan is made, the Council questioned the ability and supervisory expectation to document a borrower's ATR. Must a bank use information gleaned from other sources to determine ATR? For example, a borrower reveals in a casual conversation with a loan officer an expected upcoming life event that could have significant impacts on ATR for borrowers on the edge of qualifying. The expected level of scrutiny of customer information, customer expectations of privacy, and needed evidentiary threshold to withstand litigation is yet untested. How much is enough?

Among institutions that are exiting the mortgage business or exiting temporarily until the risks are understood, several Council members expressed hesitation at making an exception to accommodate the credit needs of known customers. A violation arising from a manual or infrequent loan origination process may carry too high a risk to a bank's reputation.

Several Council members addressed the difficulty caused by an extended QM rule-writing period and a rushed implementation schedule. Community institutions rely on automated systems provided and maintained by third-party service providers. When final regulations arrive late and implementation periods are not extended, the computerized systems used by community institutions cannot be updated in time. Council members reported systems not yet delivered or still in the testing phase and unreliable in calculating the QM thresholds. For those institutions electing to use manual processing until systems are ready, the process will be dramatically slower, and as a result, the number of loans processed will be restricted.

In addition to the QM rules, the Council discussed the cumulative impacts of other recent regulation on the decision to move away from mortgage lending. The new PMI treatment obligates a bank to cancel PMI insurance upon obtaining 78 percent of appraised value, not 78 percent of original value. Unfortunately, the rule does not address a bank's safety and soundness concern when the loan is underwater or the borrower has a history of delinquency. Also, the Basel III capital rule's treatment of mortgage servicing assets creates additional costs for community institutions with an active mortgage business. In a stagnant economic environment with flat yield curves, few community institutions are in a position to take on even incremental costs associated with residential mortgages.

The Council continues to focus on the negative impact of compliance costs on a bank's efficiency ratio. Dodd-Frank implementation has forced community institutions to increase significantly the number of full-time employees focused on compliance. These expenditures have no business development function; they are not offset by loan growth or increased product sales. Rather, compliance burden increases costs and reduces a bank's performance statistics. The Council repeatedly discussed the search for a "new normal" as a trend in rising compliance costs causes efficiency ratios to decrease significantly across the industry. These costs, as reflected in lower ratios and earnings, may severely impair the ability to maintain, grow, or attract the capital needed to continue operations.

(a) *What has been the effect on the industry generally?*

The immediate effect on the industry is restricted or discontinuation of specific products or business lines. As compliance costs increase, efficiency ratios will continue to rise, making investment more difficult to attract. The restrictions on compensation and compliance workload also make it difficult to attract and retain good talent. Employees are easily attracted to positions outside of banking (or within the less-regulated shadow banking market) with higher compensation and less risk.

Over the longer term, institution portfolios may become more concentrated and less diverse, with the correlating decrease in safety and soundness.

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?*

- Volcker Rule – Community Bank Issues

Rather than applying only to the largest banks, the Volcker Rule applies to *all* banks *regardless of size or activity*. Therefore, every community bank will be required to read and understand the Volcker Rule and adapt the bank's compliance program to the Volcker Rule's requirements. Instead of defining what is prohibited, the agencies have tried to carve out permitted activities. It is not readily apparent, however, what is permissible versus impermissible trading and investment activity. Community banks therefore will be forced to allocate precious resources not to customer service but to puzzling through regulatory requirements.

- Interest rate environment

The low-rate and flat-yield-curve environment makes spread management extremely difficult, increases interest rate risk, and increases the focus on non-interest income unnecessarily.

- Interest rate environment

Current monetary policy practices place community institutions and the Federal Reserve in competition for the same earning assets, complicating investment management.

- Cyber Fraud

Community institutions would like more guidance and support to help manage the risk posed by third-party processors and to better manage large-scale cyber attacks and IT risk.

- Government fiscal management

Community institutions remain concerned that the implications of fiscal mismanagement will overwhelm their best-laid plans and prevent executions of prudent business plans.