

RECORD OF MEETING

Federal Advisory Council and Board of Governors

Friday, May 9, 2014

Item 1: Current Banking Market Conditions

What is the Council's view of the current condition of, and the outlook for, loan markets and financial markets generally?

- Improving news on consumer demand and unemployment, as well as improved balance sheets, is fueling consumer optimism, but confidence among small business owners has been slower to recover. A modest increase in credit demand appears likely through the balance of the year.
- Lending capacity currently exceeds qualified demand, leading to continued pressure on pricing and structure across most markets and customer segments. Notably, credit availability for homebuilders, an area of recent weakness, is predominantly limited to larger national builders.
- The Fed's measured approach to dialing back the quantitative easing program has been a stabilizing factor domestically while global recovery conditions remain a source of uncertainty.
- Overall, our outlook for lending and financial markets remains cautiously optimistic for the remainder of 2014.

(A) Small Business Lending:

Has credit availability for, and demand for credit from, small businesses changed significantly recently? Have there been changes in lending standards for these borrowers?

- While members observe positive momentum among small business customers, it is still a growth-challenged lending segment, especially as compared to consumer and commercial lending. Core business lending to support working asset growth is up, while loan requests to support real estate activities remain muted and uneven across markets.
- Competitors (bank and nonbank) are aggressively seeking the most qualified borrowers.
- Small business lending standards remained stable over the past quarter, but competitive pressures are leading to slightly looser structures.
- Small business deposits continue to be strong as firms deleverage.

(B) Commercial Real Estate Lending:

Have there been any changes in the Council's view of the challenges in the commercial real estate market? How are commercial real estate loans performing compared to your expectations?

- Credit quality in Investor Real Estate loan portfolios remains stable.
- Commercial real estate fundamentals continue to improve for most major property types.

- The commercial real estate recovery has been specific to certain property types:
 - The multifamily market has fully recovered from the recession and property performance metrics are at all-time highs. New inventory levels are concentrated in high-end buildings and may pose increased risks.
 - Retail and office properties have experienced a tepid recovery.
 - Industrial assets have experienced a moderate but uneven recovery to this point. Energy-related projects are demonstrating meaningful strength.
 - Fundamentals of the hospitality industry have continued to make a progressive recovery.
 - Demand for rental housing remains favorable.
- The pace of improvement varies by geographic location, with faster improvement in those markets enjoying higher levels of job growth – Northern California, Texas, and New York.
- Strong competition to finance quality projects is placing pressure on structure and pricing.
- Multiple sources of financing for commercial real estate have returned to the marketplace, including commercial mortgage backed securities, providing property owners with various alternatives to traditionally structured debt.

(C) Construction Lending:

What is the Council’s view of the availability of credit for construction and development projects? Has the Council seen any changes in the demand for construction loans recently?

- Ample credit is available for construction and development projects. The intensity of competition to finance high-quality projects has accelerated over the past six months.
- Inclement weather in Q1 2014 delayed construction activity, leading to a decline across both the multifamily and the commercial property sectors.
- Demand and credit availability vary by property type:
 - Demand for large multifamily construction loans in major metropolitan areas remains strong.
 - Available credit for speculative office or retail development remains subdued.
 - There is a modest amount of new construction activity and loan demand for large bulk industrial facilities in port cities and major transportation hubs.
 - Loan availability and demand for hospitality projects continues to improve.
 - There is an increase in both demand and credit availability for single-family construction loans with midsized local and regional builders. However, this sector, post-recession, continues to be dominated by the national builders.

(D) Agricultural Lending:

Have there been any recent changes in agricultural lending?

- There is limited change in the agricultural lending segment in recent months, while portfolios continue to perform in line with overall expectations and targeted risk profiles.
- Lower revenue and income in 2013, due to lower commodity prices, have led to greater utilization of operating loans, but lower capital expenditures are anticipated in 2014 and customer financial conditions are stable.

- Continued volatility in certain commodity prices may have an impact on overall farm performance and profitability. Lower commodity prices compress farm profitability but have created favorable margins for protein and food producers.
- Farmland prices have experienced modest pressure, which continues to be a concern.
- Continued globalization of the agricultural industry, combined with the introduction of additional technological efficiencies and broader global competition, creates a challenging marketplace.

(E) Consumer Lending:

What changes have you seen in consumer lending?

- Consumer borrowing continues to recover. While consumer attitudes and willingness to spend are improving, households remain cautious. Illustrating the uneven pace of the improvement, credit card spending increased strongly in April.
- There is intense competition in the consumer lending space coupled with pressure to maintain retail loan growth. Lenders in the equity lending market have returned to introductory rates, while some competitors in auto lending are expanding into subprime and extending loan terms. Banks and nonbanks are being especially aggressive in the auto space.
- Demand is increasing for variable rate home equity lines of credit due to improvements in home prices and other economic indicators. The industry is seeing a moderate shift from equity-loan to equity-line productions, primarily due to an increased rate differential. Pay-offs in the home equity line of credit product are also slowing as a result of reductions in mortgage refinance volumes.
- Wealth lending continues to receive specialized focus as the top U.S. banks look to strategically grow their wealth portfolios and cater to the affluent client.

(F) Home Mortgage Lending:

What changes have you seen in the home mortgage market in the past three months? What is happening to house prices?

- The housing recovery continues but varies by geography and price point.
- Long-term interest rates have remained stable in the first quarter of 2014. Industry volume is projected to be down 30-35% in 2014. Purchase activity is softer than expected. And, refinance volumes are continuing to decline.
- Many mortgage lenders have continued to aggressively price jumbo (nonconforming) products at lower than the conforming agency (Fannie Mae, Freddie Mac) products.
- On a year-over-year basis, home prices increased by 12% in January 2014 versus January 2013.
- Housing prices in higher-income areas are continuing to move upwards, but prices in other areas have not shown the same level of recovery. The median existing-home price for all housing types in February was \$189,000, which is 9% above February 2013. Generally speaking, the housing recovery continues at a moderate pace but is uneven across markets.
- As measured in reduced delinquency and lower loss rates, mortgage loan portfolio quality has improved.

- Mortgage lending to lower-income households remains weak. Progress has been disproportionately hindered by Qualified Mortgage regulation.

(G) Mortgage Foreclosures:

What changes has the Council seen in the pace of mortgage foreclosures during the past three months?

- Completed foreclosures were flat in Q1 2014 compared to Q4 2013. Foreclosure activity is expected to remain slow over the coming quarters.
- Due to improving delinquency rates and housing prices, short sales declined in Q1 2014 compared to Q4 2013. In dollars, short sale activity declined approximately 15.5% quarter-over-quarter.
- Generally, we anticipate continued improvement.

Item 2: Student Loans and Consumer Borrowing

Some observers have argued that student loan obligations are restraining mortgage demand by younger, first-time homebuyers. What is the Council’s view of student loan burdens and their lifetime effect on homebuying and on borrowing and consumption in general? What steps can be taken to mitigate any adverse effects from student loan burden in the future?

- Federal loans account for approximately 90% of the more than \$1 trillion in outstanding student loans and approximately 95% of new originations.
 - In 2012, total borrowing by bachelor’s degree recipients who graduated with student debt from four-year, public, nonprofit institutions was 22% higher than in 2002.
 - From 2003 to 2008, the difference in the average risk score for 30-year-olds with and without student loans was approximately 3 points. By 2012, the difference increased to 24 points, implying a two times higher default risk for those holding student debt relative to those without.
 - In 2012, for the first time in at least 10 years, 30-year-olds with no history of student loans were more likely to have home-secured debt than those with a history of student loans.
- The overall shift towards more conservative mortgage underwriting criteria can limit a consumer’s ability to borrow, especially when high levels of student debt are combined with other consumer debt such as car payments. For example, the Qualified Mortgage rule requires a debt-to-income ratio of less than 43%. The addition of \$100 per month of student loan payments would render a mortgage “unqualified” for a borrower who earns \$55,000 a year, has \$360 per month of car loan payments, and is seeking a \$300,000 30-year mortgage with an interest rate of 4.5%.
- Student loans are the only form of direct consumer lending conducted by the federal government and an area where loans are funded to more than just lower-income families. The 90+ day delinquency rate for federal student loans is multiples higher than the delinquency rate for private student loans. The prospect of default is particularly

pronounced for borrowers that do not complete their course of study or take on a disproportionate amount of debt when compared to their future earnings potential.

- Broad availability of federal loans with very limited underwriting and no ability to pay considerations can make students and parents less price-sensitive, which in turn has enabled colleges to raise tuition faster than inflation and income growth. Partially as a result of the dramatic increase in federal loan availability, total tuition, room, and board rates for full-time undergraduate students at degree-granting institutions increased by 32% from the 2005-06 to 2011-12 academic year.
- Federal programs that cap monthly payments and offer loan forgiveness treat the symptoms of student debt but do little to address the root cause of increasing debt levels. Furthermore, capping monthly payments and offering loan forgiveness could make borrowers and schools even less disciplined about controlling costs. In a recent analysis, Brookings estimated that the income-based repayment program known as the Pay as You Earn Plan (PAYE) could cost as much as \$14 billion, assuming nearly universal participation.
- Student loans are an integral component for accessing higher education and ultimately improving a student's future quality of life. In order to protect students from over borrowing and limit taxpayer loss exposure, the administration and all stakeholders need to conduct a comprehensive study that takes into consideration various elements, including (i) financial literacy and consistent transparency around both federal and private student loans, (ii) limiting the amount of debt that can be borrowed, and (iii) incorporating the ability to repay while extending loans. Specifically, the study should consider:
 - Whether disclosures, such as interest rates on loans, effective APR, and monthly payments, can help borrowers understand the lifetime implications of borrowing. Currently, disclosure requirements for federal student loans are less robust than for other types of consumer debt, including private student loans.
 - Whether ability-to-repay considerations and varying loan limits based on earnings potential could avoid overborrowing.
 - The possibility of performance-based loan availability to schools. For example, schools with higher graduation rates would have greater loan availability than those with high dropout rates.
 - Whether subsidized federal loan availability for high-income families should be phased out since private loans are available.
 - Whether there should be increased transparency around the total expected economic cost of federal loans.
- Policymakers should consider additional reforms including other forms of financial aid when debt is not appropriate.

Item 3: GSE Reform

At its September 2013 meeting with the Board, the Council was nearly unanimous in preferring the Corker-Warner Bill to reform the GSEs. Has the Council's assessment of this legislation changed in light of the Johnson-Crapo Bill? In the Council's view, what are the advantages and disadvantages of each legislative approach, and what is the likelihood of GSE reform in the near future?

- Senate Banking Committee Chairman Tim Johnson (D-SD) and the Ranking Republican Michael Crapo (R-ID) unveiled their housing reform legislation on March 16, 2014. Their bipartisan GSE reform bill builds on the bipartisan legislation (S. 1217) released in 2013 by their colleagues Senators Bob Corker (R-TN) and Mark Warner (D-VA).
- The Johnson-Crapo proposal adds significant detail to the Corker-Warner bill, and the Council continues to support it as the superior legislative approach to gradually reducing direct federal participation in housing finance. While the Council has a usual preference for private market solutions, the existence of a federal emergency backstop seems to be necessary to ensure continued viability of the 30-year fixed-rate mortgage product. Johnson-Crapo provides for both private-market and government support of housing finance. However, there remain significant questions about some key issues, some of which will threaten the viability of getting a bill passed in this session of Congress.
- The new bill maintains an explicit federal guarantee on a limited class of mortgages targeted to low- and moderate-income borrowers, provides for access to the mortgage finance system by lenders of all sizes and all geographies, and provides for a substantial private-sector role in the mortgage financing system.
- The bill also calls for a wind-down of Fannie Mae and Freddie Mac over an appropriate period and for replacing the GSEs with a new federal agency, the Federal Mortgage Insurance Corporation (FMIC), tasked with the role of protecting the guarantee fund that is to be established. The FMIC would set and oversee standards for all secondary mortgage market participants, including mortgage originators, aggregators, mortgage insurers, and guarantors.
- The bill puts private capital in the first-loss position, covering at least the first 10% of losses, and uses federal guarantees as a backstop against catastrophic losses only. This measure would allow for the continued viability of the 30-year mortgage product. The FMIC would also, in coordination with the Fed and Treasury, have the capacity to expand support of the secondary market when private capital may dry up in times of economic stress.
- The bill provides for the elimination of explicit affordable housing goals while maintaining focus on ensuring the availability of appropriate housing for all by establishing accountable housing-related funds, funded by a user fee imposed by FMIC onto those using the system.
- It creates a member-owned common securitization platform that will issue a single, standardized FMIC-wrapped security, but also permits private label securities to be issued under the FMIC's securitization standards and underwriting requirements. This feature will encourage improved market liquidity.
- It establishes a mutual cooperative jointly owned by smaller lenders to ensure that institutions of all sizes have direct access to the secondary markets when Fannie and Freddie are dissolved. The small-lender mutual cooperative would importantly provide a cash window for individual eligible loans, and small lenders could retain servicing rights.
- There is also a goal of maintaining broad liquidity in the To-Be-Announced (TBA) market, and the bill directs the FMIC to take into account the impact of new products on the TBA market.
- The Council generally supports the principles behind these elements of the proposal. However, there are elements of the bill that are of some concern across the industry.
 - The regulatory authority of the FMIC and potential overlap with existing regulators is of considerable concern. Although the bill contains some steps to reduce regulatory

- conflict and redundancy, the Council believes it is important to be even more explicit about the roles of current regulators and the new FMIC. The FMIC should have authority over the specific risks presented by the functions of guarantors, aggregators, and servicers, but in levels appropriate to the risks. For example, the guarantor function presents more risk than the aggregator function. Likewise, origination risks are already within the purview of the CFPB and prudential regulators. Avoiding duplicate authority, retaining the primacy of the prudential regulators for safety and soundness issues, and coordinating the roles of all the players is critical.
- Vertical integration (allowing a single participant to be a primary market originator, a secondary market guarantor, an aggregator, a servicer, and an insurer) could theoretically allow one or more of the largest market participants to dominate the market at the expense of smaller participants. Although some in the industry have suggested prohibiting a single party from acting as both a guarantor and loan originator, there may be other ways to protect all market participants, regardless of size. Another proposal is to clarify that the small-member mutual cooperative is authorized to use either or both the guarantor channel and direct capital markets channel.
 - There are concerns over the mechanisms proposed to help ensure adequate sourcing of affordable housing. Some critics fear the current proposals may be too indirect in approach compared to the earlier affordable housing goals mandated for the GSEs. There is concern of some that the 10-basis-point Market Access Fund fee proposed to fund those initiatives may need to be lowered and/or collected upfront at inception, rather than spread out over the life of the loans, in order to keep the impact on mortgage prices reasonable.
 - Finally, there is concern over the proposal to impose a new fiduciary duty on corporate trustees as part of their relationship with servicers and investors. The imposition of this duty would fundamentally restructure the role of such trustees in securitized transactions and could detract significantly from the affordability of obtaining a mortgage.

What is the likelihood of GSE reform in the near future?

- The 2013 Corker-Warner measure was supported by eight other Committee Republicans and Democrats, and it is expected that the Johnson-Crapo bill will receive similar support from these eight members. Chairman Johnson and Senator Crapo had announced their intention to hold a Committee markup on April 29; however, in order to gain additional support, the markup was delayed. A vote may occur later this month.
- Overall, the Council believes that the Johnson-Crapo bill is a solid vehicle upon which to build GSE reform. However, given the remaining uncertainties with the bill and the challenges in reaching a compromise between both major parties on issues such as regulatory authorities and affordable housing impact, as well as debate over the viability of the proposed new market mechanisms, it is not clear that a GSE reform bill will pass both the Senate and the House during the current congressional session. Nevertheless, we are heartened by this bipartisan effort, and it bodes well for potential reform being enacted within the next session. The Council encourages the Board of Governors to continue to speak out in support of such GSE and housing finance reform.

Item 4: Short-Term Funding

What are the risks associated with short-term funding? To what extent do the largest banks need to use short-term funds? What are the costs of shifting to a portfolio with more maturity?

- Prudent and effective management of liquidity risk is a fundamental responsibility of financial company executives and directors and merits the close attention of bank supervisors. Banks take care that undue risk does not result from their traditional role in maturity transformation by using a balanced range of funding maturities appropriate to their asset composition and maintaining buffers and contingency plans to ensure access to ample funding in emergencies. The importance of a prudent balance of assets and liabilities has been demonstrated over many years, including notable recent examples of Northern Rock, Bear Stearns, and Lehman Brothers.
- Close management and supervisory scrutiny is warranted as liquidity issues can have a rapid, devastating effect on individual firms and possibly threaten systemic stability. The regulatory regime must remain responsive to the development of new financial instruments and the increasing role of firms not supported by traditional deposit funding. Because liquidity emergencies represent such a threat, and deterioration can be so rapid in a crisis, perhaps some redundancy in regulation is justified, but the cumulative cost of multiple responses to this concern (Liquidity Coverage Ratio, Net Stable Funding Ratio, leverage ratio, supplemental capital charges) must be borne in mind. The ability to attract and provide a return on capital remains important, lest the system become “too safe to be sound.”

A. Benefits to Customers and Banks

- Bank customers and financial systems benefit from the availability of funding and investment alternatives across the maturity spectrum. Short-term funding allows broker-dealers to finance their securities inventory and supplies a lubricant to support the deep and liquid securities market. Short-term deposits may also be part of a broad customer relationship that helps customers manage cash flow, including cash management, clearing, and custody. Depositors seeking shorter maturities include corporates, state and local governments, and central banks.
- Financial institutions also benefit from a funding structure that balances a range of maturities. Shorter-term deposits facilitate the daily management of balance sheet volatility. Short-term deposits invested in highly liquid securities or deposited with central banks represent no liquidity risk.
- With the substantial decline in interbank lending following the crisis and the new liquidity regulations, short-term deposits are used more frequently, along with Federal Home Loan Bank advances.

B. Costs

- With a normal, upward-sloping yield curve, funding costs increase with maturities. Moreover, as extraordinary monetary accommodation is withdrawn, liquidity is likely to

be more valuable. In an improving economy, Council members expect corporates to reduce their unusually large cash positions and increase their utilization of committed facilities.

- Material lengthening of deposit maturities will increase funding costs and increase the cost of credit. As banks face considerable net interest margin pressure, regulatory changes that increase funding costs and require lower-yielding asset holdings must be carefully considered.

C. Liquidity Regulation

- Following the crisis, the Federal Reserve and other prudential supervisors in the U.S. and abroad have enhanced significantly regulations governing liquidity management. Tools such as the Liquidity Coverage Ratio and the Net Stable Funding Ratio provide for short-term buffers against liquidity shocks and encourage more stable funding for less-liquid assets.
- Strengthened liquidity positions of individual firms contribute to systemic stability as each firm is less likely to suffer a liquidity run and all are better protected from contagion, even if a market participant's acceptance of fire-sale prices temporarily depresses broader valuations.

D. Balance

- It is challenging to strike an appropriate regulatory approach to a practice that is not inherently bad but whose misuse can have catastrophic results. The Council supports measures requiring strong asset/liability management, noting that the most important concerns are mismatches rather than particular funding sources.
- Although firms with stronger capital positions are less vulnerable to liquidity emergencies, supervisors are wise to use more targeted regulation to guide firms towards an acceptable balance of funding and not rely on the blunter instrument of increased capital requirements. Stress tests and the CCAR process offer a linkage between all of a firm's risk attributes and capital requirements.
- The Council recommends that supervisors:
 - Consider carefully the cumulative impact of existing and recently enhanced regulations governing liquidity and capital.
 - Recognize the greater stability of term repos under the Liquidity Coverage Ratio and Net Stable Funding Ratio.
 - Net out funds deposited with central banks and match customer short-term loans and deposits when assessing short-term deposit dependence.

Item 5: Bitcoin

Does Bitcoin pose a threat to the banking system, economic activity, or financial stability?

- Concerns about Bitcoin can be summarized as follows:
 1. **Banking:** disintermediation of traditional payment networks, promoting shadow transacting.
 2. **Economic activity:** disruption of traditional channels of commerce with high potential for illicit use.
 3. **Financial stability:** potential as a contagion of instability through volatility or lapse in network integrity.
- Systemically, Bitcoin's nascency makes it more curiosity than threat. Its greatest near-term hazards are its avoidance of consumer protection measures and illicit use, both of which support increased regulation. Medium- to long-term effects could be more pronounced as the network self-refines and adoption increases, requiring traditional payment processors to adapt and respond.

1. The Banking System

- Bitcoin does not present a near-term threat to the banking system by way of disintermediation.
 - While it does have peer-to-peer utility, the network effect has prevented adoption from accelerating to the point where Bitcoin supplants traditional payment methods.
 - Bitcoin transactions correspond to only a fraction of today's global fund flows.
- Various security concerns will continue to hinder adoption.
 - Lack of deposit insurance and other "wallet" protection magnifies exposure, as shown through the Mt. Gox theft and subsequent bankruptcy.
 - Unpredictability in Bitcoin's value undermines its reliability as a regular medium of exchange.
- Bitcoin's longer-term impact could be more pronounced and require adaptation by payment processors.
 - Lower transaction fees, particularly for small transactions, are especially attractive to merchants.
 - While existing payment networks have a footprint advantage, it is largely confined to the developed world. Bitcoin enables cheap international remittance to the developing world and the developed world's "unbanked," expanding financial inclusion.
 - Consumers are likely to use Bitcoin if they perceive its benefits – namely faster settlement and geographic flexibility – to exceed those of its alternatives.
- Should adoption accelerate, banking could participate increasingly in Bitcoin fund flows, especially as multicurrency accounts proliferate and reputational concerns subside.
- One area of focus should be Bitcoin's circumvention of currency controls, evidenced by China's high share of transactions and the use of Bitcoin to transmit funds out of Cyprus post-bailout.

2. Economic Activity

- Bitcoin does not present a threat to economic activity by disrupting traditional channels of commerce; rather, it could serve as a boon.
 - Its global transmissibility opens new markets to merchants and service providers.
 - Driving capital flows from the developed to the developing world should increase consumption.
- Illicit applications are rampant but not endemic to Bitcoin; sovereign-issued currencies and other precious goods are similarly used.
 - Sizing estimates for the world's black markets reach into the trillions of dollars. At this stage, the total value of Bitcoin is approximately \$6 billion, a sum that is dwarfed by other forms of payment, whether illicit or not.
 - Furthermore, Bitcoin's anonymity is overstated: it is better characterized as pseudonymous, with all transactions logged in a central and transparent block chain. Law enforcement has recently shown that it can trace the flow of specific Bitcoins, connecting user identification numbers to physical users.

3. Financial Stability

- Bitcoin's impact on financial stability is two-pronged: its intrinsic stability and its impact on systemic stability. In intrinsic stability, Bitcoin has room to improve.
 - Extreme price volatility is similar to other speculative forms of stored value, undermining Bitcoin's credibility. This volatility is likely to diminish over time.
 - Susceptibility to theft increases uncertainty for users seeking alternatives to traditional institution-based deposits.
 - While Bitcoin's protocol (its network infrastructure) has not been compromised, disruption to it could render the cryptocurrency worthless.
- Bitcoin does not yet have the scale to act as a systemic contagion of instability.
 - Recent volatility shows that swings in value have not resulted in consequences beyond those felt by Bitcoin holders.
 - In an economy hypothetically dominated by Bitcoin, its finite number (21 million) would prevent the application of traditional monetary policy tools to provide support in a downturn or reduce growth during excessive expansion.

Should this medium of exchange be prohibited or regulated, and if so, what considerations should be taken into account for its prohibition or regulation?

- Regulation is advisable; considerations include protecting consumers, addressing illicit use, and avoiding Balkanization. Bitcoin advocates may argue that increased regulation minimizes one of its greatest advantages, namely decentralization. Recent events suggest that some flexibility should be sacrificed to address obvious problems.

1. Protecting Consumers

- Bitcoin's most obvious consumer flaw is its susceptibility to theft, which can be addressed in several ways:
 - Supervised risk management of Bitcoin exchanges, including requirements for business continuity planning.

- Regulatory oversight to ensure that exchanges invest in appropriate cyber and other security measures. This includes fully secure storage of Bitcoin wallets.
- Additional consumer protections would be fraud prevention, a forum for transaction disputes, and disclosure of Bitcoin's risks and costs.

2. Addressing Illicit Use

- Illicit use, either as payment for unlawful goods and services or to fund illegal activity, remains a problem.
- The same measures employed to minimize illicit applications of traditional currencies could be appropriately extended to Bitcoin.
 - Anti-money-laundering procedures, including modified Know Your Customer policies, would ensure that organizations trafficking in Bitcoin are not facilitating criminal use.
 - Transaction and suspicious activity reports would enable ongoing monitoring and pattern recognition.
- As with any regulation, transparency will be key.

3. Avoiding Balkanization

- Consistency across geographic areas is necessary to preempt regulatory arbitrage, as is consistency with regulations governing existing payment networks.
- Recent guidance from regulators indicates growing awareness of the need for oversight:
 - The Internal Revenue Service has characterized Bitcoin as property rather than currency for tax purposes, effectively making each transaction a taxable event and increasing recordkeeping requirements.
 - The Financial Crimes Enforcement Network (FinCEN) guidance obligates certain Bitcoin participants to register as money service businesses, subjecting them to greater reporting and recordkeeping requirements.
- Additional efforts to address consumer protection and general network safety will hopefully follow.

Item 6: Economic Discussion

Do Council members see economic developments in their regions that may not be apparent from the reported data or that may be early indications of trends that may not yet have become apparent in aggregated data?

Economic Activity

- For the first quarter of 2014, Council members reported that economic growth did not materialize as expected, largely due to weather-related disruptions.
- Confidence is improving, although business development continues to be hindered by persistent, but gradually diminishing, uncertainties around the economic outlook, regulatory burdens, healthcare, taxes, and interest rates.
- Global economic risk is shifting away from the U.S. but growing in other parts of the world – notably in China, Japan, and some emerging market countries including Russia, Ukraine, and parts of Eastern Europe.

- However, there are a number of positive signs in the economy as the pace of economic activity has accelerated, in part due to the labor market gaining momentum with unemployment declining across the U.S., “catch up” from the weather-related disruptions, and improving consumer and business confidence. The resolution of the budget impasse, although short term, should also provide benefit. As an example, the Eleventh District has continued to report strong economic and population growth within Texas, placing some infrastructure pressure on the future outlook.

Employment/Wages

- Council members reported up through April 2014 that the labor market recovery is real and gaining momentum. Solid increases in construction, manufacturing, wholesaling, healthcare, education, and technical service jobs show a true sign of confidence by the business community. Local governments also increased their hiring, which is a positive sign for many communities across the country. The unemployment rate of 6.3% is the lowest rate since October 2008.
- Weakness remains due to sluggish real-wage growth, higher employer-provided healthcare premiums, and the unemployed base whose skills and income potential may be permanently affected. It was noted that businesses still do not feel they need to increase wages even with growing complaints about finding qualified workers.

Business Sector Growth

- Council members generally reported strengthening in the manufacturing and energy industries, and construction within these related industry segments. Auto, commercial aircraft, wood fabrication, metal producers, and food processors all are increasing production. Rising port activity on all coastlines indicates a pickup in international trade. The manufacturing climate from a raw materials standpoint shows positive signs across many additional industries.
- All sectors of industrial production continue to see healthy growth, with overall production 3.8% greater than year-ago levels, despite the harsh winter disruption. Positive signs of dissipating government sequestration impact may add to demand for goods and services.
- Political instability mentioned above is a threat to business growth as it adds to uncertainty. Outside of this, there remain positive signs that continue to support a cautiously optimistic outlook, which could translate into further increased investment and job growth.
- Council members reported that credit availability is high. Fierce competition for quality customers and projects is occurring, with reported easing of lending standards on business loans to small, medium, and large businesses across all Federal Reserve Districts.

Real Estate

- The multifamily housing sector remains strong with a growing concern among lenders and credit managers in the First and Third Districts that development may be getting overheated. The concern is that rental rates cannot continue to rise at current levels, and at some point buyers will have better value than renters.
- Although there are differences by region, there remains broad consensus that rising home prices and a slight increase in interest rates would mean a drop in housing affordability.

Housing activity did miss analyst expectations, and a slowdown in the majority of markets nationwide continues with minimal signs of any upturn in home construction.

- Some larger metropolitan areas in the U.S. are reporting very tight housing supply and rapid price appreciation, which could threaten the ability of these areas to attract workers from the outside.
- There continues to be demand for commercial real estate (CRE) Projects, which vary by region, include grocery-anchored centers, single-credit-tenant properties, taxing-zone office projects, and some multifamily housing. Council members commented that vacancy rates are moving down across the board.
- Loan pipelines are increasing and credit availability for quality CRE projects remains high and extremely competitive.

Consumer Spending

- Consumer finances and balance sheets have improved substantially since the recession. Despite the harsh winter and slow first quarter, consumers are regaining their confidence in the economy and are possibly more willing and able to take on debt in 2014. The Federal Reserve's debt-servicing ratio for consumers is down to its lowest level in a decade and positions consumers to make purchases they have been delaying for several years.
- The wealth effects from rising home and stock prices should further support stronger consumer spending growth. Members report that overall spending in auto, durable goods, and housing is occurring and expected to continue through 2014 in all Districts.
- Credit availability for the consumer segment remains high.

Item 7: Monetary Policy

How would the Council assess the current stance of monetary policy?

- The current state of the economy and financial markets has neutralized some of the Fed's traditional policy tools. In the current situation, "forward guidance" has gained prominence as a policy tool. The anticipated persistence of today's near-zero federal funds rate well into 2015 represents the Fed's commitment to improved growth (along the lines of the stipulated policy objectives). A potential drawback of this policy is that the near-certainty of a long time frame before seeing interest rate increases might cause firms to postpone taking advantage of current conditions, shifting business activities that could occur now – and help the economy now – into the future.
- The current policy stance of phased (but not guaranteed) tapering, subject to multiple economic performance measures and goals, appears to be prudent.
- Many on the Council believe that the Fed's bias towards an extended near-zero federal funds rate should be weighed carefully as the economy continues to improve, especially since most on the Council believe that economic growth will accelerate significantly in the second half of 2014.

12:00 Luncheon for Council and Board Members in the Board Room