Record of Meeting

Community Depository Institutions Advisory Council
and the Board of Governors
April 13, 2023

1. **Economic Discussion:**

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

Council members reported a mixed outlook on economic conditions. Inflation continues to trend downward after peaking last June, but the economy still faces a number of headwinds. Higher input costs have forced businesses to either pass the costs on to their consumers or absorb the costs and weaken business margins. Lower-income workers are impacted disproportionately as a group when costs are passed on. Similarly, wage growth has slowed, which is a good sign for inflation; however, it further limits the budgets of low-income consumers who are already spending a high share of their income on shelter and food.

The prices of most commodities are beginning to stabilize, save for those most reliant on labor. Following the pandemic there was a permanent reduction in the labor force, and sourcing qualified labor has remained a challenge for many businesses. At the same time, supply chains continue to recover from pandemic-induced disruptions, alleviating the availability of inputs and putting downward pressure on price growth.

The housing market remains strong; however, it is significantly challenged by a lack of available homes for sale. The housing shortage and increased demand, coupled with elevated mortgage rates, has raised housing costs and pushed many potential homebuyers out of the market. Rental prices have increased dramatically as well, although an influx of multifamily development may help alleviate price pressures on rental costs. Credit usage and delinquencies are both on the rise, suggesting weakness in the immediate consumer outlook.

   b. ***Particular Indicators:***

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

      Council members reported that inflation is showing meaningful signs of slowing, as the headline Consumer Price Index increased by 5 percent for the 12 months ending in March according to the Bureau of Labor Statistics, down from 6 percent for the 12 months ending in February. It appears prices are starting to plateau in some markets, with some Districts providing dining out, food, and building materials as examples. However, in areas where in-migration is fueling construction, such as the Southeast, the costs for building materials have continued to rise. Council members noted that supply chain improvements may be contributing to the stabilization in prices.

Labor costs remain elevated, and wage growth continues to put upward pressure on prices. Most Council members noted transportation costs continue to rise due to labor shortages, and these costs are being passed on to intermediate and final goods. Those cost increases are more significant for products, such as cement, that are highly dependent on transportation costs. The agricultural sector remains significantly impacted by inflation as the sector contends with rising fertilizer and labor costs.

Council members observed that people of modest means are being hit hardest by inflation, particularly by the cost of shelter. Entry-level buyers are being priced out of the housing market only to face elevated rental prices. In addition, auto prices—especially for new vehicles—generally remain elevated, though some pricing pressure might be alleviated as higher financing rates dampen demand and as auto dealers' inventories are restored.

Council members noted that as consumers have acclimated and adapted to the higher inflation rate environment, businesses have become more comfortable passing on the higher costs of inputs—although the businesses have yet to see a material impact in sales. Council members are hopeful that progress made in lowering inflation rates will allow businesses and consumers to better plan for the future, as relative prices become more predictable.

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

The housing market continues to be fairly strong, with the biggest challenge being the broad-based shortage in inventory. The lack of supply continues to be the largest driver of increased housing costs, although price appreciation has begun to decelerate. While both housing and financing costs remain historically elevated and demand remains strong, mortgage rates are off their peaks and home price growth has slowed. Council members reported that building activity is strong in regions that offer local incentives and subsidies for affordable housing, but they added that demand continues to outpace supply. Meanwhile, due to regulations and increased costs, builders are facing challenges as they try to make the economics work for building housing for moderate- to middle-income and first-time homebuyers.

Competition remains high for homebuyers. The lack of available homes for sale has priced out many prospective first-time buyers from the market, who are choosing to rent instead. Council members reported that rental prices have gone up significantly due to low housing inventory, particularly in the Sixth District, which saw a large influx in population in the Southeast region during the pandemic that is raising demand and pushing prices higher. In addition, growing numbers of seniors are choosing to avoid the hassles associated with homeownership and are looking into urban retirement, further contributing to rental demand in urban areas.

Strong multifamily building activity over the past year has helped mitigate the housing availability issue. While most Districts reported high occupancy rates for multifamily units, some Council members reported that multifamily units were not leasing as quickly as they had in the past and that rent prices and occupancy rates have been stabilizing or coming down.

Many homeowners are also choosing to stay in their current homes and invest in home improvements, reflecting an unwillingness to (1) give up lower-rate mortgages and (2) face the difficulty of finding a new home in a tight market. Therefore, fewer existing homes come on the market, further exacerbating the housing inventory shortage. Rising housing costs have contributed to a migration from urban to rural areas, where homes are more affordable. The Twelfth District reported that states with lower demand, such as Nevada, have seen housing prices decline. By comparison, housing prices in other states such as California and Utah continue to rise (albeit at a slower pace). While price growth has slowed, Council members expect housing or rental costs to remain high.

iii. <u>Labor Markets</u>*: How have the labor markets in which Council members operate changed in recent months? In particular, please assess the degree of job loss or gain (and, in which industries). Please comment on the changes to wages that Council members have observed over the past year.*

Council members agreed that trends in the labor market are similar to those in the housing market. The cost of labor has begun to stabilize, but supply remains a persistent issue. Firms are beginning to adapt by retaining workers when possible and investing more in technology to compensate for a reduced workforce.

The hospitality and restaurant sectors are especially struggling to recover their labor force, as many workers left during the pandemic. Council members believe that there has been a permanent shift in labor participation due to factors such as early retirees, parents leaving the workforce because of the lack of available childcare, and reduced levels of immigration. Businesses that require skilled workers are unable to source sufficient amounts of qualified labor, and reduced funding for local workforce boards has reduced the training needed to better prepare entry-level workers for jobs in today’s marketplace. The lagged effects of what appears to be a permanent shift in the labor force participation rates, along with inadequate funding to train entry-level workers, appears to be a secular dilemma not easily resolved.

At the same time, labor turnover rates have begun to improve. The number of quits is trending down since staffing turnover peaked during the pandemic. Improved retention rates likely reflect both an improvement in employer retention efforts and a new employee calculus regarding potential benefits from changing jobs. The First District reported that the technology industry, particularly in Boston, is facing a significant number of layoffs compared to the broader economy.

Alongside shifts in labor force demographics, Council members noted that there may also be a larger recalibration of what work means to people and what their expectations are for their jobs. Young workers have been significantly impacted in their career outlook and expectations, and remote work has become much more commonplace. However, the changes have not been limited to the younger generation. The Council observed that there are far fewer employees in the office past 5:00 p.m., but the level of email traffic after 8:00 p.m. is significantly higher than pre-pandemic levels.

Despite the chronic challenges to attract qualified labor, Council members are aware that periods of economic volatilely and uncertainty will spawn strategic and tactical adjustments among their business customers—which will require reductions in staffing. While most of the media focus has been on staff reductions at large technology companies, more traditional companies will not be immune from similar considerations.

iv. <u>*Consumer Confidence*</u>*: Are Council members seeing any signs of improved (or declining) consumer confidence? What is the outlook for consumer credit losses?*

Council members reported that consumers are continuing to spend but noted there is a difference between consumer actions and consumer confidence. There continues to be significant differences between lower- and higher-income individuals, as those deeply impacted by the pandemic and with lesser means continue to struggle under the weight of inflation. Several Council members noted that the gap has widened, as inflation eats up more of low- and moderate-income household's disposable income for necessities.

Council members primarily reported neutral movement in consumer confidence, with a few Districts reporting a decline in consumer confidence. Until the past few months, consumer credit quality has been generally strong with little to no change in delinquencies. However, delinquencies are now starting to rise, and credit balances are up for individuals with low FICO scores.

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

underwriting, and lending standards in general.

While experiences varied by District and by degree, Council members largely agreed that credit continues to be widely available, but that it is beginning to tighten. Council members cited two broad causes of why financial institutions are facing tightening: (1) balance sheet constraints such as investment portfolio compositions, loan-to-deposit ratio levels, or deposit outflows, and (2) the adoption of a more cautious approach due to market perceptions and the economic outlook. Loan demand was more mixed, with Council members noting that demand varied by geography and across lending categories.

Council members also discussed the Federal Reserve's Bank Term Funding Program (BTFP). Many community banks are currently weighing the benefits and risks of participating in the BTFP. The economics of participation make sense from a purely financial point of view, but there are significant concerns about the stigma associated with the program and how participation will be perceived by both Wall Street and Main Street. Council members would welcome more clarity from the Federal Reserve on how participation will be disclosed—particularly in cases where banks engage in small test lending for regulatory exam purposes.

a. ***Small Business Lending:*** *Has credit availability for, and demand for credit from, small businesses changed significantly? Have lending standards for these borrowers changed? Do Council members see evidence that prevailing economic uncertainty is slowing economic activity in this sector?*

   Council members reported that small business loan demand has remained fairly stable, though there were some differences across Districts. For instance, in the Tenth District, small business loan demand is slightly elevated because business liquidity is down. In the First District, Council members observed a lower demand for loans at the smaller end of the market, and many businesses who stockpiled inventory in 2022 have less of a need for financing. In the Twelfth District, there was less consensus on the trajectory of demand—with some saying it fell and others saying it rose.

   Community depository institutions (CDIs) still have a strong appetite for C&I loans, and in some Districts CDIs are pulling back in other areas to create more capacity for small business loans. However, rising rates, the increased cost of funds, liquidity challenges, high loan-to-deposit ratios, and other factors are limiting potential levels of activity. Council members observed that it is becoming more challenging for institutions to find other banks that are willing to do loan participations. In the First District, there was a dichotomy noted between smaller rural markets and growing urban centers. Rural markets are not tightening as much, while institutions in growing markets are reserving lending to await more favorable terms. By comparison, Council members from the Fourth and Ninth Districts reported that small business credit availability remained robust.

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 Council's last meeting in November 2022? How are commercial real estate loans performing compared to the Council's expectations?*

Council members agreed there is a heightened focus on risks associated with office building loans. However, levels of concern vary significantly by region. For example, there is a big difference between urban areas as compared to suburban and rural regions. High population centers, including Los Angeles, San Francisco, and Washington, D.C., are experiencing high office vacancy rates.

By comparison, office space occupancy rates remain strong in suburban areas and outside of university towns. Prices have remained stable, and these loans continue to perform well. Conditions are a little more varied in rural areas; however, depositories' level of CRE exposure in rural markets is considerably lower than urban and suburban markets.

While Council members report that CRE loans in their Districts are still currently performing well, CDIs are looking ahead to when these loans will reprice at upwards of 400 bps above their current rates. CDIs are aware of the repricing risk and are testing their portfolios and proactively engaging with their customers.

Council members generally agreed that multifamily loans continue to perform well. The lack of single-family housing inventory has pushed up demand for apartment complexes and other multifamily housing. Council members noted a significant buildup in multifamily loans over the past year. Repricing risk is less of a concern in this space as developers were able to boost margins across nearly all Districts thanks to widespread rent hikes. Rent prices are not expected to fall (due to low single-family housing inventory), so as loans reprice, Council members predict margins will settle back to more historical norms. The Eighth District was an exception, where there is more concern of an oversupply issue.

Finally, Council members all agreed that warehousing remains white hot and continues to be a standout CRE category.

c. ***Construction Lending:*** *What are Council members' perspectives on the availability of credit for construction and development projects? Have Council members seen any changes in the demand for construction loans since the Council's November 2022 meeting?*

CDIs continue to meet construction loan demand, which has remained stable. However, institutions are starting to be more cautious. Council members noted that cost overruns, where contractors frequently come back to lenders seeking more money to complete projects, have become a prevalent issue. In addition to cost overruns, Council members noted that there is still uncertainty about projects being completed in the originally agreed-upon time frame. Whereas delays were previously caused by supply chain constraints, now the delays are occurring primarily because of labor shortages. There was some variation across the Districts, however. For instance in the Sixth District, homebuilders have shortened the time to complete a house from two years down to just six months.

d. ***Home Mortgage Lending:*** *What changes have Council members seen in the mortgage market? How, if at all, is regulation impacting the participation of community depository institutions in this market?*

While mortgage lending has long been one of the traditional products offered by CDIs, Council members noted that institutions are increasingly debating whether the economics of remaining in the mortgage space make sense. In the Seventh and Twelfth Districts, some institutions have exited the mortgage business altogether. Council members cited costs stemming from HMDA reporting, TRID (TILA-RESPA integrated disclosures), compliance software, and unlevel competition from lesser-regulated nonbank players as pressures that will lead to credit tightening for home mortgage loans at CDIs.

Council members cited a recent study from the Mortgage Bankers Association that found that independent mortgage banks and mortgage subsidiaries of chartered banks lost an average of $301 on each loan they originated in 2022, down from an average profit of $2,339 per loan in 2021. Most Council members agreed that the role of CDIs will continue to shrink in terms of market share due to the activity and practices of nonbanks in the space.

There were some exceptions. In the Sixth District, demand for adjustable-rate mortgages has grown. The Tenth District reported that larger operations with more scale have been able to better handle the cost environment. Community institutions are active in the mortgage space in the Ninth District. The Council member from the Ninth District noted that regulatory pressures in the mortgage market have not constrained market presence.

e. ***Consumer Lending:*** *What changes have Council members seen in consumer lending? Please comment specifically on credit card and auto lending.*

Council members reported an increase in credit card balances and an uptick in delinquencies for consumers with lower credit scores—primarily to meet the rising costs of essential goods such as groceries. However, credit quality has remained relatively strong, particularly in the prime borrower cohort.

Observations were more mixed for auto lending. In the Sixth and Ninth Districts, auto lending activity has remained strong, yet in the First, Fourth, Sixth, and Seventh Districts, lenders are increasingly pulling back from the auto space—particularly indirect auto lending—as delinquency rates start to rise. However, Council members noted that delinquency rates are still very low compared to pre-pandemic levels.

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

Council members reported that agricultural credit quality has been extremely strong over the last three years, but that credit line usage of agricultural borrowers has declined. There has been concern about land prices for agricultural borrowers, as the market price of land has risen much higher than its value in production, especially for smaller operations, which is a barrier to entry for new farmers. Loan demand has been soft due to reduced profitability expectations for 2023, as commodity prices start to decrease from their all-time highs in 2022. Due to rising input costs, many farmers are growing only what they need to meet targets instead of "overgrowing," which could have an impact on grocery store prices. Council members in the Tenth District reported that because of rising input costs, the current crop is the most expensive ever planted. Council members believe that the current export market should continue to support commodity prices. Meanwhile, the Farm Credit System has currently fallen out as a loan competitor because its cost of funds is no longer cheap compared to that of banks.

g. ***Deposits****: What changes have Council members seen in local deposit markets? Describe these changes by segment (retail, small business, and corporate). What are Council members' expectations with respect to deposit levels?*

Council members reported that due to a rising interest rate environment and a greater-than-anticipated outflow of deposits, they saw reduced profitability in the fourth quarter of 2022 and first quarter of 2023. However, Council members also noted that there has been no significant outflow of deposits toward larger banks following the failure of Silicon Valley Bank (SVB), with most Districts seeing either flat or even slight growth in their deposits. Following the failure of SVB, the cost of deposits did jump, as deposit competition has slowly increased over the past six months. Council members noted that general depositors, not just those that are more sharply financially attuned, have begun to invest in high-rate financial instruments, which may pose a longer-term problem for banks as they must compete with higher rates from non-depository financial institutions such as money market mutual funds. Similarly, in the high interest rate environment, securities from the U.S. Treasury have become more attractive, presenting another competitor for bank deposits. Modern technology has changed how quickly and easily depositors can move funds, which will pose a challenge for some community banks. Deposit competition has ramped up, but Council members have not observed any mass outflows of deposits.

h. ***Mergers and Acquisitions Activity****: What trends are Council members observing with respect to mergers and acquisitions among depository institutions and their holding companies?*

While recent failures in the banking sector have increased discussions on mergers and acquisitions, M&A activity has not yet shown signs of increasing. Large unrealized losses on banks' holdings of low-interest securities accumulated during the pandemic, including components of Accumulated Other Comprehensive Income (AOCI), are discouraging banks from seeking acquisition targets. The Fourth District noted that it would be particularly difficult for publicly traded banks to justify acquisitions or mergers with banks with large unrealized losses, as the banks must still meet shareholder expectations. Increased economic uncertainty and expectations of a recession further dampen incentives for acquisition. The disincentives for merger and acquisition activity are not underlying weaknesses at banks—rather they are primarily the result of bank balance sheets being marked-to-market as a result of M&A.

3. **Adjustments to Increasing Costs:** *Like many businesses, community depository institutions are facing increasing costs related to labor, and in many cases, increases in funding costs as deposit rates have risen. How are community depository institutions managing rising costs, while preparing for potentially worse economic and business conditions? To what extent are sources of fee income under pressure from competitors and regulators, and what are the potential consequences for community depository institutions? Will these dynamics impact the viability of some community depository institutions' business models? Do Council members expect more community depository institutions to consider mergers and acquisitions activity (either as an acquirer or as the target of an acquisition)?*

Managing Rising Costs

Council members noted that depository institutions are considering staff reduction and outsourcing, and are aiming for greater staff efficiency in response to increased labor market costs. Beyond staffing changes, Council members reported that depository institutions are closing facilities and moving staff to a hybrid work setup to economize and downsize. Exploring shared services is a familiar idea. Council members see renewed interest in shared services, particularly with the increased overhead expected from meeting regulatory requirements and the ongoing challenges with core service providers.

Rising costs of funding are driving up lending rates. Council members see some banks focusing on existing customers and pulling back from other areas of investment to focus on small business lending where demand has remained strong. Members are also increasingly turning to deposit generation strategies, such as amending loan covenants to include compensating deposit balances.

Council members are also concerned about the cost of the implementation of FedNow. Council members are wary of high core provider pricing, strict contracts, and an increased risk level. CDIs are limited in their ability to pass these costs on to the consumer. Council members expect that prohibitive core costs will slow the adoption by CDIs, though competitive pressures will tend to force them to implement FedNow and absorb the higher costs.

Cost of Regulation

Navigating economic instability is not new for Council members—interest rate changes, inflation, and market changes are issues CDIs have faced before, and they remain confident in their ability to handle these challenges. Council members expressed deep concern about the level of regulatory costs CDIs face, and the impact of these costs on their business models and cost structures. Council members are focused on the impact of Section 1071 (small business loans reporting) and CRA modernization adding to the regulatory costs.

Council members reported designing their business lines to fit regulatory requirements, rather than the needs of their customers. In all areas of the business, the cost of regulation is impacting offerings. Strategic decisions are driven with a view to stay below certain regulatory thresholds—for example, HMDA reporting thresholds—which ends up hurting some of the more vulnerable communities.

In the context of 1071 reporting, Council members are concerned about the regulatory reporting requirements causing them to adopt standardized small business loan structures, which, in turn, will move them away from the highly customized services they are able to provide to their communities today.

Future of Community Depository Institutions

Council members agreed that there would be more M&A activity as a byproduct of ongoing stresses in the banking industry as well as costs related to Section 1071 and CRA modernization implementations. Though members' business models have changed before due to regulation (TRID and HMDA), Council members expect 1071 to have an outsized impact on the industry. Some Council members reported that community institutions are considering acquisitions in order to scale up and accommodate increased costs.

Many of the services provided by CDIs, such as online banking and ATMs, do not generate any income. Limitations on fees will squeeze already-shrinking margins and prevent banks from continuing to offer or grow such services. Many community institutions serve overdraft customers, but fee limitations will send these consumers to other, possibly unregulated, lenders. The ongoing focus on so-called "junk fees" ignores the economic risks banks face in providing specific products and services to their customers. CRA modernization will likely cut into innovation.

4. **Examination Practices***: What has been the experience of Council members in the most recent examinations? Have you seen examination practices impact the flow of credit? How can supervisors improve their communications (both formal and informal) with supervised institutions?*

   Overall, Council members reported much-appreciated positive examination experiences and examination staff relationships. Regulator staffing turnover, which creates more work for the examined institutions, continues to be a challenge in some Districts. Others have found that the hybrid examination model has resulted in less examination staff turnover, which has meant more experienced examiners with a better understanding of the institution, which, in turn, results in more satisfactory examination experiences. Council members also emphasized that sufficient face-to-face meetings remain essential.

Council members reported intensive preparation and document demands that were not always focused on the institution's primary risks. Some again noted that examiners' emphasis on technical violations leaves an impression of a "gotcha" mentality. In addition, the cost of compliance ultimately translates into higher credit costs and less access. For example, institutions expect that the Section 1071 requirements will create higher costs for borrowers and cause some lenders to exit the market. They observed that examiners often overlook the fact that implementing new regulations is a long, complex process that involves reviewing and understanding the regulation, making decisions on how to implement the regulation, operational changes, audits, staff and customer education, changes in manuals, multiple rounds of testing, etc.

Council members also raised concerns about the uncertainty of supervisory expectations around the meaning of "reasonably expected market area" under CRA and how institutions market and serve people with limited English proficiency. In addition, examiner challenges to service fees seem to lack appreciation of the fact that institutions must be compensated for the risks and costs of offering services if they are to be made available. Eliminating valued and wanted services will cause consumer harm.

Finally, Council members expressed concerns about the focus of the next examination in light of the recent bank failures and the anticipated economic slowdown, including examiner focus on increased stress testing and concentration risk.

5. **Regulatory and Payments Matters:** *How are recent changes in the regulatory and payments landscape affecting the ability of community depository institutions to innovate as well as continue providing services to their customers?*

General Regulatory Landscape
Council members expressed concerns with recent regulatory efforts to restrict overdraft and interchange fees. Consumers and other customers desire these services, but providing them is not free of cost. In many cases, CDIs do not earn a profit providing such services—they simply seek to recover their costs in meeting customer demand. If community institutions are prohibited from receiving reasonable compensation for these services, they will exit the businesses, and customers will be forced to use (potentially predatory) nonbank financial institutions (NBFIs).

Small business data collection required by Section 1071 of the 2008 Dodd-Frank Act will raise the costs of community institutions' small business lending. Though fair lending is a cornerstone of community institutions' financial services, reducing complex business underwriting decisions to statistical analyses and a "black box" approach will seriously damage relationship lending and related services to small business customers, eroding a key business line in which many CDIs enjoy a competitive advantage. An overly aggressive enforcement approach using data collected under Section 1071 will further incent institutions to exit or curtail the business line, to the detriment of customers and communities.

These current regulatory initiatives accelerate shifts in business to NBFIs that compete with CDIs, using unfair regulatory advantages. Notably in the residential mortgage business, but in other lines a, these shifts result in the sources of financial products and services being determined by regulatory arbitrage, rather than by the best providers offering the best pricing and service.

Payments

Regulatory threats to fees on payment products, such as caps on credit and debit card interchange and on overdraft services, have the potential of curbing innovation and even the provision of standard banking services. Revenues derived from payment services offset the costs of providing customers services such as “free checking.” If revenues are driven down by regulatory action, the net result is less funding available to provide existing or new services.

The concern regarding the implementation of FedNow is multipronged. First, there is general concern about the core service providers’ ability to make the service available in a timely manner. Second, the cost of the service delivered by the core service providers is discouraging and may lead to banks delaying or canceling plans to implement FedNow because the business case is no longer compelling. Finally, there is concern about the potential fraud associated with FedNow and the losses that banks and, in turn, their customers would absorb.

Many banks will weigh the risks and costs and decide to implement FedNow regardless to compete with other banks and to retain customers. These banks will absorb increased costs and risks with the hope that instant payments will be a benefit and not a burden.

6. **Additional Matters:** *Do Council members wish to present any other matters affecting community depository institutions that have emerged from meetings of the Reserve Banks’ advisory councils? [none raised]*