

RECORD OF MEETING
Federal Advisory Council and Board of Governors
Friday, September 7, 2018

Item 1: Current Market Conditions

What is the Council's view of the current condition of, and the outlook for, loan markets and financial markets generally? Has the Council observed any notable developments since its last meeting for loans in such categories as (a) small and medium-size enterprises, (b) commercial real estate, (c) construction, (d) corporations, (e) agriculture, (f) consumers, and (g) homes? 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?

General Outlook

- Overall, loan and financial markets remain healthy. Consumer and business optimism continue to run high, while consumers and investors remain more conservative than in pre-crisis years in their appetite for leverage. Aggregate commercial and industrial (C&I) demand was especially strong in the second quarter, growing at a seasonally adjusted 7.7%, compared to an average annual growth rate of 1.65% over the prior four quarters. Council members reported continued strong C&I trends, while some noted slowing growth in commercial real estate (CRE) lending and declining capitalization (cap) rates on customers' CRE projects.
- Risks include the potential for decreasing home-price affordability to meaningfully reduce demand for new homes and mortgage loans, the negative impact to sentiment and manufacturing input costs associated with trade disputes, and the potential for a multiyear downturn in farm incomes to be exacerbated by trade disputes.
- There are increasing concerns around a range of issues, including: uncertainty in the outlook for both manufacturing input prices and export demand, driven by tariffs and trade policy; labor shortages in many skilled trades; the potential implications of rising rates on mortgage loan demand; and the potential implications of yield curve inversion for banking, financial markets, and the medium-term outlook for overall economic production.
- Sentiment around new investment, which ran high earlier in the year based on the new tax cut, seems now to be somewhat more subdued based on trade concerns and related cost increases for inputs. We would describe bankers' business outlook as generally positive, though tempered a bit compared to Q2-18.

(a) Small and medium-size enterprises

- Loan growth is mixed among banks lending to small and medium-size businesses, with some Council members reporting strong loan growth and pipelines of loans to small businesses, while others report disappointing demand for small business loans relative to the strength of performance and sentiment among small businesses.
- Loan structures and pricing are coming under pressure in some areas due to the supply of credit to small businesses outstripping demand for small business loans.
- The appetite for lending remains muted, with only 3% of small businesses reporting that all of their borrowing needs were not satisfied.
- Increasing competitive intensity was reported around lending to medium-size and especially smaller customers. One Council member indicated that pricing and structures on loans to smaller business customers have deteriorated "faster and further on a relative basis" than on loans to large commercial banking customers and show no evidence of stabilization.

- Small business performance and optimism are running high, though that optimism has recently been reined in a bit by concerns around trade tensions. One Council member reported that the bank's small business loan pipeline had recently contracted slightly, as some small business customers are limiting expansion until trade impacts are fully understood.
- Credit quality remains high, and noncurrent loan levels are low.

(b) Commercial Real Estate

- Growth generally remains strong but has begun slowing of late, according to some Council members.
- The most common complaint is that cap rates are reaching very low levels and customers are having trouble hitting their financial targets on new CRE projects. As a result, CRE loan customers are in some cases asking for concessions on loan terms, such as the amount of equity required in a deal. One Council member stated that they have seen cap rates drop “close to pre-Global Financial Crisis levels.”
- CRE asset prices have rebounded from declines earlier this year, according to Green Street Advisors, which reported a very slight (less than 1%) year-over-year increase in commercial property prices in July.
- CRE credit quality remains high, and noncurrent loan levels are low.

(c) Construction

- Growth in construction lending has been mixed, varying by region and property type.
- Overall growth continues to be strong; however, the most common theme among Council members dealt with the challenges to construction going forward.
- Increasing construction costs driven by tariffs (lumber costs hit an all-time high, steel is also a pain point) and a tight labor market are driving up construction costs, while permitting processes and labor shortages have extended project lead times.
- Credit quality for construction lending remains high, and noncurrent loan levels are low.

(d) Corporations

- The market generally continues to demonstrate consistency in structure, pricing, and terms.
 - Lending to corporations remains steady. After slowing throughout 2017, year-over-year aggregate C&I loan growth has accelerated from 1.0% in January to 5.4% in June and 6.0% in July, according to data from the St. Louis Federal Reserve Bank.
 - Reports from individual Council members around C&I lending and lending to large corporations varied significantly, with numerous banks reporting lackluster growth and demand for new loans. On average, larger banks appeared to be experiencing better loan growth in this area.
- Competitive intensity continues to increase, and there are some signs of an oversupply of credit relative to demand.
- Bank “disintermediation” in corporate lending was a theme, with one Council member describing significant capital from “non-regulated lenders driving aggressive structures” and another mentioning the continued “disintermediation of the bank market into bonds.”
- C&I credit quality remains high, with delinquency rates below their decade average.

(e) Agriculture

- Concerning trends include the continuation of a multiyear downturn in farm incomes, the negative impact on demand from tariff disputes, deteriorating cash flows for farmers, and an increasingly difficult operating environment for small farmers.
- After three years of breakeven margins, the dairy industry is experiencing stress from the recent trade disputes

- Land and equipment costs continue to increase, while commodities prices continue to decrease or remain stagnant. As a result, small farmers are being pushed out of the market.
- Agriculture was the only area in which increases in noncurrent loans were reported, though the resulting level (slightly above 1%) was still low. In aggregate, the delinquency rate for real estate loans secured by farmland was 2.0% in Q1-18 versus a five-year average of 1.8%, while the delinquency rate for other agricultural loans was the highest in more than five years, at 1.6% in Q1-18 (Federal Reserve Board).

(f) Consumers

- The overall economy remains healthy, with strong consumer confidence and a continued decline in unemployment.
- Competition for consumer deposits from nonbank competitors has increased. Also, large banking organizations are offering new consumer banking products.
- A tight labor market has provided strong job growth and moderately accelerating wages.
- Loan delinquency rates remain historically low overall, but have been rising for auto loans (Federal Reserve Bank of New York).

(g) Homes

- Mortgage loan volumes, especially refinance loan volumes, continue to slow as interest rates rise.
- Lack of available inventory in the entry-level home market continues to have a negative impact on overall volumes.
- There is concern that the combination of rising costs for construction materials and rising interest rates could result in a more pronounced slowdown in home sales in the second half of the year.
- Banks eased residential mortgage underwriting standards for the 17th consecutive quarter early in Q3-18, but banks reported that standards remain at the tighter end of the range since 2005 (Federal Reserve Senior Loan Officer Survey).

Item 2: Regulatory Reform

As bank regulators continue their efforts to streamline and tailor bank regulation, what specific actions beyond those already taken do Council members think regulators should take to reduce regulatory burden without impairing the safety and soundness of individual financial institutions or the resiliency of the banking system? Among other matters, does the Council have particular principles or suggestions on how regulation could be tailored for banking organizations with total assets above \$100 billion that are not G-SIBs?

With passage of S. 2155 in May 2018, Congress initiated meaningful and necessary regulatory relief for community banks and affirmed that asset size alone is an insufficient proxy for measuring systemic risk and for the subsequent application of enhanced prudential standards. The Council recognizes that the Federal Reserve Board (FRB) adopted the principle of tailoring as part of its post-crisis supervisory framework by incorporating heightened capital requirements for G-SIBs, in recognition of the risk they pose to systemic stability. The Council supports the FRB's recent decision to eliminate the qualitative component of the Comprehensive Capital Analysis and Review (CCAR) for large, noncomplex firms and believes that further tailoring of regulation should (1) align with and have clearly articulated objectives directly related to safety, soundness, and systemic risk and (2) be calibrated and directly connected to an institution's overall risk profile.

Specific actions to reduce regulatory burden without impairing the safety and soundness of individual financial institutions or the resiliency of the banking system.

Capital Management

Since the financial crisis, capital planning practices at financial institutions have strengthened significantly. While these practices have led to a more resilient banking system, there is opportunity to reduce the regulatory burden associated with regulatory capital management without impairing safety and soundness.

The stress capital buffer (SCB) is a positive step towards regulatory relief. The proposal as written, however, does not provide enough flexibility and contains assumptions that could have unintended consequences. To that end, the SCB proposal should be modified to provide banks with the ability to distribute additional capital if they are above the SCB framework minimums and are outperforming their approved capital plan.

Additional tailoring suggestions for capital planning and stress testing include eliminating the following requirements:

- The CCAR qualitative review. Regulators should continue to leverage supervisory examinations of capital management, with the examination scope tailored to an institution's systemic importance.
- The mid-cycle stress test requirement. Regulators should allow banks to run stress tests as their boards and senior management determine is necessary.
- The adverse scenario requirements for supervisory and company-run stress tests.
- The CFO attestation requirement for the FR Y-14A/Q/M submissions.

Further, the Council would urge the Federal Reserve to consider the cumulative impact and potential unintended consequences of the SCB proposal, the countercyclical capital buffer proposal, and the pending implementation of the Current Expected Credit Losses (CECL) accounting standard.

Liquidity

The Council recommends that liquidity requirements be tailored based on the G-SIB assessment methodology. Large, non-systemically important banks should face simplified liquidity requirements due to their lower risk levels. These simplified requirements include:

- A reassessment of the Liquidity Coverage Ratio (LCR) rule for efficacy, the frequency of required disclosures, and the potential tailoring of assumptions to individual institutions.
- Eliminating the Net Stable Funding Ratio and FR 2052a liquidity reporting requirements, including any associated public disclosures.
- Continuing to leverage supervisory examinations of liquidity management, with the examination scope tailored to an institution's systemic importance.
- Ensuring that the liquidity oversight responsibilities of boards of directors and board committees are appropriate for the role of directors versus senior managers.

For institutions that remain subject to the LCR and enhanced prudential standards requirements, the Council recommends the following modifications:

- FNMA (Fannie Mae) and FHLMC (Freddie Mac) securities should be classified as level 1 high-quality liquid assets. These securities have exhibited price stability and deep markets, even in times of stress.
- Reconsideration of the runoff factors used for many deposit categories, including secured deposits.

Recovery and Resolution Planning

Similar to its recommendations for liquidity requirements, the Council believes large, non-systemically important banks should be relieved of recovery and resolution planning requirements. The size, interconnectedness, and lack of complexity of these banks simplify their resolvability in times of stress. Specifically, the Council recommends eliminating the requirement that these bank holding companies prepare annual IDI (insured depository institution), section 165(d) resolution and bank recovery plans.

For systemically important institutions that continue to be subject to recovery and resolution planning, the Council recommends moving from an annual preparation cycle to one that is no less than biennial, barring a significant change in an institution's business model.

Current Expected Credit Losses (CECL)

CECL is a fundamental change to the accounting for balance sheet assets and will likely result in changes to banks' (i) reported financial results and capital levels; (ii) product offerings, especially for longer-lived assets; and (iii) willingness and ability to extend new credit in times of economic stress. These changes could occur despite no change in the riskiness or cash flows of a bank's assets.

To minimize the pro-cyclical risks of CECL and its negative effects on consumers, businesses, financial institutions, and the overall economy, the Council recommends that the financial regulatory agencies explore and evaluate implementation methods that neutralize the effects of CECL on regulatory capital levels and ratios, including Common Equity Tier 1 capital.

Board of Directors Responsibilities

Boards of directors for U.S. banking organizations are critical to the companies' successful and sound operation. As noted in the June 2017 U.S. Treasury report,¹ "The duties imposed on Boards are too voluminous, lack appropriate tailoring, and undermine the important distinction between the role of management and that of Boards of Directors. A significant shift in the nature and structure of Board involvement in regulatory matters could be made with little or no increase in risks posed to the financial system." To that end, the Council recommends regulators ensure that supervisory guidance on governance and controls does not result in unnecessary, inefficient processes or constrain a board's business judgment in performing its oversight responsibilities.

Volcker Rule

The Council appreciates the FRB's leadership on the interagency notice of proposed rulemaking (NPR) to identify opportunities, consistent with the statute, to improve the Volcker rule and tailor its application to the activities and risks of banking entities.

The Council believes the NPR is a step in the right direction; however, the goals to simplify and tailor are far outweighed by the impact of the proposed "accounting prong" test. Additionally, the proposal does not go far enough in meaningfully tailoring application of the Volcker rule to banking entities that have only "moderate trading assets and liabilities." Lastly, the proposal introduces new requirements that threaten the ability of institutions to engage in effective risk management of their balance sheet activities.

¹ U.S. Treasury, "A Financial System That Creates Economic Opportunities: Banks and Credit Unions," Executive Order 13772 on Core Principles for Regulating the United States Financial System, June 2017

Anti-Money-Laundering/Bank Secrecy Act (AML/BSA)

A core concern with today's AML/BSA regime is that banks are no longer able to take a risk-based approach to complying with the law and its attendant regulation. The Council suggests the following:

- Regulators should (1) consider how technology has improved banks' ability to comply with the BSA and (2) allow banks to explore new techniques that might not be currently recognized by regulators as satisfactory methods for BSA compliance.
- Regulators should also work with the Department of the Treasury to consider improvements to the compliance regimes for other anti-money-laundering statutes that may be outside the bank regulatory agencies' direct legal mandate but on which regulators may have expertise to advise Treasury and related agencies.
- Regulators should consider changes to the thresholds for filing a Currency Transaction Report (CTR) to better align CTRs to current risks.

Deposit Recordkeeping Requirements

The Federal Deposit Insurance Corporation (FDIC) has imposed new recordkeeping requirements for 38 of the nation's largest banks, those that have 2 million or more deposit accounts, in order to facilitate a timely payout to depositors in the unlikely event that a bank fails. Implementation of this recordkeeping rule is a substantial undertaking for banks, requiring significant industry expenditures for an event that is a remote possibility for any individual firm.

The Council recommends that a new, robust cost-benefit analysis be performed to ensure that the proposed benefits of the rule are appropriately specified and adequately calculated before the rule becomes effective. An inclusive analysis would consider or quantify the potential impact on depositors, depositors' agents and custodians, and other financial intermediaries that place deposit funds in covered banks, as well as the potential impact on deposit and funding markets generally.

Regulatory Reporting

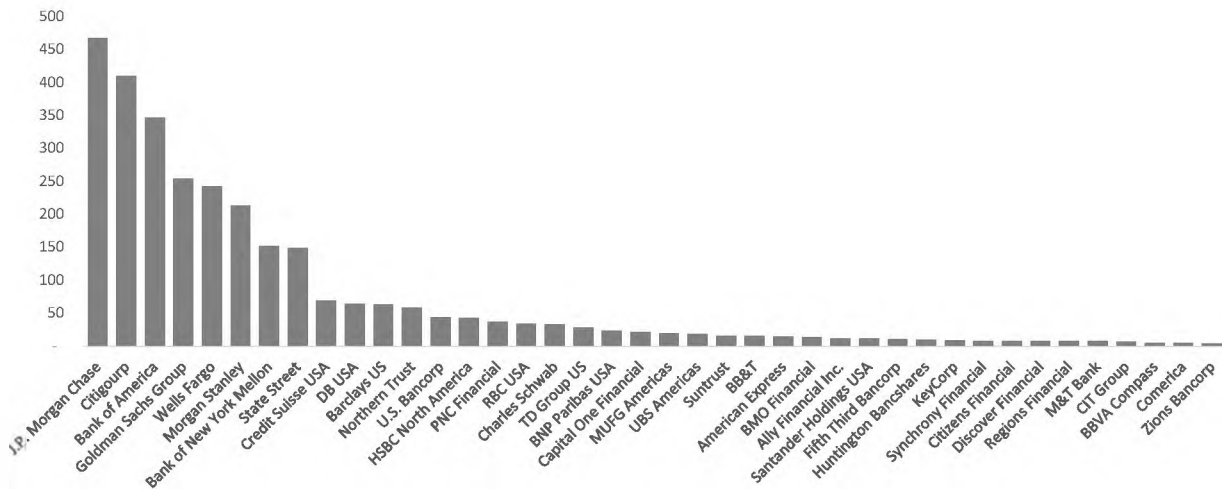
The Council believes there is opportunity to streamline regulatory reporting requirements. For example, certain reporting requirements (e.g., Basel Pillar III disclosures) are redundant with other publicly available filings, including filings with the Securities and Exchange Commission.

Regulatory Tailoring Principles for Non-GSIB Banking Organizations with Total Assets > \$100 Billion

Consistent with the tailoring principles outlined herein, the Council believes the regulation of large, non-G-SIBs should be guided by their overall risk profile, not merely their asset size. A suitable, multifaceted framework for appropriately tailoring regulation commensurate with bank risk already exists: the G-SIB assessment methodology. This methodology relies on 12 indicators within five categories, including size, interconnectedness, substitutability, cross-jurisdictional activity, and complexity, and is an objective, fact-based framework for identifying inherent risk within banking institutions and for comparing risk across institutions. G-SIB scores for large U.S. banks are shown in the table below.²

² Office of Financial Research, data as of 12/31/2016.

Large Bank G-SIB Scores (2016)



Item 3: Stress Testing of Large Banks

Given the recent completion of the 2018 stress tests, what are the Council’s views on the best ways to improve the Federal Reserve’s stress testing process, including, in particular, by enhancing transparency? In what ways have recent changes in the stress tests altered banks’ capital allocation and distribution outcomes?

Background

The stress tests have been invaluable in restoring confidence in the banking system after the financial crisis, and the Council supports the continued use of stress testing as part of macroprudential risk management. Stress testing has gone from a regulatory-focused exercise to an important business planning and risk management exercise that, even outside of regulatory requirements CCAR banks will continue to do in order to effectively manage their balance sheets and risk profiles. The banking industry is supportive of the various FRB efforts to improve the stress testing process, especially as it relates to enhancing transparency.

The FRB has multiple efforts underway to address this issue, including the following proposals: (i) Enhanced Disclosure of the Models Used in the Federal Reserve's Supervisory Stress Test, (ii) Policy Statement on the Scenario Design Framework for Stress Testing, (iii) Stress Testing Policy Statement, and (iv) the Stress Capital Buffer (SCB), which would integrate stress testing results with regulatory capital requirements. While focusing on different issues and processes, each of these initiatives would increase the transparency of the stress testing process and include the following proposed enhancements:

- release more information about the models used by the FRB to estimate hypothetical losses in stress tests;
- provide additional detail on principles/policies that guide the FRB's development of its stress testing models;
- modify the framework for the design of stress test economic scenarios, including providing more information on the hypothetical path of house prices in these hypothetical scenarios; and
- revise certain stress test assumption used in CCAR (e.g., flat balance sheet, curtailment of buybacks in stress).

The Council applauds those efforts and fully supports the underlying goal of enhanced transparency of the stress testing process. The Council also endorses the FRB's increased use of the notice and comment process to more directly solicit third-party input into the design and implementation of enterprise stress tests. That said, additional efforts are needed to address the opaqueness of the current system and the practical impact of the proposals. For example, the industry has provided comment on the SCB proposal described above, noting that the 2018 CCAR results highlighted transparency concerns with the existing process and the increased volatility of capital requirements that would result if the SCB were implemented as proposed.

Best Ways to Improve the Federal Reserve's Stress Testing Process

More specific discussion of additional opportunities to enhance transparency is provided below:

1. More information on the constructs of the FRB models (e.g., variables, segmentation, drivers) is needed to enable more proactive capital management .

The overall **opaqueness of the constructs used in the FRB models** means that the industry does not know which variables (e.g., GDP, unemployment) are driving results. More importantly, companies do not know what characteristics of their individual portfolios (e.g., loan-to-value, FICO) are driving FRB model results. As a result, the industry's ability to pro-actively manage its capital requirements through portfolio de-risking may be somewhat limited.

2. Enhanced disclosure of FRB model output, by quarter, with more breakdowns of profit and loss (p&l) components, would facilitate greater understanding of how each bank's portfolios contribute to capital requirements.

The existing **limited disclosures of FRB model output** mean that the banking industry will not fully know which portfolios contributed to the pattern of stress losses (i.e., the "low point" capital ratio). Currently, the FRB only discloses aggregate stress results, over the nine-quarter CCAR planning horizon, for a limited set of high-level p&l items. Disclosure of the quarterly breakout of the stress results would enhance the banking industry's understanding of the results and would facilitate pro-active management of capital requirements. Encompassed within this point are long-standing industry requests for enhanced disclosure of FRB model results, including:

- Separately disclosing operational risk losses from pre-provision net revenue (PPNR)
- Splitting credit card losses between U.S. and international cards; splitting retail and all wholesale losses by region
- Disclosing loan loss reserve build/release by loan type
- Splitting PPNR (excluding operational risk losses) into net interest income, operating revenue, and operating expenses, with geographic cuts
- Disclosing assumptions about tax rates (particularly critical for firms that have significant foreign sources of income)

3. Finally, stronger and more transparent governance around the supervisory scenario-design process could help to allay systemic concerns arising from the potential volatility of and uncertainty about capital requirements.

The Council believes that transparency concerns relating to the stress testing regime can be mitigated by the increased use of the public comment process in the development of scenarios and by enhancements to the governance process overseeing the development and use of supervisory stress scenarios. Increased use of notice and comment would enable all stakeholders to better understand – and provide feedback on – the scenario design process, the overall coherence and plausibility of stress scenarios, and the possible

range of expected impact the stress scenarios could have on bank capital ratios. This additional transparency, especially as it relates to the expected impact of the proposed scenarios on bank capital ratios, would also facilitate more effective capital planning on the part of bank management and boards. To assist banks in more effective capital planning, the Council would also encourage an earlier release of scenarios.

The FRB should also consider enhancements to the governance process overseeing the development and use of supervisory stress scenarios. The increased use of stress test results, particularly in light of the proposed SCB, provides an additional basis for reviewing the governance process. The Council believes this process can be enhanced through consideration of the following:

- For each CCAR cycle, what is the review and approval process for the supervisory scenarios?
- Is the review and challenge process for the supervisory scenarios of comparable rigor to that used for model governance?
- What is the quality assurance process for addressing anomalies in individual institutions' results? Should the FRB be willing to make idiosyncratic adjustments to address these anomalies?
- As part of the governance process, is anyone assessing the impact of these increasingly severe scenarios on a BHC's ability to lend, as well as the knock-on impacts on the overall economy?
- As part of the governance process, is anyone assessing the potential volatility in banks' capital requirements arising from volatility in the severity of the supervisory scenarios?

How Recent Changes in the Stress Tests Have Altered Banks' Capital Allocation and Distribution Outcomes

The Council notes that the effects of recent stress test changes have been the subject of various recent studies and acknowledges that additional analysis on the possible impact of stress testing on lending activities, especially in certain asset classes, is warranted. Broadly speaking, recent changes in the stress tests may allow greater flexibility in capital management.

Item 4: Oversight of Cloud Technology

Banks are moving from their own servers to cloud service providers for data center information and document management. How are banks addressing issues of data privacy and information security in this environment? What controls are they putting in place? In what ways should regulators oversee cloud-based storage providers and the services they provide to banks?

Banks across the industry are evaluating opportunities to leverage cloud service providers to manage various data sets and technology-driven business processes. Cloud programs provide flexible operating platforms that allow for rapid delivery of products and services to customers. The agility and scalability of these platforms have the potential to improve customer service while lowering costs; however, the cloud also presents new challenges in risk management and data privacy that must be addressed by the industry and considered by regulatory agencies.

How are banks addressing issues of data privacy and information security in this environment?

Banks are approaching data privacy and information security issues associated with the cloud similarly to how they have addressed the risks of any new technology in the past. It is important to note that the use of cloud computing services does not necessarily introduce entirely new risks to the delivery of technology services; however, the cloud does introduce unique challenges to a financial institution's control environment. As such, banks are addressing data privacy and information security by leveraging and enhancing existing data governance and control frameworks.

To determine what activities can and should move to the cloud, many banks first identify low-risk processes suitable for the cloud, test their institution's capabilities for managing risk associated with these processes, and then develop a standardized governance model before implementing cloud use more widely. This standardized governance process should be established in relation to a firm's architectural, operational, and security standards. Risk assessments should be performed to assess the suitability of procedures for placement on the cloud. Risk assessments should also consider the threat landscape, innovation opportunities, and the multitude of interconnected systems and platforms in order to safely adopt cloud services in a measured way that achieves business value and cost savings without introducing unnecessary or unmanageable risk.

Institutions should also ensure that their due-diligence processes for selecting vendors have been updated to reflect cloud-based environments and risks. In addition, visibility into a cloud service provider's controls should all be taken into scope when selecting a provider.

What controls are banks putting in place?

As with all processes, especially those involving third parties, financial institutions must implement a comprehensive risk and control framework – including preventive, detective, and reactive controls – and requirements based on the nature of the service. In simplest terms, IT organizations need to know what data moves into the cloud and who is responsible for, and should be allowed to interact with, that data. These logical access controls and other activities for data rights management are already in place in financial institutions, and these controls must simply be extended to cloud providers and monitored via service agreements and operational reviews.

The use of credential-based identity verification (user name/password, temporary tokens, etc.) and access controls, together with frequent and regular oversight by operating management and review by internal risk and audit teams, helps to maintain these manual and technical protections. Encryption technologies to make data at rest and in motion unintelligible and therefore useless to any process, platform, or user without de-encryption is common practice, as is securing and storing data offline and immutably. Firms also use data loss prevention (DLP) technology to monitor traffic and identify data moving in and out of an organization. DLP and other technologies allow firms to build technical controls to identify adherence to their data protection and use policies. Similarly, firms can use data file delivery, pre-designed application program interfaces (API's) and the like as both vehicles and as a means of controlling when using a cloud provider.

In what ways should regulators oversee cloud-based storage providers and the services they provide to banks?

While the Council agrees that, there is a role for the regulatory agencies to play in coordinating with and monitoring the use of cloud-based storage providers, there are two schools of thought on the most appropriate form of oversight. One argument is that (1) the third-party risk management practices and control frameworks within financial institutions are sufficient to control risks associated with cloud technology and (2) regulators should continue to focus their attention on reviewing these practices at financial institutions within existing supervisory activities. The major cloud service providers have also demonstrated a thorough understanding of the regulatory expectations regarding data management at financial institutions and are developing robust compliance programs to facilitate providing secure and auditable services to the industry.

Another view suggests that cloud service providers should meet the requirements to be considered for the Multi-Regional Data Processing Servicers (MDPS) Program coordinated by the Federal Financial Institutions Examination Council (FFIEC) and should be overseen in a similar manner to the payment-processing servicers currently operating under this program. As a general rule, the FFIEC considers Technology Service Providers (TSP) “for the MDPS Program when the TSP processes mission-critical applications for a large number of financial institutions...or from a number of data centers located in different geographical regions.”³ Although financial institutions are slowly evaluating the process for including cloud service providers in the MDPS program, the geographic diversity of these the MDPS centers would support the consideration of including cloud providers in the program.

Additionally, while the Council agrees that financial institutions are ultimately responsible for the protection of client data, there are risks that individual banks are not as well positioned to monitor, such as concentration risk. It is of the upmost importance that the information stored on and transmitted between financial institutions and cloud service providers is secure. To the extent that cloud service providers begin to overly concentrate the data that financial institutions store at these sites, regulatory agencies are in the best position to identify, measure, and control this risk. Ultimately, use of the cloud in the financial industry is expected to continue increasing and to play a vital role in future innovation. As the use of these services increases, regulatory agencies are encouraged to monitor concentrations and ensure that oversight of individual banks and the cloud providers is commensurate to the risks and opportunities posed by use of this technology.

Item 5: Small Dollar Lending

In the Council’s view, what factors are most important to the success and profitability of products designed to meet consumer demand for small dollar loans? What has discouraged banks of various sizes from offering products to meet this demand?

There continues to be a very high need for small dollar lending. A recent Federal Reserve survey reported that 40% of consumers have not saved enough to meet a \$400 emergency cash need. Yet, in a Bankrate survey that reported a similar conclusion, only 5% of consumers facing an emergency used a personal loan from a bank as the funding solution.

Overall, the Council supports satisfying consumer needs for small dollar loans but acknowledges the many challenges of implementing these programs. The key to a successful, sustainable, and profitable small dollar lending program is having a simple, risk-based, highly automated customer experience, along with a low unit-cost structure made possible by technology and a more flexible regulatory framework.

Even with these structural changes, it is expected that small dollar lending would be only marginally profitable to banks. But small dollar loans remain a necessary product if banks are to carry out their mission to meet consumer credit needs. We The Council also believes that banks, under the oversight of their regulators, would provide and service small dollar loans in a more consistently, at a lower cost, and in a more scrupulous manner than consumers currently find available..

Factors Discouraging Banks from Offering Products to Meet Demand:

- *An Over-prescriptive, adverse, and uncertain regulatory environment.* While the Office of the Comptroller of the Currency has relaxed some of its requirements, there should be more coordination between the regulatory agencies. The FDIC’s 2013 guidance mandates that a lender document, verify, and project a borrower’s income, major financial obligations, housing costs, and basic living

³ FFIEC IT Examination Handbook: <https://ithandbook.ffiec.gov/it-booklets/supervision-of-technology-service-providers/supervisory-programs/mdps-program.aspx>.

expenses. The Consumer Financial Protection Bureau has also issued rules on small dollar lending that regulate deposit advances, loan terms, and loan structures. State usury laws may also limit state-chartered banks' ability to offer higher-APR products.

- *Profitability.* The cost of originating and servicing small dollar lending programs, coupled with the risk of credit and fraud loss, can be prohibitive for banks. Some of these costs and risks can be minimized by leveraging technology.
- *Competition from nontraditional lenders.* Competition from nontraditional lenders, captive finance companies, credit unions, and other sources that have lower regulatory burdens and a lower possibility of risking their existing brands creates additional hurdles for banks' success with small lending products.
- *Reputational risk.* Several Council members cited reputational risk as a discouraging factor in offering small dollar loan products. Banks have historically avoided high-APR/high-charge-off products out of concern that consumers and regulators would label the loans as predatory, which could have a negative impact on the bank's brand.

Factors for Success and Profitability of Small Dollar Loans:

- *Technology.* The number of loans necessary to achieve a profitable volume in the small loan sector is much higher than in other sectors. Success at such a scale requires substantial investments in the automation of decision-making, origination, and servicing -- all of which is possible through recent innovations in financial technology.
- *Decisionmaking.* Banks are uniquely positioned to make better decisions about small dollar loans because of their ability to leverage existing customer data (e.g., transaction history and income verification via regular deposits). To encourage banking participation in small dollar lending, regulatory guidance for decisionmaking needs to be more flexible, allowing banks to develop and update their own metrics and standards.
- *Regulations.* Simpler, streamlined, coordinated, and consistently enforced regulations are the most pressing need to encourage banks to do more small dollar lending. Council members made a number of suggestions for conceptual and tactical changes, which could be best addressed in a forum of bank representatives and regulators.

Council members stress again that even with the most efficient end-to-end operations and clearer, streamlined regulations, small dollar lending would be a marginal offering in terms of profitability; however, this product enables banks to meet a demand in the community that is not well served now and may also be an entry point to a full, lifetime traditional banking relationship for the non-banked and under-banked. Regulators should support banks' efforts to make this product offering acceptable, simple, efficient, and profitable.

Item 6: Trade Policy

Have recent changes in trade policy altered Council members' views, or the views of their business customers, on the economic outlook? How are these changes influencing the business of banking? Are there particular geographic areas or industries in Council members' Districts that are being impacted by recent trade disputes?

Have recent changes in trade policy altered Council members' views, or the views of their business customers, on the economic outlook?

- In the short term, Council members believe the United States can absorb trade escalation, which is a small component of GDP. Long term, however, the Council believes that escalating trade tensions that result in the imposition of meaningful trade tariffs will create a drag on global GDP.

- The Council expects modest but manageable impact to commercial credit quality in 2019, given the continued escalation of trade concerns.
- Business customers remain optimistic about the broader economic outlook. However, recent changes in trade policy have tempered their outlook and added uncertainty to their strategic plans. Much of the optimism from business owners comes from the view that trade disputes may create an opportunity to open new markets and trade partners, creating an even larger international market for U.S. products.
- On the flip side, heightened uncertainty is beginning to show in U.S. economic data, particularly the dampened business investment and hiring plans. Small businesses, including those in agriculture, seem to be especially concerned that their well-established export and import relationships could be detrimentally disrupted. Small and even intermediate-size businesses and farms lack the ability to secure alternative supply chains and may lose substantial access to new markets and business growth opportunities.
- On a forward-looking basis, there is more caution in the economic outlook, as concern mounts that the impacts could persist or begin to spread beyond those industries facing a direct impact.
- There is also consensus among Council members that any escalation of trade tensions may partially or fully offset the momentum from the fiscal/tax stimulus shown in business surveys.
- In conclusion, the Council believes there is some uncertainty in the outlook, given the tension around tariffs.

How are these changes influencing the business of banking?

- Council members note that changes in trade policy are not influencing how they do business at this time. The majority concur that credit policies and processes are designed to support customers through anticipated cyclical variations.
- Generally, customers remain careful when deciding to invest in capital and maintenance expenditures, as higher prices and uncertainty weigh. Specifically, a Federal Reserve Bank of Atlanta study found that trade disputes have prompted almost a fifth of U.S. businesses, including about 30% of manufacturers, to review their capital spending plans.
- The Council has observed that customers who are electing to move forward with investments are acting decisively and are able to negotiate better terms as a result of higher competition.
- In some areas, Council members say there has been a rush to ship products internationally ahead of the imposition date for certain tariffs, which may have “pulled forward” some spending/sales numbers. This situation has the potential to distort seasonal demand patterns over the balance of 2018 for some industries. One specific example is a customer who purchased a seven-month supply of steel in advance of the tariffs.
- Because of the tariffs, some companies are transitioning from foreign supply to domestic supply, with higher costs. Additionally, concerns are rising regarding anticipated shortages. How long will the tariffs last? What additional goods will be covered? Will supply chains be disrupted? Increased uncertainty usually results in delays in undertaking long-term projects, such as large capital expenditures or new product lines.

Are there particular geographic areas or industries in Council members’ Districts that are being impacted by recent trade disputes?

- Tariff-impacted trade flows as a percentage of U.S. imports and exports are still relatively low. Specific manufacturing industries, however, are obvious beneficiaries, offset by higher potential prices to U.S. consumers in those industries. The retaliatory response has largely impacted U.S. agricultural exports, with subsidies now being offered to U.S. farmers.
- The agriculture sector, particularly pork, soybeans, dairy, fruits, and nuts, has been acutely affected by tariffs imposed on agricultural exports, resulting in lower commodity prices. Second-

order impacts on agriculture-dependent local economies and upstream machinery and equipment suppliers may ripple though. According to one forecast, the Midwestern Corn Belt states of South Dakota, Nebraska, Iowa, Missouri, and Kansas will lose nearly \$6.5 billion in gross revenue as a result of price declines caused by trade tariffs. In addition, states like Michigan and Ohio are closely watching developments concerning the North American Free Trade Agreement, given the potential impacts on the auto, manufacturing, and technology sectors.

- Construction and manufacturing companies, especially those reliant on lumber, steel, and aluminum, are being significantly affected by higher input prices.
- Domestic industries that should be poised to benefit from tariffs imposed on competing imports have yet to fully see the benefits.
- Steel and aluminum prices are higher because of the tariffs imposed by the United States, which is bad news for users of steel and aluminum, such as manufacturers and purchasers of manufactured goods. Alternatively, the tariffs could be good for domestic steel producers, such as mining operations in the Iron Range. These opposite results demonstrate the ambiguity of the effects.
- Impacts on the auto industry have the potential to affect banks through consumer and commercial lending. Higher auto prices would likely reduce the number of motor vehicle loans originated, but those loans would likely have higher origination amounts. The net effect on the dollar volume of originations is unclear.
- Tariffs are generating shocks in the wind and solar power sectors. These emerging sectors report that tariffs for raw materials are eating into margins and threatening to create cost headwinds.

Item 7: Inflation

Does the Council see any evidence that inflation is picking up?

After remaining fairly depressed during much of the recent economic cycle, most measures of inflation have picked up through mid-2018 and are running near the Federal Open Market Committee's target of 2 percent.

The headline consumer price index (CPI) rose 2.9% in July, matching a six-year high and led by an increase in energy prices, which are up over 12% from a year ago. The core CPI increased 2.4% year-over-year in July, the highest increase since September 2008. The primary driver of the increase in the core CPI came from shelter costs, including both rent costs for a primary residence and owners' equivalent rent. Rents have been increasing at a steady rate for about five years, providing support for inflation, and they rose 3.6% year-over-year in July. Rental vacancy rates remain low, suggesting that shelter CPI is likely to remain elevated. Owners' equivalent rent, which imputes the rent homeowners would pay to live in their houses, has risen 3.4% year-over-year. Importantly though, the core CPI, excluding shelter, has risen only 1.5% over the past year.

The headline personal consumption expenditures (PCE) deflator rose 2.3% year-over-year in July. Consumer price inflation, as measured by the core PCE deflator, rose 2.0% year-over-year in July, an over six-year high. The key question is whether this latest move higher in inflationary conditions is likely to be sustained, advance further, or decelerate in response to the ongoing tightening cycle and normalization of monetary policy.

To summarize, the Council's view at the current time is that inflation continues to firm across multiple indicators but does not appear to be accelerating. Council members do not believe the core PCE deflator will meaningfully exceed 2% through 2019. Further, the gradual increases in interest rates are not yet an obstacle to business growth, and the Council agrees with the view expressed in Jackson Hole that the Federal Reserve's gradual process of normalization remains appropriate. While one-year inflation expectations from both the University of Michigan and the Conference Board have risen to multiyear

highs, they remain low and anchored. The Council does not observe any near-term scenarios in which inflation expectations could be at risk of overheating.

The Council believes it is important to attempt to differentiate between inflation that is starting to emerge due to tariffs and trade policy and inflation that is being driven by economic strength and labor market conditions in the domestic economy. Some of the specific readings of inflation have been related to recent tariffs and trade policy. The core PCE deflator, for example, reflected an 8.4% year-over-year increase in major household appliances in July, highlighting the impact of tariffs on washing machines.

Wages were a key factor discussed by Council members. Specifically, they discussed whether there was broad-based evidence of increases in real wages and whether consumers would be able to withstand higher prices and higher debt loads, given increases in interest rates. Most Council members noted a potential for future risk but also noted that wage expectations were manageable, especially considering the overall tight conditions in labor markets.

Wages and Labor

A tight labor market raises the risk that wage inflation could accelerate. Reported wage inflation has risen to near-cycle highs, but the acceleration has been inconsistent and below historical norms--again considering the extremely low level of unemployment. Average hourly earnings and the employment cost index have increased in the +2.5% range. However, after adjusting for consumer price inflation, primarily for higher energy costs, real hourly earnings for all private workers fell 0.2% year-over-year in July. In some contrast, Council members do recognize that real disposable income has accelerated year-over-year (driven by increases in equity markets, other factors of income, and tax cuts), which could boost overall consumer spending and offset modestly higher inflation conditions.

Small business surveys reveal elevated intentions to raise workers' wages -- 32% of small businesses reported increasing wages in the last three to six months, according to a survey by the National Federation of Independent Business, a figure close to the recent 34-year series high of 35%. In July, 22% of businesses reported planning to raise wages in the following three months. A lack of real wage inflation may make it difficult for businesses to raise prices, potentially dampening the overall outlook for inflation. Also, as noted in Jackson Hole, it is uncertain whether the economy will move out of its low productivity mode. This dynamic is also being reflected in the markets, with the spread between 10-year and 2-year Treasuries at approximately 20 basis points, which is near the lows of 2007.

With respect to wage and employment conditions, Council members offered the following viewpoints:

- Salary expectations of new hires continue to rise, particularly for specialized skill sets.
- Stricter guidelines for H1-B visa applications are limiting the talent pool.
- Demand for technical skills is spanning across many industries.
- Market survey providers continue to estimate a 2.5 to 3.0% increase in salaries this year.
- Some business customers are having to increase wages faster than in previous years.
- The lack of recent experience with such low unemployment rates creates some risk that inflation will not move up gradually as anticipated but rather accelerate meaningfully higher.
- There are some signs of wage inflation in the Texas economy, reflecting the shortage of workers in some industries, such as homebuilding. However, the Council has not yet seen this translate into a level of wage inflation that is meaningfully above the overall level of inflation.

Consumer Notables

Examining specific consumer categories in July's PCE deflator shows modest-to-benign increases outside of household appliances and housing. Health-care prices, for example, were up 1.8% year-over-year. Prices of used cars and trucks rose 0.8% in July, according to the CPI, but have declined year-over-year in 27 of the past 29 months. In contrast to the CPI, data from industry sources show that the average transaction prices of new and used vehicles continue to rise. In line with reports from J.D. Power, the National Automobile Dealers Association, TrueCar, and Manheim, the Council has witnessed strong price gains, particularly in used vehicles, throughout much of 2018. The Council believes these price gains are less about general inflationary conditions and more about robust demand, as consumer confidence remains high and employment conditions remain favorable.

Tariff effects have the potential to expand to more products made with steel and aluminum, including motor vehicles and motor vehicle parts. Tariffs currently being contemplated will lead to higher production costs and ultimately higher prices for consumers and could potentially shift demand. General Motor's CFO stated the following: "Our biggest exposure, our biggest unmitigated exposure is really steel and aluminum when you look at all the commodities. And frankly, the biggest driver of that is steel." Transportation represents a 17% weight within the CPI, so this is a component to watch. These dynamics are less about real inflation versus trade policy.

One Council member noted that, at this point, there is little evidence that higher costs for inputs are being broadly passed to consumer prices.

Producer and Import Prices and Commodities

Most measures of producer price inflation are accelerating; many have recently risen to the highest rates in over six years. Specifically, the Producer Price Index (PPI) rose to 3.3% in July on a year-over-year basis. Core PPI was up 2.8%. The increase in headline producer inflation was helped by crude oil prices, which reached their year-to-date high at the end of June. Higher oil prices have also added to import prices. Outside of steel prices and higher aluminum and lumber prices, trade policy and tariffs have yet to have a noticeable effect but could pressure future prices and, therefore, remain another risk to watch.

Home and Land Prices

Home prices continue to rise at a faster pace than measures of rent. As measured by the S&P Case-Shiller CoreLogic and Federal Housing Finance Agency indices, home price appreciation remains above 6% year-over-year nationwide and is much stronger in some areas of the country, mostly on the West Coast. Home price appreciation has been supported by strong demand for housing and a historically low supply of existing homes for sale. However, supply of existing homes increased year-over-year for the first time in over three years in July. Limited supply and higher home prices can limit the number of buyers who qualify to buy houses, increasing rental demand and the rent measures included in consumer price measures.

The median sales price of existing homes was \$269,600 in July, according to the National Association of Realtors -- 17% above the pre-recession peak and 74% above the post-recession trough. The U.S. Bureau of the Census reports the median new home sales price was \$328,700 in July, up 1.8% year-over-year. The series' high sales price for new homes was \$343,400 in November 2017.

Council member observations included the following:

- The Federal Reserve Bank of Chicago's Q1-18 AgLetter reported that Seventh District farmland values were flat last year and had not risen significantly in almost four years.
- Lumber prices increased somewhat dramatically earlier this year due to U.S. tariffs on Canadian lumber, which should put upward pressure on housing prices.
- Inflation in Texas is most apparent in areas driven by the oil and gas industry, where rapid growth in investment is driving rapid economic expansion. The value of all building permits in Midland, Texas, was up 101.6% year-to-date through June.

In summary, while there is evidence within pockets of the data that inflation has started to accelerate, it remains important to expand beyond just the headline numbers and examine the full picture. It is also important to decompose whether current price increases are being driven by a function of trade policy versus core economic strength. Recalling the discussion on the Phillips curve at its May 2018 meeting, all else being equal, Council members would have expected higher inflationary conditions given the tight conditions in the labor market. However, Council members do not believe inflationary conditions are being under-reported and encourage the Federal Reserve to remain vigilant.

Wall Street economists project the core PCE deflator to remain near the 2.0% target through 2019, and Council members do not see a current risk for a rapid rise in inflation that may signal the Federal Reserve drops its gradual process of normalization. The Council believes the path the Federal Reserve has articulated remains appropriate for navigating current inflation conditions.

Item 8: Monetary Policy

How would the Council assess the current stance of monetary policy? Does the Council foresee any impact or significant disruptions to the financial system if interest rates continue to rise? Have the interest rate increases to date had any impact on banks' assessments of their credit risk?

Feedback from the Council suggests a nearly unanimous belief that the current stance of U.S. monetary policy, which includes both gradual rises in interest rates and balance sheet reduction, remains modestly accommodative and appropriate. Tightening labor market conditions in which unemployment is below 4%, inflation near the Federal Open Market Committee's (FOMC) 2% objective, and continued expectations for above-trend GDP growth offer further support for the current policy stance. While current policy is seen as accommodative, several Council members noted interest rate policy may be characterized as approaching "neutral" in the near future; most estimates for "neutral" real rates appear to be in the zero to 1 percent range. With inflation at roughly 2%, the next hike by the FOMC is expected to put real interest rates into positive territory for the first time since 2008. The unwinding of the Federal Reserve's balance sheet is having a minimal impact on the slope of the Treasury yield curve due to the gradual nature of the stimulus withdrawal.

In terms of higher interest rates and the strength of the financial system, Council members note that the economy is responding well to the Federal Reserve's tightening to date. The majority of Council members do not anticipate disruptions to the financial system as the process of rate normalization continues. Financial market expectations for the path of the federal funds rate in 2018 have aligned with the latest FOMC Summary of Economic Projections released at the June 12-13 FOMC meeting, which suggested a total of four rate increases in 2018. One Council member noted that the benefits of higher rates for banks may be beginning to wane and further increases in rates may present some challenges, particularly in terms of the cost of funding (i.e., deposit betas) and in managing the capital impact on AOCI (accumulated other comprehensive income) for institutions with more than \$250 billion in assets. Higher interest rates could also place a higher debt burden on consumers, though Council members note

this possibility has yet to materialize in higher loan delinquency rates, which remain low -- except for auto loans, whose delinquency rates in Q1-18 were close to the highest levels in more than five years.

Furthermore, Council members highlight that the impact of higher rates has not significantly affected internal assessments of banks' credit risk. Credit trends remain stable across most asset classes, with steady consumer and commercial credit demand. One Council member noted that, thus far, the impact of higher rates on credit does not appear concerning. Most borrowers have extended the maturity profile of their borrowings; therefore, it may take some time for the impact to become more apparent.

Outside of monetary policy, some near-term risks highlighted by Council members included potential impacts resulting from tariff tensions; economic stress in Turkey, which could impact European and global markets; a potential slowdown in China; the risk of a government shutdown in fall 2018; and political uncertainty in the United States, with upcoming mid-term elections. These factors, along with global rates, may be putting downward pressure on U.S. rates, resulting in a relatively flat yield curve.

12:00 pm – Luncheon for Council and Board members in the Board Room