RECORD OF MEETING

Federal Advisory Council and Board of Governors

Wednesday, September 7, 2016

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:

- The Council believes there has been only modest change in the current condition of, and outlook for, loan markets and financial markets in general.
- Small business owners remain cautious and indicate mixed signals related to improving confidence.
- Commercial real estate markets remain healthy and stable in most Districts, with the multifamily construction market showing signs of moderation.
- Corporate lending remains competitive, with capital equipment financing well off the earlier pace.
- In the agricultural markets, the extended period of low commodity prices has impacted even the strongest of balance sheets. Stress is reflected in both direct and indirect segments.
- Overall, consumers remain overall optimistic, creating demand for all consumer loan classes.
- The mortgage market continues to be healthy, and a recent rate decrease is driving another flurry of refinance activity.

(a) Small and Medium-Size Enterprises

- The pace of recovery for small business enterprises remains uneven, with the pace of new business formation continuing to be a concern. Business owners continue to constrain investment in capital expenditures as they await further improvement in the overall economic and regulatory outlook. Capital investments are limited to maintaining capacity and capability.
- Business lending pipelines are stable but not necessarily improving, as there is hesitancy on the part of entrepreneurs to invest in new inventory, physical plant, or equipment. Business owners note ongoing concerns regarding the current political environment and the upcoming fall 2016 elections. Recent confidence measures from small business data aggregators have shown very modest improvement in the past three months, but overall levels remain muted.

- Customers with strong credit profiles know that their business is sought after among competitors, and consumers are shopping rates and terms. Competition also continues to intensify as marketplace lenders provide a source of capital for certain small business owners.
- There is rising concern among borrowers that the commodity downturn may last longer than historic durations because sellers manufacture or hold significant commodity inventory for resale.

(b) Commercial Real Estate, (c) Construction

- Market fundamentals continue to reflect a "stable to softening" environment for commercial real estate (CRE).
- Property-price appreciation is signaling flat asset values over the next twelve months, on the heels of what had previously been a forecasted decline in real estate values. Property appreciation has slowed from the pace of prior years, but values remain historically elevated.
- While concerns over a potential recession, continued political turmoil, and commodity prices have created uneasiness in the markets, initial strains following Brexit have largely abated.
- Concerns about growth from a global perspective continue to gain attention as the level of negative-yield global debt continues to increase.
- Borrowing costs remain low for all but the riskiest loans, which has spurred new discussion on rate floors.
- Real estate private equity fundraising remains strong but is moving marginally under the levels raised over the past few years.
- New-home sales continue to strengthen in what is considered a well-tempered progression, but prices are rising at a pace noticeably above inflation.
- Demand for CRE product continues to be strong within retail, office, and industrial properties, as their pro-cyclical nature and limited development continues to support expansion.
- Apartment fundamentals appear to be slowing. Markets with greater amounts of supply and exposure to areas of the economy under pressure are of concern. In general, the market has demonstrated a clear tightening of multifamily underwriting, and the recent deceleration of start activity is a positive. Multifamily completions are expected to peak in 2017.
- Several Districts raised concerns that construction demand has put pressure on the skilled labor force, to the point that smaller to mid-sized contractors reported delays in finishing jobs.

(d) Corporations

- Loan demand continues to be soft among corporations, especially when compared to 2015. Current pipelines are down significantly from the peak of mid-2015; however, pipelines have trended upwards over the past several months.
- After several quarters of intense price, structure, hold amount, and covenant competition, these pressures have begun to ease. Competition has now shifted to non-interest revenue, with a focus on relationship profitability across competitors. Competition in distressed segments of the market is not as significant.

- Certain industries, particularly those related to energy and agriculture, continue to see headwinds that retard growth in the corporate segment. Loan growth has been driven primarily by onetime events (M&A, share repurchases, refinancing) and not by organic growth. Therefore, in the absence of organic growth, and in light of current macroeconomic conditions, we continue to expect 2016 to be a slower year for growth during which nonperforming loans may increase.
- The energy segment has achieved a degree of stability as prices have stabilized and as the business has benefited from prompt decisions to reduce operating expenses and capital investments.
- Corporate clients continue to keep excess liquidity with banks, leading to continued deposit growth in 2016 but at a slower pace than in 2015. There is increased competition for large blocks of deposits, which has driven rates higher over the past few months.
- Capital equipment financing is off. Fixed capital spending by corporations remains very soft.

(e) Agriculture

- Since the steep drop in agricultural commodity prices in late 2013, producers have struggled to maintain profitability. Producers have seen asset values drop and have had to cover operating shortfalls with working capital (liquidity).
- Agricultural entities that are focused on livestock, and other protein items are experiencing much better performance. Consumer demand for protein items continues to grow, and the drop in commodity prices resulted in a reduction in operator-input costs.
- Recently, there have been macroeconomic signs that a rebound of commodity prices will provide opportunities for producers to market their crops at higher prices. These signs include revisions in USDA inventory and production estimates, global weather issues that are impacting producers outside the U.S., and overall continued growth in demand for soybeans.
- Credit quality continued to weaken through the spring renewal season as 2015 operating results were finalized. Midyear crop inspections are just now underway and are not complete enough to make any predictions to possible outcomes for 2016. Reports from the Midwest project strong yields for both corn and soybeans, and though instances of drought and excessive rainfall have been reported in isolated areas, there appears to be limited degradation in performance.

(f) Consumers

- Consumer demand for automobile lending softened in June, but overall demand remains strong. Borrowing costs remain historically low, gasoline remains inexpensive, and vehicle purchasing incentives are attractive to the consumer. Fleet activity has increased 9.5% in the first five months of the year, helping to offset softening consumer demand.
- Demand continues for home equity lending. Drivers of demand include improved home values, improved economic conditions, and consumers reinvesting in their homes via renovation/home repair/maintenance projects that were previously postponed. The industry is still experiencing portfolio runoff but it has slowed.
- There is also increased demand for unsecured and deposit-secured lending that is most likely due to the easier process for obtaining these loans compared to the requirements for and length of time to close a home equity loan. Marketplace lenders are impacting the

unsecured borrowing landscape by providing the convenience of broad-based online borrowing offers, although funding for marketplace lenders has slowed, causing a corresponding decline in production.

- Student lending continues to be a concern given the overall exposure level and the ability of borrowers to repay.
- Consumer spending overall and on credit cards is up. However, consumers are saving more, as reflected in credit card payment rates - balance growth is muted compared to spending growth.
- The digital channels are seeing a faster growth in spending than the traditional physical channels, although the absolute amounts are still much bigger in the physical space.

(g) Homes

- The mortgage market continues to be healthy. Based on the current rate environment, the industry is expecting volume to be up 8% in 2016, in contrast to earlier projections that volume would be down.
- The Brexit announcement caused rates to temporarily drop to a new 30-year low. They have started to tick upward, but a degree of uncertainty remains.
- Production mix has fluctuated week to week. Shortly after Brexit, both refinance volume and overall application volume increased. Since then, however, purchase volume has increased but overall application volume has decreased week over week.
- New buyers are poised to enter the market, as rent prices continue to increase and negative credit events from the start of the crisis move off borrowers' credit reports.
- New home construction continues to be constrained in many markets.

Do Council members see economic development 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?

- There are marked differences in rates of job and income growth and levels of housing market activity across individual states and metro areas, all of which are not evident in the aggregated national data. Year-over-year growth in total nonfarm employment is running slightly below 2.0%. Yet in many metropolitan areas, employment is either little changed or even lower on a year-over-year basis. Many areas with greater exposure to energy have seen employment fall, as cutbacks in payrolls and expenditures on equipment and services within the energy sector spread into other areas of the local economies. Similar effects are being seen in metro areas whose economies are more reliant on the production of capital goods or more reliant on trade. Additionally, many smaller, less economically diverse metro areas with less-favorable demographic trends have not seen their economies recover to the same degree as has been the case nationally since the end of the 2007-09 recession.
- Payrolls in the energy and manufacturing sectors have continued to decline in 2016. Two potential downside risks to manufacturing are a slower pace of motor vehicle sales and cutbacks in business investment spending outside of the energy sector. Though to date there has been no meaningful tapering in the pace of vehicle sales, this cannot be ruled out over coming quarters. There has, however, been a clear pullback in business capital spending. Whether this is mainly due to transitory factors, such as elevated uncertainty stemming from the upcoming U.S. elections or the results of the Brexit vote, or whether it

is due to more fundamental factors, such as declining corporate profit margins, remains to be seen. Either way, this situation merits close attention over coming months.

- Distress sales continue to account for a higher-than-normal share of all home sales. Though well below cyclical peaks, distress inventories remain elevated. Distress sales, typically at significant price discounts, are likely acting as a weight on new single-family construction in many areas, leading builders to be more focused on the upper end of the price spectrum. At the same time, limited inventories of existing homes for sale have contributed to rapid house-price appreciation.
- As with job and income growth, there are large discrepancies in rates of house-price appreciation in the metro areas. These discrepancies are not apparent when looking at the aggregated data. There are many metro areas in which house prices, as measured with the CoreLogic HPI, are flat or down on a year-over-year basis. There are economic drivers, such as heavy reliance on a stagnating/declining industry, that in some cases explain this behavior in house prices, but there are also demographic drivers, such as below-average rates of population growth and household formation, that are driving the behavior of house prices in other metro areas. In contrast, in larger and more economically diverse metro areas with more favorable demographic trends, house-price appreciation is in many cases running well above average. It is important, both from an industry perspective and a policy perspective, to be mindful of these divergent growth rates rather than being too reliant on aggregated data when forming views of the housing market or the broader economy.
- Recent flooding in Louisiana impacted more than one-third of the parishes in the state and flooded more than 100,000 homes. It represents the worst natural disaster in the state since Hurricane Katrina. While there will be rebuilding efforts that will foster an eventual increase in economic activity, what is often overlooked is that economic activity will grind to a virtual halt in the interim. With over 10,000 businesses impacted, jobs will be lost, discretionary spending will not take place, and overall economic activity will be put off or lost altogether. Consumer and commercial borrowers may be more prone to fall into delinquency on loan obligations to the extent they have lost their income/revenue streams for a prolonged period. Rebuilding efforts will help stimulate economic activity but must be balanced against the loss in the immediate aftermath of the flood. The rebuilding process will be a lengthy one, and until it is complete, there are considerable downside risks to the state's economic outlook.

Item 2: Brexit

What impact will Brexit have on the U.S. banking industry and financial system? How will worldwide banking and finance evolve after Brexit, particularly if London does not continue to be a financial center?

What impact will Brexit have on the U.S. banking industry and financial system?

- On the whole, the risk of contagion from Brexit to the U.S. banking and financial system appears limited.
- Brexit is one of a number of global economic worries affecting the economic climate in the U.S. and the U.K.

    - The access of U.S. banks to the single EU market is unlikely to be disrupted, as most already have (or can easily set up) legal entities in the EU through which business can be conducted with EU-domiciled clients.
- The Bank of England (BOE) has taken steps to calm U.K. markets' response to Brexit, reducing the risk for volatility spillover into U.S. financial markets.
    - On August 4, the BOE lowered its benchmark interest rate by 25 bps to 0.25% and revived a bond-buying program that had been on hold since 2012.
    - In July, the BOE reduced capital requirements for U.K. banks by decreasing the countercyclical capital buffer requirement to zero until June 2017. The BOE estimates the relaxation in standards could translate to £150 billion in additional credit for U.K. borrowers.

How will worldwide banking and finance evolve after Brexit, particularly if London does not continue to be a financial center?

- The basis for London's position as a global financial center extends beyond EU membership, and its importance to the broader U.K. economy makes it unlikely to lose its status for the foreseeable future.
- Short term - The impact on London's status appears minimal in the near term.
    - The importance of the negotiated exit and the expected timeframe to completion means many firms may take a wait-and-see approach before overhauling their London footprints.
    - There is an expectation that the U.K. will negotiate an "elegant exit" from the EU to ensure economic ties are not unduly disrupted.
- Long term - The outlook is more uncertain, but we are unlikely to see a significant degradation of London's position as a global financial center, as its position is long-standing and based on more than EU membership.
    - Several key reasons for this positive outlook include London's historical global linkages, English law, the English language, a skilled labor pool, and geographical proximity to the EU.
    - The importance of financial services (FS) to the U.K. economy motivates the U.K. to protect London's status as a global financial center.
        - The FS sector is responsible for 8% of national output, while associated professional services contribute a further 4.9%.
        - U.K. FS account for 24% of all EU FS (40% of EU FS exports).
        - FS employs 1.1 million people in the U.K. (3.4% of the total workforce); nearly an additional one million work in associated professional services.
        - The sector paid estimated taxes of £66.5 billion, or 11% of total U.K. government tax receipts.
    - London remains the largest single foreign exchange trading center (US $2.15 trillion traded daily, according to the BOE).
    - London recently overtook Singapore to become the largest renminbi offshore clearing center outside of China (Hong Kong remains the largest).
- The results of exit negotiations will be critical to understanding London's position as a global finance center.
    - Lobbying efforts by the financial and broader business community are likely to ensure that the U.K.'s economic relationship with the EU remains close.

  - The U.K. is the second-largest EU economy, with significant trade links to the rest of the EU.
    - 44% of U.K. exports are sent to the EU.
    - 53% of U.K. imports come from the EU.
  - The current government seems to value London's position as a global finance center, which should provide support during the exit negotiations (the expectation is that negotiations will be concluded under the current government).
- Many FS regulations are global in nature, so leaving the EU should not materially impact the U.K.'s regulatory regime, thereby maintaining its attractiveness to global firms.
  - This provides some opportunity for the U.K. to compete with the EU to be more attractive to global businesses.
- Potential issues:
  - Middle- and back-office jobs may leave, but front-office positions are likely to stay.
    - Many FS firms have significant London operations even though the majority of their business comes from EU countries. We may see a shift of these workers into the EU.
  - Passporting - The political cost, measured in immigration and EU payment concessions, is likely to be too high to achieve.
    - Some alternative that is short of full passporting may be the result.
  - There is an expectation that EU cities like Frankfurt and Paris will increase their market share of EU FS and transactions but not to a level that would preclude London from remaining a global financial center.
  - Timing remains unclear as to when Article 50 will be invoked.
    - The outcome of elections in France and Germany next year could harden the EU's negotiating position should there be a continental voter backlash over the U.K's "leave" vote.
- Under the assumption that "Brexit means Brexit," the two likely post-Brexit scenarios differ only in the U.K.'s level of integration with the EU. However, as explained above, the downside risk to London's status appears to be manageable.
  (1) High EU integration would be least disruptive to financial firms operating in the U.K. and pose a minimal threat to London's position as a global financial center.
  (2) Low EU integration may incent some firms to shift operations from the U.K. to the EU, creating the potential for some degradation of London's status in global finance.
- Either scenario is unlikely to have material impacts on the U.S. banking industry or financial system, particularly as stakeholders will have time to adapt to the new ecosystem as Brexit is negotiated.

Item 3: Loan Loss Accounting

> **What impact will the recently finalized accounting procedures for current expected credit losses (or CECL) have on banks in general? Specifically, how will these procedures affect the level and pro-cyclicality of capital and reserves at both large and smaller institutions?**

Background

The new FASB loan loss accounting framework (CECL) changes the current incurred loss model to a projected loss model. Required adoption dates are Jan. 1, 2020, for SEC filers and a year later for nonfilers. However, depending on regulatory response, the nine-quarter projection period in the Comprehensive Capital Analysis and Review (CCAR) may require CCAR banks to incorporate the CECL initial adjustment into their CCAR submissions as early as April 2018.

Under the current incurred loss approach, reserves are estimated based on the observed economic conditions and credit conditions as of the balance sheet date, without consideration of the conditions expected over the foreseeable future, and no reserves are established until there is evidence of impairment. As such, loan loss provisioning under the current incurred loss model tends to be pro-cyclical because reserve builds increase in a downturn.

Under CECL, reserves will be established upon loan origination for the expected lifetime losses, which incorporates a forward-looking component based on a reasonable and supportable economic forecast. CECL covers not only loans but also trade receivables and held-to-maturity debt securities. Other than temporary impairment (OTTI) goes away prospectively, as does purchased credit impaired (PCI) accounting. This moves credit impairment on these loans out of yield and back into a reserve category.

Implementation Costs and Challenges

Implementation of CECL will be a challenge for banks, as it requires the production of new models to forecast life of loan losses and the incorporation of changing economic forecasts into those models. Larger banks, especially banks subject to CCAR and Dodd-Frank Act Stress Testing (DFAST), already have developed databases and analytical tools that can be adapted to cover CECL modeling. Smaller banks will on average have less-robust databases and tools to assist them in this process and will likely find the cost of implementation to be proportionately higher. Although the pronouncement allows smaller, less-complex institutions to have less-complex models, it is still unclear what the accounting profession's level of acceptance of these models will require. The models will also require substantiation from historical data, which smaller banks may find more difficult to obtain. The projections of future economic conditions, and the correlation of those projections to potential losses in a portfolio, will need to be substantiated for both auditors and regulators.

CECL's reliance on individual banks to make their own projections means that comparability between banks will be difficult. We expect management teams that are currently more conservative will continue to be more conservative in applying these future models. Very conservative companies may well hold higher levels of reserves versus their peers, despite similar or even better credit metrics during a given period. Also uncertain is the level of convergence that regulators and auditors will require between CECL economic projections and regulatory-mandated CCAR/DFAST and even internal budget projections. Although

CCAR/DFAST/internal projections are developed for different purposes, a lack of consistency between these projections could lead to more questions.

Impact on Reserve Levels

The adoption of this standard, which requires the build of reserves for the life of a loan at its origination, means the build will occur earlier in the economic cycle, resulting in a higher level of reserves held on the balance sheet through the cycle. Since the new allowance levels will be dependent on management discretion, modeling methodologies, existing loan portfolios, and the economic environment and projection both at the time of origination and ongoing, the actual impact will vary greatly from bank to bank. The initial adoption of CECL is projected to result in increases in reserves from as low as 2% to more than 200%. Although the higher levels are likely to be rare, banks with longer-duration portfolios are likely to post the largest increases, which could be a risk to the availability of longer-duration credits.

Pro-Cyclical or Countercyclical

The impact could be measured on both capital levels and lending appetite. All else being equal, the adoption of CECL will lower capital levels for the industry as a result of the increased level of required reserves upon its adoption and the impact of incremental reserve builds associated with future loan growth. However, it is less certain whether CECL will be less pro-cyclical than the current incurred loss model. While reserve levels should not go as low under CECL, the peak reserve levels will be dependent upon the economic forecasts, which could result in significantly higher peak reserve levels than the incurred loss approach.

There is always a bias to see conditions continue as they are. CECL will be pro-cyclical if management forecasts during good economic times project a continuation of a robust economy. Then reserve builds under CECL will be smaller than if an economic downturn is projected (although reserves will still be higher than under the current model.) If the economy is in turmoil, and if continued turmoil is projected, then reserve levels will increase, impacted both by projections as well as worsened individual loan risk ratings. Although absolute levels may be higher than under the current incurred loss model, the reserve trends after adoption of CECL may not change their current pro-cyclical patterns. Would regulators, investors, and management actually allow reserve ratios to fall during poor economic conditions?

The need for more reserves in economic downturns could lead to less credit availability, potentially exacerbating economic conditions. As noted earlier, it may also lead banks to shorten the duration of the loans they offer. Conversely, lower required reserves, given rosier economic forecasts, could lead to more lending activity in those periods.

The current limit of 1.25% of reserves as eligible for tier 2 capital, given the potential pro-cyclicality of CECL, should be reconsidered. As credit loss reserves grow under CECL, tier 1 and tier 2 capital levels will drop, as increasing deferred tax asset levels, caused by loan loss provisions not yet deductible for tax purposes, create new temporary differences.

<u>Item 4</u>: <u>Current State of the Financial Industry</u>

What has been the effect of persistently low interest rates on banks' ROE and margins? How does the shape of the yield curve affect the Council's views on these effects?

What has been the effect of persistently low interest rates on banks' ROE and margins?

- Banks are skilled and capable managers of balance sheet structure and interest rate risks in normal (and even extreme) rate environments but are clearly challenged by an artificially prolonged environment in which interest rates are stuck at historic lows, both globally and domestically.
- As a basis for context, banks have operated under the extraordinary pressure of a low interest rate environment for almost 8 years, since the end of 2008 when the target federal funds rate was lowered to between 0 and 0.25 percent. It remained at that level until December 2015. A protracted period of low interest rates means that banks often have to take on more risk and go longer on the yield curve in an attempt to maintain even adequate returns. Excessively low interest rates encourage aggressive reach for yield in a low interest rate environment, and this environment has also likely generated bubbles in real estate assets that are difficult to quantify and will be hard to bring to a healthy resolution.
- The overall effect of lingering low rates is making core banking practices more difficult by minimizing the margin for error and potentially magnifying the negative consequences of unexpected shocks. The Office of the Comptroller of the Currency pointed out in a December 2015 research paper that an extended low interest rate environment can lay a foundation for future vulnerability, as banks increase exposure to both interest rate risk and credit risk by reaching for yield to boost net interest income. The negative psychology associated with low rates and the widely broadcast concerns about the economy are holding back business investment, and minimal asset yields are causing savers to hoard cash and delay discretionary purchases.
- The cumulative effect of persistently low rates has a significant impact on bank core operating returns. The lack of loan demand lead banks to compete for a limited pool of loan opportunities, which is driving down new loan yields. The pressure on long rates from domestic demand for high-quality liquid assets and the addition of foreign demand for safety is making investment portfolios increasingly unattractive places to deploy excess cash. As the low rate environment has persisted, and as bank earnings have been further pressured by increasing costs of new regulations, risk management, technology, and compliance, the need to improve earnings has led to the initiation of major cost-management programs, both formal and informal. The impacts of these programs have yet to be seen in industry returns, although future opportunities to rationalize costs are becoming scarcer. Meanwhile, new Dodd-Frank provisions such as, the Durbin Amendment and the Volcker Rule, have largely muted opportunities for increases in non-interest income to offset margin compression.
- As loan pricing has contracted, loan structures (especially in the leveraged market) have become increasingly aggressive, driven largely by so-called shadow banking participants. By driving the marketplace to seek and accept more risk at lower pricing, the shadow banking system increases volatility and represents a currently unquantified risk to the

financial stability of the marketplace. In addition, the introduction of unregulated capital and liquidity increasingly undermines the risk-management principles that govern the financial services industry and has also pushed leverage borrowing beyond traditional industry levels.

- Net interest margins in the industry are at more than 25-year lows, and returns on equity at most institutions (both large and small) are below levels required by investors. When returns on equity are lower than investor-required returns, those institutions that need to raise capital externally are challenged to do so. As a basis for comparison, return on equity for all commercial banks in the fourth quarter of 2000 was approximately 13.4%, versus 8.4% today. It is commonly believed this level of return does not even hurdle the industry cost of equity capital. Worse, since the onset of the financial crisis and the imposition of a protracted low rate environment, institutions of all sizes have struggled to reach even double-digit returns on equity. Only a very few larger banks, generally those with more-diversified nonmargin revenue streams, are able to exceed a 10% return on equity. Furthermore, there are other pressures on return on equity in addition to lower net interest revenues, most notably "denominator inflation" resulting from significantly higher required levels of capital. Average equity to assets for commercial banks was 8.5% in 2000, versus 11.3% today.
- Low industry margins resulting from an artificially low rate environment have reduced normal profitability, returns on equity, and price-to-earnings ratios. These effects have conspired to make the industry as a whole less likely to attract investment capital, and arguably less competitive. At the end of 2000, there were about 8,300 commercial banks, compared to just over 5,200 today, an almost 40% decline that is concentrated almost entirely in smaller community banks. The largest domestic bank in 2000 had approximately $800 billion in assets, whereas the largest domestic bank today posts assets of approximately $2.5 trillion. Further, since 2009, only 5 new banks have been chartered, compared to the pre-crisis average, which ranged from 100 to 200 annually. While consolidation is a natural and systemic phenomenon of the banking industry, the enormous concentration of assets at the largest banks, combined with the declining number of smaller and even newly created banks, can in some ways undermine the efficient allocation of credit to all sectors of the economy and impair the provision of banking services to small businesses, rural communities, and consumers.
- The Council believes that the stimulative impact of zero rates may have run its course. It may be a prudent time to adjust policy thinking to shift the balance from stimulus through lower rates to encouraging investment activity through investment returns. Shifting the policy stance to a normalization posture that steadily moves to higher rates could increase confidence and reestablish the normal relationship among savers and borrowers. If rate normalization happens in a steady and more predictable approach, the economy can incorporate this change in rates and psychology and make investment decisions based on the best allocation of capital to productive sources versus riding the asset bubble being generated by the easy-money policies around the globe.

How does the shape of the yield curve affect the Council's views on these effects?

- Because banks transform short-dated liabilities into longer-dated assets, net interest margins are negatively affected by shallower yield curves. The effects are magnified in a low-yield environment, as limited room to lower deposit rates naturally compresses spreads on loan yields over those rates. Conversely, bank margins increase as the yield curve steepens, increasing the difference between bank borrowing (short-term) and lending (long-term) rates.

- The Council notes that the flattening yield curve has only exacerbated the pressure on bank margins. Any encouragement to go out further on the yield curve has been diminished by the lack of reward for the duration risks. Reduced opportunities to cut costs and increased capital requirements suppress bank earnings, with margins likely to continue to be pressured (along with returns on both assets and equity). None of this makes the industry more attractive for long-term equity investment. As such, this phenomenon has resulted in an attraction of decidedly transaction-oriented investors into the banking sector. These investors are typically more interested in generating quick profits, making headlines, or forcing sales as opposed to caring about the generation of long-term value, the broader stability of the industry, or the interests of other constituents, such as communities.
- There are multiple drivers of return on equity, including the level of capital and the ability to return capital to shareholders. To put it simply, higher rates and a steeper yield curve would help contribute to increased and more normalized bank profitability. A steeper yield curve would likely allow banks to deploy capital more effectively to support customers, serve all communities, and appropriately reward shareholders.

Item 5: Innovation and Safeguards

What should be the regulatory approach to innovation in the financial services industry? Is there some tension between the aims of supporting innovation and maintaining evenhanded regulatory safeguards among all market participants, banks and nonbanks?

Is there some tension between the aims of supporting innovation and maintaining evenhanded regulatory safeguards among all market participants, banks and nonbanks?

The answer is, of course, yes, tension exists between both worthy aims. Regulation, by its very definition, naturally always lags any new phenomena that require modulation. In addition, existing or traditional participants in the industry (in this case banks) will feel the effects of that regulation more and sooner, as they are already subject to an established framework of agencies, rules, and formal and informal expectations coming from many sources.

First and foremost, a good public policy question is how we can collectively establish a better regulatory framework for both new products and new market entrants that balances the many positives of innovation with the safeguards that are needed to avoid short- and long-term consequences that end up outweighing those benefits. The benefits of any innovation, if utilized well, include broader access, greater transparency, more choices, better outcomes, higher productivity, fewer negative byproducts, and lower costs, all of which lead to a healthier society and improved quality of life for the individual. On the other hand, the financial crisis of 2008 is a recent, stark, and well-documented reminder of the severe negative consequences that can occur when innovation in financial products and markets outpaces controls.

The next area of concern regards how we can mitigate the risk that existing market participants are not unduly and unevenly burdened with the regulatory costs and the regulatory response to an innovation wave because they are already the most easily regulated. This is not only a matter of fundamental fairness but also a matter of setting a good economic policy precedent: making an investment and being a good corporate citizen (following the existing rules) are worthwhile and fruitful endeavors. Those principles are important in encouraging market participants to make future investments and behave lawfully, which are critical goals in achieving a healthy, sustainable balance of societal progress and order.

We have seen recent high-profile examples in other industries where existing participants (e.g., medallion cabs, flag hotels, chain restaurants) are severely and structurally, and even existentially, challenged by new participants (e.g., ride share, residence share, pop-up food and beer gardens) who knowingly and unknowingly are playing by different sets of rules and responsibilities. On the one hand, this is the way of innovation generally and, to varying extents, has always been the case in our country's economic history. But on the other hand, the recent elevation in innovation around demand for ubiquitous information, mobile platforms, and on-demand and sharing business models can be a threat to the stability of financial services.

Financial services, regardless of who delivers them, and trust in the financial system underpin our whole economic system (again, the events of 2008 and the years thereafter bring this point into stark relief). The financial services industry over its history has been, through thoughtful public policy and strong regulation, shielded to a greater extent than most industries from any revolutionary disruption that might cause systemic economic damage.

Recently, many traditional financial services organizations have been rightfully concerned about the degree of freedom that exists for new entrants, the so-called neo-banks and fintech companies, to deliver products and services, especially in the markets for small-dollar loans, payments mechanisms, and insured deposit products. Through years of required investment and heeded regulation, traditional players have substantial "old economy" investments that are at risk, not because of an unwillingness to think "new" or disinvest then reinvest, but more because of a need to keep those established investments that are tied to a web of regulatory and other requirements, including CRA, BSA/AML, KYC, physical and data security prudence, commitment to their communities, and various consumer protection requirements. The danger is that these existing and required investments will become a substantial handicap that may hold traditional players back, while newer entrants can nimbly bypass these requirements to get new products to market and thus take the market share and the revenue that are needed to sustain the required legacy investments of traditional players.

The tension between innovation and regulation has always existed. Yet today, that tension is even more poignant. Therefore, even more careful attention needs to be paid to the regulation of innovation, particularly in financial services.

What should be the regulatory approach to innovation in the financial services industry?

With the above as background, the Council offers the following recommendations for significant elements of a comprehensive framework, to be further elaborated on and evaluated, with the goal of improving and more evenly balancing innovation and regulation in the delivery of financial services.

<u>Expertise and Resources</u>

Regulatory agencies should evaluate dedicating more resources to understanding the new economy, new technologies, new business models, new products, and new market entrants. Devoted experts, expert systems accessible to field examiners, and systemic oversight committees would be helpful in assessing and balancing the risks and rewards in the regulation of innovation.

Collaboration

Regulatory agencies should consider collaborating and establishing formal collaboration mechanisms across federal, state, and local jurisdictions in order to share resources, examples, lessons learned, and practical approaches to regulating the new economy and innovations as they arise. This collaboration may also help reduce regulatory turf wars and regulatory arbitrage, two potential negative outcomes of the multi-regulator environment that exists for U.S. financial services.

The financial industry itself is collaborating across company lines in the development and utilization of new technologies (e.g., blockchain), and these collaborations can serve as a template for regulatory collaboration. We also encourage the regulatory agencies to collaborate with financial services industry members to share the deep knowledge the industry has gained and continues to accumulate at a more rapid rate than might occur with a standalone regulatory approach. Agency/industry collaboration would not only accelerate learning and reduce regulatory costs but also enhance healthy relationships between the regulators and regulated in vanguard arenas.

Encouraging Partnerships

Regulators should also consider encouraging sound and thoughtful partnerships between traditional players and new market entrants. In financial services, existing participants have many advantages, including stable funding, an existing customer base, branding power, and regulatory know-how. New entrants have the somewhat complementary advantages of newer thinking, lower-cost equity capital, more abundant high-quality millennial talent, and fewer legacy investments, systems, or bureaucracies. Together, these combined strengths could provide the right balance for implementing responsible innovation.

Activity-Based vs. Entity-Based Regulation

Especially in the post-Dodd-Frank world, the U.S. financial system is replete with regulations governing almost every aspect of financial service delivery. We do not believe new or additive regulations are necessary. More evenhanded regulation might be achieved by applying existing regulations to the activities found in the marketplace rather than to the entities that already have the benefit of an established regulatory relationship. Focusing on the activity is not only fairer but also potentially more effective (e.g., catching the changing mortgage products and derivative activities by nonbanks in the run-up to the 2008 financial crisis) and efficient (regulators can divide up new activities to regulate rather than all regulating similar institutions).

Pilot or "Sandbox" Regulatory Approach

Banks should be encouraged to approach primary regulators with new ideas, and in a principled and risk-based dialogue, bankers might be given clearer parameters within which they could conduct expanding phases of new product introduction into an initially limited market. For example, a certain band of losses, mistakes, required capital, remediation protocols, and requirements for moving to the next phase can be agreed to upfront. This approach would allow for more confident and speedy execution, enhance responsible innovation by traditional players, and likewise enhance the comfort of regulators that risks may not threaten an institution's viability, have a significant negative consumer impact, or become a systemic risk.

Limited-Purpose Charters

Council members are somewhat divided on the merits of limited-purpose charters for new entrants. Some Council members believe these charters might be a good way to invite innovation while facilitating the better regulation of new entities. However, the stronger view of members was that the charters might encourage a new form of regulatory arbitrage, adding to uneven regulations and risks in the system. Council members are especially concerned that limited charters would lead to lighter regulation, which could be systemically dangerous. If limited charters are pursued, the Council believes this charter option should also be available for the new activities of existing traditional institutions.

Clearer Guidance

We encourage clear and definitive guidance on what is "responsible innovation." The OCC white paper on this topic is a very good first tonal step, and we recommend further detailed deliberation and discussion among all major regulators on what is clearly acceptable and unacceptable in the area of responsible innovation. Such guidance should be both an interim and an end-state product of pursuing the above framework.

Item 6: CCAR

> **How do Council members assess this year's Comprehensive Capital Analysis and Review process compared with the process in previous years? Which features of the process should be preserved and which should be changed?**

How do Council members assess this year's Comprehensive Capital Analysis and Review process compared with the process in previous years?

The Council recognizes continued improvement in the CCAR process in 2016 with regard to both efficiency and effectiveness. The observations and recommendations the Council offers today are likely to be consistent with those gathered by the Board (FRB) from bankers, investors, and academics in the course of its outreach on the occasion of the fifth anniversary of the CCAR process.

That being said, it is very difficult to answer this question with a one-size-fits-all response. While we can say that the banks and the FRB teams grow in their mutual understanding of expectations each year, unique facts and circumstances for each firm can and do play a large role.

Overall, this year's CCAR reflected an increased focus on the intersection of risk management, strategic planning, and the capital adequacy process. Many of this year's examination questions had traceability to the SR 15-18/19 capital planning guidance issued in December by the FRB, which linked the examination focus more clearly to those written expectations.

Which features of the process should be preserved and which should be changed?

CCAR Instructions / Requirements

Shifting the annual CCAR submission from January to April was a welcome change for most, if not all, firms and should be maintained. New instructions and/or requirements should be issued earlier in the year (ideally by June each year) to allow firms proper time to prepare and incorporate them into their governance process. This schedule would allow banks more time to understand and adapt to the revised guidance. The FRB has indicated additional guidance is expected in the fall of 2016. Depending on the significance of the changes, it may be challenging for banks to implement these changes in a well-controlled and well-governed way.

All firms would benefit greatly from delivery of the scenarios as early as possible in the production cycle. The scenarios for CCAR 2016 came about a week later in the cycle than they did in CCAR 2015. While this timing was still within the regulatory window, earlier delivery of the scenarios facilitates a higher quality of production, review and challenge, and assessment. It also helps to ensure that the banks' scenarios are calibrated to be more severe than the supervisory scenarios and that the banks' scenarios are well governed from an internal review and approval standpoint.

The published FAQ document has become a comprehensive list of questions and feedback and is useful to management to help improve the CCAR process in the upcoming year. However, consideration should be given to a more timely response mechanism, as responses to FAQs are generally not provided in a time frame that allows management to address immediate issues at hand.

Banks are providing tens of thousands of pages of documentation for the CCAR submission. There is an opportunity to tailor the submissions in order to reduce documentation that is not used in the review process. Feedback from the exam teams on what documentation was utilized versus what was not would be helpful to banks and would also reduce the burden on the examination teams, who have thousands of pages of documentation to sift through. Consideration should be given to a more streamlined list of documentation that must be submitted versus documentation that could be "available on request" (i.e., within a 24-hour time frame).

The continued assumption that banks would maintain all capital actions, over nine quarters in a severely adverse economic scenario and in violation of their internal capital policy and Board governance, may appear incongruent within the intentions of the CCAR process (which has focused on strengthening capital policies and Board governance). The capital actions assumed in stress cases should be consistent with the bank's capital policy, including contingency capital plans. For the SR 15-19 less-complex banks, alternatives should be considered to reduce their CCAR requirements and allow these firms to focus resources accordingly. Examples include eliminating the midyear stress test, providing greater specificity in certain rules through examples, and/or elimination of the adverse scenario.

DFAST Quantitative and CCAR Qualitative Disclosures

While we do appreciate the FRB's objective to limit the transparency of its modeling approaches, we continue to believe that more detailed quantitative disclosures in certain categories would help to facilitate banks' greater understanding of the FRB's areas of concern and would help to promote more stability in the planning process. Such selected areas would include operational risk losses (currently embedded within Pre-Provision Net Revenue) and a breakdown of consumer loan losses into domestic versus international.

Additionally, some banks believe that the process could be improved through increased disclosure around the qualitative component of the process. The limited disclosures for this pivotal aspect of the process limits investors' and external stakeholders' ability to understand which areas of the process are still in need of improvement and which banks have relatively stronger CCAR processes and controls in place. The redacted letters that the FRB and FDIC jointly published for the 2015 Resolution Plan submissions were a useful resource because they provided insight into the type of deficiencies that each bank faced. This increased disclosure afforded investors, counterparties, and other stakeholders the ability to assess the severity of the deficiencies and the potential costs associated with resolving them.

<u>Post-Submission Examination Process</u>

Generally speaking, there was an increase in both the quantity and granularity of the exam questions in most areas. Many firms did note that examination questions clearly linked back to the SR 15-18 and SR 15-19 guidance, which is encouraging, as it allows the qualitative assessment to be more clearly linked to written guidance. However, without consistent application from the examiners, it can be difficult to determine what standards are ultimately intended. For example, many banks (both SR 15-18 and -19) continued to experience "deep dives" by examiners into nonmaterial elements of the submissions, which often consumed significant firm resources and are arguably not required to do an assessment against the capital planning principles in SR 15-18/19. In addition, we would recommend that the FRB consider providing a follow-up white paper that further clarifies SR 15-19 by providing specific examples of where and how noncomplex BHCs may alter their current processes and still satisfy expectations.

As in the past, some banks experienced more continuity year over year in their horizontal exam teams. Others saw more turnover, resulting in more time spent on educational aspects instead of more substantive components of the capital planning process. In a worst case, such turnover can lead to different (and sometimes even contradictory) expectations from one year to the next.

Many banks believe that on-site supervisory teams can and should play a stronger role in helping to identify areas of examination focus, based on SR 15-18/19, and can make capital planning assessment more of an ongoing supervisory activity throughout the year and less of an annual examination that requires such significant time and resources in a short amount of time for both banks and supervisors.

<u>Written Feedback Process</u>

Timely and specific written feedback is enormously helpful to firms, as they focus resources on necessary remediation efforts. Most firms are expected to receive written feedback in mid- to late- August, more than 4 months after the CCAR 2016 submission, and more than 7 weeks after verbal object/non-object decisions were shared. This schedule leaves banks with a very limited window of time to identify and implement steps to address regulatory concerns in a well-controlled and documented manner prior to CCAR 2017. While we understand that many firms are provided with some verbal feedback on areas of concern prior to receiving the letter, the clarity of the written feedback is necessary to ensure that actions being taken are in fact responsive. Verbal feedback can and often does differ in its quality, depending on the experience level and familiarity of the individual delivering the feedback. What may seem like clear verbal guidance from an examiner can often be interpreted in a multitude of ways by those on the receiving end.

In a similar vein, we understand that the FRB's intention is to provide more thematic feedback in its letters this year rather than provide the level of specificity seen in prior years. While we recognize that in some cases this approach represents the "maturation" of the CCAR process, we cannot overstate the importance of clear and unambiguous feedback. Thematic feedback can leave readers unclear on intent. The FRB should provide the opportunity for immediate discussions after the receipt of the letters to clarify any ambiguities quickly.

Y-14A/Q/M Requirements
Concerns continue about the ongoing iterations of the Y-14A, Q, and M schedules. Most recently, a proposal was released on 7/28/16, with a comment period ending 9/26/16, detailing changes across many schedules, with most changes taking effect for the December 31, 2016, filings. Of note, many of the large firms were subject to a horizontal examination of their Y-14 reporting processes early in 2016, which highlighted the need for well-controlled, reconciled, automated, and rigorous processes to populate these schedules. Continued iterations of content requirements often necessitate the utilization of manual processes in order to meet filing deadlines. We strongly encourage stability in schedule-content requirements.

Cross-Agency Coordination
Finally, there is opportunity for closer coordination with the OCC to ensure a joint agency focus that does not create conflicting objectives or a different view of what are critical aspects of capital planning. While this is not an issue at all firms, which may be more a reflection of the working relationship between the FRB and OCC on-site teams at each firm, it remains an issue for some.

Item 7: Monetary Policy

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

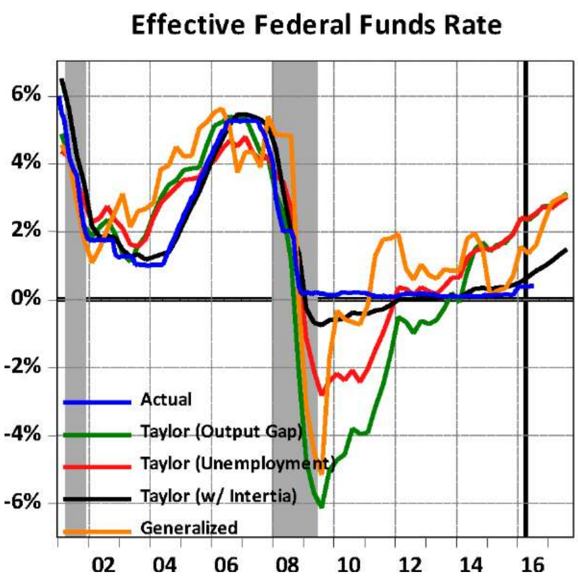
Any consideration of monetary policy must begin with an assessment of current and prospective economic conditions. In this regard, we perceive economic expansion to be at an advanced stage with little economic slack but still with unacceptably low inflation and inflation expectations. Over the intermediate term, the most likely economic path forward entails steady growth at a moderate pace, with additional labor market tightening and upward pressure on underlying inflation. This view broadly aligns with the Federal Reserve's median forecast, as presented in the June Summary of Economic Projections.

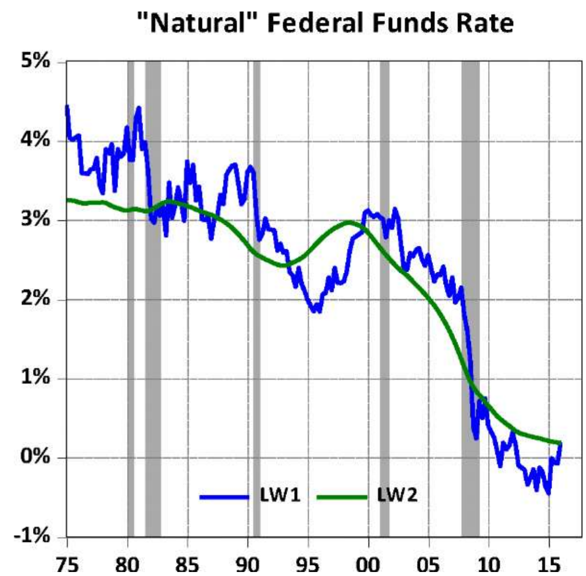
With risks to the forward path roughly balanced, monetary policy accommodative at the outset, and the recognized lags between monetary policy actions and their consequences, we believe a tightening, best characterized as "normalization," is appropriate.

With respect to interest rates, economists are in a dilemma. Conventional approaches to the determination of short-term interest rates - usually characterized as "reaction functions" - posit that short-term interest rates reside at some level based on historical relationships to output, unemployment, inflation, and an assumed "normal" (or "equilibrium" or "natural") level. Simply put, an overheated economy with rising inflation justifies an actual federal funds rate above the equilibrium rate, and vice versa. According to four such reaction functions in the FRB's macroeconomic model (FRBUS), and assuming that economic conditions follow the path stipulated in the June Summary of Economic Projections, these conventional approaches imply federal funds rates during the present quarter ranging between 0.8% and 2.5%, with an average value of 1.9%, which is well above the actual federal funds rate of 0.4%.[1]

Recently, the conventional wisdom about reaction functions has been challenged by the view that historically normal interest rates no longer apply. This new perspective asserts that the equilibrium rate has fallen sharply, perhaps even to zero in recent years, as compared with the 2% or higher levels of just a decade ago.

While a firm conclusion on this debate does not exist, it seems prudent to place the weight of emphasis on the long-established, conventional approach, which finds current levels of the federal funds rate far below what is implied by its historical relationship to output, unemployment, and inflation.





While maintaining an accommodative posture might be defensible given the low inflation rate and inflation expectations cited above, the preponderance of evidence indicates that wage and underlying price trends have been trending upward for the past couple of years. And given the usual lagged relationship between capacity restrictions and broader inflation outcomes, there is good reason to expect these trends to continue, further making the case for a gradual normalization. With respect to open market operations and the balance sheet, the Federal Reserve's Policy Normalization Principles and Plans, issued in September 2014, is due for updating. In particular, it stipulates that "The Committee expects to cease or commence phasing out reinvestments *after* it begins increasing the target range for the federal funds rate; *the timing will depend* on how economic and financial conditions and the economic outlook evolve." (emphasis added.) While the sequencing of balance sheet reduction subsequent to interest rate increases seems reasonable, we encourage the Federal Reserve to increase its verbal emphasis on

[1] Effective federal funds rate forecasts are drawn from the Baseline Scenario in FR/BUS and are consistent with the June Summary of Economic Projections. The natural federal funds rates are from "Measuring the Natural rate of Interest," by Thomas Laubach and John C. Williams, published in the Review of Economics and Statistics, November 2003, as updated.

balance sheet management. For example, if the Federal Reserve advertised its intention to cease reinvesting dividends, it would likely encourage the steepening of the slope of the yield curve, which in combination with elevating the federal funds rate, would also contribute to an effective normalization of monetary policy.

The Council members offered their opinions on this topic and, at least with respect to interest rate policies, unanimously agreed that continuing on a path to normalization was appropriate, with characterizations ranging from "deliberate but slow" to "prudently but quickly." The word "gradual" was often invoked. One Council member, using the word "cautious," emphasized economic risks outside of the U.S.

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