RECORD OF MEETING

Federal Advisory Council and Board of Governors

Thursday, February 6, 2020

<u>Item 1: Current Market Conditions</u>

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) consumers, and (f) homes? Do Council members see economic developments in their regions that may not be apparent from the reported data or that may be early indicators of trends that may not yet have become apparent in aggregated data?

General Outlook:

- Council members uniformly believe that economic growth in most geographic regions remains solid, with no significant change from the last Council meeting in November. Consumer confidence remains strong, and consumer and business activities indicate general optimism across the board. Financial markets remain stable and continue to support economic growth, despite the overhang of global economic and geopolitical risks, including trade risks.
- Job growth continues in all regions and wages continue to increase modestly due to the tight labor market. Job vacancies are more difficult to fill than they have been historically: many Council members identified the inability to find and retain skilled labor as the most limiting factor for overall business expansion.
- Overall, loan markets remain fairly strong. Volume remains stable, while rate competition is intense. Terms and conditions also remain quite competitive. In general, the Council believes that banks are remaining relatively disciplined on loan structures and terms. On the other hand, nonbank lenders continue to be more aggressive, particularly in the leveraged lending space. Asset quality across all geographies and most sectors remains solid. The agriculture and energy sectors are among the exceptions.
- The Council sees well-functioning and liquid financial markets, modest economic growth, and solid pipelines resulting in continued moderate loan demand growth and strong rate competition in the first part of 2020.

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) consumers, and (f) homes?

Council members observed only marginal changes in loan markets since the last meeting in November. Overall, credit quality remains steady and strong. Losses remain at historically low levels. Loan pricing and underwriting standards are very competitive in all categories.

(a) Small and Medium-Sized Enterprise

- Loan demand from small and medium-size enterprises remains healthy and stable, consistent with general business optimism.
- Scarce availability of talent and rising wages remain challenging for this category.

(b) Commercial Real Estate

- Commercial real estate (CRE) loan demand is also steady, and delinquency remains at a very low level.
- Supply and demand fundamentals in this category remain generally balanced, with some Council members noting concerns related to oversupply in metropolitan markets that have experienced dramatic multifamily development expansion.

- Bank lending standards have remained disciplined; however, loan structures have modestly loosened with respect to guarantees and interest-only periods.
- Nonbanks are also active in this category, changing the competitive landscape.

(c) Constructions

- Construction loan demand remains reasonably strong, including for multifamily developments.
- Construction of single-family residences is solid but varies among regions. Council members have seen some evidence of price inflation in this category, impacting overall construction costs and budgets, driven by price volatility for raw materials (due to tariffs) and higher labor costs (due to scarcity of workers).

(d) Corporations

- Corporate lending conditions are favorable and stable.
- While commercial and industrial (C&I) loan demand and growth slowed modestly at year-end 2019, market fundamentals and business confidence remain favorable. Pricing and structure competition in this category is strong; however, bank underwriting remains balanced.
- Asset quality in this category remains strong, with delinquencies and classified assets at cycle lows.
- The Council noted the following potential risks in this category:
    i. (i) the overall level of outstanding corporate debt, including an elevated level of nonfinancial business indebtedness;
    ii. (ii) high levels of nonbank competition and lending; and
    iii. (iii) the approaching LIBOR transition.

(e) Consumers

- As stated above, consumer confidence remains strong, and consumers are generally optimistic and employed.
- Aggregate consumer loan balances have increased modestly.
- Single-family residential refinance loan volume remains strong, while purchase finance is stable.
- Credit quality remains good, and aggregate delinquency rates are still very low. Automobile lending is holding up well, with rational demand, modest delinquencies, and low loss levels.
- Credit card utilization is normal to strong, and delinquencies and losses remain steady and below historical averages.

(f) Homes

- Single-family home sales are slowing a bit - which is seasonal - but are better than a year ago.
- Price run-ups, new tax laws, and short supply have moderated home purchases, consistent with the last Council meeting.
- Refinance loan volume has increased due to the recent decline in rates.
- Council members note some slippage in the prices of upper-end single-family residences, sometimes significantly, largely in urban markets.
- Entry-level and midrange single-family residential transaction activity is steady.

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

- Most Council members do not see meaningful changes from November's report in the general conditions of their regions. Overall, the Council sees strong consumer confidence, as well as solid loan demand and activity across almost all sectors, along with strong asset quality. Financial markets are functioning and stable.

- Most recently, the onset of the coronavirus in China has introduced another macro risk into the overall economic equation. While it is too soon to predict or quantify the impact on business activity and behaviors, markets and sentiment have clearly changed based on the onset of this epidemic.

Item 2: Agriculture

International trade flows, the imposition of tariffs, and changing climatic conditions present challenges for U.S. agriculture. What does the Council see as the likely future path for this sector of the economy, both in the near term and longer term?

The U.S. agricultural economy is extremely complex, spanning vastly different geographic areas, diverse climates, and a broad array of livestock and crops, as well as varying operational structures, including farmers and ranchers, farming cooperatives, and agribusinesses. Almost all sectors of the agricultural industry were impacted by the 2019 trade talks and tariffs, and those regions of the country with the highest rates of farm exports felt the most severe impact.

Despite these adverse impacts, the agricultural economy appears to have performed well in 2019, with net farm income increasing for the third straight year after hitting a low in 2016. Net farm income was supported by the Market Facilitation Program (MFP) payments, in both 2018 and 2019, that went to farmers affected by tariffs. In addition, commodity prices have stabilized since the drop in 2015 after the peak years from 2011-2014. Nationwide, delinquency rates on agricultural loans have also stabilized in the last two years with improvements in net farm income.

The largest U.S. agricultural export markets all had tariffs in place in 2019 that affected U.S. agricultural products. The trade talks with China had the greatest impact on U.S. agricultural products, as China used retaliatory tariffs in the trade negotiations. China's tariffs on agricultural products significantly reduced U.S. crop and pork exports. Tariffs also had a negative impact on commodity prices as demand fell for U.S. agricultural exports. This not only hurt the farmer but also the agribusiness sector through lost sales.

The U.S. signed trade agreements with the four countries that represent our largest agricultural export markets. Chinese trade negotiations and the subsequently signed “Phase One” trade agreement garnered much of the attention in 2019. However, equally as important was the signing of the United States-Mexico-Canada Agreement with our two largest export markets. The U.S.-Japan Trade Agreement provides America’s farmers and ranchers with enhanced market access in our third-largest agricultural export market. Each of the four agreements touches most production agriculture. The success of production agriculture can provide positive momentum toward expansion of the other agriculture industries. Provided each party to these agreements upholds its promises, U.S. agriculture should see a benefit in 2020 and beyond, and the adverse impacts of the 2019 trade wars and tariffs should be diminished or altogether eliminated.

Farmers have been dealing with changes in weather and climate forever. Regardless of trade talks and tariffs, weather consistently remains the most significant factor affecting the farm sector's annual performance. In that regard, it is important to note that a weather event may have a negative impact in one part of the country and, at the same time, have a positive impact in another part of the country. These changes can cause quick and drastic changes within the agricultural economy. For example, in 2019, headlines focused on the excessive rains at the height of planting seasons in the upper Midwest and the Corn Belt, where the rain reduced the number of acres planted and ultimately the yield. In contrast, for other areas of the country, the additional rainfall created more advantageous growing conditions compared with previous years, and farmers produced more abundant crops. These contrasting points of view were demonstrated by the following statements by crop farmers: A southwestern Oklahoma farmer stated, “The 2019 spring planting season has been a disaster, the weather has prevented farmers from planting corn, and what is planted doesn’t look good”; meanwhile a farmer in northern Colorado stated, “Planting went well and crop conditions also look good."

Going forward, it is imperative for the U.S. agriculture industry to continue to adapt to changing climate conditions to survive. Farmers and the industries supporting farming operations, like financial institutions and agribusinesses, must help facilitate the changes needed to adapt field operations to climate change. Adaptations will include new varieties of seeds and crops, changes in tillage or irrigation practices, and modernization of other business practices. In the longer term, farmers must use technology, data analysis, and automation to develop more efficient and productive responses to climate change.

The agriculture sector has handled many challenges in 2019 and will find ways to meet future challenges. The economy has experienced stabilized U.S. net farm income over the last three years, improvements in working capital, solid land values, low interest rates, new potential export markets, a focus on climate change, and trade agreements signed with countries that represent our four largest export markets. Altogether these developments create a solid foundation and path of opportunity for growth in the U.S. agriculture industry going forward.

Item 3: Emerging Risks

Are there particular areas in which Council members see economic or financial risks beginning to emerge? Along these lines, how does the Council interpret two financial market trends: the growth in personal loans and the growth in corporate borrowing? How might policymakers consider mitigating these risks? In addition, how does the Council view financial market activities at year-end, particularly in the repo market?

Current discussions raised two emerging risks: the current rapid spread of the coronavirus within China and potentially beyond, and increasing awareness of threats to consumers' personal privacy, potentially leading to a broader regulatory response, which could impact economic growth. Council members continue to monitor the growth in personal loans, corporate borrowing, and cyber threats.

I. Emerging risks:

Coronavirus reproduction and fatality rates are unknown: The Centers for Disease Control and Prevention is closely monitoring an outbreak of respiratory illness caused by a new coronavirus first identified in Wuhan City, Hubei Province, China. Additional cases have been identified in a growing number of other countries, including the United States. China has ordered an unprecedented quarantine of more than 50 million people. However, China's government acknowledges that millions of travelers left their borders before quarantines were enacted. Other countries in the region have introduced travel restrictions, closed public facilities, and cancelled public events.

There is concern that travel and luxury-goods brands could be among the first areas impacted in the U.S. Several U.S. airlines have suspended some flights to China. Nearly 3 million Chinese traveled to the U.S. in 2018, with a median trip length of 14 days, and spent $8,000 to $10,000 per traveler.[1] According to McKinsey & Company, Chinese consumers spent over $115 billion on luxury goods in 2018.[2] Concern was also expressed about disruptions to supply chains in affected areas.

Policymakers should revisit supervisory guidance on pandemic preparedness (SR 06-5 and 07-18) and urge member banks to revisit their own response and contingency plans.

State privacy regulations add to a complex regulatory environment: Privacy is becoming a growing issue. States are pursuing legislation to protect consumers from misuse of "privileged personal data."

[1] "China Travel and Tourism," International Trade Administration, 13 October 2019, https://www.trade.gov/knowledge-product/china-travel-and-tourism

[2] "China Luxury Report 2019," McKinsey & Company, April 2019.

Eleven states passed privacy laws in 2018 and 2019, and Council members anticipate this trend will continue. [3] Coordination among the multiple federal regulatory agencies involved could have the beneficial result of updating regulation in a thoughtful way, applying common principles and basic consumer privacy protections across all industries. Policymakers may consider taking a lead on that coordination.

Cybersecurity remains a challenge for most companies: Several Council members remain concerned about cyber threats, particularly after U.S. tensions with Iran escalated. The annual "Data Breach Investigations Report" illustrates that breaches are still on the rise, and the time to detect a breach remains a significant challenge for most companies.[4] Recent ransomware attacks on U.S. state and local governments lead some Council members to question overall response readiness. The migration to cloud computing also raises concerns about third-party cybersecurity risk-management practices. Policymakers should consider facilitating collaborative programs between the public and private sectors to encourage cyber-threat intelligence sharing, as was recently done in response to tensions with Iran.

II. Interpretation of financial market trends and year-end activities

Growth in corporate borrowings: The Council again discussed the growth in corporate borrowing, as well as the significant increase in the level of BBB-rated investment-grade debt. The absolute amount of BBB-rated debt has grown 170% since 2008. [5] Growth has been spurred by record low interest rates and ample availability of credit in the public and private markets. In earlier credit cycles, lenders were only willing to offer covenant-lite loans to the strongest borrowers. Recent studies have shown that covenant-lite-loans now constitute up to 80% of leveraged loans outstanding, compared to 15% a decade ago. Lenders have been accepting lower spreads for more highly leveraged deals. Council members remain concerned about the potential for widespread downgrades if the economy contracts.

Growth in personal loans: While the unsecured credit facility represents a small portion of overall consumer debt, one Council member believes it is arguably the riskiest. Consumers are moving towards digital borrowing processes and away from highly regulated banks and secured products. The use of artificial intelligence and technology has a rising acceptance rate and contributes to this growth.

The Federal Reserve, along with the other prudential regulators and the Consumer Financial Protection Bureau, encourages prudent use of alternative data in credit underwriting, recognizing it may increase the speed and accuracy of credit decisions and improve availability of credit for those who currently may not obtain credit in the mainstream credit system. Council members agree but recognize the importance of managing credit and compliance risks.

Policymakers can mitigate growing risk by monitoring subprime, unsecured installment credit in the U.S. Policymakers should continue monitoring the increased use of alternative data in credit underwriting to ensure it is appropriate for measuring the borrower's ability to repay and that risks are appropriately managed.

Year-end financial market activities: Council members viewed year-end financial market activities as a non-event for the short-term borrowing markets, as the Federal Reserve provided clear communication and ample liquidity. Several Council members question whether the liquidity shortage is an unintended consequence of the liquidity coverage ratio (LCR) mandate. Council members agree that the Federal

---

[3] "2019 Consumer Data Privacy Legislation," 3 January 2020, https://www.ncsl.org/research/telecommunications-and-information-technology/consumer-data-privacy.aspx.

[4] "2019 Data Breach Investigation Report," 21 May 2019, https://enterprise.verizon.com/resources/reports/dbir/.

[5] "Next Debt Crisis: Will Liquidity Hold?," S&P Global, 12 March 2019, https://www.spglobal.com/_assets/documents/corporate/global-debt_will-liquidity-hold-v11mar2019.pdf

Reserve needs to carefully time any liquidity drawdown to avoid market disruption. Policymakers may consider clarifying supervisory expectations related to LCR.

Item 4: Employment and Inflation Dynamics

What are Council members' expectations for labor market conditions in the coming year? Is wage growth likely to pick up? Are employers looking for other ways to increase employees' compensation packages? Does the Council see any signs that price inflation will pick up? Are Council members seeing any direct effects of higher tariffs in their regions?

What are Council members' expectations for labor market conditions in the coming year?

Since the November meeting, payroll growth continued at a slowing rate, the labor participation rate leveled off, and national unemployment remained steady at 3.5% (a 50-year low) with 1.2 job openings for every unemployed worker. As discussed in the last several meetings, Council members expect employment conditions to remain tight, particularly in certain highly specialized job categories such as technology, cybersecurity, and digital. Council members shared anecdotes from their customers on continued challenges related to filling open positions, especially for workers with specific skill sets. Employers in certain regions, such as Upstate New York, are experiencing a compound effect of low unemployment and labor pool declines -- in contrast with average workforce growth of 10% for the top 53 metropolitan areas and 7% for the U.S. over the past decade.

Is wage growth likely to pick up?

Average hourly earnings have continued to increase, although the magnitude of change varies by region. While some Council members expect wage pressure to remain strong and potentially accelerate for lower-tier earners, on the whole, Council members believe wage increases will be moderate. Specialized skills are expected to continue to command higher-than-average wage growth. Some Council members have observed that the "switch premium," or the amount required to entice an employee to take another job, has doubled to 20-25% from normal levels of 10%.

Are employers looking for other ways to increase employees' compensation packages?

Council members continue to seek ways to increase compensation and attract workers without raising base pay and, as discussed in the last several meetings, employ a wide range of creative strategies to attract and retain high-performing talent. A significant number of these strategies fall into the category of ancillary benefits and thus are not reflected in wage growth. Student loan repayment assistance, employer contributions to 529 college savings programs, paid time off for participation in community-related activities, and changes or enhancements to physical accommodations are important in attracting today's workforce.

Council members reported enhanced and/or specialized training programs to develop "in-house" talent and upskill labor within their markets. These programs have struggled to attract qualified candidates due to obstacles such as some candidates' prior criminal convictions or other social or legal impediments.

A number of colleges have reported experiencing accelerated recruiting cycles combined with new techniques, such as employers making students "on the spot" offers rather than offering higher starting salaries.

Does the Council see any signs that price inflation will pick up?

As discussed in the last several meetings, Council members continue to report little evidence that price inflation is increasing, though some members noted anecdotal signs of rising prices in part due to higher U.S. import tariffs. Inflation is expected to gradually move toward the 2.0% target in the coming year.

Are Council members seeing any direct effects of higher tariffs in their regions?

Consistent with discussion in the last several meetings, Council members continue to report that tariffs have had limited, but observable, effects particularly in the manufacturing and agriculture sectors. Businesses have generally reported that they are trying to absorb increased costs or have only passed on a portion of these costs due, in part, to pressure from large retailers and/or higher-than-average inventories built before tariffs took effect. Replenishing these inventories may add pressure to pass a higher portion of tariff-related costs to customers. One Council member noted that some manufacturing businesses reported layoffs due to reduced demand resulting from tariffs and that large export orders have, so far, failed to materialize despite progress on tariff agreements. Another Council member cited a recent survey of mid-market businesses in which over 40% reported a negative impact from tariffs. The tariff burden is expected to continue in 2020, which may ultimately lead to inflation if additional costs are passed on to consumers in the form of higher prices.

Item 5: The Outlook for Banking in 2020

a. **What will be the drivers of bank profitability?**
b. **How is deposit pricing evolving?**
c. **Is the industry well positioned if interest rates change?**
d. **What is the outlook for brokerage services at banks?**
e. **How is the competitive landscape for banks evolving with respect to fintechs and other organizations?**

(a) What will be the drivers of bank profitability?

Bank profitability is expected to remain relatively steady in 2020. Council members believe earnings growth will slow due to a flat yield curve, a competitive lending environment, compressed net interest margins, minimal operating leverage gains, and impacts from implementation of the CECL (Current Expected Credit Losses) accounting framework. Council members expect credit trends to remain favorable, which will be positive for the industry. The pace of mergers and acquisitions may continue in 2020 as banks look to drive efficiency gains via scale. A summary of industry analysts' projections suggests that revenue growth will be 0 - 2%, the slowest since 2015.

Loan growth is expected to be competitive, with consumer lending outpacing commercial. Analysts believe that loan growth of 2-3% will be offset by compression in net interest margins (NIMs) of 0-10 basis points. Council members noted that margins continue to shrink due to increased competition and low interest rates. Banks have remained disciplined with their underwriting; however, less regulated participants (nonbanks) are noted as being more aggressive and taking market share.

Fee income trends are likely to be varied, with flat to modest growth in traditional bank fees, lower mortgage fees relative to 2019, and higher payments fees. Brokerage and asset management fees have also declined over the second half of 2019, as many brokerage firms have reduced fees to $0.

Strong employment and wage growth are important factors for steady credit performance in 2020. Provision expense is expected to increase year-over-year across the banking sector for the first time since 2016, as net charge-offs rise from historic lows. While no meaningful signs of credit deterioration exist across the various Districts and portfolios, commercial loan books continue to be closely monitored.

Given the implementation of CECL, 2020 will be a significant year for reserves and provisioning. CECL introduces a higher level of uncertainty into bank earnings and reduces comparability across banks. While the overall risk profile or lifetime profitability of underlying loans does not change, markets are generally uncertain as to the volatility of earnings.

Expense controls and efficiency gains will be key in 2020 but may be challenging to obtain, given rising personnel costs and ongoing business investment. Council members noted that tight labor market conditions are driving compensation costs higher. Expense growth of 1-2% is expected across the banking sector in 2020, with a trend of technology investment that is aimed at increasing efficiency, productivity, and speed to market.

(b) How is deposit pricing evolving?

Industry analysts expect deposit growth to slow to 3-5% in 2020 from 6% in 2019. A variety of competitive and market forces will ultimately drive the demand for deposits, which will impact pricing strategies across the sector.

Council members noted that retail deposit pricing has become increasingly competitive as the adoption of digital banking has risen across all demographics. According to Gallup, millennials are switching banks 2.5 times faster than baby boomers. Traditional and diversified banks are likely to continue leveraging multiproduct relationships to maintain lower deposit costs. Also, technology has helped consumers have multibank relationships, e.g., having checking accounts with traditional banks and savings accounts with direct banks.

Direct banks, with their large digital footprints, will continue competing through a combination of service, higher rates, and innovation. Council members discussed examples of leading direct banks that had delivered strong deposit growth while also maintaining high levels of customer retention. Direct banks have continued to gain market share, growing at two to three times that of the traditional banking market, and are expected to continue to outpace retail-industry growth rates.

The forward curve projects one to two decreases in the federal funds rate in 2020. Industry-wide deposit betas of 33% through the last tightening cycle demonstrated strong pricing discipline among banks. As a result, the starting point for deposit costs in 2020 is lower, which may limit the ability of banks to reduce deposit rates in connection with a decrease in market rates.

In the current rate climate, the threat of price-disruptive new entrants has diminished but is expected to return when rates begin to rise. New entrants will utilize technology, innovation, marketing, and rates to differentiate themselves from traditional banks. Further, nonbank providers and wealth-management-focused providers have launched a variety of disruptively priced savings products.

(c) Is the industry well positioned if interest rates change?

Council members believe that banks are generally well positioned to manage gradual changes in interest rates — up or down. Given the current forward path of rates, asset-sensitive banks are expected to face additional pressure on net interest margins, but bank balance sheets have demonstrated resiliency over the past several years. Many banks have used derivatives and hedging strategies to remain fairly neutral to a gradual shift in rates. Large or sudden movements could be disruptive to market participants, but this seems unlikely under current conditions.

Barclays estimates that 16 of the 23 banks it analyzes would experience less than a 5% earnings per share impact from a 100-basis-point downward move in interest rates and that 19 of 23 banks would benefit from a 100-basis-point upward move. While relatively balanced across these scenarios, these estimates demonstrate that the risk to banks' net interest income would be higher in a sustained downward movement in rates of 50 basis points or more. Notably, a 100-basis-point downward move would imply a federal funds target and 10-year Treasury rate of less than 1%.

Predicted exposure to interest rate movements depends largely on deposit-pricing assumptions in various scenarios. Additional considerations for lower-rate scenarios include mortgage prepayment behavior, in

addition to the broader economic environment and the potential for credit underperformance, both of which would exacerbate earnings impacts.

(d) What is the outlook for brokerage services at banks?

In 2019, brokerage services underwent significant change, which is expected to continue in 2020. Council members expect that increased scale resulting from ongoing consolidation may take place, offsetting reduced fees ($0 trade commissions) and compressed margins reflecting the current interest rate environment. The impact of emerging providers, which are focused on customer service and low fee structures, will increase the emphasis across the industry on strong, digitally based, affordable product offerings. Trends demonstrate the rapid shift in the brokerage services to commoditized products and technology-driven offerings.

Smaller providers, including community and mid-sized banks, are likely to see reduced strategic benefits in offering brokerage services, given reduced profit margins. Larger providers may consider mergers with competitors to increase scale or enhance and bundle in-house offerings to drive increased value to customers.

The ongoing secular shift toward do-it-yourself and robo-advisory products will likely result in lower revenue opportunities relative to historical levels. This will be partly mitigated by subscription-based products and customized financial planning services, similar to what Charles Schwab began offering in early 2019. Beyond this, revenue opportunities will increasingly shift toward economies of scale, customized advisory services, and cross-product activities. Over the next several years, the lines between large players will continue to blur while disruptive players will look to further expand their niche offerings across targeted market segments.

From a regulatory perspective, the implementation of the Securities and Exchange Commission's Regulation Best Interest (Reg BI) in June 2020 will have an impact on every function of brokerage firms, including sales, operations, product, risk, and the client experience. Several states are also advancing proposed standards of conduct for brokers and investment advisers. These concurrent changes will each create implementation challenges.

(e) How is the competitive landscape for banks evolving with respect to fintechs and other organizations?

The rapid development of technology across financial services over the past decade has often focused on seamless and frictionless customer experiences, accelerated speed to market, and cutting-edge product offerings. These have increased the focus of both banks and fintechs on leveraging existing technology infrastructures and broad customer relationships to develop increasingly innovative, digitally based products.

Fintechs have been able to demonstrate rapid technology development and customer adoption; however, many have yet to generate sustained profitability, even while operating under a less rigid risk and compliance framework. Council members noted that regulatory oversight has been slower to develop for fintechs and has resulted in an uneven playing field in some areas, introducing incremental consumer risk and increased cybersecurity vulnerabilities.

Council members pointed out that key questions remain as to whether fintech business models can mature and remain viable during periods of economic stress, capital market disruptions, or higher regulatory oversight. While fintechs have been innovative, many have had difficulty scaling despite strong supplies of venture capital.

Fintechs' ability to offer traditional bank products, including savings, investing, payments, peer-to-peer lending, and insurance products across all geographies, introduces a reduced cost-to-acquire opportunity. While partnerships have occurred, fintechs have increasingly become competitors rather than partners." And fintechs have demonstrated a desire to expand in the payments sector. Boston Consulting Group estimates big tech will generate revenue on $1 trillion in payment volume through 2027.

In response to fintech developments, Council members noted that banks have continued to innovate their existing products, leveraging their vast technology and infrastructure, to benefit their customers. As the industry has evolved, banks have increasingly acquired or partnered with fintechs to maximize utility and relevance. Banks collaborating with nonbank firms to offer products and services must consider whether such a relationship helps the bank achieve its strategic objectives: in so doing, banks have increased the importance of sufficient due diligence and appropriate controls to limit unintended outcomes.

Finally, digital-only banks and digitally based product offerings from traditional banks have continued to grow over the past decade, allowing banks to address shifting secular trends for competitive rates and frictionless product offerings.

Item 6: Credit Union Competition

Over the past ten years, credit unions have been growing rapidly relative to banks. Have Council members' institutions been impacted by this growth? Has the nature of competition with credit unions changed in recent years? From Council members' perspectives, should credit unions be viewed as full-fledged competitors of banks? Do Council members see any meaningful difference between banks and credit unions? How do Council members interpret the recent uptick in credit unions buying banks?

Have Council members' institutions been impacted by this growth?

Credit unions are an important part of a well-functioning financial system. Credit unions generally share the same types of customers as community and commercial banks, and, like banks, credit unions accept deposits, make loans, and provide a wide array of other financial services. Over the last five years, it is estimated that credit unions have increased their assets by more than 35%, while banks' assets grew only 20% during the same period. Community banks and smaller regional banks tend to face the most significant competition from credit unions. These institutions have experienced competition mainly in retail deposits and consumer lending, with inroads into small business and commercial banking in some regions. Assets at small banks, defined as banks with less than $10 billion in assets, have declined in both 2017 and 2018, while assets at credit unions have increased more than 5% each year. Credit union assets now total $1.5 trillion, with credit unions holding 9.2% of insured deposits. Credit unions have experienced significant growth in business lending in the last few years, to $71 billion by year-end 2018 from $56 billion in 2016 and $4 billion in 2000. Credit unions have a nearly 25% share of auto lending and a 17% share of mortgage originations.

Has the nature of competition with credit unions changed in recent years?

Recent changes to the credit unions' Member Business Loan rules have made it easier for credit unions to participate in the small business credit space. As a result, credit unions' share of business lending, although still small, has accelerated in recent years. Credit unions have also relaxed membership requirements, allowing access to a wider customer base than contemplated by the original credit union model, which focused on a customer base from a specific employer or community group. California's largest credit union has a field of membership that covers the entire state of California. The largest credit union in Washington State, which was established to serve employees of a particular company, now serves anyone who lives, works, or worships in Washington State. Additionally, a credit union in Alaska recently purchased seven branches from a bank in Arizona. The common bond of membership, historically part of

the credit union model, has largely dissolved as credit unions, like community or regional banks, serve large communities of borrowers with little affinity to each other. As a result, credit unions are now directly competing with banks in many areas of the country as the barriers to entry have been relaxed or eliminated.

Many large credit unions now operate and market themselves in ways that are functionally indistinguishable from community or smaller regional banks. Credit unions have begun to market themselves as banks and leverage their tax subsidy, not to the benefit of their members, but instead to grow their institutions for profitable purposes. For instance, one credit union recently bought the naming rights to the arena of an NBA team for $120 million. Also, a large credit union in California, in addition to being the title sponsor of a college football bowl game, uses the tagline, "It's not big bank Banking, it's better." If one Googles "credit unions," especially larger credit unions, the online marketing positions the credit union as a bank and is directly aimed at competing against banks.

From Council members' perspectives, should credit unions be viewed as full-fledged competitors of banks?

Credit unions should be viewed as full-fledged competitors of banks, specifically community or regional banks, especially in the area of consumer deposits and consumer finance. From a retail consumer perspective, credit unions offer a similar deposit product suite relative to banks. It is hard to distinguish differences between the two outside of pricing, as credit unions typically offer better rates and lower fees due to their tax-advantaged status. Competition from credit unions can be seen in diverse consumer lending product products, including direct and indirect auto, home equity, recreational finance , and, to a lesser extent, mortgage lending. Banks report that this competition tends to take the form of lower pricing, extended loan tenors, and more liberal credit underwriting. From a commercial perspective, larger credit unions are building out their product and service offerings for small businesses and commercial real estate investors by recruiting commercial lenders from banks. Credit unions can offer business loan terms that are more aggressive than banks' terms, such as longer maturity and amortization periods with no prepayment penalties. To compete and/or maintain relationships, banks are faced with the choice of either offering loans with less than optimal pricing and underwriting standards or passing on specific deals.

Do Council members see any meaningful difference between banks and credit unions?

The main differences between banks and credit unions are the regulations credit unions are subject to and the tax advantages that they are afforded. These differences have created an unequal playing field in the industry. As not-for-profit organizations, credit unions are not subject to income tax, which provides credit unions with a pricing advantage over banks for loans and deposits in both the consumer and business banking areas, as well as with respect to mergers and acquisitions. Additionally, although the statutory mission established for credit unions in 1934 was to serve persons of "small means" with "provident or productive" financing, credit unions are not subject to the requirements of the Community Reinvestment Act. Another distinction, as credit unions have entered commercial lending, is the difference in regulatory thresholds for required appraisals. For credit unions, the threshold for requiring an appraisal for a commercial real estate transaction is $1 million, whereas federal financial regulators have set the appraisal threshold for banks at $500,000 — resulting in a riskier business model for credit unions. Finally, while banks have been subject to Basel III capital standards for several years, the National Credit Union Administration has delayed the implementation of risk capital rules for credit unions until January 2022.

How do Council members interpret the recent uptick in credit unions buying banks?

An emerging trend in mergers and acquisitions is credit unions' buying community banks. Sixteen deals were announced in 2019, which is double the number in 2018. The earliest examples involved small credit unions and small, at-risk community banks; however, more recently, larger, growing banks have been targets. Additionally, as noted earlier, credit unions are beginning to acquire bank branches in new markets, further calling into question the "common bond" of membership. Given the tax advantage credit unions have, this is not surprising, as a dollar of earnings of an acquired bank is worth 79 cents to a bank after-tax but is worth a dollar to a credit union. As a result, credit unions are able to pay more for a bank.

Additionally, a credit union can carry goodwill as capital on its balance sheet without it being deducted in calculating capital compliance. Credit unions' purchases of community banks support the claims that any difference in the business models between credit unions and banks is increasingly immaterial and that the regulatory requirements for credit unions, as well as their tax-advantaged status, allow credit unions to operate more profitably.

Item 7: Modern Branching

How is branch banking evolving? Some observers have argued that in the digital age, branches need to become "engagement hubs" that offer customers more than just banking services. To what degree do bank customers still desire a physical branch to access their banks, and do branches need to provide other services to remain relevant?

How is branch banking evolving?

As more banking transactions are moving to self-servicing channels online or on mobile devices, banks have responded by adjusting branch strategy to accommodate fewer visits and changing service demands. The number of full-service branches of FDIC-insured banks has fallen to approximately 83,100 in 2019, from a series high of 94,900 in 2009, and Council members expect this trend to continue. FAC members disagree about the pace of this change, with some expecting a rapid shift to alternative channels, while others see this change occurring at a more gradual pace.

Some Council members have observed reductions in the footprint or size of branches as well as in retail-only branch employee headcounts. Branches are shifting priorities away from transactions to self-service options through virtual channels (digital and call centers) and, throughout the physical network, to transaction-enabled kiosks that offer service, sales, cash, and video contact with a range of specialists. These offerings allow associates to spend more time engaging clients with valuable advice, solving customers' needs, and being out in the communities they serve. Retail headcount is not the only transition happening. Other consumer bankers with specialties in private wealth management or business services are increasingly using the branch network as the hub of the community. As transactions dwindle over time, driven by customer preference and banks' shifting emphasis to self-serve options, the evolution of bank delivery continues.

The reduction in the physical branch network has also pushed banks to optimize their remaining networks, using space for advisory conversations and transactions during business hours and special events after hours. Branch location has also become more strategic, with banks choosing locations to reach the broadest geographic base and to target expansion markets with physical branches acting as "always-on" billboards. This observation is complemented by a study from McKinsey & Company that finds that a single branch in a large market can be worth millions of dollars in annual marketing.

Many institutions are working to balance the needs of more rural, less populated markets with operating viable branch networks.

Some observers have argued that in the digital age, branches need to become "engagement hubs," which offer customers more than just banking services. To what degree do bank customers still desire a physical branch to access their banks, and do branches need to provide other services to remain relevant?

Council members believe that customers still desire a physical branch, although their frequency of visits continues to decline. Although many customers prefer executing transactions on alternative platforms, such as online or on mobile devices, they still value the branch for account opening, complex or substantial transactions (e.g., home purchases and student loan refinancing), financial advice, and problem resolution.

The branch continues to evolve from a transaction- and administrative-oriented function to one focused on sales and engagement.

Some Council members believe proximity to a physical branch continues to be a primary consideration in a customer's purchase decision, while others have not observed customer attrition as a result of branch closures. These Council members believe the consumer's definition of convenience is also changing: It is better measured by a customer's ability to interact with their bank through their channel of choice at the time they choose. While the proximity to a physical branch and the hours that the branch is open are important to the new definition of convenience, the ability to interact and solve a need is no longer dependent on these two factors.

To address customers' changing preferences, banks have been redesigning branches to create a comfortable environment that facilitates advisory conversations and promotes trust and relationship-building with customers. One successful example is the Capital One Café model, which allows customers to get financial advice in a casual, relaxed atmosphere featuring coffee and snacks. Although this model is still new and has not proven scalable by others in the industry, Council members have observed that similar "engagement hub" styles are taking off at branches in their Districts and in their communities; in fact, many FAC members are experimenting with the engagement-hub model of branch banking.

The engagement-hub model emphasizes personalized offerings to customers, including financial advice, full-service capabilities, and community offerings and education from subject-matter experts on topics that have financial implications, such as cybersecurity, new tax regulations, and financial literacy. Although Council members agree that this model works well in certain markets, some Council members note that their range of markets necessitates differentiated delivery, with some branches in transaction-oriented, high-share markets. These engagements hub models become a challenge where the legacy experience is primarily transaction-based. Some banks are also experimenting with alternative methods of bringing bankers to customers, including setting up pop-up branches, investing in larger fleets of mobile units, revamping in-store branch designs, and building more dynamic stand-alone drive-up ATMs.

Council members note that branch-experience design is catering more to millennials, a large generation that is getting older and moving into a more complex financial-life stage. As they age, they are demonstrating increasing preference for visiting a physical branch after they exhaust their online research to determine the best solution for their need. The millennial generation has also changed the purchase cycle of any product or service by creating and defining two distinct journeys, shopping and buying. Before digital channels, these journeys were combined, whereas now banks must consider the two paths as independent yet related. For banks to be attractive to millennials, they will have to be prepared to service customers who tend to be more knowledgeable and expect the branch to continually provide value beyond being the single service-point of a transaction or the venue for setting up a new account.

Although banks are investing more in digital offerings, Council members note the importance of delivering a consistent, cohesive experience across all channels. Customers are demanding a frictionless experience that allows them to pivot between channels with ease, including visits to a physical branch. At the same time, direct banks note that an increasing number of consumers have demonstrated a willingness to unbundle banking services to take advantage of higher deposit rates. Despite the growth in customer activity at direct banks, most customers still maintain a checking account at banks with branches to access their service offerings.

The frequency and vastness of transformative cycles appear to be increasing, which translates to more frequent branch strategy changes. As a result, most Council members report using a test-and-learn approach to collect feedback, as changes are implemented to inform future strategy.

Item 8: Monetary Policy

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

The three recent cuts to the targeted federal funds rate, totaling 75 basis points, have provided for a neutral to modestly accommodative monetary policy, at a level of 1.5% to 1.75%. The domestic economy is relatively healthy, but growing slowly, as evidenced by GDP growth of 2.1% in the fourth quarter. Growth expectations for 2020 are slightly lower, at 1.8%. Household spending and confidence remain relatively strong, with the reduction in interest rates providing renewed support for the housing sector and a demand for loanable funds.

That being said, it is important to measure monetary policy in light of the Federal Reserve's mandate to promote maximum sustainable employment and price stability. Employment figures remain healthy and are expected to continue to be so throughout 2020. The unemployment rate declined to 3.5% in 2019, matching a 50-year low, and is at the low end of the longer-run normal unemployment range of 3.5 to 4.5 percent. The tight labor market did not result in as large of an acceleration in wage growth as might have been expected. The annual growth in average hourly earnings was close to 3% in 2019. This lack of acceleration in wages likely contributed to tame inflation. Should unemployment fall further as a result of continued economic expansion this year, wage pressures are likely to intensify over time, with firms finding it easier to pass on cost increases due to increased demand. Inflation conditions currently remain subdued at 1.6% year-over-year, underperforming the 2% inflation target. The FOMC's recent rate reductions should continue to promote stronger inflation and increase the likelihood of achieving this target.

The Council views current monetary policy as appropriate in the current environment, with moderate economic growth, a strong labor market, and inflation near the Federal Reserve's objective of 2% as measured by the core PCE (personal consumption expenditures) price index. Accordingly, this policy is consistent with the Federal Reserve's dual mandate. The Council also supports the Federal Reserve's stance that monetary policy is data driven.