Record of Meeting

Federal Advisory Council and Board of Governors

Thursday, May 6, 2021

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

As deployment of the COVID-19 vaccine continues, and with the enactment of another round of COVID-19 relief legislation, the economy continues to recover. What is the Council's assessment of the strength and sustainability of the recovery?

<u>Consumer Spending:</u> **What are Council members observing with respect to the overall strength of consumer spending in their Districts, and what trends are likely in the second half of the year? Aggregate household savings, much of it in cash, have risen uncharacteristically since the onset of the pandemic. How are banks' customers deploying those savings? Are any segments of consumer spending currently showing particular strength or weakness, and are there any indications that spending in these segments will increase or decrease in the near term? What differences have Council members observed by geography or among urban, suburban, and rural communities in their Districts?**

The economic outlook has improved significantly over the past few months, and most banks reported upgrading their forecasts accordingly. Vaccine distribution has been smoother than anticipated, passage of the American Rescue Plan Act of 2021 (American Rescue Plan) has provided $1.9 trillion in additional stimulus, and the associated uptick in spending is rivaling what was seen in round one. Incoming data on the first quarter of 2021 have also been better than expected, despite rising COVID-19 caseloads in early 2021 and severe winter storms.

All Council members reported that consumer spending grew at a very rapid pace in the first quarter despite weather-related disruptions in some parts of the country in February 2021. March 2021 was particularly strong, with several Council members reporting record debit spending (+20% to 40% versus 2020, with slightly higher rates versus 2019 levels). This trend continued to accelerate in April and is likely supported by the stimulus payments and pent-up demand. Council members noted that debit-purchase volume has generally exceeded prior-year levels consistently since May 2020 as credit volume shifted to debit and consumers replaced everyday purchases with larger average ticket items.

In general, Council members are anticipating that consumer spending growth will remain strong through 2021 due to increased vaccination rates, additional government support, and job and wealth gains. However, slightly slower consumer spending growth is expected in the second half of the year as reopenings stabilize.

Employment for low-income jobs (less than $27K a year) is still down significantly (~30%) from January 2020 levels, while high-income employment (greater than $60K a year) has almost fully recovered. Often these job and wealth differences are most pronounced along geographic, gender, racial, or ethnic lines. However, generous government income support has allowed low-income consumer spending growth to outdistance high-income consumer spending growth throughout the pandemic.

U.S. consumers have accumulated around $2.0 trillion in excess savings since the pandemic began, and aggregate household net worth has increased $70 trillion in nominal terms from the Great Recession low—more than doubling (+117%) due to rising equity, bond, and home prices. While consumers who received a stimulus payment in March 2021 did increase spending, particularly lower-balance households, more notable was the increase in savings transfers (three times higher than the norm across urban, suburban, and rural geographies).

There is still a high level of uncertainty around how much of the excess savings will be spent. Council members reported that balances in both checking and savings accounts remain high, as customers have been using income to increase their goods spending, pay down existing debts, especially credit cards, and increase their checking and savings deposits.

In terms of sectors, the first quarter of 2021 has seen spending growth slow in the best-performing categories of 2020 and improve in the hardest-hit sectors. Council members reported strong year-over-year growth in March for airlines, lodging, and fuel, and even in clothing and department stores. Pent-up demand for contact-intense services has rebounded sharply as restrictions have been lifted. Council members caveat that there may be lasting structural shifts in consumer behavior for a number of these sectors. They also noted that many of the most severely impacted sectors (retail, restaurants, etc.) are having a hard time hiring talent because many former employees are staying home due to childcare issues.

Council members reported differences in consumer spending via geography that appear mostly correlated to the speed with which states eased restrictions (i.e., Texas and Georgia are growing at much higher rates than California and Washington). While these differences will likely lessen with increased vaccination rates and increased openings throughout the year, the possibility of increased COVID-19 caseloads or new variants could change this.

Several Council members observed variances in consumer spending between urban and suburban/rural communities. Recovery has been more pronounced in suburban/rural communities, as consumers and families are still favoring less-dense living situations, whereas spending growth is lagging in high-cost metro areas, such as San Francisco, Los Angeles, Boston, and Washington, D.C. The exception appears to be tourism-driven cities that have lifted restrictions, such as Miami and Orlando, which are having among the biggest "bounce backs" since reopening.

<u>Business Investment</u>: Is business investment spending among bank customers changing, and how will spending likely trend in the near term? What are the primary factors influencing business sentiment toward investment? What types of projects are business customers considering, or what projects are underway? What types of projects are businesses considering delaying? How are businesses currently approaching the rebuilding of inventories?

Over the last quarter Council members have started observing a modest increase in business spending, led by greater confidence in the economic recovery as the COVID-19 vaccine has become more widely accessible and administered. During the pandemic, businesses were in cash preservation mode and liquidity was a priority, resulting in a curb of nonessential spending. The Council believes that this posture is slowly beginning to change, driven mostly by larger businesses starting to spend excess liquidity. Spending by small businesses continues to lag and is focused on essential expenditures.

Businesses are beginning to make investment decisions as their optimism in the recovery increases. The main factors being monitored include a combination of COVID-19 impact data (i.e., declining case counts and increasing vaccinations); government actions, such as fiscal stimulus, ease of restrictions at state and local levels, and corporate tax law changes; as well as general customer confidence and market sentiment.

Several Council members observed that larger firms have led the recovery in investment spending and have noticeably spent capital towards pivoting their strategies to meet customer demands via e-commerce, digitization of products and services, and automation. One Council member noted an increase in demand for and investments in warehouses and distribution centers to support the heightened demand of the online consumer. Another Council member cited that, with oil prices stabilizing at $60 per barrel there is anticipation for meaningful and potentially outsized investment in the oil and gas sector, as well as in renewable energy and electric vehicles.

Merger and acquisition (M&A) activity has also been healthy, which emerged as another form of business investment during the pandemic as businesses looked to combine and scale in order to weather the health

crisis. As the economy begins its recovery, Council members remarked that M&A activity has become more robust due to companies' increasing need for scale to compete and their having the liquidity to make acquisitions at a relatively low cost of capital.

Certain small business sectors, conversely, have been disproportionately impacted by COVID-19 and have relied heavily on government assistance programs, such as the Paycheck Protection Program (PPP), to obtain short-term relief. The Council believes that these small businesses are still lagging in terms of revenue recovery, compared to middle-sized and corporate organizations and as compared to pre-COVID levels. However, the pace of recovery for these small businesses depends significantly on state and local government reopening policies. Small businesses in states such as Florida and Texas that have had fewer restrictions have been able to recover at a faster pace than those in other states that have had tighter rules in place. In general, small businesses are beginning to grow increasingly optimistic, but it will take time to rebuild to pre-COVID revenue levels.

Generally, industries that were more heavily impacted by the pandemic have yet to recover fully and start new capital investments. With the exception of warehouse and industrial sectors, and certain geographies that have strong population and business inflows, like Texas and Florida, businesses have continued to show a reluctance to expand real estate until future work strategies are more fully developed. As many organizations move to hybrid working models, they may have more real estate than they require. This could have meaningful implications for investments in the office and retail sector for a prolonged period.

With respect to inventory, the Council noted that business inventory has plateaued to date, especially during the pandemic. Companies have rethought and minimized inventory levels and explored expanding their vendor base to minimize concentration and country risks. This shift has affected supply chain strategies, as business owners continue to work on supply chain optimization to lower financing and storage costs. One Council member stated how the recent congestion issues in the Los Angeles ports have negatively impacted and disrupted global supply chains for clients, with movement expected to normalize by the summer. Another Council member noted that some customers are building up inventories in anticipation of expected inflation. In general, a building-back of business inventory is expected to happen during the second half of 2021 and will be an important driver of overall business investment this year.

State and Local Governments: The budgets of state and local governments have been strained by stronger demand for their services amid decreasing tax revenues. How do Council members see state and local governments in their Districts managing this challenge?

State and local governments are still working through the same revenue and expenditure challenges that they had at the time of our February meeting and throughout a good part of 2020. The degree of financial pressure at the state and local levels varies considerably depending on factors such as the COVID-19 impact, geography, population size, demographics, and the mix of urban/suburban populations. Over the last 14 months, most states have experienced wild fluctuations in revenue estimates and economic conditions. The sources of revenue also play a significant role in how each locale is managing its challenges. Localities that rely on the leisure/hospitality or energy industries faced a deeper decline in revenues and are seeing a slower recovery than those with a more diverse economy. Just as the business sectors did in the last year, some state and local governments are doing well, and some continue to struggle.

More recently, optimism is growing across most Districts as the COVID-19 vaccine rollout pace increases and the nation's confidence improves regarding the pandemic. The positive adjustment is visible, with civic events, organizational events, and in-person meetings beginning to happen, along with bars and restaurants filling up and having wait times for seating. The optimism coupled with the increased activity levels should soon be reflected in state and local government revenues. Some state revenue sources have held up well over the last year: real estate taxes, as the housing market has performed at peak levels; wage-related taxes, as higher-income employees were working remotely; and capital gains taxes, as the stock market performed well. There are areas of the country that have been more cautious in dealing with

COVID-19 or have had new outbreaks, causing those states, counties, or cities to lag in a return to normalcy compared to the rest of the country.

Since February, the greatest lift to state and local government finances has been the latest round of stimulus money from the American Rescue Plan. This funding has helped state and local governments meet their challenges of funding public safety, mental health services, medical services, and education costs. The $1.9 trillion American Rescue Plan provided $350.0 billion for states, territories, and tribal governments, as well as to local governments, to mitigate the fiscal effects stemming from the pandemic. State and local governments now have additional funding outside of their own budgets to restore the services they were forced to cut last year, and to replenish lost revenue and rehire workers that were furloughed or laid off. In addition to the $350.0 billion, the American Rescue Plan earmarked $130.0 billion for K-12 education, $40.0 billion for higher education, which both suffered deep cuts in 2020, and $7.0 billion for broadband infrastructure.

An enormous amount of work remains to be done to get communities back on track. As long as state and local governments allocate the stimulus funds as intended and manage their budgets wisely, and as public confidence continues to grow, communities will be able to restore the services and expenditures that were cut because of the financial impact of the pandemic.

Price Pressures: Considering the disruptions to demand patterns, supply chains, and especially employment during the pandemic, are there particular sectors in which Council members see, or expect to see, bottlenecks or price pressures?

Council members consistently noted that customers reported increased input costs, resulting from supply chain disruptions, rising commodity costs, and higher costs for transportation.

Increased labor costs were not consistently noted as a significant element of price pressure at this time, although some increased wage pressures were noted in particularly hard-to-fill positions, such as transportation, IT, construction, and retail. At the same time, Council members report that a very common complaint from customers is the difficulty of finding employees, which is exacerbated by the need to compete with the jobless benefits currently available through late August of this year. This situation was highlighted in a March survey by the National Federation of Independent Business (NFIB), which showed that 42% of firms have been unable to fill positions. A number of Council members noted that the pandemic's increasingly serious and tragic impact in India has been a developing risk to the supply chain for technological services for many companies.

Arguably the most visible and ubiquitous example of bottlenecks and price pressures is in the construction sector, which has been impacted by supply constraints and price pressures. Numerous examples of sharp price increases for materials such as lumber, steel, copper, PVC, concrete, and general materials have been noted. Contractors have begun adding verbiage to their contracts to help protect against sudden and drastic price increases.

The shutdown of petrochemical plants in Texas during the winter storm Uri has led to numerous supply chain delays in raw materials for manufactured plastics, which are used in a variety of industries. The turnaround and restarting of these plants can take months to complete, and these supply chain disruptions, though temporary, are expected to last through mid-2021. Issues associated with materials like lumber and steel may be more long lived, against increasing construction demand as the economy rebounds.

The recent semiconductor shortage has been widely viewed as problematic by the Council, especially in the areas of personal electronics and automobiles. Amid new car production shutdowns due to a lack of semiconductors, the Mannheim Used Vehicle Value Index reported an increase of 26% year-over-year in March 2021. A Council member noted that inventory levels at high-volume dealers were down as much as 70% but that higher margins are helping to mitigate this decline.

Transportation and freight contributed to both increased costs and supply chain disruptions. A recent survey by Freightos revealed 77% of importers have encountered supply chain disruptions over the last six months, and one-third of those importers have increased prices as a result. Shipping container shortages, port backlogs, and the Suez Canal blockage have increased input price pressure. Shipping container prices from East Asia have roughly tripled over the past year. Meanwhile, shortages of truck drivers and trucks, increased fuel prices, and prioritization of vaccine deliveries have contributed to sharply higher shipping rates. The Cass Freight Index reported a 16% year-over-year increase in March 2021, up from a 12% increase in February 2021.

The Council believes it is unclear whether recent increased prices brought on by higher input prices and supply chain disruptions are transitory. For example, higher wages, which may be necessary to broadly fill current open positions, are unlikely to decline in the future, and the dramatic increases in construction costs, along with the lack of available labor, will significantly increase the cost of capital investment in major facilities.

Item 2: Current Market Conditions

What is the Council's view of the current condition of, and the outlook for, loan markets and financial markets generally? To what extent is the accumulation of debt during the pandemic affecting credit availability in various sectors of the economy? Are there other conditions or developments that are particularly noteworthy in lending categories such as consumer, commercial or residential real estate, construction, small and medium-size business, or corporate?

General Outlook

Optimism is building regarding the markets and overall economy. In the past couple of months, activity has picked up significantly, primarily due to vaccinations, stimulus funds, and the weather.

Additional stimulus funds have provided some relief for certain consumers and a boost to discretionary spending for others. Certain businesses that have struggled through the pandemic have received short-term benefits from the latest round of PPP funding, but they need the economy to fully reopen in order to have a sustained recovery.

The loan market is becoming more active. After a year of being cautious and significantly increasing deposit levels, banks are eager to lend. Excess liquidity and previously muted demand are creating significant competition among banks, leading to some price and structure pressure. Loan demand from borrowers is increasing, but many are deploying excess liquidity they built up during the pandemic and are still cautious about making significant investments.

U.S. high-yield bond issuance has shown few decelerations, as firming market conditions continue to attract borrowers. Thus far, the supply mix has included a larger share of M&A/LBO paper (40% of new issuance). Refinancing remains the dominant purpose for tapping the market – representing 51.5% of the ~$167.0 billion issued YTD April 2021.

To what extent is the accumulation of debt during the pandemic affecting credit availability in various sectors of the economy?

There has not been a large impact on credit availability from accumulation of debt during the pandemic, other than in certain highly affected sectors that have not yet recovered (e.g., leisure/hospitality, entertainment, full-service restaurants, energy, etc.). Many of these entities borrowed heavily or raised capital to sustain operations and need a robust recovery to remain a going concern. For many other business sectors, however, availability has not been affected.

Many companies did not see an increase in debt during the pandemic, and some deleveraged. But on another note, the leveraged loan volume for the first quarter of 2021 hit record levels, as companies took

advantage of the low interest rate environment. A Council member noted that highly leveraged organizations could face considerable financial difficulty if interest rates rise even modestly. For those companies who received funds from PPP, banks have appropriately analyzed and underwritten the indebtedness. They have factored in the likelihood of PPP forgiveness and future cash flows, among other elements, when determining creditworthiness for borrowers affected by the pandemic.

Are there other conditions or developments that are particularly noteworthy in lending categories such as consumer, commercial or residential real estate, construction, small and medium-size business, or corporate?

Consumer

Total consumer debt finished 2020 at $14.5 trillion, a historical high, but there were significant shifts in the mix of debt. The highest growth was in residential mortgages, which hit $10.9 trillion, due to a demand for housing amid a low interest rate environment. Retail auto loans were also up meaningfully in 2020. Conversely, credit card and HELOC loans were in a state of decline (11.2% and 10.9%, respectively) for most of 2020 and finished the year down on an aggregate basis. Much of this shift in debt mix can be attributed to the widespread stay-at-home orders, which shut down or severely restricted discretionary activities. Consumer savings reached all-time highs during the fourth quarter of 2020. Delinquency and charge-off levels were much more moderate than many feared at the start of the year, which can largely be attributed to the impact of stimulus checks and enhanced levels of unemployment benefits. This creates a picture of a consumer with better quality debt, more liquidity at hand, and less credit card debt than in recent years. The consumer is heading into the second half of 2021 in very a strong liquidity position and is able to support the economy through consumption. However, despite the many positive signs, there are still many low-wage earners who have worsened debt metrics.

Consumer confidence has greatly strengthened during the past quarter. A combination of "vaccination liberation," stimulus checks, spring weather, and one-year COVID fatigue have all contributed to the increase in confidence.

Commercial Real Estate

As of early 2021, commercial real estate activity has increased, with new requests primarily centered in the multifamily, industrial, and to a lesser extent, grocery-anchored retail segments. Hotels and hospitality lending continues to suffer. Conditions are improving, but lending remains very selective. General retail and office lending activity remains very limited, as these property types were so heavily impacted during COVID. Further, these segments have less clarity as to any major structural changes resulting from the pandemic as customer behaviors shift and the longer-term impact of remote working is still not fully understood. Thus, commercial real estate loan growth for banks should be very modest in 2021 and possibly into 2022. It should be noted, however, that the outlook for commercial real estate is uneven across the nation, with significant uncertainty in many metropolitan cities.

Overall, rent collections have improved significantly to over 85% for almost all property types. This number should continue to improve as existing businesses reopen and new businesses are formed.

The office outlook remains uncertain. The actual number of employees working back at the office remains low, and vacancies in metropolitan markets are high, as a migration to the suburbs is beginning to be more prevalent. At some point, it is anticipated this trend will slow and reverse, but the timing and degree are unclear. The return-to-work trend that should begin this fall will be a key driver of improved office performance going forward.

Residential Real Estate

The housing market continues to be very robust. In many markets, residential housing construction is very strong, and demand is outpacing supply. General contractors, architects, appraisers, distributors, and labor associated with residential construction are having a hard time meeting the demand.

The demand has been driven by consumers taking advantage of low interest rates to improve their residences, refinance their loans, or purchase second homes. Also, many people with the ability to work from home have moved to smaller, sunnier communities away from condensed urban areas. As a result of this surge in demand and lack of supply, home prices have risen significantly, often resulting in affordable housing shortfalls. Overall, the asset class is staying strong and anticipated to continue to increase well into 2022.

Construction

Demand for construction financing was slow for most of 2020 but has now picked up. One of the greatest challenges at this point is increasing costs (lumber, steel, labor, etc.) due to pandemic-induced supply chain issues combined with increased demand.

Lenders continue to be judicious at this time. However, competition among construction lenders is elevated, as more lenders are returning to the market while there is still a muted number of new projects (primarily multifamily and industrial projects) that need financing. Retail and hotel construction levels remain very low, while office construction is generally limited to build-to-suit projects for high-quality tenants.

Small and Medium-Size Business

Economic conditions related to small- and medium-size businesses continue to vary based on the industry and maturity of the business. NFIB survey data for March 2021 showed an increase in small business optimism (2.4 points) over the previous month, although uncertainty has increased (6 points) as owners assess whether it is the right time to make capital expenditures and expand their businesses in the coming months.

The PPP continued to provide necessary relief in 2021. As of April 25, over $248 billion in loans have been approved. Tighter eligibility requirements were effective in targeting relief to generally smaller businesses, especially in the accommodation, food services, construction, health care, and social assistance industries.

Corporate

As with small and medium-sized enterprises, the strength of corporations varies depending on industry and size. Transportation, e-commerce, construction and building material distribution companies continue to do well. Energy companies are also seeing the signs of a recovering market.

The two primary challenges facing many corporates right now are supply chain disruption and insufficient skilled labor. Sourcing materials and parts has slowed down production for many industries. Additionally, it has become difficult to find enough skilled labor as volume and orders ramp up. Corporates are "paying up" to retain good employees and are having a hard time finding new ones.

From a financial perspective, smaller corporate borrowers are returning to the market for line-of-credit increases, while larger corporates are taking advantage of the historically low-rate environment to access the bond market. Many are using bond market funding to pay down lines rather than opting for more traditional term loans. Transaction volume in the syndicated market has been stronger than anticipated in the first few months of 2021, and this trend is expected to continue throughout the rest of the year.

Additionally, M&A activity continues to increase, particularly from private equity firms that have capital designated for consolidation and turnarounds.

Item 3: Expanding Opportunities Within Minority Communities

The COVID-19 pandemic has exacerbated income inequality in the United States. What are the Council's views on measures that financial institutions and regulators can take to focus investment in minority communities in order to address widening disparities? How can banks and regulators more

effectively target lending activities toward the development of minority-owned businesses? Are there additional efforts that financial institutions and their regulators can take to improve access to housing and housing finance for low- to moderate-income (LMI) individuals and communities?

What are the Council's views on measures that financial institutions and regulators can take to focus investment in minority communities in order to address widening disparities?

Council members recognize the disproportionate impact that the global pandemic has had on minority communities and how it has exacerbated underlying disparities that Council members already were addressing through specialized and focused programs. Council members reported on programs they initiated during the pandemic to provide a specialized focus on racial equality and economic opportunity. By one industry estimate, banks have collectively made commitments during the pandemic in excess of $50 billion through giving, lending, and investing in order to address these priorities. Council members emphasized the importance of partnering with other institutions, including nonprofit partners, but also and importantly Community Development Financial Institutions (CDFIs), and Minority Depository Institutions (MDIs), to help ensure capital is deployed as deeply and equitably in target communities as feasible.

Many Council members continued to enhance account structures to meet the needs of unbanked and underbanked households, consistent with the Bank On product principles.[1] The accounts are low cost and limit overdraft potential. Council members noted that enhancements could be made to facilitate greater access to the banking industry and that better reflect the customers that are unbanked, such as by simplifying AML and KYC requirements for these accounts to reflect customers' actual usage and habits.

Council members highlighted that many of the pandemic-focused programs build upon existing programs they already had in place to help minimize the number of unbanked and underbanked households. These programs include extensive down payment/closing cost assistance for affordable home mortgages, lending aimed at minority-owned small businesses, financial literacy programs and partnerships, and other means of ensuring the broadest possible access to capital and wealth creation.

Council members shared perspectives on regulatory matters that they believe would help with the objective of focusing additional investment where it can help address disparities. A common theme is the important role that Community Reinvestment Act (CRA) enhancements could play. Council members' suggestions include, for example, creating CRA service test credit for such activities as:

1) Engaging in advocacy for government programs and policies that support affordable housing.
2) Finding opportunities to provide technical assistance/mentoring for qualified business owners.

Some Council members also emphasized the importance of other federal tools, including Low-Income Housing Tax Credits, as another method to build on the work being done by banks to help drive racial equality and economic opportunity.

What are the Council's views on measures that <u>financial institutions</u> can take to focus investment in minority communities in order to address widening disparities?

The Council agrees that financial institutions play an important role in helping to close economic disparities. Accordingly, they have undertaken programs to close disparities in access to business capital, housing finance, and financial services more broadly. Council members will continue to develop new strategies, welcome new partners, and advocate for regulatory and supervisory modifications as appropriate.

Council members recognize the need to be institutions of opportunity and operate in a manner that promotes inclusion and opportunity. Council members were universally committed to hiring, retention, and

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[1] BankOn is a program of the Cities For Financial Empowerment that brings together local government, financial institutions, and community organizations to connect consumers to safe, affordable bank accounts. See https://joinbankon.org.

promotion practices that will result in diversity among employees at all levels and on boards that matches society's diverse representation. Council members acknowledged the need to be leaders in vendor and other practices that result in greater opportunity for minority and women-owned businesses and that ensure other vendors' employment practices mirror those of the industry.

In addition, Council members shared other actions centered on (1) retail and commercial lending, (2) partnerships, and (3) enablement.

In terms of lending and other financial product delivery, Council members shared insights into mortgage programs targeted at first-time homebuyers, with a particular focus on helping provide greater access to mortgage lending for low- and moderate-income (LMI) borrowers. Council members shared perspectives on grant programs for eligible borrowers in LMI census tracts and encouraged consideration of alternative approaches to underwriting.

One Council member noted the importance of providing incentives for traditional banks to implement special lending programs targeted at underserved communities. These programs can expand credit availability for minority business owners and help overcome impediments to credit availability, such as credit scores and limited business experience, that may arise. The Council member indicated that credit override exceptions are available but acknowledged the negative regulatory connotations that can accompany that approach.

Council members also referenced low-cost transaction accounts that are available to bring unbanked individuals into the banking system and the important role regulators play in helping to disseminate information and raise awareness that these accounts are available at local insured institutions.

Council members are innovating in other ways to increase the flow of capital into minority-owned businesses. One approach shared by several Council members involved increased liquidity and capital being made available to CDFIs and MDIs. In addition to the more customary provision of deposits for these institutions, there is a move toward providing equity capital to help facilitate additional lending by, and the growth of, these important institutions. During the pandemic, Council members have stepped up their existing activities in these areas by including CDFIs and MDIs in loan syndications and other activities. Apart from expanded support to CDFIs and MDIs, at least one Council member has undertaken a program of investing in private funds that are themselves investing in minority entrepreneurs and small businesses.

Council members provided insight on other partnerships they are pursuing, including expanded relationships with local housing counseling organizations to which they refer borrowers who are unable to qualify for a loan, in collaboration with housing agencies and non-profit organizations engaged in mortgage product innovation. Other partnerships with non-profit groups are in broad use by Council members to help provide access to financial education and financial literacy within the communities they serve.

Council members noted that one area of focus should be to provide government support (through FHA in particular) for loans to rehabilitate properties in communities with individual homeowners. This would require revisiting appraisal guidelines and potentially require government-supported mortgages to fund the improvements.

What are the Council's views on measures that <u>financial institutions and regulators</u> can take to focus investment in minority communities in order to address widening disparities?

In addressing areas in which regulatory actions may drive even greater capital penetration into minority communities to address racial and economic disparities, the CRA warrants particular focus. Among the changes that could enhance its effectiveness, the Council recommends simplifying existing CRA regulatory measures to focus on LMI and minority lending and investing and expanding CRA credit to a broader array of activities. One Council member recommended that CRA credit be considered for partnerships with minority chambers of commerce that are focused on expanding minority-owned businesses or on

partnerships with nonprofits providing financial training, technical assistance, and mentoring. Another Council member suggested expanding the existing definition of qualified economic development activities to include:

- small businesses that fall under a certain threshold of annual gross revenues
- minority-owned or -led small businesses
- minority-owned or -led investment/loan funds
- small businesses located in a minority community

Finally, Council members suggested other areas of potential regulator engagement. One Council member suggested that regulators consider flexibility in capital ratios and other restrictions to permit greater use of LIHTC, affordable housing, and other LMI-focused loans. Some Council members referenced their participation in the OCC Roundtable for Economic Access and Change (REACh), which is convening engagement among the industry with other business and civil rights leaders to address ways to reduce barriers to broad participation by all in the economy.

Item 4: Evolving Cybersecurity Risks

Concerns persist about the growing sophistication and frequency of cyberattacks against U.S. companies and various governmental bodies, particularly in light of the SolarWinds attack. What have financial institutions learned from, and how are they adapting to, recent cyber events? What actions would Council members advise to enhance and further strengthen the nation's cybersecurity framework, particularly as it relates to banking?

General Outlook

Council members have seen the cyber threat environment shift significantly and continue to evolve for several reasons, including (1) the increased sophistication of cyber adversaries and criminals; (2) an expanded threat landscape due to the remote work environment created by the global pandemic; and (3) financial institutions' continued migration to the cloud. As threat actors, particularly nation-state actors, have increasingly targeted firms' infrastructure and use of supply chains, the financial services industry has sharpened its focus on reducing exposure to these threats and making the technology environment more resilient.

What have financial institutions learned from, and how are they adapting to, recent cyber events?

Recent cyber-attacks, including SolarWinds and the Microsoft Exchange vulnerability, have highlighted the interconnected nature of IT systems. Financial institutions are dependent on secure supply chains and are quickly learning that preventing, detecting, and responding to new types of attacks requires a renewed focus on security fundamentals. Council members noted that supply chain vulnerabilities can be exacerbated by older hardware/software versions existing in the environment. Council members have also learned that cyber criminals are becoming more and more patient and are willing to spend long periods of time planning and executing an attack.

In response to these changing dynamics, Council members reported using a range of practices, and they generally agreed that traditional network security designs that rely on "perimeter" defense protocols are no longer adequate. A multi-layered approach, using cross-functional teams, is more effective and required today, given the changing landscape. Every level of an organization must be aware of the constant threat, including those bankers that are engaged in third-party vendor management. Financial institutions must continue to recruit and retain individuals with strong domain expertise in cybersecurity. Events such as the SolarWinds attack and the Microsoft Exchange event reinforce the need to approach cybersecurity with an "always assume a breach" mentality. Adopting a "zero trust" architecture/mindset provides business resonance, defines the business use of segmentation, and provides a methodology for building a segmented network.

The sophistication of recent attacks implies that firms should more carefully scrutinize technology providers that use commercial off-the-shelf software, based on risk. This includes having strong controls on privileged "system accounts" – access rights held by software applications - on the company's network and more rigorous technology update cycles to reduce security risk. Further, Council members noted that a team approach to cyber risk management has been a critical success factor in managing and preventing attacks. Cooperation and collaboration within a company and with vendors has helped during and after an attack.

Like most risk management strategies, taking a risk-based approach is warranted as some technology architecture and IT solutions would be cost prohibitive for many financial institutions. Also transitioning from reactive capabilities to more preventative cyber threat capabilities, including "hunting" technology solutions, has been more effective and is ultimately less expensive if it prevents a loss/breach.

Recent cyber events have validated the importance of security frameworks such as that of the National Institute of Standards and Technology (NIST), which comprehensively details the controls that mitigate cyber risks and prescribes respond and recovery planning and testing to bolster preparedness.

What actions would Council members advise to enhance and further strengthen the nation's cybersecurity framework, particularly as it relates to banking?

The complexity and sophistication of threats requires partnership and collaboration at every level of business and government. The two-way sharing of both information about threats and best practices to prevent them is paramount, and the approach to these issues must recognize a constantly changing technology landscape. Rules and frameworks need to be outcome-based and flexible so that companies can take a strategic approach, informed by risk and operational requirements. The right balance should be struck between requiring good security practices and giving the IT industry the flexibility and freedom that fosters innovation. As it relates to banking and other critical infrastructure, the standards could also relate to how the technology is used by the downstream firm that support U.S. critical infrastructure.

It is important to work together with government partners, including regulators, to ensure that oversight is effective at reducing risk without causing firms to dedicate cyber security experts to regulatory engagements at the expense of protecting the sector from threats. Council members noted the importance of establishing consistent cyber risk standards for cloud providers, as well as creating a framework through which cloud providers can be uniformly assessed. The financial services sector and the government have a shared interest in clear and consistent expectations, such as timely, informative reporting of cyber incidents. The draft Notice of Proposed Rulemaking on Computer Security Incident notification recently issued by the FDIC, OCC, and FRB is a good first step in more specifically, and uniformly, establishing expectations for notification of computer security incidents. Similarly, the industry can work together with government partners to reduce risks associated with the sensitive information the government collects from financial institutions to ensure that requests are properly scoped, transparency is provided for how the information will be protected, and notification will be provided in the event of unauthorized access.

Item 5: Forbearance

What are the Council's experiences with forbearance during the pandemic? What programs have and have not worked? What has been the impact on bank credit quality? What credits are most at risk? What are banks doing to monitor and mitigate credit losses?

What are the Council's experiences with forbearance during the pandemic?

Council members did not report a material change in financial institutions' experience with forbearance or deferrals since the previous meeting. After an initial spike in activity early in the pandemic, banks have been prudently working with customers and clients on deferrals, and volumes continue to decline.

Borrowers have been supported by generous income replacement and direct payments through COVID-19 relief legislation, a rapid recovery in the job market, and strong home prices.

Council members reiterate that the elevated levels of deferral (i.e., pushing payments to the end of the loan) and forbearance (i.e., skipping payments and making them up later over a period of time) requests at the onset of the pandemic reflected the heightened uncertainty at the time and the resulting fear and anxiety it caused. As such, forbearance programs provided an excellent short-term solution to offer businesses and individuals time to resolve their financial hardship and better understand and adapt to the impacts of the pandemic. These programs have helped banks avoid unnecessary delinquencies and losses and have minimized contagion to other parts of the economy.

Several Council members noted that many customers continued to make payments while in forbearance. The ongoing economic recovery has also aided consumer transitions out of forbearance. With respect to mortgage loans, the American Bankers Association notes that the majority of borrowers exiting forbearance are exiting through a loan deferral, reinstatement, or with all payments current. Only 7.5% of borrowers paid off their loans through refinancing or sale of the home (supported by a strong housing market), and the remaining 14% exited without a loss mitigation plan.

According to the Mortgage Bankers Association, as of late April, total loans in forbearance were 4.49% of servicers' portfolios. While Fannie Mae and Freddie Mac delinquencies totaled 2.42%, Ginnie Mae delinquencies totaled 6.02%.

In cases where credits have required more than six months of deferment, financial institutions have increased outreach and are addressing needs based on individual circumstances on a case-by-case basis. Council members noted very few first-time deferral requests in the second quarter and attribute the vast majority of current deferral activity to accounts requesting multiple deferrals.

What programs have and have not worked?

Council members report the continued success of the PPP program in delivering critical capital to businesses hardest hit by the pandemic. Some Council members noted the program inspired the creation of new techniques and processes that will benefit and augment other areas of their organization.

Regarding other programs, Council members reiterated their comments at the February meeting. Specifically, deferrals have been preferred over forbearance by both businesses and consumers, as most customers could not afford the higher catch-up payments required by forbearance programs. Deferrals brought more immediate relief.

What has been the impact on bank credit quality?

Most Council members reported that credit quality has remained stable or improved. While criticized/classifieds and reserve levels were elevated, very few institutions saw significant increases to non-accruals and charge-offs during the pandemic. For some, net charge-offs in the first quarter reached historic lows.

While certain industries and specific borrowers continue to be impacted by the pandemic, those potential losses are expected to be less than originally projected and absorbed by the large provisions for credit losses booked at the onset of the pandemic. Proper regulatory tone and action has also contributed to overall credit quality.

Notably, residential real estate values have not declined except in isolated submarkets, and home sales have continued in an orderly manner. As a result, borrowers continue to have equity in their homes, which provides added incentive to return to payments or sell in an orderly manner. The stability of the residential real estate market should limit losses to banks if forced to liquidate homes in foreclosures.

What credits are most at risk?

Commercial credits most at risk were in industries such as travel and entertainment (i.e., movie theatres, restaurants, cruise lines, airlines, sporting event venues); hospitality; retail (those that sell non-essential items without a digital strategy); commercial real estate (especially hotel properties and retail centers not anchored by grocery or essential goods stores); nonprofits; and energy. Businesses that were already undercapitalized and/or more highly leveraged prior to the pandemic are also higher risk. Additionally, states with tighter restrictions for longer periods had more significant customer and economic impacts.

With respect to consumers, those who worked in the aforementioned affected industries and regions were the most at risk.

Although the hospitality and retail sectors remain the worst performers within the commercial real estate category, some retail segments are beginning to show signs of recovery, with the loosening of restrictions and rebound in retail spending in the first quarter.

In the medium to long term, concerns about future demand for office space are impacting re-appraisal values, most notably in high-cost real estate markets like Los Angeles, the Bay Area, and New York. Some industrial and healthcare properties are also under stress due to supply chain issues and weak demand for non-COVID-19 procedures.

Although most Council members reported the majority of their residential borrowers in forbearance have exited successfully, loan performance could quickly deteriorate if COVID-19 lockdowns are reinstated. Vaccinations have been occurring at faster-than-expected rates, but trepidation about vaccine safety and failure to inoculate higher percentages of the population could derail the economic recovery. There are also concerns about what could happen to the consumer sector after government supports are withdrawn, as it is difficult to assess the full impact on the sector with government stimulus checks and programs creating so much money in the system.

What are banks doing to monitor and mitigate credit losses?

Banks are implementing additional and more frequent portfolio management measures to identify potential credit deterioration, often with increased staffing. Heightened monitoring is occurring for credits in the most at-risk industries and with certain other risk factors, such as current or prior deferrals. Banks have also enhanced pandemic-related reporting, increased meeting frequency with key stakeholders (board members, investors, regulators) and have remained transparent throughout the pandemic.

Council members continue to maintain higher levels of contact with customers and in many cases, proactively contact them to understand their cash flows, provide additional deferrals as necessary, and facilitate access to and education about federal funding options when available.

One benefit of increased surveillance during the pandemic has been significant technology advancements to identify and monitor credit stress. Further advancements in digital capabilities are expected in 2021.

<u>Item 6: Supplemental Leverage Ratio</u>

The Board and the other federal bank regulatory agencies announced on March 19, 2021, that the temporary exclusions to the supplementary leverage ratio requirement announced in April and May of 2020 would expire as scheduled on March 31, 2021. The Board also indicated that it planned to invite public comment on potential measures to adjust the design and calibration of the supplementary leverage ratio to ensure that it remains an effective prudential measure in an environment of higher reserves. What adjustments to the supplementary leverage ratio would Council members suggest the Board should consider? To what extent would these adjustments help ensure that the supplementary leverage ratio continues to (1) serve as a complement and backstop to the risk-based capital requirements, and (2) support safety and soundness objectives, such as maintaining the overall level of capital in the banking system.

As the banking agencies have acknowledged, leverage capital requirements should generally act as a backstop to the risk-based capital requirements in normal economic times. However, in the current era of substantial quantitative easing and the likelihood that firms will continue to hold significant amounts of U.S. Treasuries and excess central bank reserves, supplementary leverage ratios (SLRs) are under considerable pressure at the largest banking organizations and could become a binding regulatory capital constraint for many of these firms.

In the March 2020 interim final rules that temporarily excluded U.S. Treasuries and deposits at Federal Reserve Banks from the SLR, the banking agencies rightfully noted that "the ability of depository institutions to hold . . . deposits at a Federal Reserve Bank and Treasuries, is essential to market functioning, financial intermediation, and funding market activity, particularly in periods of financial uncertainty."[2] A leverage ratio that becomes a binding constraint through the economic and credit cycle hampers the ability of banks to intermediate in financial markets, including in the vital U.S. Treasury market, and to provide credit to households and businesses; moreover, it creates an incentive for firms to move away from or increase costs for relatively risk-free transactions like market making or providing repo financing to support trading in U.S. Treasuries.

The SLR and enhanced supplementary leverage ratio (eSLR) requirements were calibrated at a time when the Federal Reserve's balance sheet and reserves were forecasted to decline considerably. However, following the Federal Reserve's ongoing large-scale asset purchases to restore and maintain market functioning during the global COVID-19 pandemic, the Federal Reserve's balance sheet has increased to $7.7 trillion and is expected to remain elevated for the foreseeable future. In turn, reserves have grown from roughly $1.7 trillion at the onset of the COVID-19 pandemic to over $3.7 trillion at the end of the first quarter of 2021 and are expected to surpass $5 trillion by the end of 2021.

To mitigate the adverse impact of macroeconomic factors and monetary policy decisions on market liquidity and low-risk assets, particularly during periods of financial market stress, the majority of Council members recommend that the banking agencies permanently exclude central bank reserves from the total leverage exposure measure (i.e., the denominator of the SLR and eSLR). A permanent exclusion of central bank reserves is appropriate because they are riskless, and exclusion helps avoid the SLR and eSLR from constraining U.S. Treasury market functioning as during periods of expansive monetary policy, which may well coincide with fiscal expansion and increasing Treasury issuance, as it did during the ongoing COVID-19 pandemic. In addition, some Council members recommended that the banking agencies replace the static 2% eSLR buffer with a risk-sensitive buffer that is equal to 50% of the G-SIB surcharge. The proposed recalibration, which is consistent with the Basel Committee's "Basel IV" standards, would allow a more targeted leverage buffer that is commensurate with a firm's systemic risk. Some Council members also recommend that the Federal Reserve exclude U.S. Treasury securities from the SLR denominator and/or replace the static buffers of the eSLR with a countercyclical component that could be released during times of market stress.

The recommended adjustments to the U.S. leverage capital framework would help ensure that the leverage requirements act as a backstop measure, as intended by the banking agencies and the Basel Committee, and not a binding constraint, particularly in times of economic stress. Furthermore, in light of the risk-based capital requirements and other aspects of the U.S. capital framework, the recommended changes would not appreciably reduce tier 1 capital requirements for U.S. firms or affect the overall resilience of the banking sector or financial system.

In addition to the proposed adjustments to the leverage capital framework, some Council members suggested that that the Federal Reserve consider other regulatory changes to enhance the liquidity of the U.S. Treasury market under stress, including, for example, creating a new standing repo facility that offers

[2] 85 Fed. Reg. 20579 (Apr. 14, 2020); 85 Fed. Reg. 32980 (June 1, 2020).

backstop-secured financing of Treasury or agency securities in stress periods and taking actions to promote the central clearing of Treasuries.

Item 7: Federal Reserve Policy

What are the Council's views on the stance of monetary policy? How does the Council view the current activities of the Federal Reserve facilities created in response to the pandemic?

Monetary Policy

Monetary policy remains extremely accommodative, with short-term rates pegged close to the zero bound and expected to remain low for a sustained period. The Council views the policy communications by the Federal Reserve as being consistent, transparent, and helpful to market participants about the Federal Reserve's views with respect to inflation risks and future asset purchase plans. Long-term rates have risen substantially this year, reflecting a strong rebound in the economy and an optimistic outlook for growth in 2021. In addition, inflation expectations have also risen from the very depressed levels witnessed during March and April of last year; however, it will take time to determine if inflation will be above 2% on a sustained basis. Credit spreads remain near historically tight levels, and equity prices are at all-time highs. Council members believe a highly accommodative stance of monetary policy continues to be appropriate, given the high levels of unemployment and below-target low inflation levels. However, Council members are mixed with respect to whether continuing to add to the Federal Reserve's balance sheet at these levels is warranted, given the strong recovery and functioning of the financial markets. In the view of some Council members, the Federal Reserve should start tapering, while others believe tapering should not start until the end of 2021 or early 2022. Furthermore, there are several signs of froth in the credit, equity, and commodity markets, which could potentially get worse if the Federal Reserve continues to inject significant amounts of additional liquidity into the financial markets. One Council member expressed a view that the Federal Reserve should be somewhat concerned about very lofty equity valuations in high-growth technology and crypto currencies, which are exhibiting bubble-like behavior. Additionally, the banking system is flush with deposits created primarily due to reserve creation by the Federal Reserve. These deposits are of minimal marginal use to banks. As such, certain members of the Council believe the Federal Reserve should consider slowing down the amount of reserve creation in the coming months.

Federal Reserve Facilities

The various facilities created in response to the pandemic and last year's lockdowns were effective in restoring market liquidity, tamping down fear, and bringing normalcy to the capital markets in a highly uncertain time. However, usage of these facilities remained at low levels, reflecting functional financing conditions in the credit markets. The Council agrees with the Federal Reserve's decision to close the Commercial Paper Funding Facility, the Money Market Mutual Fund Liquidity Facility, and the Primary Dealer Credit Facility as of March 31. The Council also agrees it was appropriate to extend the Paycheck Protection Program Liquidity Facility through June 30 in connection with the extension of the PPP in order to provide liquidity, if needed, to smaller financial institutions, ensuring the needed funding gets to small businesses.