Record of meeting

Summary of Discussions Among Members of the

Community Depository Institutions Advisory Council

November 14, 2024

1. **Economic Discussion:**

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

Council members noted that the economy remains resilient despite some challenges, such as inflationary pressures driven by insurance costs and slowdowns in housing construction. There is a bifurcation in the economy between upper- and lower-income groups relating to their ability to purchase a home and to their level of consumer confidence. Council members also discussed the growing variation in economic conditions by region and industry. Overall, Council members expressed cautious optimism regarding the economic outlook, given the slow return of small business capital investment and the labor market coming into better balance.

   b. ***Particular Indicators:***

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

Council members reported that inflation has slowed from its peak but remains elevated, driven by labor costs and shelter. Inflation continues to hit low- and moderate-income families the hardest. Households are spending the same amount of money for food and medicine but have largely shifted to buying more affordable product substitutes (e.g., generic brands).

Council members discussed current sources of inflationary pressure: labor, insurance, property taxes, technology, potential tariffs, and shelter. Council members noted that entry-level employees' expectations of (relatively) high starting wages may have some inflationary impact. Insurance costs are also affecting businesses throughout the country, as prices are up 14–30 percent compared to pre-pandemic levels. Many insurance providers are permanently leaving high-risk areas due to large losses from natural disasters. All Council members agreed that real estate and property taxes are adversely impacting businesses and consumers. Lastly, the potential inflationary effects from higher tariffs being passed onto U.S. consumers is a cause of concern, as businesses are moving their imports away from China to emerging export countries, some of which could be affected by tariffs.

Council members noted that to account for inflation, businesses are spreading higher costs across their products to maintain their margins. Additionally, many businesses face cyber- and fraud-related costs. Council members discussed that while their core providers have been increasing prices at a steady clip, they have also noticed that various technology firms are being pushed by their investors to grow their earnings and profits by increasing prices.

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

In the housing market, inflationary pressures persist. Council members noted that prices remain elevated, and that there has been a slowdown in development compared to a year ago due to higher construction and input costs. Establishing price points for lower-end homes has been more difficult due to higher material and labor costs. Housing is bifurcated between lower- and higher-end consumers; this bifurcation likely will persist due to construction constraints.

States and cities are attempting to address the shortage of housing by allowing for a larger number of auxiliary dwelling units to be built. Consumers are also affected by private equity firms purchasing real estate properties, which has reduced the owner-occupied supply. For example, in Columbus, Ohio, private equity accounted for 20 percent of house purchases.

Multifamily building varies by District, with some Council members reporting overbuilt development and others noting strong demand conditions. Grant money in one District supported multifamily and affordable housing development, while subsidies and government incentives are being used in another District to build lower-end housing

The factors contributing to the affordability and availability crisis in the housing market vary by District. However, mortgage activity has decelerated across all Districts compared to a year ago.

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

Council members agreed that labor markets are in better balance since the last meeting in April, with continued variability in conditions by region and industry.

The remote work debate has settled down as of late. The hybrid approach is the prevalent choice for businesses to remain competitive in attracting top talent. Regional differences are evident, however, as there are more hybrid workers in urban areas, and more in-person workers in rural areas.

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

Council members discussed consumer confidence, analyzing its correlation to inflation. Currently, consumer confidence has remained reasonably strong in many regions despite inflationary pressures.

There is a notable divergence between consumer sentiment and actual spending behavior, raising questions about the sustainability of current consumption patterns. Across various regions, consumers are spending the same amount but have shifted to cheaper substitutes. Council members warned that if consumers are not able to continue to switch to more affordable substitutes, consumer confidence may fall.

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

Council members observed regional differences across the various loan categories, but, overall, they agreed that after interest rates were lowered, loan demand for most categories remained steady or improved. Larger banks have been pulling out of varied markets in different regions, creating more opportunities for smaller banks. Larger banks, especially mid-sized and regional banks, were pulling back, especially in commercial real estate (CRE), due to supervisory pressures and overall risk considerations. On the supply side, some banks were experiencing liquidity challenges and were having to turn down deals to preserve liquidity. Slower growth is leading to softened projections for some banks that are being pushed to sell by fatigued shareholders. Although there is a pipeline for loan growth for banks that want it, lenders are limited by their available liquidity.

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

Council members reported a difference in small business lending by District. Small business lending was generally stable in some Districts, and demand softened in one District as borrowers waited for rates to come down further. Lending in the aforementioned District was generally flat or softening, including in the trucking industry, as previously high demand has been overtaken by supply. In another District in the Midwest, larger, industrial firms were performing well, while mom-and-pop stores and restaurants were struggling.

   b. ***Commercial Real Estate Lending:*** *Have there been any changes in the Council's view of challenges in the commercial real estate market since the Council's last meeting in November 2023? How are commercial real estate loans performing compared to the Council's expectations?*

CRE comprises a diverse set of property types: office, multifamily homes, retail, hospitality, industrial, warehousing, etc. Council members agree that lending conditions vary by geography and sector and that urban office spaces have stood out as the weakest sector. Community banks also saw larger banks pulling out of certain sectors, giving more opportunity to smaller banks. CRE market conditions have improved and continue to perform well in one District, except for office space. The outlook for CRE was neutral or strong in another District. One District noted that urban areas were performing poorly relative to more suburban and rural areas, which were seeing lower vacancy rates. In another District, demand for CRE was softening due to (1) the declining rate environment in which people are waiting for the bottom of the rate cycle and (2) the political climate pushing people to the sidelines. Another Council member reported seeing less demand for CRE projects, although current projects are performing within debt service guidelines.

Council members largely agreed that debt service coverage on CRE was good. They did note, however, that many CRE loans were underwritten in 2020 and 2021 (when rates were lower), and that those loans would typically be due for a reset five years after origination. There was a discussion on whether these properties would be able to service the debt increase and be able to pass costs on to tenants, or if they would seek to renegotiate loan terms.

c. ***Construction Lending:*** *What are Council members' perspectives on the availability of credit for construction and development projects? Have Council members seen any changes in the demand for construction loans since the Council's November 2023 meeting?*

Construction lending was mixed across the Districts. In one District, inflated prices for construction materials were reported, although the price increases were not as sharp as they had been in previous years. Council members in other Districts noted that input costs—specifically for lower-end homes—remain a challenge for new construction as developers move to higher price homes or look to shrink home sizes.

In one District, most building has been for low-income housing driven by city subsidies, which are keeping construction robust. Construction lending was also relatively strong in another District, with construction seen around new manufacturing plants, although there was not always enough land to meet the demand. One Council member noted that lending was strong in areas that were rebuilding after being struck by tornados last year. Additionally, areas in Arkansas saw an increase in multifamily construction as many companies have relocated their headquarters to the state. Another Council member noted overall health on the construction side, and added that there was a divide between performance in one state, where one region was struggling while another region witnessed an influx of people.

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

Mortgage lending was mixed across Districts, though most Council members noted seeing a bifurcation in the market between low- and high-income households. Although each District's price threshold varies for what qualified as a "low income" house versus what qualifies as a "high income" house, Council members concurred that smaller and entry-level homes remain less affordable. Nevertheless, most Districts saw improved sales activity in less expensive homes. However, a Council member in one District reported that there was little demand for houses priced under $800,000, and added that there appeared to be sustained demand for higher-priced housing in areas where buyer finances were stronger. There was also an increase in home equity loan volume, although usage rates varied. It was noted that in a few Districts, "many" borrowers were taking out home equity lines of credit, although the overall usage rate was low, and Council members expect a slowdown in this activity. Another District saw little demand for mortgages, likely due to the "lock-in effect" that is occurring with borrowers who had secured lower rates and are unwilling to give those rates up. This District also saw borrowers turning to home equity lines when they needed additional money. Council members in a few Districts reported seeing large year-over-year increases in lending. They noted that although activity was not back to 2021 levels, it had improved over the prior year.

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

Council members agreed that delinquencies have been starting to increase on the consumer side, specifically credit card delinquencies. Council members largely agreed that this increase was a normalization, as delinquencies are reverting from historically low levels. Council members largely echoed the trend of consumers spending down their accumulated savings and maintaining their standard of living by borrowing. One District noted seeing some consumer lending demand growing at fintechs.

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

Council members agreed that agricultural lending varies by industry segment, and they noted some upcoming challenges. One Council member reported seeing strong performance from protein producers that are benefiting from higher prices. However, row croppers have been experiencing challenges because they held onto excess grain with the expectation that commodities prices would be higher. Additionally, Council members were concerned about the potential negative effect of tariffs on commodity prices and wondered how farmers would mitigate the increased costs.

Another District was experiencing a trend of smaller farms selling out to larger corporate farms. Council members in multiple Districts noted seeing trends of farmland being converted to other types of uses that have higher returns, such as solar panel farms or housing.

In another District, there was significant concern over farm labor, including how the supply of labor may be affected by potential mass deportations of undocumented immigrants. It is a requirement to provide H-2A workers (foreign nationals who are temporarily admitted to the United States to perform agricultural work) with housing, which is not currently available or feasible. Additionally, there was concern over the government's role in labor costs, as California is trying to raise the minimum wage for farm workers from $16 to $26 per hour.

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

Council members broadly agreed that, despite mixed inflows and outflows from community banks, deposits have largely stabilized in the third quarter. However, Council members largely agreed that customers are having difficulty adjusting to lower deposit rates after experiencing a high-rate environment. There is a mismatch between the rate the depositor expects and the rate that lenders can expect to earn on their loans, and customer loyalty has been impacted as a result.

In one District, some larger banks have continued to offer higher deposit rates, putting pressure on community banks.

In another District, more banks have been using brokered deposits for contingency funding planning—or as a liquidity management strategy. In addition, reciprocal deposits were noted as an important tool to keep funds within the banking system and to ease depositor concerns over Federal Deposit Insurance Corporation (FDIC) insurance limits. Council members noted the potential negative impact that the reclassification of reciprocal deposits as "brokered" deposits could have on the ability of depository institutions to manage their client relationships and manage their liquidity.

Council members in a few Districts noted seeing competition for municipal deposits from state government-run programs that are offering higher rates than banks. There was an acknowledgement that this is an important source of funds for state governments, and that this trend would likely expand elsewhere.

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

Council members remarked that current economic conditions are favorable for mergers and acquisitions (M&As). Previous deals had been delayed by higher rates, and the appetite for M&A is expected to increase in a lower-rate environment. Bank stocks have accelerated following the November election, leading many banks to believe that they have a stronger currency to work with. In one District, some M&A activity is below book value, and current M&A deals are being driven toward those whose currency is more undervalued. Overall, though, Council members are expecting larger deals to take place, where larger banks would be able to take on significant acquisitions. In another District, current M&A activity has primarily consisted of credit unions buying banks, especially in the Pacific Northwest. Council members also noted a higher volume and deal size in credit union acquisitions of banks.

3. **Discount Window:** *What changes do Council members recommend to improve the operational efficiency of the discount window for community depository institutions (e.g., documentation setup, collateral pledging (including prepositioning of collateral), borrowing)?*

   a. Does your institution use Discount Window Direct[1] *(DWD)? Why or why not? Should DWD be improved or expanded and, if so, how?*

   b. Are there operational features of other funding structures and regimes community depository institutions use (e.g., Federal Home Loan Bank (FHLB) advances) that Council members would recommend the discount window adopt? Are there any other

---

[1] For information on DWD, refer to the Discount Window and Payment System Risk public website: DWD_20240624 (frbdiscountwindow.org).

opportunities for greater operational efficiency (e.g., better aligning the eligibility and valuation of collateral for discount window loans and FHLB advances)?

c. *What messages, guidance, and/or direction are examiners giving to community depository institutions with respect to discount window use (e.g., pre-positioning of collateral, periodic testing, other aspects of readiness)?*

Council members reported that most community depository institutions are either already set up to use the discount window or are in the process of setting up to use it. Council members also noted that many community depository institutions do not access the Federal Reserve's discount window directly, and instead access it through their correspondent banks.

Community depository institutions understand the need to be prepared to tap the discount window in the case of an emergency, yet many institutions wondered why there is so much focus on it now and what problem the Federal Reserve is trying to solve. For example, was it the failures from 2023, the dependence on a single provider such as the FHLB, contingency liquidity in an emergency, or general asset and liability management—or some combination of these issues? Council members suggested that the Federal Reserve clearly state the purpose and create a program that meets that need, while not harming other funding providers.

One of the areas of concern noted by Council members is that the speed of the discount window does not match the speed at which money moves. This is particularly acute with respect to moving collateral from the FHLBs to the Federal Reserve and vice versa. Currently, the bulk of collateral pledged is to the FHLBs. One Council member noted that a standardized agreement for collateral transfer between the FHLBs and the various Federal Reserve Banks would be helpful, and others agreed.

Comparatively, many community depository institutions prefer not to pledge collateral or even use the discount window at all because they use other providers, such as the FHLB. Council members indicated that pledging collateral to the Federal Reserve is not optimal, because having collateral sitting (or pre-positioned) at the discount window in case of an emergency would likely restrict credit.

Council members noted that currently the product offerings available at the discount window are not conducive to day-to-day liquidity management, and, as a result, Council members questioned whether the proposed expansion of the discount window is appropriate or whether it will have unintended consequences.

Regarding operations, Council members reported that community depository institutions find the discount window process to be long, painful, and frustrating. For example, several Council members noted that information is difficult to obtain, and a question asked of the Federal Reserve can take up to a week to resolve. Council members suggested that the Federal Reserve create a comprehensive fact sheet and list of FAQs to answer some of the banker queries. Council members also suggested that an account representative system (or something similar) could be beneficial.

Lastly, community depository institutions are concerned about the stigma of using the "lender of last resort," which raises questions from examiners and investors. Council members noted that community depository institutions want to access the discount window, but to be usable, the window should not come with a stigma, and it must have proper pricing and an ease and flexibility of use. Council members suggested rebranding the discount window in an effort to eliminate the stigma.

Regarding DWD (or Discount Window Direct) portal, Council members reported that a relatively small number of community depository institutions were using it and, overall, community depository institutions were unaware that DWD was available.

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

Council members noted that hybrid exams—in which certain aspects of the exam are conducted on-site, and other aspects are conducted remotely—worked effectively. Council members said that regulators' safety and soundness exams are conducted in a professional and efficient manner, and that the examiners who conduct them have reasonable expectations for how banks may comply with regulations. By contrast, Council members described regulators' compliance exams as "punitive" because examiners frequently had unrealistic expectations when it came to the results.

Council members also stated that compliance exams were less efficient than safety and soundness exams because of long delay between the end of the exam and the receipt of the exam report. One Council member stated that their bank completed an FDIC compliance exam in February 2024 but did not receive the exam report until November. Council members noted that staff turnover at the FDIC may be contributing to the delays. Regardless of what is causing them, lengthy delays in providing exam reports prevent the bank from being able to act on findings and prepare for its next exam. In addition, one Council member stated that regulators held fair lending exams at banks in their District at a frequency that did not appear commensurate with the risk presented at the bank.

Council members described a disconnect between the policies and regulations issued by agencies' leadership and how bank examiners implement those policies and regulations. For example, a Council member stated that the Consumer Protection Financial Bureau's (CPFB's) final rule to implement section 1071 of the Dodd-Frank Act is intended to identify banks and credit unions that are "outliers" with respect to their lending to small businesses run by underrepresented minorities. But the prudential regulators conduct compliance exams on a cycle—not based on risk. Consequently, banks are examined by their prudential regulator for compliance with the 1071 final rule on a regular basis, despite the risk-focused intent behind the rule. Additionally, although agencies' leadership have policies of scaling expectations to a bank's size, Council members have observed this policy often is not well reflected in examinations.

Council members expressed that greater coordination between the Federal Housing Finance Agency (FHFA) and the prudential regulators is needed before the FHFA finalizes changes to government-sponsored enterprise credit scoring. The Economic Growth, Regulatory Relief and

Consumer Protection Act mandates that the FHFA modernize the credit scoring methods used by Fannie Mae and Freddie Mac, but the Act does not specify a specific approach or timeline. The FHFA has established a timeline that will implement new scores in the fall of 2025. Thus far, a lack of (1) coordination between the FHFA and the prudential regulators as plans are developed and (2) data regarding the performance and reliability of the two models chosen (Vantage Score and FICO 10T) are making that timeline untenable. Additionally, core providers may be unable to implement the changes in time.

Council members are also concerned that changing requirements for credit scores for the government-sponsored enterprises but not for loans made by the Federal Housing Administration, the Department of Veterans Affairs, and other loans will lead to increased costs for lenders and borrowers, as lenders will likely have to apply multiple standards. Council members recommend the FHFA and prudential regulators coordinate on the development of credit score changes and that exam procedures are developed to ensure that changes do not result in examiner confusion and increased exam burden around credit scores, fair lending, and other issues. To accommodate that coordination and to address concerns about data availability, the FHFA should set a longer timeline for adopting new scoring models in consultation with other stakeholders.

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

Council members reported that community depository institutions have been facing a "tsunami of regulation" that threatens their ability to remain economically viable and to serve their customers. In particular, resources that would otherwise be used to innovate are instead being diverted to meet mounting compliance burdens. The confluence of the following regulatory actions is creating significant challenges for institutions:

- Small business lending data reporting requirements (under the CFPB's final rule implementing section 1071 of the Dodd-Frank Act) (Section 1071 rule)
- Interagency Community Reinvestment Act final rule issued in 2023
- Regulation II, which capped debit card interchange fees
- Expected CFPB final rule on overdraft fees
- Regulators' criticism of community depository institutions' lawful and fully disclosed fees, including overdraft and nonsufficient funds
- CFPB's final rule on open banking (to implement section 1033 of the Dodd-Frank Act)

Council members stated that the Section 1071 rule's requirement to collect and report 81 data fields may lead banks to extend credit only to those small businesses whose loan applications score well based on those particular data fields, thereby depriving otherwise creditworthy small businesses of credit. This result would be inconsistent with the CFPB's professed desire to increase lending to small businesses.

Council members stated that unlevel competition from nonbanks creates challenges for banks. Nonbanks are not subject to regulations such as the Community Reinvestment Act or to federal supervision. The disparity in the legal framework applicable to banks and nonbanks can distort competition.

Council members expressed concern over the outsized role that core processors play in an institutions' ability to comply with regulations. Compliance with regulations often is dependent on the products that core processors develop. After the core processors' product is released, depository institutions need time to integrate that product with their systems. Relatedly, Council members also expressed frustration that each institution must validate its vendor. They stated that it would be more efficient if after a vendor is validated the first time, any institution could use that vendor's services without additional regulatory scrutiny.

One Council member expressed concern that recent and expected regulatory changes could create a disconnect between credit scores and credit risk. Medical debt is a leading driver of consumer bankruptcy, and there is concern that the CFPB's proposed rule to prevent medical debt from appearing on credit reports or being used in credit decisions would reduce banks' ability to accurately assess consumer lending risk. Additionally, thus far there has been a lack of data regarding the performance and reliability of the two models chosen by FHFA in its changes to government-sponsored enterprises credit scoring.

6. **Additional Matters:** *Do Council members wish to present any other matters affecting community depository institutions that have emerged from meetings of the Reserve Banks' advisory councils?*

Council members engaged in a discussion of payment-related fraud and highlighted some key challenges impacting the ability of community depository institutions to manage fraud incidents.

There was broad agreement among Council members that both the frequency and financial impact of fraudulent activity have grown substantially in recent years. The type of fraud ranges from so-called "romance scams" to spoofing customers into sharing their user IDs and passwords. Council members and their peers are frustrated that they cannot stop payments when they see a customer falling victim to fraud. Council members shared examples of incidents where a customer walks into a branch to initiate a payment transaction, and despite the bank flagging obvious signs of fraudulent intent by the potential recipient of the payment, the customer insists on wanting to complete the transaction, and bank employees are unable to stop the transaction from happening. It is especially frustrating, Council members added, when the customer returns to the branch a day or two later complaining about being defrauded and insisting that the institution cover the losses. In one District, Council members have seen instances where a customer erroneously believes that deposit insurance will cover any losses from fraudulent activity.

The growth of online payment systems and the speed at which money can be moved out of depository institutions further complicates the ability of these institutions to fight fraud. Council members depend on law enforcement authorities to halt payments and to investigate the fraudsters. Unfortunately, the authorities do not always appear to act with a sense of urgency, and delays could affect the ability of a community depository institution to prevent the processing of a payment. They noted that there is now growing awareness within the industry that law enforcement at all levels should address payment fraud with greater urgency—with formal policies, procedures, and protocols to freeze payments—to prevent and recover losses from such activity.

Council members are dismayed by bills that have been introduced at both the state and federal levels to put the burden of fraud protection on depository institutions. For example, California is looking to make the paying institution cover 100 percent of the losses. At the federal level, it appears that the bill's intent is to have the paying and receiving institutions share equally in the customer loss emanating from such transactions. Depository institutions have limited, if any, authority to stop transactions from occurring—and Council members are concerned about the potential harm to their reputation among customers and legislative bodies who are unaware of these limitations.

Council members highlighted a challenge unique to smaller depository institutions. For example, in the context of wire fraud, the receiving institution is typically a large bank, and small institutions struggle to establish communication channels and to elicit responses to their messages. In many instances, it can take months before they receive a response. Council members wondered how larger banking institutions, who are subject to the "know your customer" verification process, allow fraudsters to open accounts.

Council members also highlighted the fraud directory developed by the American Bankers Association. It is an information portal designed to facilitate communications among banks. Council members saw value in joining the portal, and they expect the value will increase as more banks of all sizes join.