Record of Meeting

Federal Advisory Council and Board of Governors

Thursday, May 23, 2024

Item 1: Economic Activity

Are Council members seeing any signs that consumers' willingness or capacity to spend has been changing of late? In what ways? Are businesses reporting significant changes in sales volumes, up or down? If so, are these changes in any particular product categories or consumer segments? What is the Council's prognosis for the pace of spending by consumers and businesses in the second half of the year?

The resilience of consumers continues to surprise Council members. Overall, consumers remain financially healthy, given that (1) the labor market has been strong and (2) wages have been keeping pace with inflation. However, despite overall healthy consumer balance sheets, consumer sentiment declined notably in April as inflation and interest rate concerns weighed on consumers' minds. Although spending is slowing in the aggregate, growth in inflation-adjusted spending in the first quarter of 2024 was stronger than anticipated. Council members noted changes in spending patterns, especially from lower-income households, which have been shifting away from discretionary purchases and trading down to less-expensive alternatives. While retail continues to be largely in line with 2023, dining and travel expenses have contracted, and grocery has accelerated as lower-income individuals opt to eat at home rather than dine out. Additionally, even though vehicle prices have declined, used car sales have softened as cash buffers for lower-income individuals run out. Conversely, individuals in higher-income categories continue to spend on discretionary services such as travel, tourism, entertainment, recreation, and dining out.

Small businesses remain generally healthy, with balances and cash buffers still elevated over pre-pandemic levels and continuing to normalize. Overall, businesses continue to invest, with an increased focus on necessary, strategic, or high-return investments. Council members noted that economic activity has been mixed based on geography—specifically, activity in the South and Southeast has been outpacing activity in the Midwest and Northeast. One Council member said that California, Georgia, and New York have experienced a spurt of growth as film and television production has restarted following last year's strikes. Additionally, new manufacturing construction has benefited Texas, Tennessee, Georgia, South Carolina, Kansas, Missouri, and Oklahoma. It was also noted that construction for companies that can finance their own projects continues to be robust, especially for data centers and those companies that are supported by the CHIPS Act or the Infrastructure Investment and Jobs Act. Meanwhile, projects have stalled for smaller companies that need financing. Council members noted that the timing of large construction projects continues to be impacted by the availability—or lack thereof—of electrical equipment. In addition, given that many of these projects (such as data centers) require significant electricity, a strain is being placed on the electrical grid, and electricity is not always available at project sites, leading to delays.

Overall business conditions remain solid; however, margins are compressing. Corporate earnings are showing the extent to which elevated inflation in 2021 and 2022 was artificially propping up profit growth. As inflation has decelerated in recent quarters, earnings growth has turned negative on a year-over-year basis. Specifically, after excluding the mega cap "Magnificent 7" companies, earnings growth has been negative for the past six consecutive quarters. Sales growth has remained positive during that time, indicating operating margins are still contracting from peak levels in 2021.

Although the Council's forecast of the pace of growth for the remainder of the year was mixed based on geography (as described earlier), overall, the expectation by businesses is that sales will remain solid as long as household employment and wage growth remain strong, and consumers continue to spend.

With respect to the consumer, Council members believe that consumer spending should continue to increase through the rest of 2024, but at a slower pace. Positives for consumers continue to be (1) a healthy labor market, including solid, although slowing, job growth, and wages that are rising more quickly than inflation, and (2) rising household wealth due to increasing stock prices and home values. Consumers have savings in excess of pre-pandemic levels by approximately $500 billion, down from a peak of $2 trillion in 2021.This savings is skewed toward higher-income consumers. Another positive is strong household balance sheets, with debt payments relative to after-tax incomes near record lows, although increasing. Consumer credit usage continues to normalize both in usage and quality, although delinquencies and severely derogatory balances and ratios remain below pre-pandemic levels. Additionally, the savings rate is below pre-pandemic levels. Headwinds to future consumer spending growth include high interest rates, persistent inflation, and high energy prices. Another potential drain on the consumer, which is only beginning to be felt, is increased premiums for car and home insurance (assuming insurance is available), as insurance companies have applied to state agencies for increases north of 20 percent.

Item 2: Labor Markets

Based on Council members' own experience and that of their clients and contacts, how would Council members describe the balance between demand and supply in the labor market at this point in the year? What do Council members see as the drivers of supply and demand? How do Council members foresee employment levels and compensation rates evolving across sectors in the second half of 2024?

Council members continue to view the labor market as strong overall, with availability of lower-skilled workers improving, but that of skilled workers remaining tight. The trend rate of job growth is slowing, largely as a function of a reduced pace in hiring rather than rising layoffs, which continue to run slightly below pre-pandemic levels. The demand for labor has been increasingly moderated by many companies reducing their headcount through automation, shifting customer delivery methods, outsourcing non-core tasks, and implementing other expense management initiatives to offset the rising cost and reduced reliability of lower-skilled labor. A continued reduction in voluntary turnover and a higher number of job applicants has also helped bring the overall labor market into a better balance, as many candidates remain hesitant to switch organizations due to uncertain economic conditions and fear of potential layoffs. In addition, employee relocations are deterred by the limited supply and high cost of housing and the "lock in" effect of low mortgage rates on employees' existing homes.

Significant labor shortages persist in health care, hospitality, and restaurants. The skilled labor market is facing multiple structural challenges, exacerbated by the aging of the workforce and retirement of key personnel. Many employers are facing a shortage of ready replacements and a lack of adequate internal training programs to prepare the next generation. As a result, a growing number of manufacturers are partnering with local high schools, community colleges, and trade schools to better develop the necessary talent given the relative lack of white-collar professionals and licensed tradespeople. Construction and manufacturing jobs continue to see growth as funding flows from the CHIPS Act and the Inflation Reduction Act, impacting numerous sectors, including transportation, energy, and housing.

As a result, compensation growth continues to remain at higher-than-historical norms, with employees highly focused on flexibility, compensation, benefits, career development, and their overall workforce experience. These employee expectations are coupled with the "hidden" premium associated with reduced qualifications to attract applicants at higher wages as compared with those hired pre-pandemic. That said, compensation expectations for new hires are increasingly better aligned with those of the companies.

Although wage pressures are easing, there is a growing acceptance in many sectors that operating margins will be "lower for longer" as wages are seen to be sticky at elevated levels, coupled with a reduced ability—especially for small businesses—to pass along those costs through price increases. Overall, Council

members anticipate the labor market to continue its current trend toward gradual normalization, albeit more slowly than expected, with overall salary increases consistent with inflation.

Item 3: Loan Markets

What is the Council's current assessment of supply and demand conditions in loan markets? Are Council members seeing any noteworthy developments in various lending categories, such as commercial real estate, residential real estate, construction, consumer, small and medium-size business, or corporate?

Council members have observed that the near-term U.S. and global economic outlook has sustained, and long-term interest rates have declined from fourth quarter peaks. Bank credit generally remains available for those with good credit, and banks are marginally more willing to lend to consumers than they were in the second half of last year. Most banks have already increased reserves in anticipation of higher credit losses and are comfortable with their current credit risk exposures. Alternatively, on the loan demand side, the environment remains soft and suppressed in certain areas, extending the trend that has been in place for several quarters, driven by interest rate uncertainty, recessionary fears, inflation, and wage pressures.

Council members said that there have been no notable changes to commercial real estate (CRE) demand given higher interest rates and inflation. Credit markets for office mortgages in the banking sector are thin. Transaction volumes across property types remain soft. Office continues to be the area of greatest concern, primarily attributed to reduced demand driven by entrenched remote-working trends. Council members noted distressed office sale activity increasing, in both urban and suburban areas. Last year's decline in longer-term interest rates has rebounded to higher levels this quarter. This movement renews concerns around higher rates for longer, elevating financing costs, and lowering valuations. Overall, uncertainty continues in the office real estate segment.

On the residential real estate side, overall demand for home loans remains tepid. Affordability concerns, limited for-sale inventory, and higher mortgage rates (staying mostly above 7 percent) continue to temper demand, resulting in an expectation of sluggish home sales this year as compared to prior years. Higher mortgage rates are also disincentivizing many homeowners from selling their homes, given their current low mortgage rates, resulting in continued constraints on housing supply and thus higher prices. Tight net interest margin spreads continue to dampen portfolio interest. Portfolio credit quality has remained good. Homeowners staying in their homes provides a tailwind to home improvement lending; however, rising costs of materials and labor—combined with higher levels of "do it yourself" projects—are headwinds to home improvement lending growth. Consumers are less willing to invest in discretionary high-dollar improvements (i.e., swimming pools) in the current economic and rate environment, while non-discretionary spend—such as HVAC systems—remains stable. Anecdotally, homeowner insurance premiums across most districts have substantially increased, with borrowers seeing their escrow payments almost double, further dampening demand.

Demand for construction loans remains lower over the past 18 months, related to elevated costs, higher interest rates, a slowing economy, and tightening lending. Where there have been supply additions, they are focused on economies with expanding job employment and primarily in growth segments, such as multifamily and industrial. Industrial new construction has declined from high levels over the last year, albeit remaining elevated.

On the consumer side, the return of cash buffers to pre-pandemic levels is driving stronger demand for credit cards as consumers are revolving, on a per account basis, at pre-pandemic levels. From a supply side, credit largely remains accessible to consumers. Credit standards are largely unchanged quarter over quarter but remain tighter on the margins. Credit card balances are expected to grow with consumer spending at a moderate pace while payment rates remain at current levels. Home equity is expected to face headwinds due to continued elevated rates but remains attractive to customers with low-rate mortgages with near

record-high equity in their homes. Spotty demand across consumer-secured lending is due to higher interest expenses and inflation. Comparatively, demand remains relatively strong for new auto loans despite continued elevated car prices and interest rates, while used car prices have normalized in line with expectations.

Small businesses remain generally healthy, with balances and cash buffers still elevated over pre-pandemic levels but continuing to normalize. There is a softer loan demand in this segment, as many business owners defer larger expenses and investments, hoping for a return to a lower-rate environment. Tightening credit standards have increased the cost to borrow for small businesses, though some accept higher rates and pass the costs on to customers. Inflation and wage pressure are impacting small and medium-sized businesses especially, and negatively impacting their margins and cost structure. Business card revolving loans and payment rates continue to normalize toward pre-pandemic levels.

For the corporate market, inflation and uncertainty around interest rates and the macroeconomic environment continue to put pressure on pricing and deal activity, causing the outlook for new loan demand to remain muted. In the middle market, credit demand and utilization have stayed reasonably consistent in the first quarter but have moderated when compared to the first quarter of 2023. The outlook for new loan demand remains subdued as clients continue to deal with economic concerns and closely manage working capital. M&A activity is slowly increasing but transaction timelines are very long as spotty financial performance has made buyers cautious. Terms for commercial and industrial (C&I) loans remain largely unchanged quarter over quarter; however, there is some tightening reported for premiums charged on riskier loans. Despite increasing headwinds in C&I credit, tight credit spreads show market participants remain confident in the creditworthiness of borrowers and see the overall economy as favorable. Sectors most dependent on discretionary spending (e.g., consumer goods, media, and entertainment) and those most sensitive to high interest rates (e.g., real estate, higher education, and healthcare) saw credit quality decline, while some sectors continued their post-COVID rebound (e.g., airlines and leisure) and others (e.g., oil and gas) even benefitted in the tumultuous macroeconomic environment. The municipal sector is showing higher loan demand than traditional C&I as states, cities, and counties move forward with infrastructure and school spending. Most transactions are short term and have a variable rate, as the loans are considered a bridge to public finance bond issuance when rates decline. Equipment finance observed delays in capex spending by some borrowers, and equipment loan demand overall is holding up. This demand is supported by the federal stimulus from the CHIPS Act and Infrastructure Investment and Jobs Act—the impact of which is yet to be fully realized. Also, some companies are still catching up with their maintenance capex needs following the lingering effects of the supply chain disruption over the past few years.

Item #4 Inflation

Have Council members observed any recent patterns or trends in businesses' pricing power or pricing behavior? How do Council members foresee businesses approaching pricing decisions through this year and next?

Overview

Higher input costs, including for labor, are still a top concern for small and medium-sized businesses. These businesses are focused on expense management, but they are also being forced to continue raising prices. Price increases by large businesses have moderated. In general, businesses have become more responsive to shifts in demand. Cumulative price increases are making consumers more cautious and willing to "trade down," which means that businesses' capacity to pass along cost increases has weakened, putting pressure on margins. Council members expect more companies to pursue expense control and operational efficiency aggressively. Some companies are also adopting new business strategies to protect their profit margins, with many corporations targeting fewer, more-profitable sales.

Achieving 2 percent consumer price inflation on a sustainable basis will be difficult due to structural challenges. Inflation is still a top concern for small and medium-sized businesses, both of which remain focused on expense management. One Council member noted that recent customer surveys indicated that a higher percentage of small businesses were planning to raise prices from February to March, while price inflation among corporate clients had moderated. Several Council members also mentioned the cost of insurance as a contributor to inflation. Another Council member is concerned that once the current shakeout of 2021–22 new entrants to the transportation market is completed, costs will increase, putting further pressure on inflation. This will add to the pressure on transportation costs linked to some customers with long-term contracts that include a price escalation clause.

In general, businesses are more responsive to shifts in demand. Though inflation has moderated, it is the cumulative increases in prices over the last few years that are shaping consumer attitudes. One Council member noted that their business contacts reported that the ability to pass along cost increases to their customers has weakened, putting pressure on their profit margins, while some marginal customers are becoming more cautious in their purchases and in some cases are trading down to other items to help manage the affordability challenge. This is leading companies to pass on costs to their customers at a slower rate, and in sectors such as consumer-packaged goods and restaurants, businesses have lost their pricing power. Deal flow is also slowing in construction given the escalation in costs, which has caused project delays and a concerted focus on repricing. In the auto sector, auto and truck original equipment manufacturers (OEMs) are seeing higher margins slowly normalizing. Retail car dealers have indicated that the OEMs are reluctant to reduce pricing despite raw material costs dropping. Conversely, car dealers are seeing prices drop and margins contract as inventories rise.

Members expect more companies to look to expense control and operational efficiency to help manage their balance sheets and protect their margins. Some companies are adopting strategies to protect their profit margins, with many corporations becoming "margin-dollar focused versus revenue-dollar focused," implying that fewer, more-profitable sales are preferred to many, less-profitable ones. A bright spot is the pace of labor productivity growth, which grew at an above trend rate in the last three quarters of 2023. If this continues (Q1 2024 data is not yet available), the increase in productive capacity would allow businesses to absorb faster wage growth while maintaining margins. Strength in labor productivity, if sustained, would help inflation return to the 2 percent target rate.

Item #5: Federal Reserve Policy

What are the Council's views on the stance of monetary policy, including portfolio activities?

The Council views the stance of monetary policy to date as appropriately restrictive. However, recent inflation readings indicate that progress on bringing down inflation appears to have slowed. Large government deficits and the recent surge in immigration are drivers of growth that would not traditionally respond to monetary policy. Moreover, the impacts of contractionary monetary policy and quantitative tightening may be lagging. With little apparent sign of the economy suffering from the Federal Reserve's restrictive policy, Council members believe the Federal Open Market Committee (FOMC) can afford to be patient in approaching the first cut.

Financial conditions have tightened following the recent inflation readings but have still eased since October, as evidenced by lower interest rates and tighter credit spreads. Possible signs of marginal funding pressure have begun to arise, with short-end rates increasing at month ends, potentially an early indicator that liquidity conditions are deteriorating. Liquidity pressure could also increase as the prospect of growing deposits in the short term remains uncertain. Activity and pricing in non-core funding sources, such as brokered CDs, have remained somewhat elevated. Conversely, prolonged high interest rates will likely continue to constrain lending, result in tighter underwriting standards, limit growth, and further stress rate-sensitive sectors of the economy such as autos and housing. One Council member noted that at the edges of

consumer credit, there are signals of a continuing deterioration, with delinquency rates migrating north of pre-pandemic levels.

Although it is important that the Federal Reserve reduces its balance sheet to a more normal level to preserve flexibility going forward, Council members agree a slower pace of runoff is warranted to ensure markets continue to function smoothly. Banks have prioritized liquidity and capital in the wake of last year's banking disruption, and these priorities have been apparent in the stability of reserves since March 2023. Council members noted the importance of ensuring ample reserve balances to support stability in funding markets, especially in an environment where recent declines in reverse repurchase agreements (RRP) are stabilizing. The RRP balance of $500 billion has also been relatively stable for the better part of a month, which suggests that there may be a structural level of RRP that prevents it from nearing zero. That structural level may be driven by a regulatory requirement for overnight liquidity at money market funds that makes the FRB reverse repo the most desirable option. While reserve balances appear sufficient, Council members believe the FOMC should continue to monitor reserve levels, as the lowest level of reserves is likely higher than forecasted.

Item #6: Short-Term Liquidity Risk

Considering the banking stress in 2023, are there liquidity policy adjustments the Council believes the Federal Reserve should be considering? In addition, what policy or operational changes to the discount window would Council members recommend?

Considering the banking stress in 2023, are there liquidity policy adjustments the Council believes the Federal Reserve should be considering?

Council members fully support the Federal Reserve's efforts encouraging banks to maintain actionable contingency funding plans, including preparedness to use the Federal Reserve's facilities (i.e., the standing repo facility and the discount window) during periods of stress. However, while the banking stress of 2023 highlighted the potential impact of insufficient liquidity risk management practices and contingency preparedness, the Council generally does not believe that fundamental changes to liquidity coverage ratio (LCR) or net stable funding ratio (NSFR) are necessary. If a proposal to increase deposit outflows in the LCR were considered, Council members believe it should also consider recognizing some level of pledged capacity at the discount window and standing repo facility.

Separately, to the extent banks can demonstrate effective monetization for held-to-maturity (HTM) securities under the existing LCR rule (i.e., via repo) or through an expanded LCR definition that allows pledging, HTM securities should continue to be permitted as high-quality liquid assets (HQLA) and not subject to limitation (e.g., additional haircuts or caps) given they are already reflected at fair value in the LCR. Additionally, zero-day or short-term liquidity measures currently being discussed by policymakers should focus on cash and discount window capacity to cover non-operational deposits, rather than be directed toward all uninsured deposits. Overall, Council members expressed a need for a coordinated effort to align all liquidity policies with clearly defined objectives, solutions, and impacts.

Most importantly, in any proposed changes, Council members encouraged the Federal Reserve to take into consideration the right standards for each cohort of banks and the full suite of effective liquidity risk management practices already in place, including strong resolution and recovery planning, complemented by robust balance sheet management practices, loss absorbency requirements, and internal stress testing. Further, the Federal Reserve should consider clarifying tailoring rules to explicitly require rapidly growing institutions to be prepared for increased standards in advance of certain thresholds and require a timelier path to compliance when firms reach applicable thresholds.

The Federal Reserve Bank of New York standing repo facility could be improved by increasing the aggregate program size (currently capped at $500 billion), increasing the limit that one counterparty can

borrow, adding collateral types that are agency level or higher, and expanding the operating window from the current 15-minute time frame.

Retrievable one-way sell deposits, uninsured deposits, and unencumbered securities pledged to the discount window should be considered as additions to small bank call reports to allow for better assessments of liquidity risk while allowing institutions to more efficiently manage their balance sheets. Utilization of a liquidity asset ratio may significantly underrepresent small bank liquidity inasmuch as it excludes off-balance sheet sources.

In addition, what policy or operational changes to the discount window would Council members recommend?

Council members agree that reducing the stigma of using the discount window is critical to increasing banks' preparedness and its use as a funding source. To do this, the Federal Reserve could consider the following:

- Enhancing existing liquidity requirements to reinforce that the discount window is an acceptable form of contingent funding by including a portion of available capacity as a source of liquidity.
- Allowing banks to include temporary use of the discount window in their liquidity stress testing assumptions, especially for high-quality liquid securities that have accumulated unrealized losses.

In addition to reducing the stigma associated with using the discount window, Council members recommended the following operational changes:

- Improving the efficiency and mobility of pledging loans by establishing a defined process to create more flexible borrowing capacity. This could include working with banks to understand the digitization of loan documentation, simplifying the pledging process, reevaluating collateral haircuts and increasing the transparency of lendable values, and allowing for easier transferability of collateral between the Federal Home Loan Bank (FHLB) and Federal Reserve Banks.
- Increasing the hours of availability and methods for accessing funding, adapting to the 24/7 nature of payments.
- Eliminating or reducing public disclosure for utilization of the discount window. Any disclosure, even on delay, is received negatively by public stakeholders regardless of the Federal Reserve's public stance for increased usage of the discount window. Additionally, the Factors Affecting Reserve Balances of Depository Institutions and Condition Statement of Federal Reserve Banks (H.4.1) report's weekly disclosure disadvantages banks without other large banks in its district (allowing almost immediate implied disclosure of discount window usage).

Item #7: Buy Now Pay Later (BNPL)

BNPL, a type of short-term unsecured lending to consumers for retail purchases at the point of sale, has risen in popularity and availability over the past several years. What roles do banks play in these financing arrangements? What roles do fintechs play? What do Council members see as the biggest opportunities and risks for consumers and financial institutions from BNPL? What efforts should the financial services industry take to ensure this category continues to grow in a healthy, sustainable way? What approach should regulators take in support of those efforts?

Council members generally agreed that the evolution of installment lending has been a positive development and that BNPL should continue to grow provided it is done with appropriate protections; in a clearly disclosed, consumer-friendly way; and with a level playing field ensured. BNPL can provide consumers with payment flexibility, utility, and new ways to access credit.

The role of fintechs and banks in BNPL financing arrangements:

Council members have focused their responses on two loan types that are offered by modern bank and nonbank BNPL providers at the point of sale (POS). **Pay in 4** BNPL are small-dollar-amount loans that require a 25 percent down payment and three biweekly payments, with no fees or finance charges assessed if paid on time. Pay in 4 is often funded by a merchant discount rate and is increasingly self-funded (e.g., banks are adding Pay in 4 BNPL loans as a free capability to augment demand deposit account relationships). **Pay Over Time** are larger-dollar-amount loans, paid over a longer period of time. These loans are funded by assessed interest or a merchant discount rate. Initially, Pay Over Time loans existed in retail only, but by adding solutions to e-commerce flows, the market has evolved. BNPL products compete against credit cards and unsecured loans.

The **role of fintechs** involves managing a two-sided network of consumers and merchants. Specifically, the fintechs are responsible for marketing and acquisition, onboarding (including credit underwriting, fraud risk, and KYC/AML), and servicing, including processing returns and cancellations. Many fintech BNPL providers also operate integrated shopping applications.

Banks started as a partner, limited to warehouse lines, merchant processing, and payment facilitation. Banks have begun to participate in BNPL loans through POS financing programs, installments tied to credit cards, and other constructs. Banks have some advantages over fintechs, including the ability to leverage deposit account data to do cash flow underwriting for owned products. Many community banks are currently reviewing BNPL products (viewed similarly as small-dollar loans) for their product suite.

What do Council members see as the biggest opportunities and risks for consumers from BNPL?

Opportunities:

As noted, Council members generally agree that BNPL loans can be a positive development and offer a new form of credit for consumers to help with liquidity needs. The benefits of BNPL for consumers include the ability to pay over time with fixed monthly payments at attractive rates. Pay in 4 BNPL typically does not require a hard credit inquiry to the credit bureaus. Thus, data has shown that BNPL provides credit to those who may be unable to access traditional credit, and BNPL loans can often serve as a good alternative to payday lending or other higher-cost products.

Risks for both Pay in 4 and Pay Over Time (unless noted):

Lack of level playing field for banks and fintechs. Although fintechs are generally subject to the same regulations as banks, adherence to and enforcement of regulations differ. A notable exception is that fintechs lack certain capital requirements and supervisory oversight that banks have, creating an unlevel playing field. More examples (e.g., autopay) are below.

Discrete consumer harms from inconsistent consumer protections

- Regarding Pay in 4 (only), there is a lack of clear and standard disclosures (e.g., on fees, including secondary fees charged to borrowers such as overdraft/insufficient funds).
- Challenges in filing disputes, returns, and chargebacks are caused by a lack of uniform billing dispute rights and by differing policies among and between BNPL providers and merchants. Notably, dispute resolution was the top BNPL-related complaint in the CFPB 2022 BNPL report.
- Some fintech BNPLs require the use of autopay, or otherwise attempt to circumvent Regulation E, create friction in autopay unenrollment, and have varying levels of quality and servicing channels.

- Lack of clear disclosures on fintechs' data use may impact consumers' privacy.

Overextension

- Regarding Pay in 4 (only), there is a risk of loan stacking through sustained and frequent use of BNPL and a lack of visibility given the absence of credit bureau reporting.
- Enabling the use of credit cards for fintech BNPL repayment.

Operational risk due to third-party reliance. Lack of direct oversight of merchant management, or of control over activities of third-party relationships, may increase operational and compliance risks.

Inconsistent legal framework. Recent developments show the potential for inconsistency across state-level regulations, which could introduce inconsistency, complexity, and conflicts of law.

What efforts should the financial services industry take to ensure this category continues to grow in a healthy, sustainable way? What approach should regulators take in support of those efforts?

Level playing field. In regard to Pay in 4 products, the industry can ensure adherence to directly applicable regulations such as Regulation E; Regulation B; and unfair, deceptive, or abusive acts or practices. The industry should also consider leveraging existing consumer protection regulation frameworks, such as the Truth in Lending Act, as a best practice. Regulators should engage in consistent or expanded oversight of fintechs and expand consumer protection opportunities to ensure third parties offer the same protections that banks are required to offer.

Discrete consumer harms. To address the lack of clear disclosures, the financial services industry should publish clear disclosure language, including loan repayment obligations and potential secondary fees. Regulators should continue to encourage the use of clear and transparent disclosure language. For disputes, the industry can ensure a robust merchant dispute regime and build digital self-servicing options for disputes. Regulators should encourage (1) transparency around the difference in dispute rights of BNPL versus traditional payment products such as credit cards, and (2) a robust or standardized merchant dispute regime through third-party oversight expectations.

Autopay on Pay in 4 BNPL. There are two options. First, the fintech BNPL players can follow Regulation E and give customers a clear and conspicuous choice regarding the use of autopay. And regulators could publish guidance reiterating to BNPL providers that Regulation E prohibits making autopay required. Second—and potentially requiring changes to Regulation E—given the unique nature of Pay in 4 BNPL credit (i.e., no finance charges and four or fewer payments), Pay in 4 transactions could be exempt from the prohibition against requiring autopay if there are disclosures on fees that can be incurred by the customer.

Data privacy. The financial services industry can ensure clear disclosures to consumers on how data is used and perform the same oversight as banks for consumer protection.

Overextension. The industry and regulators should encourage reporting of BNPL to credit bureaus and discourage the use of credit cards for repayment. Regulators could provide guidance for fintech BNPLs to assess affordability and set appropriate credit limits. As of this meeting, only one BNPL provider has begun reporting Pay in 4 loans. It will take time for the industry to incorporate the new data into credit scores and determine the impact of BNPL loans. Under current scoring models, repayment of a BNPL loan will not necessarily improve a consumer's credit score. Regulators could influence credit reporting agencies to require a unique BNPL code in credit bureau files to distinguish them.

Operational risk due to third parties. Given the offering of lending products through merchants' checkout and merchant acquisition and management, the industry could create internal policies to govern third-party relationships and risks. In addition, providers should educate merchants to offer products fairly and ensure regulators engage in consistent oversight of third-party relationship standards.

Payments and lending innovation, such as BNPL loans, when done responsibly, appears to add value to merchants and consumers, especially for lower-income consumers who otherwise may not have access to credit. Council members do not oppose this innovative product now in a nascent stage. However, to help safeguard sustainability in the long term, the industry and regulators need to work together to ensure that requirements and supervision of all players are consistent in credit bureau reporting, the customer experience, consumer disclosures, and dispute regimes.

Item #8: Reserve Demand

How has the demand for reserves at banks shifted over time? Do Council members expect that a possible decline in reserves in the banking system would alter banks' preferences for reserves and their willingness to redistribute reserves throughout the system? What sources of short-term funding do Council members expect banks will rely on if reserves decline?

How has the demand for reserves at banks shifted over time?

Council members were aligned in noting that the demand of banks to hold reserves on their balance sheets has increased substantially post-October 2008 following the Federal Reserve's transition from a "scarce" to an "ample" reserves setting regime. The primary explanations given for this shift include the following:

- Increased regulatory requirements for banks to hold more cash on their balance sheets, including the introduction of the LCR, internal liquidity stress tests, recovery and resolution planning, and the NSFR. Some Council members noted that the binding constraint on the level of reserves needed on banks' balance sheets has come from Federal Reserve feedback on annual liquidity stress tests, creating a "cash buffer" above what would be required to meet the LCR.
- Introduction of interest rate on reserve balances (IORB). Council members noted that following the introduction of IORB, demand to hold reserves increased. Prior to IORB, banks did not earn interest on their reserve holdings at the Federal Reserve; hence, banks were incentivized to hold other forms of liquid assets or to lend overnight in the federal funds market. Council members noted that the demand for reserves increases during hiking cycles when the yield curve inverts, as short-term rates are the highest point on the curve, increasing the attractiveness of floating rate assets such as reserves relative to other forms of HQLA.
- "Scarring" post-March 2023 banking sector stress. Most Council members noted that increased focus from the media, regulators, customers, and ratings agencies following the collapses of Silicon Valley Bank, Signature Bank, and First Republic Bank has put pressure on banks to increase their level of reserves in HQLA to offset a potential sudden drop in deposits or liquidity.

Few Council members specified what level of system-wide reserves would constitute a "lower bound," below which liquidity stress in bank or repo funding markets would emerge. Those Council members who were specific suggested it was likely around $3 trillion in total system-wide reserves, with a range of $2.8 to $3.2 trillion. One Council member noted that one factor impacting the lowest comfortable level of reserves in the banking system was the increased concentration of reserves amongst large domestic and foreign banks, noting that foreign banks and large domestic banks hold nearly 80 percent of reserves in the banking system. Such a skewed distribution of reserves raises the likelihood of potential stress at smaller banks and raises the bar to how low the Federal Reserve can shrink its balance sheet before liquidity stress starts to emerge.

Lastly, some Council members noted that any new liquidity requirements, such as a five-day uninsured deposit test or a change in LCR, would have the potential to amplify risks. If regulators indicate that new requirements or changes to requirements are needed to resolve liquidity issues, public concern about bank health could result, which could lead to banks tightening standards and potentially hoarding more reserves.

Do Council members expect that a possible decline in reserves in the banking system would alter banks' preferences for reserves and their willingness to redistribute reserves throughout the system?

Council member feedback was varied on how declining reserves in the banking system would alter bank demand for reserves. Some Council members noted that the primary driver of reserve demand is to meet liquidity regulations, which does not change in a declining reserve environment, and so competition for reserves will increase as they grow more "scarce." Other Council members noted that the demand for reserves increases–-and conversely banks' willingness to share reserves declines--during periods when the Federal Reserve is hiking interest rates. Hiking cycles are typically associated with heightened risk aversion and more uncertainty around liquidity conditions. Additionally, toward the end of hiking cycles, the yield curve can invert deeply, leading to the short rates being the highest point on the curve, increasing the demand for floating rate assets like reserves relative to other forms of HQLA (such as longer-dated treasuries). All these situations make holding reserves more attractive when system-wide levels of reserves are falling.

Prior to 2008, one of the primary ways banks "shared" reserves across the banking system was through lending in the overnight interbank federal funds market. A few Council members noted that post-2008, regulatory changes no longer make the federal funds market a viable source of liquidity in size, since borrowing overnight in the interbank markets is treated punitively from an LCR perspective and is not considered a "stable" form of funding in a bank's NSFR. Partly as a result, interbank lending between domestic banks has all but dried up, and banks have responded by holding excess levels of cash and relying more heavily on FHLB borrowings (which are treated more favorably from an LCR perspective and have more flexible term structures) and by borrowing longer term.

What sources of short-term funding do Council members expect banks will rely on if reserves decline?

Council members were aligned in noting that short-term advances from FHLBs likely would be the primary source of short-term funding that banks would rely on if reserves decline. Unlike short-term interbank or repo funding, FHLB borrowings are treated more favorably from an LCR perspective, where less potential net short-term outflows from FHLB borrowings enter into the LCR equation. After FHLB borrowings, the next most cited source of short-term funding was brokered CDs, followed by borrowing in repo markets. One Council member noted that larger banks might rely more heavily on issuing longer-term debt.

There was also general agreement among Council members that a viable and usable liquidity backstop from the Federal Reserve—such as the discount window or the standing repo facility—may be required to prevent a repeat of the repo and bank funding stress that emerged in late 2019. The absence of such a backstop will force banks to respond by holding more reserves on their balance sheets than they would otherwise need, potentially exacerbating liquidity stress in the system when financial market liquidity is already running low. Many banks noted that the stigma associated with a bank having to use the discount window significantly discourages its use, and some Council members recommended that the Federal Reserve take efforts to reduce that stigma.

The standing repo facility is another potential backstop that does not carry the same stigma as the discount window. However, one Council member pointed out the discrepancy between how Federal Reserve officials are publicly portraying the standing repo facility as an effective liquidity backstop in times of stress, but privately discouraging banks from planning to use it as a last-ditch funding source as part of their internal liquidity stress tests. This disconnect not only creates confusion, but it discourages banks from using the facility in times of deep liquidity stress—potentially exacerbating the issue.