Record of Meeting

Federal Advisory Council and Board of Governors

Thursday, December 5, 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 first half of 2025?

Most Council members reported that consumer spending growth remains relatively stable; only one Council member mentioned seeing signs of slower growth. Economic activity has been supported by a tight labor market, as wage growth has remained positive on an inflation-adjusted basis. While overall consumer spending has been stable, it has slowed in the lower income quartile groups while rising in the top two income quartile groups. There has been a general trend toward consumers "trading down," that is, choosing to buy less expensive brands and products. Council members noted that consumers have largely drawn down the excess savings they accumulated during the pandemic, resulting in a stabilization of cash buffers across income groups. Further, households have increasingly turned to credit—especially credit cards—to finance purchases, and household borrowing rose for the third consecutive month in September. Consumer spending in general, and discretionary spending in particular, have stabilized since the last meeting.

Commercial borrowers have been cautious as they deal with disparate impacts being felt in various sectors. Small businesses have remained generally healthy, as their cash buffers are still elevated over historic levels while continuing to normalize from earlier highs. Small businesses have experienced flat to increasing revenue growth depending on the region. Council members expressed differing views on the hospitality sector, with two Council members reporting strength, and another reporting a systemic slowdown. The manufacturing sector appears stable, with the exception of certain industries. In addition to strikes at an aircraft factory, auto production declined in five of the last six months. The auto industry remains hampered by higher vehicle inventories post-pandemic along with the impact of higher interest rates on car sales. Similarly, sales of new and existing homes continued to struggle for nearly all of 2024, with the exception of September when interest rates fell to multiyear lows. However, Council members noted different views of strength in the manufacturing and home building sectors: the Northeast showed signs of slowing down, while the South showed signs of continued growth. This theme of regional differences was echoed in comments made by various Council members regarding the impact on revenue for companies associated with the home and home construction markets. However, in part due to increased government spending, there was broad consensus regarding the strength in the construction of industrial and infrastructure projects.

Corporate customers have continued to invest and see growth broadly across all sectors. However, companies that primarily focus on the consumer and retail sectors have seen some stress due to slower growth and tighter margins—but this stress is not a broad concern. Hiring has remained a challenge for certain areas, although not extensively across Districts. The healthcare and technology sectors have been growing strongly, while most consumer-oriented sectors have continued to struggle. Despite economic activity remaining solid, there were marked swings due to hurricanes and the aircraft manufacturer strike—the impacts of which will continue to be felt for several months, and may result in distortions that challenge economic analysis.

Council members have not shifted their core view on the economic outlook since their meeting in September and that they continue to view a "soft landing" as the most likely outcome. Consumer spending is expected to continue to increase in the first half of 2025. Commercial clients are currently exhibiting caution and delaying significant investments; however, there is growing interest in mergers and acquisitions (M&A) because companies are feeling more optimistic about the outlook for 2025. Larger companies have been faring better overall, except for those in certain sectors—particularly those most impacted by higher interest rates. Council members believe that solid overall growth at a moderate pace should allow inflation to move closer to the Federal Reserve's two-percent policy objective.

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 in the first half of 2025?

Council members reported a somewhat bifurcated labor market. Supply and demand appear relatively balanced for lower-skilled workers, though one Council member noted a regional shortage. Skilled workers continued to be in short supply, particularly in sectors such as healthcare, manufacturing, and construction.

The key drivers of labor supply include increased participation among lower-skilled workers and reduced voluntary turnover due to economic uncertainty. However, geographic mobility has been constrained by high housing costs and the "lock in" effect of low mortgage rates. On the demand side, companies have been actively seeking to fill skilled positions, driven by growth in industries such as advanced manufacturing, renewable energy, and infrastructure development. Federal investments through the CHIPS and Science Act and the Inflation Reduction Act appear to have further bolstered demand in these sectors.

Automation and outsourcing have also moderated demand for certain roles, as businesses seek cost efficiencies to offset rising wages and operational challenges. Meanwhile, structural factors such as an aging workforce and insufficient training pipelines have exacerbated supply constraints in key areas.

Council members reported that economic initiatives and regulatory changes resulting from the new administration may also have an impact on the labor market. Such changes may lead to sector-specific results but could also affect the overall economy and the labor market more generally. Immigration reform could negatively impact the labor market, though it is too soon to estimate the extent of such as impact. Artificial intelligence (AI) is also likely to cause further shifts in the labor market, and any significant impact could serve to bring greater balance to both the skilled and unskilled job sectors to the extent AI affects high-skilled jobs that have been largely insulated from other automation efforts.

In the first half of 2025, Council members expect employment levels to stabilize, with continued growth in the construction, manufacturing, and technology sectors. The healthcare and hospitality industries may continue to struggle with persistent labor shortages. Compensation rates are projected to grow modestly, aligning more closely with inflation as wage pressures ease in some sectors. Council members are expecting average wage increases of 2.5 to 3.5 percent, with lower-paid staff receiving the higher percentage. However, skilled roles will likely see sustained wage premiums due to ongoing demand and limited supply.

While many organizations anticipate gradual normalization of labor market conditions, Council members expect the path forward to remain uneven, with sector-specific variations and continued adjustments to hiring strategies and workforce development initiatives.

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?

Overall, Council members view that, due to a variety of factors, commercial credit demand and utilization are still soft compared with historical levels, yet are slightly stronger than last year and have been modestly building in recent quarters. Residential and office real estate lending remain particularly weak, while consumer borrowing continues to demonstrate strength—although with deteriorating credit characteristics. Most notable is the continued emergence of nonbank lending sources, particularly in the middle market and in commercial real estate (CRE). Banks continue to be selective regarding pricing and structure, although they are increasingly reentering the market as liquidity levels stabilize, margin pressure persists, loan outstandings remain flat, and overall credit quality continues to be strong.

Middle market

Loan demand and line utilization from mid-sized to larger companies remained muted due to an uncertain outlook regarding the impact of future economic policies and the direction of interest rates, disciplined inventory management and strong cash reserves that are self-funding capital expenditures, and increased access and receptivity to the private and capital markets. However, some Council members reported signs of an increase in borrowing activity in the most recent quarters. Although concerns remain regarding sufficient liquidity to support lending activity, competition continues to be intense for full banking relationships. There is a greater availability of syndicated transactions, yet larger loans continue to be a challenge from a participant standpoint. And although the lack of M&A has exacerbated a relative lack of credit demand, there is growing optimism about M&A activity in 2025. Overall, credit quality continues to be stable with little expectation of future weakness. Some deterioration in agricultural portfolios is expected due to higher financing costs, lower commodity prices, and tightening cash flows, mitigated by strong crop yields in the Midwest.

Small business

Driven by greater expense discipline, the financial performance of many small businesses is continuing to normalize, despite continued concerns regarding higher costs and economic uncertainty. Although these concerns have led to hesitancy among small businesses to make capital investments and fixed asset purchases, some Council members reported a moderate increase in loan demand and line utilization—especially among more established businesses. However, as cash flows have come under increased pressure, there have been more requests for relief on existing credit facilities through modifications, re-amortizations, etc. Many small business owners have been finding that receivables are stretching, and they are having to rely on debt, cash, and other sources of liquidity while awaiting payments.

Commercial real estate

There has been no material change in CRE. Most asset classes remain reasonably in demand, with the exception of office and rent-regulated multifamily properties. However, all segments are susceptible to refinance risk due to the emergence of significant financing gaps.

Overall, multifamily housing continues as the favored asset class, both in the construction of new properties and the rehabilitation of older properties. Much of this activity is centered around all types of multifamily categories. Pre-development activity has been restarting on previously shelved projects in the Northeast and Midwest, areas that have been generally immune to much of the current oversupply seen in the Sunbelt markets. Soaring insurance premiums have continued to be a limiting factor in new loan demand.

Alternative lending sources such as life companies, the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, debt funds, and the securitization markets have provided additional liquidity, taking advantage of a more limited bank and insurance appetite while expanding into more traditional bank products (such as construction and bridge financing). Commercial mortgage-backed securities and real estate investment trusts (REIT) have rebounded significantly. The increased competition has impacted pricing and structure in the secured real estate market. However, banks are increasingly returning to the market, having reduced CRE exposures in recent years and facing loan growth headwinds from payoffs and limited new originations. Some banks have been focusing on increases in non-secured positions, lines of credit, and subscription facilities for real estate funds, public REITs, and note-on-note financing, which has created an indirect position in CRE lending, allowing banks a lower cost of capital and less direct exposure.

Office and retail loan quality have continued to deteriorate, especially in most major downtown areas. Although office REIT prices appear to have bottomed out over the past few quarters, increasing vacancies in the lab/life sciences space represent new supply coming online over the next 18 months with minimal pre-leasing in place. Data centers have currently emerged as a source of strength as AI has fueled an insatiable demand for data centers, hindered only by the availability of power.

Construction

Demand for construction loans has remained slow, due to elevated costs, higher interest rates, and tighter lending criteria. New multifamily has led in the construction space, but supply levels are elevated in certain regions and new project construction demand has declined materially due to saturation and economic viability. Zoning requirements, supply costs, higher rates, and insufficient available labor have also negatively impacted new construction. Industrial construction has also softened due to increased costs and flattening demand for industrial product. Conversely, many large municipal clients have exhausted pandemic relief funds and are now facing the need to borrow to implement projects, driving more need for loans in this space. Pricing remains competitive for these high-quality loan opportunities.

Residential

Residential lending has remained weak due to a lack of supply of new homes and preexisting low-rate mortgages, the latter of which have sharply curtailed refinance activity. Recent estimates indicate less than 6 percent of homeowners with 30-year conventional mortgages are incentivized to refinance. While the 50-basis-point cut in September initially spurred increased mortgage refinancing opportunities, this increase diminished when strong economic data pushed the 10-year Treasury yield back to pre-cut levels. However, affordable lending is increasingly well supported by downpayment and other financing assistance programs. Due to affordability challenges, multifamily properties continue to be in demand, although the residential rental market appears to be nearing its peak and landlords have had to lower rent expectations, causing a flattening in investment rental property values.

Consumer

Due to widely available access to credit, consumer spending has been strong, leading to stable credit card usage, with consumers' average revolving balance per account roughly in line with pre-pandemic levels. Auto also has continued to experience healthy demand, supported by improved dealer incentives. Nonauto consumer secured and unsecured lending demand is mixed. Consumer demand for home improvement financing continues to be flat. Home equity borrowings are being used primarily for debt consolidation, as the rising costs of materials and labor, combined with higher borrowing costs and consumer uncertainty, are headwinds to home improvement lending growth. Delinquencies in auto loans and credit cards across consumer loan products have continued to increase and are now above pre-pandemic levels.

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 in 2025?

Since the Council's last meeting, broad inflation trends continued to moderate, although the month-to-month variation has been mixed. Though the path to 2 percent inflation will continue to be choppy, Council members believe there are reasons to be optimistic that the downward trend will continue, although at a slower pace. Businesses continue to report an inability to pass along further cost increases to their customers, which puts pressure on their profit margins as consumers continue to be more cautious about purchases—for example, focusing on essentials, shopping for the best deals, and trading down to help manage the affordability challenge. Though inflation has moderated, it is the cumulative increases in prices over the last few years that are shaping consumer attitudes. As demand has softened, providers of discretionary services have adapted to changing behaviors by offering more discounts or payment plans. As consumers' savings continue to deteriorate, clients have noted more instances of customers taking payment plans instead of a discounted cash option. One Council member noted that as a result of the drop in consumer savings, the percentage of businesses planning to increase prices fell to an all-time low in their most recent survey.

In addition to offering discounts and payment plans, businesses have responded by continuing to focus on expense management and operational efficiency. Council members noted that many businesses are slowing growth plans to attempt to maintain margins, which continue to deteriorate. A boon to businesses' expense management is the continued abatement of labor pressures as the labor market comes more into balance. Although pockets of the labor market are still stressed, overall, the cost of labor as an input for businesses has continued to moderate.

Council members noted that there are exceptions to the dynamic of passing along pricing. Specifically, insurance companies, cattle producers, government-funded projects, and renters continue to experience price increases. Home, car, and health insurance continues to increase to the point where consumers are accepting higher deductibles to manage the affordability of their policies. Council members also noted that in areas where there is significant construction activity driven by government-funded projects, contractors have been able to achieve higher pricing. Finally, shelter continues to be a challenge, as it accounted for more than 50 percent of the monthly increase in headline inflation in October.

While progress has been made overall, caution on near-term inflation remains. Council members noted that, along with the continued increasing cost of insurance and shelter costs, energy prices remain volatile month to month, trade protectionism and tariffs have added a new upside inflation risk, and geopolitical risks could further impact global supply chains and raise transportation costs.

Item #5: Federal Reserve Policy

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

Council members continue to believe that monetary policy is appropriately restrictive and are in favor of a gradual reduction in rates toward neutral territory. Although economic data has generally been better than market expectations since the initial 50-basis point rate cut in September, Council members are generally supportive of the additional 25-basis point rate cut in November as they believe inflation will continue to move toward the Federal Reserve's 2 percent target. Additional rate cuts should be data dependent and made at a gradual pace. Additionally, there should be a consideration for an eventual pause in rate cuts to observe the economic response to a loosening of monetary policy as well as any potential impacts from proposed fiscal policy. Overall, Council members view the Federal Reserve's policy actions, portfolio activities, and communication to date to be appropriate.

Council members largely agree that additional rate cuts are necessary, and there was some discussion regarding at what pace these cuts should occur and when it might be appropriate to pause. GDP growth remains positive, and the labor market remains relatively healthy, especially considering historical norms. Optimism around a pro-business agenda of the new administration and strength in equity markets could encourage further consumer spending. Additionally, there may be upside risks to inflation with proposed policy such as broad-based tariffs and an expanded fiscal policy. However, Council members believe that it is appropriate for the Federal Reserve to be mindful of its dual mandate when it comes to labor markets. In addition, Council members agreed that the Federal Reserve has been correct to point out that the potential for long and variable lags of monetary policy could eventually impact labor markets, consumer spending, and growth at an accelerated pace.

Council members continue to support efforts by the FOMC to reduce the size of its balance sheet. Quantitative tightening (QT) has been necessary in normalizing the post-pandemic economy and has played an important role in normalizing the yield curve. As the Federal Reserve continues to shrink its balance sheet, it is apparent that the reverse repurchase facility (RRP) has borne the brunt of the runoff from a liquidity perspective. The RRP has been a successful monetary tool for the Federal Reserve in administering the federal funds target rate and has helped keep reserve levels stable. As the RRP facility continues to wind down, it may serve as a barometer—along with other indicators such as overall banking reserve levels and the spread between the Secured Overnight Financing Rate and the Interbank Offered Rate (SOFR/IBOR spread)—as to when the Federal Reserve might consider ending QT. Overall to date, the effective federal funds rate has remained anchored and has shown little sensitivity to shifts in the reserve balances, indicating that reserves remain abundant.

Item #6: Discount Window

In September 2024, the Board issued a request for information (RFI) around the operational practices of the discount window. Among other items, the RFI seeks input on operational frictions or inefficiencies with respect to submitting legal documents to a Reserve Bank, pledging or withdrawing securities or loans as collateral, and requesting discount window advances, receiving proceeds, and repaying advances before maturity. The Board would appreciate hearing the Council's view on any of these items and its suggestions on actions the Federal Reserve could take to address them.

Council members appreciate the Board's interest in this topic. Aligning the operational readiness of depository institutions ("borrowers") and the operational efficacy of the discount window is critical in supporting the liquidity of the banking system and promoting overall financial stability. With these goals in mind, the Federal Reserve is encouraged to consider the following actions, which rely on an increased use of automation, more consistency of processes, and greater transparency.

Reduce operational inefficiencies when submitting legal documents to a Reserve Bank.

- Incorporate the use of electronic forms, and permit the use of both wet and e-signatures when updating the OC-10 Official Authorization List and other required forms.
- Implement consistent eligibility requirements, operating hours, processes, and guidance—and make that information publicly available across Federal Reserve Districts.

Create efficiencies when pledging or withdrawing securities and loan collateral.

- Synchronize loan pledging across Reserve Banks by ensuring a uniform, consistent collateral pledging process across all Reserve Banks.
- Enhance and extend the timeline for transferring securities from custodian to the Federal Reserve.
- Accelerate the pace at which borrowing availability is assigned. Enhance transparency on haircuts, as currently the ranges are extremely wide, and pledgors cannot accurately ascertain what value will be provided until the asset is pledged.
- Remove the $50 million cap on per collateral movement, and allow bulk upload of collateral data to make it easier to move collateral to the discount window.
- Use a common data taxonomy that is aligned with existing regulatory reporting mandates (e.g., FR 2052a or FR Y-14M/Q).
- Update and expand the Borrower in Custody program handbook and accompanying materials.

- Establish standardized intercreditor agreements with the Federal Home Loan Bank (FHLB) and other custodians to allow for efficient movement of collateral (loans and securities).
- Similar to the FHLB, allow firms to pledge new loan portfolios on a "blanket lien" basis.

Create an online platform for requesting discount window advances, receiving proceeds, and repaying advances before maturity.

- The Discount Window Direct web interface (which is a good enhancement) time window should be extended to align with the traditional process.
- Align the discount window operating hours with those of participating banks by District.

Other considerations:

- The RFI focuses on operational efficiencies, but effective utilization of the discount window also depends on the regulatory framework and greater clarity on the treatment of discount window capacity and availability in quantitative assessments of liquidity coverage, such as liquidity coverage ratio (LCR) and internal liquidity stress tests.
- District-level H4 reporting currently exposes banks to reputational shocks when using the discount window. Reducing the stigma associated with discount window use will depend on clear Federal Reserve supervisory support.
- The Reg YY FAQ of August 13, 2024, provided some latitude to include discount window borrowing capacity on high-quality liquid assets (HQLA) into options for contingency funding. To promote use, discount window capacity on HQLA and non-HQLA collateral should be regarded as liquidity within internal stress testing, LCR/net stable funding ratio, and small bank Board-monitored liquidity.
- Ensure consistency in the reporting of pledged investments in the call report. Currently, pledged investments are not delineated as to whether they are in use or free, which impacts liquidity ratios.

Item #7: Disaster Relief and Recovery

How have individual financial institutions been impacted by recent natural disasters? Have the stress dynamics changed from previous disasters? Are financial institutions equipped to step in during times of natural disaster stress? What are the implications for risk management at individual institutions? Are those implications different for different-sized institutions? How should banking, and bank regulation or supervision, change to meet the stresses from natural disasters?

Financial institutions (FIs) have been impacted in several key areas by the recent natural disasters; however, the full impact has yet to be quantified. Locations have been impacted by power outages and damaged by wind and water. Staffing challenges have arisen when staff or their family members have been displaced or have suffered injuries. And support services (e.g., cash delivery) have been interrupted or delayed. Financially, there has been an impact from the loss of revenue, the cost to restore or rebuild services or locations, and the cost to provide humanitarian aid and other needed financial support to the communities in which the institutions serve. Finally, an FI's reputation is potentially impacted by clients frustrated by (1) temporary branch or location closures, (2) the continuation of business-as-usual banking processes that result in fees being assessed to their accounts, and (3) being unable to reach live agents 24/7.

Have the stress dynamics changed from previous disasters?

The stress dynamics are similar to previous disasters. However, Hurricane Helene's inland path and resulting flooding in areas not designated as flood zones raised new concerns about underinsurance. This issue is exacerbated by high population growth in these vulnerable areas. Financially, insured wind and storm surge damages are expected to have a negligible impact on the U.S. property and casualty sector. Operationally, clients expect an immediate response and quick resolutions because that is the norm in so many areas of their daily lives. Today, people are more dependent on electronics, and that includes the way they transact financially. When power and cell services are limited or down, FIs are under pressure to make sure their customers have a way to access their funds and—more specifically—cash to conduct transactions.

Are financial institutions equipped to step in during times of natural disaster stress?

FIs must put plans in place to support both their communities and the financial industry during times of natural disaster stress, and the size and footprint of the FI will be factors in how much aid and support it can offer. For clients, FIs can deploy mobile branches and ATMs, offer humanitarian aid and basic needs support, serve prepared meals, provide jugs for potable water, and have staff volunteer their time. Ensuring cash is available has proved to be one of the most instrumental ways banks can provide support during natural disasters. Banks have established practices to increase cash balances in advance of storms by max-filling ATMs and discontinuing outbound shipments of cash from branches. This allows branches to increase cash inventories without reliance on third parties, such as armored car services, which are not immune to the impacts and disruptions of natural disasters.

Additional support that FIs provide to their customers includes guidance to avoid post-disaster fraud scams. Clients depend on FIs to keep them informed of fraud-related activities and concerns, including measures to take to protect themselves against scams related to insurance settlements and government benefits, tools FIs may employ to increase their fraud prevention processes, and ways clients can access information related to fraud processes. FI employees are not forgotten: emergency alerts are activated to ensure staff are fully accounted for, staff members' requests for assistance are fielded and supported, and special lending benefits are offered to staff.

FIs can also offer loan payment deferral programs, temporarily halt all repossession and foreclosure activity in disaster areas, and reimburse ATM fees for impacted clients. Hurricane Helene's impact on electrical and cell service resulted in several lessons learned, including adjusting normal business hours in physical locations and call center hours to better serve clients as well as leveraging radio broadcasts to get messages out to large populations regarding where to get resources for financial support.

What are the implications for risk management at individual institutions?

In alignment with existing practices, FIs should ensure that their processes for managing provisions for credit losses appropriately consider the anticipated impacts of natural disasters. The stress dynamics from the recent natural disasters are currently proving to be manageable given the current client aid and support capabilities, but they could become less manageable over time if the pace of such disasters remains elevated—or accelerates—or if the time between natural disasters remains tight (or narrows).

Given the persistence and intensity of natural hazards, FIs should also consider incorporating natural hazard risk considerations into existing policies and procedures as well as in risk management processes. Specifically, FIs should evaluate their exposure to natural disasters, including in their operational footprint (with particular consideration given to data center locations and concentration) and loan portfolio, and establish capabilities to analyze the impacts of climate-related weather events. These calculation efforts include leveraging climate scenario analysis to estimate the impact of natural hazards under different time horizons and scenarios of varying severity. FIs should also consider the changing dynamics in insurance markets, including the rising cost or unavailability of insurance, and the potential impacts on property valuations, different markets, and potential asset quality. Advancing in data analytics and standardizing the leveraging of natural hazard data will be critical in enabling FIs to develop and mature these capabilities.

Are those implications different for different-sized institutions?

FIs should tailor their approaches to mitigating risk from natural hazards based on the risks that are most material given the financial institution's geographical footprint, business activities, and other relevant considerations. FIs with larger concentrations in the southeast are more likely to focus on flood and hurricane risk, while FIs with concentrations in western states will likely emphasize wildfire risk analysis.

While all FIs should incorporate natural hazard risk into their enterprise risk management framework, the level of detail and sophistication will vary for different-sized institutions based on the availability and comprehensiveness of risk peril data, modeling capabilities, scenario design, and other resources.

How should banking, and bank regulation or supervision, change to meet the stresses from natural disasters?

Council members appreciate the interagency statements published following natural disasters that could impact banking operations and regulatory requirements. These provisions facilitate the ability of FIs to operate flexibly to meet client needs and provide CRA consideration for community development loans, investments, or services that revitalize or stabilize disaster areas.

Recent disasters identified that when banks need to communicate with clients, electronic communication is not considered sufficient because regulatory requirements mandate that paper notifications accompany electronic messages. Adhering to this mandate was a challenge, as some of the affected areas were not reachable by U.S. mail. Modifications to paper notification requirements or temporary waivers of the requirements for a certain period after a declared natural disaster should be considered to ensure electronic communications can be provided as timely as possible.

Financial institutions and regulators should also work with the Federal Emergency Management Agency (FEMA) on several issues, the most significant being that flood risks are not accurately depicted by current flood maps that banks rely upon for requiring insurance coverage. Recent disasters have resulted in significant impacts beyond flood zones, and that trend is expected to continue. Additionally, FEMA provided emergency funds via paper checks, which presented challenges as banks needed to ensure that the full FEMA funds were available to clients for a period—even if the client had a current negative balance in their deposit account. To help protect their customers, FIs would benefit from better information from insurance providers, the federal government, and the Treasury Department. Access to payee information, the timing of transactions, and the increased use of electronic transfers are ways FIs could help reduce the risk of fraud and scams perpetrated against bank clients.

<u>Item #8: Synthetic Risk Transactions</u>

Transactions that transfer credit risk from the banking book to third parties have been growing rapidly over the course of this year. They have taken a variety of forms, such as through the use of credit-linked notes and seem to be used by a wide range of banks. What factors are driving the growth in this market? How are banks of different sizes assessing and managing the risk in these transactions? To the extent banks are financing the transactions or structures, how do they manage the risk? How are Council members assessing the systemic risk of this market, particularly to the extent that the securities are sold to leveraged clients? How would banks manage the risks if the market shut down in a downturn?

Synthetic risk transfer (SRT) transactions are an effective tool for banks to hedge credit risk and diversify exposure while managing their capital footprint, provided the transactions are appropriately structured, monitored, and controlled. Perhaps most importantly, these transactions are fundamentally different from those executed in the lead-up to the Great Financial Crisis—principally because today's SRT transactions are fully cash collateralized, eliminating counterparty credit risk.

What forms are these transactions taking?

There are two broad underlying asset classes, with differing structures and investor bases:

<u>Retail credit</u>

- Commonly structured as publicly rated credit linked notes (CLNs) issued directly off banks' balance sheets that provide junior credit protection.

- Unlike traditional cash securitizations, the underlying loans remain on the balance sheet and available for liquidity management purposes (e.g., to be pledged to the FHLBs).
- The CLNs have CUSIPs and are rated and trade similarly to existing cash asset-backed securities (ABS).
- Primarily seasoned high-quality auto loans and residential mortgages.
- Broad investor base ranging from ABS investors to private equity and pension funds.
- Currently, banks are required to obtain approval from the Federal Reserve prior to applying any capital benefit—limited to SRTs covering an aggregate underlying loan notional of the lower $20 billion and 100 percent of a bank's total capital.

Wholesale (corporate credit)

- Often, structured as a bilaterally negotiated collateralized credit default swap with a bankruptcy remote special purpose vehicle that then issues unrated CLNs to a small number of investors.
- Corporate revolvers and term loans (relationship lending), spanning large corporations to small and medium-sized borrowers.
- Investor base is limited to sophisticated institutional investors, including private equity and specialist private credit "sponsor" firms.

What factors are driving the growth in this market?

Growth in SRTs can be attributed to increased bank issuer and investor demand.

Bank issuers

SRT transactions allow banks to hedge credit risk and optimize their capital footprint without the need to sell the underlying loans, which could undermine the relationship with the borrower or result in the realization of losses on underlying assets driven by the higher rate environment. For certain lower risk assets, particularly retail loans, the misalignment of capital with the actual underlying risk—as expressed by the market's pricing of SRT transactions—is a fundamental driver of banks' efforts to develop SRTs and grow the market.

The European SRT market has been highly active over the last decade, while the U.S. market is still small and has only recently begun to grow significantly. One main driver of this growth is the September 2023 release by the Federal Reserve Board of an FAQ clarifying the treatment of credit-linked notes in the context of synthetic securitization capital regulations. A number of Council members cited an increased need for capital relief due to the potential increase in U.S. bank capital requirements as a result of the "Basel 3 Endgame" as another important driver of growth.

Investors

Investor demand for SRT transactions on retail assets has increased due to attractive returns combined with the ability to obtain exposure to seasoned low-risk retail assets on banks' balance sheets that are not commonly securitized today.

For SRT transactions on wholesale assets, investor demand has increased with the emergence of private credit investing. SRT transactions allow these investors to prudently deploy capital in size quickly. This combined with investors' familiarity with the underlying credit as well as the tranched credit risk of SRT transactions makes the product compelling.

How are banks of different sizes assessing and managing the risk in these transactions?

Regardless of bank size, Council members believe that there are several best practices for managing the risk of issued SRT transactions:

- Structure and manage for durability of the risk transfer in a range of economic environments.

- Actively monitor to prevent overreliance on them, so that a reduction in SRT demand would not impact the bank's ability to continue lending and supporting the real economy.
- Banks should proactively and transparently engage supervisors on planned SRT usage.
- Banks should consider the appropriateness of both the underlying risk and the structure of SRTs for the investor base. For wholesale assets where risk is narrowly distributed in a private market, it is important to be selective and engage with an appropriately sophisticated investor base. For retail assets, best practice includes high-quality asset selection, price transparency, and broad distribution of issued CLNs.

Different banks executing these transactions may have varying abilities to follow the best practices outlined above, and any limits established by regulators should reflect the specific risk management capabilities of an issuing institution.

To the extent banks are financing the transactions or structures, how do they manage the risk?

Banks should not directly finance their own SRT transactions, as that would undermine the transfer of underlying credit risk. Financing the investor in another bank's SRT transaction does not undermine the transfer of credit risk by the originating bank. The concern that this brings the underlying risk back into the banking system is negated if the risk is appropriately managed through collateralization—with appropriate haircuts and margining—and sufficient capital held by the financing bank against that risk.

How are Council members assessing the systemic risk of this market, particularly to the extent that the securities are sold to leveraged clients?

Following are two primary sources of possible systemic risk from SRT transactions:

- Risk of uncertainty around issuing banks' true capital positions if protection purchased by the banks is not enforceable.
  - Meaningfully reduced as the notional value of the CLN is fully cash collateralized, thereby eliminating banks' counterparty credit risk to the investor. SRT transactions must comply with current capital rules, which are designed to ensure that they are enforceable and that the risk transfer is durable.
- Risk of reduced bank lending to the real economy if the demand for SRTs diminishes rapidly.
  - Mitigated if best practices are adhered to, specifically that banks do not become overly reliant on SRTs, and that supervisors have appropriate transparency into these transactions.
  - Several Council members highlighted the relative resiliency of SRT demand following the COVID-19 pandemic and the fact that underlying loan demand may also decrease in a stress event that impacts SRT investor appetite.

Several Council members mentioned that the systemic risk posed by SRT transactions is currently small given the limited size of the market.