

Forefront

New Ideas on Economic Policy from the FEDERAL RESERVE BANK
of CLEVELAND

Stronger Pipelines, Lessened Uncertainty, and Investing in Fun

The Cleveland Fed and regional businesspeople
compare last year to the year before and answer our question:
What's in store for 2015?

2015



INSIDE:

Improving communities
for the sake of our health

Q&A: 3 businesspeople
who inform the Fed

Small business survey says...



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Presidential Pulls

Loretta J. Mester, president and CEO of the Federal Reserve Bank of Cleveland, has delivered about half a dozen public speeches since taking office June 1, 2014. Here is some of what she's had to say.



Forward Policy Guidance

"My preference is for forward guidance to convey that changes in the stance of policy will be calibrated to the economy's actual progress and anticipated progress toward our dual-mandate goals, and to the speed with which that progress is being achieved."

— From a speech in Pittsburgh, PA, September 4, 2014

Economic Outlook

"My read of the data and the incoming information we collect from our business contacts is that the economy is standing on firmer ground than it has been for some time. The economy has made, and continues to make, substantial progress on its journey back to our dual-mandate goals."

— From a speech in Pittsburgh, PA, September 4, 2014

Policy Normalization

"There is likely to be some learning-by-doing as normalization proceeds, and the FOMC is prepared to adjust details of the plans if warranted by economic and financial developments."

— From a speech in Cleveland, OH, September 24, 2014

Improving Communications

"I believe it would also be helpful over time to provide more information in our statement and other communications ... That is, the FOMC should explain how and why we came to our assessment that realized and expected progress toward our goals is pointing to a particular policy path."

— From a speech in New York, NY, November 6, 2014

Fed Accountability

"A body of research both here and abroad shows that when central banks formulate monetary policy free from government interference and are held accountable for their decisions, better economic outcomes result."

— From a speech in New York, NY, November 6, 2014

Regional Representation

"I make it a point to bring in the information my staff and I have gleaned about economic and financial conditions from the businesses and banks in my District, as well as from our directors. This regional information, along with national data and analysis, plays an important part in our setting of national monetary policy in pursuit of our goals."

— From a speech in London, UK, November 20, 2014

Financial Stability

"At this point, given the state of our knowledge, I would opt to use the macroprudential tools as the first line of defense, since they can be more targeted to the markets and institutions where the risks are emerging. Whether monetary policy would be as effective is debatable."

— From a speech in Washington, DC, December 5, 2014

Monetary Policy Independence

"I believe that calls to audit the Fed are misnamed and misguided. Misnamed because they really aren't about auditing the Fed — the Fed is already subject to many audits of its financial statements and activities, and Chair Yellen regularly testifies before Congress on monetary policy. Misguided because they really are about allowing political considerations to influence monetary policy decisions."

— From a speech in Columbus, OH, February 4, 2015

Community Bank Regulation

"The actions community banks take do not typically impose costs on the rest of the financial system or create the kinds of contagion that can put the entire financial system at risk. So community banks shouldn't be subject to the same types of macroprudential rules and supervision aimed at the systemically important institutions."

— From a speech in Columbus, OH, February 4, 2015

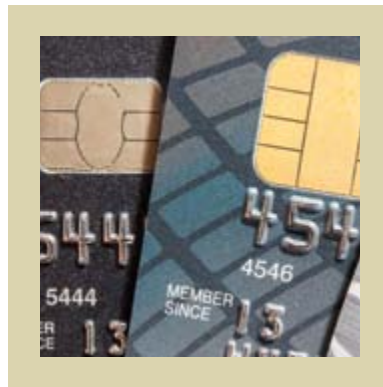
Payments, Security, and Your Credit Card

A new standard for credit card security embodies the Federal Reserve's objectives to improve the US payment system.

Security enhanced EMV-enabled credit cards will soon be distributed to all American credit card holders, marking a new standard for payments. It will be fully realized in the next two years.

EMV—an abbreviation for its developers Europay, Mastercard, and Visa—is one example of how the private sector is stepping up the security of its payment methods.

On January 26, 2015, the Federal Reserve released its paper "Strategies for Improving the U.S. Payment System," presenting a multi-faceted plan for collaborating with payment system stakeholders to enhance the speed, safety, and efficiency of the US payment system. Security is one of its five key objectives. The Federal Reserve aims to spur even more private-sector action like EMV by sponsoring security taskforces to obtain input from stakeholders and by identifying practices the payment industry as a whole could adopt. Implementation of any agreed-upon proposals will likely be left to payment system participants across the private sector.



EMV-enabled cards are already the standard for credit cards nearly everywhere in the developed world except the United States. How do they differ from what US consumers already carry in their wallets? In addition to the magnetic strip, EMV technology embeds into credit cards a chip that encodes transaction data for every purchase and also requires a personal identification number (PIN) to complete the purchase. Another way of understanding the difference between magnetic strip and chip cards: The former contains only static data, while the latter is dynamic, making it more difficult to steal from EMV-compatible points of sale (POS).

There is a liability shift for security breaches: Merchants, rather than credit card issuers, will be responsible for fraudulent charges if they do not make the transition to EMV by this fall. This will encourage retailers to switch over to EMV technology.

EMV cannot eliminate all fraud, however. The cards will continue to have magnetic strips for the foreseeable future, containing information that can be skimmed at POS. And remote transactions, like those over the phone or online, will continue to involve consumers' supplying card numbers, expiration dates, and card verification numbers.

Many US credit card issuers have already begun the transition by deploying cards with EMV chips to their customers. The move is indicative of the overall desire for more secure, standardized instruments in the payment system as a whole. The fight against adversaries in payment security is ongoing, to be sure. And while the Federal Reserve hasn't yet identified a timeline for the completion of an updated payment system, plans for safer, more secure practices are already underway.

—Maureen O'Connor

Read more



Get the details on the Federal Reserve's payment system improvement strategies:

fedpaymentsimprovements.org

Eager to Expand, but Money's Tight

A survey of some 2,000 small businesses shows it's still not easy for Main Street companies to borrow these days.

At a time when many say businesses are gaining strength and the credit environment is improving, a recent report reveals that small businesses still face an uphill climb to secure credit—and often go empty-handed.

Forty-four percent of respondents said in the first half of 2014 they got none of the financing they sought, and a majority (55%) of those who failed to secure any financing said they planned to try again in the subsequent 12 months.

The top reason businesses wanted financing? To fund expansion. And when they can't get the money they need to do that, it can have economic implications.

Inna Kinney, founder and CEO of ECDI, which provides loans and technical assistance to small businesses in all 88 counties in Ohio, agrees.

"Our data show that for every startup business that we invest in, there's a minimum of 2 to 3 jobs being created," she said. "If small businesses don't have access to funding, to capital, what is the result? They don't have enough working capital, and if they cannot fulfill demands of the business or of customers, they may let someone go."



The Small Business Credit Survey, conducted across 10 states by the Federal Reserve Banks in Cleveland, Philadelphia, New York, and Atlanta, also found that two-thirds of businesses walked away with less financing than they wanted.

It's anecdotal, but we are hearing that some banks are saying small business lending is not all that profitable. Part of this stems from the fact that other types of loans—mortgages, for example—can be pretty easily automated. Small business lending can take many different forms (SBA loan, asset-based, lines of credit, etc.), plus the terms and collateral vary from one deal to the next, so it's very difficult to automate this process. Therefore, it's more expensive to do this kind of lending.

The number of businesses reporting that they had applied for credit from an online lender was surprising. Eighteen percent of the approximately 2,000 respondents said they'd done so. Previous surveys, while not altogether comparable, have indicated very little activity with online lenders. For example, a 2013 New York Fed survey asked small business owners about their primary source of funding, and almost none of the respondents cited an online lender. The response we found could indicate that awareness of these online, alternative lenders is rising and that business owners are increasingly open to and searching for new sources of credit.

The other result I found interesting was the variation between the responses given in two different states. For example, when asked about their top business challenge, 23% of Pennsylvania businesses replied, "lack of credit availability," compared to only 9% of Ohio businesses. I was surprised by how different two adjacent states could be, especially since the mix of industry in the two is not all that different.

Bottom line: Small businesses, especially the newest and smallest of firms, still face challenges in accessing credit. Their struggle can have real implications for both the firms themselves and for economic growth. ■

—Ann Marie Wiersch

Read more



There's more to the Small Business Credit Survey than fits in *Forefront*. Read online to see regional snapshots of profitability, reasons businesses were denied credit, and differences among not only states, but sectors: <http://tinyurl.com/oz6yf7f>

2015



Stronger Pipelines, Lessened Uncertainty, and Investing in Fun

The Cleveland Fed and regional businesspeople reveal how 2014 compared to 2013, and offer expectations for the year ahead. Hint: People expect to stay busy.



Michelle Park Lazette
Staff Writer

As 2015 was just beginning, we wondered: How were the economic conditions as 2014 came to a close different than when 2013 ended? Had optimism climbed? Had spending risen?

"It depends on the industry sector you're talking about," replies Bob Sadowski, the senior economic analyst who manages the production of the Cleveland Fed's Beige Book report. "I would say, in general, things are somewhat improved."

Sadowski has some context: He's spent 9 years overseeing the Beige Book, a compilation of anecdotal business conditions in the Cleveland Fed's District, which includes Ohio, western Pennsylvania, the northern panhandle of West Virginia, and eastern Kentucky.

Below, we highlight some of the more meaningful changes between the last Beige Book of 2014 and the last one of 2013.

Builders get busy

Probably the biggest change year over year occurred for nonresidential construction, Sadowski says. Whereas many developers in late 2013 said they were reluctant to start large projects, “that sentiment has largely disappeared.”

“A year ago in nonresidential construction, so many of our contacts would tell us, ‘Our clients aren’t building; they are keeping the projects in the pipeline, but won’t release them to construction phase. They don’t want to make that big investment yet,’” he recalls. “The reason they were reluctant in 2013 is they still had a lot of concerns about the economy, about fiscal issues, and so on. If you come forward 12 months, you’ll see that most of our contacts say that projects are moving more freely through their pipelines.”

Market demand is much broader, too, with vacancy rates starting to decline for retail, office, and industrial spaces, Sadowski adds.

That multifamily momentum picked up in 2014, he adds.

Driven to attract and retain students, colleges and universities are feeding increased demand for high-quality, suite-style housing unlike their cinder-block, group-bathroom predecessors. As baby boomers age, they’re seeking different alternatives in senior housing. And, the appetite for new apartments in both urban and suburban areas is up for several reasons, Goldman says, not the least of which is the fallout of the recent housing crisis.

“There are people who have lost their homes who can no longer buy for credit reasons, or they just don’t want to own a home,” Goldman says.

The availability of capital from banks coupled with the lower land costs in Ohio and western Pennsylvania makes those areas “very, very attractive, especially to out-of-state developers,” he adds.

Expectations for 2015: The need for subcontractors (or those who do work in trades such as electrical, plumbing, carpentry, and masonry) is increasing, but the pool of skilled tradesmen has shrunk as a result of the recent recession. Thus, subcontractor pricing has increased, making it more expensive to build in parts of the Cleveland Fed’s region (namely Ohio and western Pennsylvania), Marous Brothers’ Goldman says.

The shortage of skilled tradesman is likely to become more acute, too, as a number of developers rev up to complete their projects by spring 2016, before Cleveland hosts the Republican National Convention.

“The trades are so busy right now because there’s a lot of work out there, so it’s getting more expensive for us to hire them,” he says.

He expects the appetite for new market-rate and affordable apartments to continue to grow, too, especially as more empty-nesters and millennials decide to roost in urban centers.

“Studies have shown that Cleveland is still underserved in terms of market-rate apartments,” Goldman says. “Until that pent-up demand is met, I don’t see that this trend is going to slow down. The key is not to overbuild.”

The number of companies moving their operations to downtown centers such as Cleveland is an indicator to Goldman that, this time, developers are building units to meet the demand created by jobs, instead of repeating the overbuilding that happened in Cleveland in the 1990s.

construction



One corner of construction seemed strong in both late 2013 and late 2014, and it’s multifamily construction, which includes apartments, senior housing, and student housing. Sadowski attributes that persistent strength, in part, to millennials not wanting (or being able) to buy.

“A lot of millennials simply aren’t interested in buying a house; they want the mobility,” he says. “Plus, many young people have so much college debt, and the credit markets for homebuyers are extremely tight.”

Marous Brothers Construction Inc., a Willoughby, Ohio-based construction service provider that builds in several states, including Ohio and Pennsylvania, is seeing “a lot more multifamily projects across all subsectors,” including student and senior housing and affordable and market-rate apartments, reports

Arne F. Goldman, director of business development.

Manufacturers expand

The major change that becomes clear when comparing the reports of manufacturers in the last Beige Book of 2014 to that of 2013 is they are more willing to spend money on equipment and plant expansions, the Cleveland Fed's Sadowski says.

"A year ago, there was this uncertainty working its way in manufacturing," he adds. "People were simply reluctant to commit dollars. That uncertainty has lessened."

"Companies that aren't investing are falling behind pretty quickly."

Eric L. Burkland, president of the Ohio Manufacturers' Association, which represents roughly 1,500 member companies throughout the state, large and small, agrees.

"There's growing confidence in the economy and the opportunity for return on investments on equipment and new technologies," he explains. "The other factor is that these technologies are advancing so rapidly that manufacturers are able to sometimes, in some instances, dramatically reduce costs or increase product design capabilities, (and) investments are paying off more quickly."

manufacturing



Reports of manufacturers' purchasing productivity-enhancing technologies really jumped in 2014, Burkland says.

"There's more investment going on across the board, really," Burkland notes. "All different kinds of companies. There's an increasing imperative to invest because the technology is advancing so quickly, and companies that aren't investing are falling behind pretty quickly."

Similar to the year-ago Beige Book reports, motor vehicle production remains a big driver of manufacturing demand.

"This last year was a terrific year for automobile sales across North America, and 2015's projected to be the same," Burkland says.

Also driving up manufacturers' confidence is the willingness of families to spend on household goods, such as appliances, in the wake of the mortgage crisis, Burkland reports.

Still, in late 2014, those compiling the Beige Book actually downgraded their assessment of manufacturing conditions to modest from moderate because sales weren't quite as good as people expected, the Cleveland Fed's Sadowski says.

Something positive stuck out to him, though, as "very significant" in last year's final Beige Book.

"We had many manufacturers late last year tell us that the source of their growth is organic, meaning that their revenues are not just new orders from repeat customers, but that they have been gaining new customers," Sadowski explains. "We haven't heard that lately—in a long time."

Expectations for 2015: From his perspective, the Ohio Manufacturers' Association's Burkland says, "all signs are for more of the same in 2015." And he means increased investment and increased economic output.

But, he cautions, things can change pretty quickly. Presently, manufacturers here have access to more affordable energy and can produce and export goods at a lower price than some major trading partners can do it for themselves.

There's also the challenge manufacturers face in finding the skilled workers they need.

"We've got to do a better job of recruiting kids into technical fields, in working with educators to get students into programs, into the pipeline, into manufacturing careers," he stresses. "If we don't, it will stall our economy for a long time."

Capital investments by and growth of manufacturers ripple throughout their economies, both in terms of the demand they pass through supply chains and the purchasing power of their employees, according to Burkland.

"It's something to celebrate because the economic effects go well beyond the factory walls into the supply chain, into the community," he says.

Retail sales disappoint as consumers opt for experiences

While retailers had complaints in late 2014, hotel operators and restaurateurs were telling a different story.

The contacts for the Beige Book say that while consumers are spending their disposable income, it's not necessarily on shoes and sofas, the Cleveland Fed's Sadowski says.

retail sales

"Retailers observed that even though lower gasoline prices are helping to boost spending, consumers are more interested in buying motor vehicles and experiences, such as vacations, rather than merchandise," the last Beige Book of 2014 reported.

The same goes for dining out, according to Sadowski.

In one regard, the late 2014 report is similar to the last one of 2013: Sales of motor vehicles were up, year over year. And the part about people wanting to spend their money on intangible pleasures?

"That's nothing new," Sadowski says. "We started hearing about that 2 years ago already. But I will say, lately, in the past couple months, we've been hearing more about that than I ever have before.



While consumers are spending their disposable income, it's not necessarily on shoes and sofas.

We are hearing a lot of anecdotal reports that especially millennials want to buy experiences. They don't want to buy stuff.

"If you look at your traditional retailers, be it department stores, furniture dealers, sellers like that, they're not seeing the kind of growth they want," he adds. "If you go to a restaurant, they're seeing growth in sales. If you talk to hotel owners, they're seeing an increase in business. They are finding their customers are willing to pay more."

So says Anton Giovanetto, who owns the Lyndon House Bed and Breakfast in downtown Lexington, Kentucky. This past year was his best year yet out of 13 years he's operated in the historic building. He estimates he enjoyed a 20 percent increase in room bookings in 2014 compared to 2013.

"I think easy, convenient, and fun is what Americans are experiencing with this rediscovery of their country," he says. "People in the middle class, they're traveling more because it's one way to deal with their stress. It's recreation therapy."

The Beige Book, explained

Who: Those informing the Beige Book include people from businesses of all sizes—from micro firms to Fortune 500 corporations. In all, the Federal Reserve Bank of Cleveland counts approximately 230 Beige Book contacts, including members of its three boards of directors and its business advisory councils.

What: The Beige Book, or, as it's formally called, the Summary of Commentary on Current Economic Conditions, is drawn up based on telephone and online surveys. We ask our contacts in six industry sectors—real estate, manufacturing, freight transportation, banking, energy, and retail—about demand, expectations, investment, and more. Each of the 12 Federal Reserve Banks does its own canvassing and reporting about the region it serves.

When: The Beige Book publishes 8 times a year.

Where: Our contacts hail from the Fourth Federal Reserve District, which the Cleveland Fed serves. It comprises Ohio, western Pennsylvania, the northern panhandle of West Virginia, and eastern Kentucky.

Why: We use the Beige Book to inform those making monetary policy decisions for our country: the members of the Board of Governors and the presidents of the 12 Federal Reserve Banks. It's also made public for all to see.

A lot of this is discussed at breakfast. The middle class is very clear: 'I want to have fun, and I only have so much money to do it with.' They want an experience."

And according to Giovanetto, he heard similar feedback from others at the Bed & Breakfast Association of Kentucky's annual conference in November.

One result, according to Sadowski, is that hotel owners and others in the hospitality field are upgrading their properties, good news for the construction industry. Meanwhile, retailers are investing in something they also said they were investing in back in 2013: ecommerce.

"People just like buying online, (so) many of the people retailers are hiring will be for jobs linked to ecommerce," he explains.

Expectations for 2015: Bed and breakfast owner Giovanetto expects his increased business to continue, but he notes, "Interest rates will affect a lot."

Lower rates have given people more money to do things they enjoy, he asserts.

More of the same for bankers

For bankers, things in late 2014 were a lot like they were in late 2013.

Words like "modest" and "slight" were used in both year-end Beige Books to describe the growth in demand for loans and lines of credit from businesses.

That's not to say, however, that businesses aren't spending, the Cleveland Fed's Sadowski cautions.

"A lot of even small businesses, when we ask them about credit, they say, 'I don't go to a bank, I have cash,'" he explains.

Where the last Beige Book of 2014 does cite strong growth in demand is for commercial real estate (CRE in industry speak) loans.

Tom Fraser, president and CEO of First Federal Lakewood, a Lakewood, Ohio-based bank that lends mostly in Northeast Ohio but also in Toledo and Columbus, can attest to the CRE demand.

"There's more requests for new projects going online, especially multifamily (construction) and small businesses and middle-market companies looking to expand their facilities," he reports.

Almost every one of the bank's commercial and industrial loan and CRE loan customers in late 2014 was having a better year than 2013 in terms of financial performance, according to Fraser. And while it's certainly positive that there's demand, in particular for CRE loans, bankers and builders "have to be careful that it doesn't become too frothy," he notes.

If real estate demand is overestimated and too many units go online, he warns, it could affect building values and, potentially, the ability of owners to pay on the debts they owe.

While Fraser agrees that demand for nonresidential consumer credit had been flat, he says loans for purchases of single-family homes have been noticeably strong.

"We were seeing purchase demand in November and December as if it were June or July," he notes. "So it's a real outlier."

The only thing Fraser anticipates could be discouraging home loan applicants is the perception that the regulatory burden on mortgage loans has increased. (It was roughly a year ago, in early 2014, when new home loan regulations called ability-to-repay and qualified mortgage came online.)

"We do get comments through the process that there's more paperwork," he says.

banking



Home equity loans were again cited as a product households were using more, but overall, bankers' reports about consumer credit demand (that it was "roughly stable") roughly mirrored what they said a year ago.

Similarly, delinquency rates, which reveal the ratio of loans not being paid per their terms, and credit standards, which bankers use to determine to whom they will lend, hadn't really changed.

Expectations for 2015: First Federal Lakewood's Fraser expects demand for loans for commercial real estate projects to stay strong, particularly in downtown Cleveland and adjacent neighborhoods. He's not so sure about the demand for it as one moves farther out into the suburbs.

He expects demand to continue, too, for single-family home loans.

"We've gone several years with low purchase activity and low consumer confidence," Fraser begins. "It (the demand) has been so repressed for the last seven years, it would seem the combination of optimism and pent-up demand will keep things strong. The bigger challenge is inventory of homes for sale. Inventory seems tight, so increasing demand and tight supply suggests that home prices will continue to increase."

All's not quiet on the hiring front

A near majority of the Cleveland Fed's contacts reported in late 2014 that they planned to hire in the next 12 months, driving an upward trend that's lasted roughly 24 months now, the Cleveland Fed's Sadowski says.

That's despite the fact that staffing firms reported in the last Beige Book of 2014 that the number of job openings and placements had fallen in recent weeks, though they attributed that fall, in part, to seasonal effects.

Danny Spitz echoes the growth story, though. And Spitz, the CEO of EverStaff International, a recruiting and staffing firm that serves clients in 20 states, including Ohio, Pennsylvania, and West Virginia, says this is no longer limited to project-to-project hiring.

As opposed to adding temporary workers to handle only what they perceive as temporary assignments, more EverStaff clients are hiring temp-to-hire workers in full-time. Plus, the firm's "direct-hire" placements, or the number of full-time people it's found for clients who hired it to conduct specialized searches, grew probably 60 percent from 2013 to 2014.

"What it means is there's continuous growth," Spitz says. "That's the major difference that we've seen, is businesses actually feeling comfortable and confident that their business is on the rise and growing, compared to just sustaining it."

"The continued increases in employment ... mean there is more job security in America today than there has been."

That contrasts with recent years, particularly 2012, when companies were hesitant to make any "true hires," he adds.

And the growth EverStaff is enjoying spans all 4 of its divisions: professional services, light industrial, call center, and retail.

"As the economy gets stronger, each feeds off of each other," Spitz says. "As one gets stronger, it creates growth across others, and they're able to expand their business lines."

Another reason for the improvements in hiring, particularly in parts of the Midwest, is the recovery for manufacturers, which now are investing.

Already employed? This piece of year-over-year news carries impact for you, too, because as the market tightens up for talent, it's more likely that companies are willing to pay more for top talent. (Read: Wages improve, but that's not all. Some employers, Spitz says, already are offering more vacation time, touting the growth potential available to employees, and allowing more flexibility in schedules.)

"The continued increases in employment ... mean there is more job security in America today than there has been," says Richard Wahlquist, president and CEO of the American Staffing Association out of Alexandria, Virginia. "People with skills in demand are back in the driver's seat."

Expectations for 2015: Forecasts, at least for EverStaff International clients, predict a continued increase in the number of people they are hiring, Spitz says.

Wahlquist expects much the same, "assuming that the US economy and the global economy don't all of a sudden go into the tank."

"We don't believe we've hit saturation or capacity," he adds. ■

Read more



Find the Cleveland Fed's Beige Book reports and others from across the country at www.federalreserve.gov/monetarypolicy/beigebook



Preventing Crises and Protecting Pocketbooks



Ericka Thoms
Policy Analyst

Not everything is new in the new year. As Congress moves from its 113th to its 114th session, many policy issues that were top of mind in 2014 will continue to be priorities in 2015. Here are some of the top financial services issues that will stay on the plate of lawmakers in the new year.*

Too big to fail

How best to prevent another financial crisis remains a priority. As we saw during the 2008 crisis, the size of some financial institutions, coupled with their interconnectedness with various aspects of the economy, can put the country's financial stability at risk should the institutions not be able to meet their obligations. This type of failure not only compromises the broader economy, but it also raises concerns about taxpayers' having to foot the bill when failing banks call on the federal government for loans to keep them afloat.

The 114th Congress began work on January 3, 2015. Implementing Dodd–Frank, reforming Fannie Mae and Freddie Mac, and studying what banks are doing to keep financial data safe are all still on the docket.

In an effort to prevent a crisis similar to the one from which many are still reeling, Congress passed in 2010 an expansion of regulatory authorities through the Dodd–Frank Act. The complexity of the act means, in part, that regulators are still in the process of writing and implementing rules the act set forth. Through January 2014, 73 percent of the rulemaking needed under Dodd–Frank has been completed, with another 16 percent in progress.

Legislators, however, continue to express concern over the length of time it has taken to implement the law and look to the legislative process to protect taxpayers from another bailout. Multiple bills on the issue were introduced in the 113th Congress, including two by legislators from the region the Cleveland Fed serves (which includes Ohio, western Pennsylvania, the northern panhandle of West Virginia, and eastern Kentucky). S. 798, introduced by Sens. Sherrod Brown (D-OH) and David Vitter (R-LA),

* Information is as of January 30, 2015.

would set an 8 percent equity capital to consolidated assets standard for banks with more than \$50 billion in assets. An additional 15 percent capital surcharge would be required of banks with more than \$500 billion in assets. Rep. Marcy Kaptur (D-Toledo, Cleveland) has already introduced the Return to Prudent Act, which bans affiliations between an “insured depository institution” and investment banks or securities firms.

At the same time, there is bipartisan interest in making sure that the increased scrutiny placed on “too big to fail” institutions does not hamstring smaller banks that do not have complex relationships or the compliance capacity of larger banks. (Indeed, in order to ensure that the implementation of Dodd–Frank does not put undue burden on community banks, banking agencies such as the Federal Reserve are taking a tiered approach, tailoring oversight based on an institution’s complexity and the level of risk it poses to the overall financial system.) Debate on how to handle this issue continues on the national level, though it is important in the Fourth District (the region served by the Cleveland Fed). Here, the majority of the banks supervised by the Cleveland Fed are small, community banks, defined as those with assets of \$10 billion or less. While some Congress members favor a simple asset level standard, others propose a tiered approach based on the size, business model, and risk profile of the institution. Identifying the best way to protect community banks from the costs of regulation intended for systemically important institutions will be on the agenda for Congress’ committees on banking and financial services in 2015.

GSE reform

Also stemming from the most recent financial crisis is a push to dismantle Fannie Mae and Freddie Mac, the government-sponsored enterprises created to increase the availability of mortgage credit for middle-income Americans. Most members of Congress support some type of reform, but debate over what shape the reform would take fueled many conversations in 2014 and will continue to do so in the new year. For example, some members would like to see the work of the housing finance agencies turned over to the private sector, with Fannie and Freddie eventually being eliminated. Others believe there is still a need for government involvement in housing finance, especially as it relates to lower-income, moderate-income, and first-time borrowers. The House Financial Services Committee’s first hearing of the 114th Congress focused on housing finance and featured Federal Housing Finance Agency Director Mel Watt.

This past spring, Senate Banking Committee leadership proposed a compromise bill that would wind down Fannie and Freddie over five years. It also established a new regulator called the Federal Mortgage Insurance Corporation that would function much like the Federal Deposit Insurance Corporation for the mortgage finance markets. While it did pass through committee, it lacked enough support for Senate leadership to feel confident in bringing it to a vote of the full Senate. Chairs of both the House Financial Services Committee and the Senate Committee on Banking, Housing and Urban Affairs are on record saying they want to see Fannie and Freddie close shop.

Some members would like to see the work of the housing finance agencies turned over to the private sector, with Fannie and Freddie eventually being eliminated.

Cybersecurity

2014 was the year that the cybersecurity of individual Americans and corporations came to a head, with well-known companies such as Target, JP Morgan, and the US Postal Service reporting major hacking incidents. Concerned about the consequences of such a breach at a major financial institution, Rep. Elijah Cummings (D-Baltimore) and Sen. Elizabeth Warren (D-MA) wrote to 16 large financial institutions in November with questions about their cybersecurity protections. Among the information asked for in the letter was how many data breaches they have had in the past year, how many people were affected, and what measures have been taken to protect customers’ data.

Given the level of interconnectedness between banks and the rest of the economy, legislators are taking a closer look at what banks are doing to keep their and their customers’ financial data safe. This issue will be of growing concern for the Federal Reserve System as it is a key player in ensuring the financial stability of the country. It has already begun training bank examiners on how to assess banks’ data security protocols. ■



Investing Beyond Individual Health

While improving the health of individuals used to be the primary goal of many healthcare initiatives, an increasing number of partnerships now strive to improve outcomes for individuals and the communities they live in — and they're producing results.



Anne O'Shaughnessy
Contributing Writer

Health is about far more than treating illness. And increasingly, the community development and health sectors are working together to promote healthy individuals *and* healthy communities.

Consider the impact on a child once asthma triggers in the home are identified and addressed. The child misses, on average, 12 fewer days of school per year and reduces his risk of landing in the emergency room because of an asthma attack by almost half, according to a study published in the *American Journal of Preventive Medicine*. In another study, residents in Charlotte, North Carolina, lost weight through walking when light rail was introduced into their neighborhoods.

“Research and outreach have shown that you typically can’t improve outcomes for individuals simply by making sure they are in safe, affordable housing,” says Paul Kaboth, vice president and community development officer for the Cleveland Fed. “The community development industry has adopted a more holistic approach to helping underserved populations, including working with the health sector.”



For decades, affordable housing has been a primary focus of the community development industry—not surprising, given that the industry was born largely of banks’ redlining practices in the 1960s and 1970s. This focus on housing was especially useful in the wake of both Congress’s 1977 passage of the Community Reinvestment Act as well as the recent foreclosure crisis. Community development corporations, or CDCs, work with motivated lending institutions to help improve housing options for individuals and families in low- and moderate-income areas. But recently, the focus of the industry has broadened to support the varied needs of individuals and families in low- and moderate-income areas, including workforce development, education, health, and housing.

Building healthy communities

To learn more about the intersection of community development and health, the Cleveland Fed hosted “Building Healthy Communities Ohio” this past fall in Columbus. The one-day forum was part of a series of meetings convened around the nation to focus on ways to leverage resources in the public health and community development sectors to help promote healthy environments for all.

“These partnerships are already promoting improved health for both residents and communities,” says Lisa Nelson, senior policy analyst at the Cleveland Fed. One such partnership between health and community development in Ohio involves Nationwide Children’s Hospital (NCH) in Columbus and area nonprofits, neighborhood groups, residents, the City of Columbus, and multiple private entities.

Why is the Fed involved in community development?

Broadly speaking, the Federal Reserve’s three primary responsibilities are supervising banks, serving as a bank to the banks, and crafting monetary policy. An additional function that’s related to supervision of banks came about as a result of Congress’s passage of the Community Reinvestment Act (CRA). In the 1960s and ‘70s, redlining was a practice some banks engaged in that resulted in residents of poorer communities being excluded from access to credit, including home mortgages and small business loans. With passage of the CRA in 1977, Congress outlawed redlining among banks.

As an overseer of banks, the Fed then created a Community Development function to work with banks, nonprofits, municipal leaders, and elected officials to not only help ensure impartial access to credit for all, but also to promote stable, sustainable communities in our regions.



Each of the 12 Reserve Banks and the Board of Governors has a Community Development group that conducts applied research and outreach to learn more about conditions in low- and moderate-income communities. You can learn more about the Fed’s work in community development at www.fedcommunities.org.

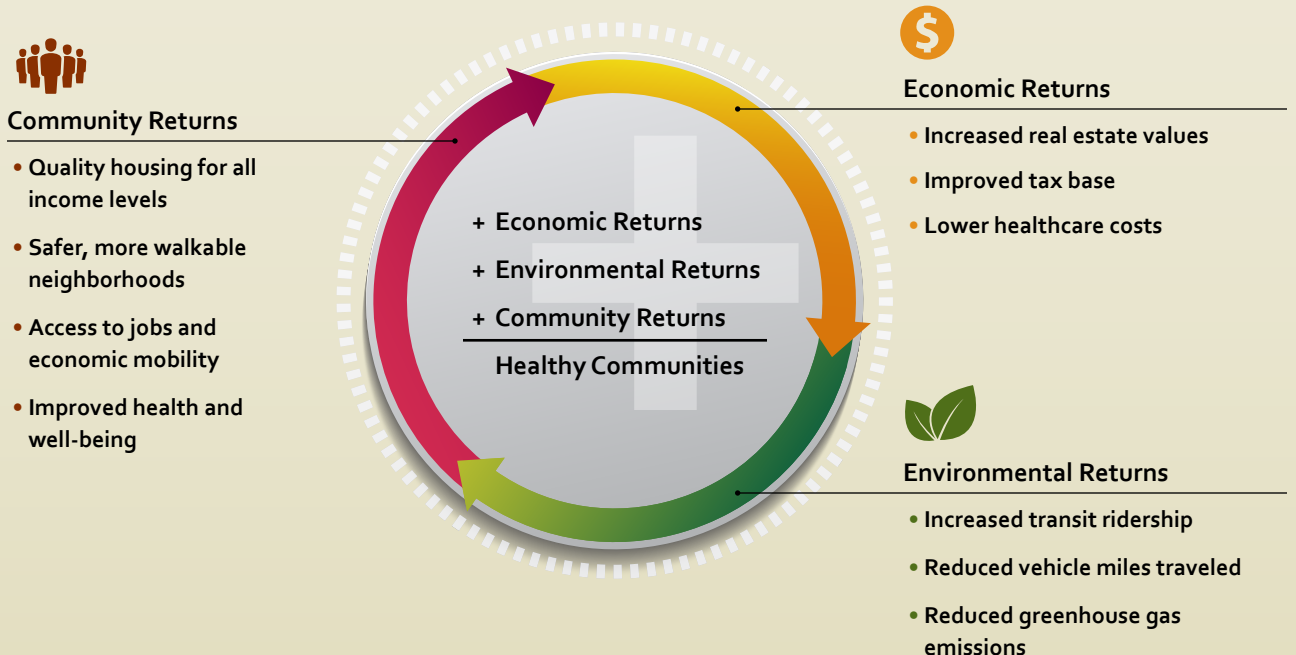
“It’s not an easy sell to direct housing funds toward a health initiative.”

Angela Mingo, director of community relations for NCH, noted that as an anchor institution and one of Columbus’s largest employers, the hospital recognizes the value of being engaged with its surrounding neighborhood. Located in an area where more than three-fourths of the residents are in single-parent homes and just 13 percent of adult residents have a bachelor’s degree, NCH created a program, “Healthy Neighborhoods, Healthy Families,” as a way to strengthen families and neighborhoods. The multi-year initiative has five prongs—education, health and wellness, safety, housing, and workforce development—and targets 31 residential blocks, with a total of 417 homes.

To date, the NCH program has had an impact on more than 100 homes directly, through either renovation or a home-repair grant program. These improved homes are then marketed for sale (only three of the improved homes remain on the market as of year-end 2014). Homebuyers include hospital employees, longtime area residents, and others drawn to the neighborhood’s proximity to NCH. For example, Mingo cited an example of a single mother whose child receives ongoing treatment at NCH; as a result of the Healthy Neighborhoods, Healthy Families program, she was able to buy an affordable home closer to the hospital and to her place of employment. The result? Mother is now able to walk with her wheelchair-bound child to the hospital for treatments in far less time—and with far less hassle—than it took previously.

More than financial returns

This chart shows how Massachusetts’s Healthy Neighborhoods Equity Fund drives triple-bottom-line returns.



Funding healthy communities

Financing such collaborations is a critical part of the equation. Nationwide Children's Hospital lined up public and private partners to provide both financing and in-kind support. Partners range from the Franklin County Land Bank, the City of Columbus, and United Way of Central Ohio, all of which provided financial support, to Turner Construction, Keller Williams Realty Collaborative, and Wexner Service Corps, all of which provided volunteers to make home repairs, clean up yards, and landscape renovated properties.

"Some organizations are crafting really innovative ways to fund these projects," says the Cleveland Fed's Mary Helen Petrus, an expert in community development issues. "It's not an easy sell to direct housing funds toward a health initiative, for instance, but if that's what will drive better health outcomes for individuals and neighborhoods, that's what needs to happen."

Funding for these projects is typically sophisticated. Michelle Norris, senior vice president of business development and public policy for National Church Residences, described how her organization—a respected nonprofit that provides affordable housing to the elderly, low-income families, and residents with disabilities—aligns a complex array of financing sources from federal and state grants, loans, and tax-credit programs to develop its properties. "We're using funds from HUD [the Department of Housing and Urban Development], Medicaid, and other sources to make sure appropriate healthcare options are available in the housing we build for seniors," she explained.

Maggie Super Church, a consultant with Healthy Neighborhoods Equity Fund in Massachusetts, described how the fund solicits capital for "catalytic residential, commercial, and mixed-use projects with the potential to strengthen community and environmental health and improve regional equity." Community input is also essential, she asserts, adding that "if the residents aren't supportive of a project, we won't invest in it."



Carol Naughton explains how investments in the East Lake Meadows neighborhood of Atlanta have driven improved health, economic, and social outcomes for residents and the community. East Lake is a national model for successful partnering of health and community development.

Super Church explained how the Fund's impact confers a "triple-bottom-line return" of economic benefits (e.g., lower healthcare costs), environmental benefits (e.g., increased transit ridership), and community benefits (e.g., access to jobs and economic mobility). This approach yields compounded benefits that extend well beyond improving the health of individuals, which used to be the sole goal of many healthcare initiatives. With partnerships and combined efforts, families, communities, and investors also benefit. ■

Read more



Building Healthy Communities Ohio conference materials, including examples of communities where these collaborative efforts are working, are now available: <http://tinyurl.com/lznjlr>

Learn more about what's happening at the intersection of community development and health at Build Healthy Places Network at www.buildhealthyplaces.org and the San Francisco Federal Reserve's Healthy Communities Initiative at <http://tinyurl.com/mszw6ko>



To Keep Strong Even in Bad Times, More Banks Test Themselves

For the first time, regional banking organizations with assets between \$10 billion and \$50 billion are required to conduct stress tests and disclose results. The overarching goal? To ensure that even in times of crisis, banks have the capital they need not only to survive, but to keep lending.



Michelle Park Lazette
Staff Writer

In the words of one senior vice president of finance, this was a meeting regional bankers couldn't afford to miss.

About 200 bankers attended a day-long Dodd-Frank Stress Testing Symposium in which regulators and bankers discussed company-run stress tests, a new requirement regional banks face.

Officials were in attendance from most of the approximately 70 US regional banking organizations that in 2015 must run these tests to assess their capital adequacy.

The focus on bank capital certainly intensified following the Great Recession. It's only recently that stress testing became required of regional banking organizations, defined as banks having assets between \$10 billion and \$50 billion. The Dodd-Frank Wall Street Reform and Consumer Protection Act requires the testing. Regulatory agencies, such as the Federal Reserve, issue guidance on how the testing requirements will be implemented.

On the larger scale, banks with assets of more than \$50 billion have been required to conduct different, more comprehensive stress testing for several years.

What bankers and their regulators run the tests to glean is, how would a bank's capital withstand adverse economic scenarios?

For example, what might be the fallout for an institution if the local manufacturing plant shuts down? Or, if an institution's portfolio is heavily concentrated in one form of lending, what might happen in the event of an economic downturn?

“That’s what stress testing is,” Jeffery Stanovich, a senior examination specialist with the Federal Deposit Insurance Corporation (FDIC), said while speaking on a panel at the symposium. “Today, we’re putting numbers to it. How much capital do I need?”

Capital is a cushion—dollars that help an institution absorb unexpected losses. And there’s more at stake than the institution itself.

The availability of bank capital in good times and bad carries importance for the regional economies in which institutions operate, banking insiders say. For one, a bank that finds itself in an undercapitalized position—like many did during the financial crisis—may reduce or outright stop lending.

And there begins what can be an unfortunate cycle for any region, even when the lender isn’t a systemically important institution with national reach, said Stephen H. Jenkins, the Cleveland Fed’s senior vice president who

oversees the Bank’s supervision and regulation of financial institutions. A bank’s inability to lend affects economic growth in the regions it serves, and when a regional economy struggles, a bank’s customers may be rendered less able to stay current on loans they’ve borrowed.

So, regulators want banks to be capitalized to the extent that even in severe economic downturns, they’re able to continue to lend to creditworthy customers.

“Access to capital, to loans, is the oil that lubricates the economy,” explains Jenkins. “It becomes a downward spiral. Creditworthy customers can’t get credit. If it’s business owners who can’t, then they can’t help the economy expand through expanding their business and hiring new employees.

“These regional banks are critically important to the regions that they serve,” Jenkins adds. “A regional bank is not a JPMorgan Chase, but that doesn’t mean in Akron, Ohio, a FirstMerit isn’t as important.”

A bank that finds itself in an undercapitalized position—like many did during the financial crisis—may reduce or outright stop lending.

For its part, the Federal Reserve Bank of Cleveland—which supervises four regional banking organizations, among them Akron, Ohio-based FirstMerit Corp. and Pittsburgh-based F.N.B. Corp.—is conducting research to better understand the relationship between the health of regional banks and the health of regional economies.

A domino effect

Bank capital levels have generally risen in the years since the financial crisis.

Such capital comes from varied sources, including retained earnings. Banks also can raise capital through the sale of stock, for which investors pay to own a piece of the company. However, in times of financial crisis, raising capital can be hard-fought—even impossible.

Put another way, it is *before* adverse scenarios that capital should be shored up, notes Nadine M. Wallman, vice president in the Cleveland Fed’s Supervision and Regulation Department.

“Not surprisingly, when we find the economy is going through difficult times, we often find that bank capital is being depleted,” notes Dr. Kevin T. Jacques, who worked to develop and write capital regulations for the US Department of the Treasury, where he worked for 14 years.

The relationship between the economy and bank capital can run the other direction, too, adds Dr. Jacques, today the Boynton D. Murch chair in finance at Baldwin Wallace University in Berea, Ohio.

“A bank can become sick or unhealthy because it’s just not doing its business well” or because its portfolio lacks diversification, he explains. “It can have nothing to do with the macroeconomy. If you get a large enough group of banks to which that happens, it can cause the economy in that region to stagnate.”



The Cleveland Fed calls it contagion—when one firm’s insolvency affects other firms connected to it.


Dr. Jacques cites as an example the domino effect the substantial decline in oil prices had in the 1980s in Texas. Numerous oil firms had borrowed money from the financial system, and as those companies failed, bank capital levels decreased to such an extent that some Texas banks failed right along with them.

Such destabilization of banking is what regulators seek to avoid in sharpening the industry’s focus on capital, Jacques explains. While the depositors of a bank rendered insolvent are protected by deposit insurance through the FDIC up to a certain amount, regulators have their eye on more than deposits. There’s the safety and soundness of the whole financial system to sustain and large-scale financial crises to avoid.

They must share only the results of the severely adverse, or extreme-case, scenarios they run, the Fed’s Wallman explains. The disclosures are a means of fostering greater transparency to the industry.

Regulators won’t use the regional bank stress test results to approve or object to actions midsize banks want to take regarding their capital such as paying dividends. Regulators do use stress test results in this way for larger organizations submitting to the Comprehensive Capital Analysis and Review, or CCAR. CCAR—required of bank holding companies with assets of \$50 billion or more—requires not only more sophisticated stress testing approaches but also entails a supervisory test conducted by the Federal Reserve.

Many regional banks are new to scenario-based stress testing, so many of them are on a learning curve.



Besides, he notes, even where deposits are fully protected, bank customers still lose something if their bank disappears from the banking landscape.

“What ends up happening is when a bank fails, a lot of those relationships between a bank and the mom-and-pop store, the bank and the business owners, the bank and the person who wants to borrow money to go to college, a lot of those relationships get broken,” he says.

Notes for round two

Regional banks completed their first annual, company-run, Dodd–Frank Act-mandated stress test in early 2014.

Last year’s symposium—hosted in Cleveland by the Federal Reserve, the Office of the Comptroller of the Currency, and the FDIC—provided a forum for regulators to discuss key themes arising from the first round of stress tests. Additionally, the symposium provided an opportunity for bankers to discuss stress testing practices with their peers and to seek clarity on supervisory expectations. Dodd–Frank financial reform allotted institutions a year to run the tests without disclosing the results; 2015 will be the first year during which regional banking organizations must disclose them publicly.

Some common themes highlighted during the symposium include ensuring institutions have the necessary qualitative information supporting their risk management framework and process for stress testing such as documenting assumptions and the limitations they encounter.

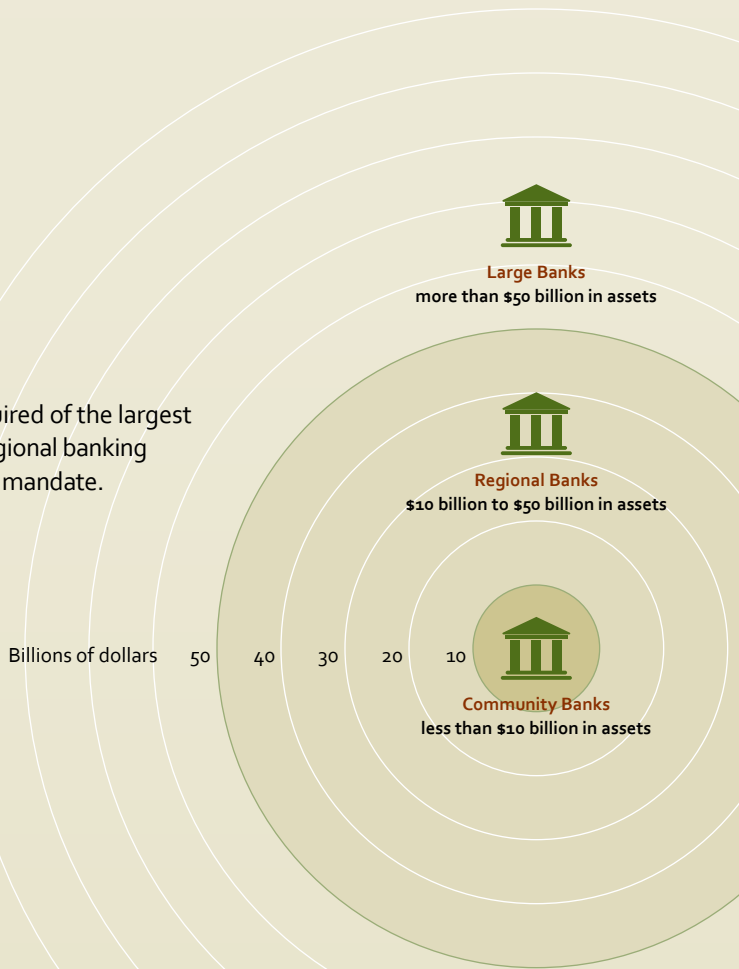
Board of director involvement is also important. Boards need to stay informed about the stress testing and what it reveals. Directors, several regulators emphasized, are ultimately responsible for aligning their post-stress test results with their firm’s capital goals and risk appetite.

“We do not expect the board of directors to be statisticians,” explained Alisha Riemenschneider, a senior analyst with the FDIC. “What we expect is they understand the main framework... the bank’s vulnerabilities, and how that’s being captured so they can have a meaningful dialogue with bank executives on the stress testing process and results.”

In addition, data is an important element for stress testing. Having quality data sets and staff with the skill sets needed to conduct the stress tests and analyze the results is important. Hiring a third-party vendor appears to be a fairly common practice for regional banks, but it does add vendor management risk responsibilities.

To stress test, or not to stress test

Though it is less complex than the testing required of the largest US banks, stress testing is now required of regional banking organizations. Community banks face no such mandate. Here's a look at how they all differ.



Large Banks

Assets of more than \$50 billion

Examples you might know: Cleveland-based KeyBank and Pittsburgh-based PNC Bank

Stress test required? Yes, since 2009. The Federal Reserve conducts the Comprehensive Capital Analysis and Review, or CCAR, annually. Based on the stress testing results, the Fed chooses to object or not to object to capital plans submitted by the banks.

In plain speak: Generally, these banks are more complicated and more plugged into the national and global financial system. They have a national and international scope of service.

Regional Banks

Assets of \$10 billion to \$50 billion

Examples you might know: Akron-based FirstMerit Bank and Pittsburgh-based First National Bank

Stress test required? Yes, and a first round was completed in 2014. Financial reform requires the stress testing, and regulators, including the Federal Reserve, set forth guidelines for how the tests are to be implemented. There is no supervisory test; companies conduct their own stress tests.

In plain speak: Though large, regional institutions tend not to be so complex that if they fail, it would have national financial market implications. They service broad US regions.

Community Banks

Assets of less than \$10 billion

Examples you might know: Lorain, Ohio-based Buckeye Community Bank and Cincinnati-based First Financial Bank

Stress test required? No.

In plain speak: Banks of this size can be closed relatively simply and with limited impact on their regional economies. They service local markets.

“While firms may have conducted some forms of stress testing in the past, they aren’t used to doing scenario-based stress testing,” Wallman explains. “This requires different data sets and, in particular, more granular and quality historical data sets.”

So, two clear messages: Bankers, ensure you have effective risk-management and corporate-governance processes, and strengthen your data collection.

And, another? Those contemplating and executing mergers and acquisitions should be planning accordingly if they expect to grow to the size (north of \$50 billion) where they’ll need to perform the more complex Comprehensive Capital Analysis and Review. Ramping up for it will not be accomplished overnight.

‘Quite a ways to go’

Stress tests are not meant to be throw-away exercises, regulators stressed during the symposium. They’re intended to be tools bankers use to improve their businesses and their management of risk. Where red flags are raised, the hope is that bankers will make decisions to change their risk profiles, perhaps by deleveraging; incorporating additional thresholds, or concentration levels, for certain kinds of lending; etc., Wallman says.

Drawing up clearly articulated capital goals and a method of notifying a bank’s board if a bank’s capital is approaching such levels were among the capital planning practices discussed during the symposium.

“Firms should not treat this as a regulatory exercise,” Jenkins says. “If they just throw it in a desk drawer, they’re missing a huge opportunity and not complying with the intent of these stress tests.

“We do recognize there is a cost to these organizations,” Jenkins says. “However, I believe that the benefits to these organizations and to the financial system as a whole more than justifies putting these processes into place. If they really use the information to make business decisions, I actually think they’re getting a significant return on their investment.”

One banker said he expects that the stress tests, over time, will be positive.

“We think it can really help us manage our business better,” he said while at the symposium. “The perception is that we are a conservative bank. This reinforces that.”

But there’s work to do. His team members are working to get their arms around validating their models and collecting data differently.

“My major takeaway is we do have quite a ways to go,” he said.

He clearly wasn’t the only banker in the room thinking it. Speaking up during the symposium, another banker noted, “Many days the stress-testing process is managing me, rather than me managing it.”

The intent, of course, is that as regulators answer questions and provide guidance and feedback, bankers increasingly command the process and produce insights that result in stronger banks, even when times are tough. ■

A Hurricane's Hit to Households

New research on Hurricane Katrina's impact on household finances surprises both a Cleveland Fed researcher and a risk management executive. Do the findings hold any bearing for our region? Sure do, says one of them.

Cleveland Fed economist Daniel Hartley and his co-author wanted to know: How did Hurricane Katrina affect the household finances of those flooded by the costliest catastrophe in US history?*

Then *Forefront* wanted to know: What surprised Hartley, and how might his findings apply to the region the Cleveland Fed serves?

It's true: That region (Ohio, western Pennsylvania, the northern panhandle of West Virginia, and eastern Kentucky) isn't exactly hurricane valley.

But, the impact of catastrophic storms on households' financial viability certainly holds relevance for these areas, too. Consider the story the pie chart tells: From 1994 to 2013, hurricanes and tropical storms are blamed for 39.9 percent of insured catastrophe losses in the US, followed by two storm types that are no stranger to these parts. The tornado, to which 37.2 percent of such losses is attributed, is a close runner-up, and rounding out the top 3 is the winter storm, to which 6.7 percent of such losses is attributed.

Forefront sat down with Hartley, an expert in urban/regional and labor economics, to discuss the findings detailed in his working paper "Household Finance after a Natural Disaster: The Case of Hurricane Katrina." We then called Michael Davis, president and CEO of Risk International Services, Inc., a Fairlawn, Ohio-based company that provides risk management services to businesses, including claims-recovery work related to tornadoes, earthquakes, flooding, and more, to get his reaction to the research.

*Hurricane Katrina, with \$47.6 billion (in 2013 dollars) in estimated insured property losses, is the costliest US catastrophe, according to the Property Claim Services, a unit of ISO, a Verisk Analytics company. That figure excludes flood damage covered by the federally administered National Flood Insurance Program.

Forefront: You call this one of the first papers to use credit-history data to show the causal effect of a large natural disaster in the US on household finance. What motivated you to study this topic?

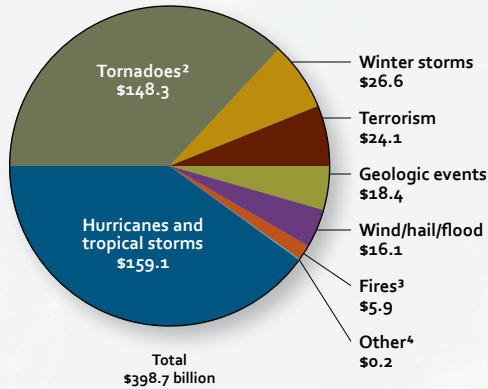
Cleveland Fed's Hartley: There have been scientific reports about climate change resulting in increased prevalence of natural disasters. In that regard, getting more of a sense of how natural disasters affect people's households may be increasingly important. Also, the data we used were not previously available.

Forefront: What surprised you about your study? What did you not see coming?

Hartley: I was surprised to find such limited damage to the liability side of the household balance sheet. My co-author (Justin Gallagher) had written a paper on flood insurance take-up—or enrollment in flood insurance—after a flood event and then we started thinking about the impacts of flooding generally.



Inflation-adjusted US insured catastrophe losses by cause, 1994–2013
Billions of 2013 dollars¹



1 Adjusted for inflation through 2013 by ISO using the GDP implicit price deflator. Excludes catastrophes causing direct losses less than \$25 million in 1997 dollars. Excludes flood damage covered by the federally administered National Flood Insurance Program.

2 Includes other wind, hail, and/or flood losses associated with catastrophes involving tornadoes.

3 Includes wildland fires.

4 Includes losses from civil disorders, water damage, utility service disruptions, and any workers compensation catastrophes generating losses in excess of PCS's threshold after adjusting for inflation.

Source: The Property Claim Services® (PCS®) unit of ISO®, a Verisk Analytics® company.

Going into the project, we thought that we may find large negative credit impacts as a result of the damage caused by Hurricane Katrina to people's households, to their properties, to their livelihoods.

What we found was a moderate short-lived impact on credit card delinquency and a very small negative impact on credit scores that also was pretty short-lived, and also a really big drop in the propensity to have a home loan. We discovered the latter was due to people's paying off their mortgage debt; it corresponds in timing to when flood insurance checks would have been dispersed.

Forefront: *Your working paper found that non-local lenders seemed to want to reduce their exposures in New Orleans more than local lenders. Why do you suppose that is, given that it's reasonable to assume the portfolios, and thus the risks, of non-local lenders are more diversified than local ones?*

Hartley: There are some interesting interactions between the degree of lending provided locally versus non-locally and possible outcomes after a natural disaster.

Non-local lenders may have a harder time determining which neighborhoods are likely to be rebuilt, and thus they may see the city as homogeneously high-risk for lending, while local lenders may have better information about which neighborhoods may come back, meaning they see some damaged neighborhoods as less risky than others. Another possibility is that local lenders have a vested interest in seeing the city come back and thus may be more willing to lend to help ensure that the city returns to a good equilibrium.

Forefront: *When it comes to the answers you discovered, what do you see as the most important piece of knowledge you gleaned, and why?*

Hartley: The National Flood Insurance Program along with other governmental assistance seems to have prevented households, on average, from financial ruin in the wake of Katrina. It suggests that the policies in place are at least providing the benefits that they were intended to provide. We didn't do any cost-benefit analysis, so that's not to say these benefits justify what the costs are.

Forefront: *What reaction do you have to the working paper's findings?*

Risk International's Davis: I kind of did a mental double take. I said, what? Why would debt levels drop as a result of the natural disaster? After reading through the data and their summary, it makes sense. I think maybe, though, they're missing one piece of the equation. They're saying this has a relatively small effect on household finance as measured by debt levels, credit scores, and I think that's probably all that you could ask them to look for. But, if you looked at the total net worth of these individual homeowners, they probably lost equity.

Forefront: *What do you see as the major takeaway(s)?*

Davis: Overall, I was pleasantly surprised by how steady everything was. It did reinforce the concept that insurance works. It removes the pain, both short-term and long-term, from a shock event—even with Katrina, when so many had 6 feet of water in their houses.

The same thing happens for businesses. The finances of a company are also protected by the presence of insurance.



Hazard risks (fires, floods, bad products, car accidents, lawsuits) that befall a public company generally are not recognized by the market [i.e., in falling stock prices], and the main reason for that is people know that the company is going to be able to rebuild or restore. Insurance has removed the stock market risk for hazards.

Forefront: *What, if anything, about the working paper surprised you?*

Davis: It seemed to me that the implication was that non-local lenders were encouraging their customers to not rebuild, to pay off their mortgages, because they did not want to reinvest in the area. I found that interesting; I wouldn't have thought there'd be a difference [between non-local lenders and local lenders]. My self-commentary is it should be against overall public policy to be putting buildings in an area below sea level, in an area that is really exposed to loss, especially when the federal government bails out those who were uninsured.

Forefront: *Are there lessons our region can and should learn, even though Hurricane Katrina was not our experience?*

Davis: Homeownership is the goal and the ideal for American society, and we want to encourage it, but homeowners need to take the steps necessary to protect themselves in case of a problem.

I do not think anything should be compulsory, but if the guy who spends \$600 a year on flood insurance gets the same amount as the guy who doesn't spend anything, what do you think is going to happen next year? There's got to be some skin in the game for people who make bad choices.

Flooding is an issue in our region. I've had quite a few claims along the Ohio River. You can't lose sight of the fact that even though we're not very bright on a risk map, still in this area we have earthquake risks and wind risks.

Municipalities could make the choice that all the land in their flood zones, they are going to use as park land. I think sometimes they ignore that because generally waterfront property is pretty valuable. They pass the societal risk onto the rest of us by saying, "We're going to build down on the river," when really it shouldn't be done from a risk manager's perspective. ■

—Michelle Park Lazette

Read more



Learn more about the research and revelations of "Household Finance after a Natural Disaster: The Case of Hurricane Katrina." Read the PDF: <http://tinyurl.com/pv38gu5>

Boots on the Ground

Forefront interviews 3 Cleveland Fed board and council members in a wide-ranging conversation that touches on gentrification, banks and social media, and the role the members play in the Bank's work.



They work in different industries and hail from different corners of the Fourth Federal Reserve District—which comprises Ohio, western Pennsylvania, the northern panhandle of West Virginia, and eastern Kentucky—but they have this in common: They all do some very important talking with the Cleveland Fed.

Meet Eddie Steiner, Holly Wiedemann, and Doris Carson Williams, three people who, by sharing what they hear and see as members of boards or councils of the Federal Reserve Bank of Cleveland, help the Bank ensure that those formulating national monetary policy know what's happening at home.

Forefront interviewed all three, asking for their takes on how our regional economy is performing (optimism reigns), their thoughts on how their board or council contributes to the Federal Reserve's work, and the scoop on their favorite spots in the region this Bank serves (Amish country is one).

First, here's an introduction to them and what they say is happening in their respective industries.



Eddie Steiner

Eddie Steiner is president and CEO of the Commercial & Savings Bank of Millersburg, Ohio, and a member of two Federal Reserve councils: the Federal Reserve Bank of Cleveland's Community Depository Institutions Advisory Council (CDIAC) and also the national CDIAC. He's served since early 2011 on the Cleveland Fed's council, whose members meet with and report to senior executives of the Cleveland Fed on the economy, lending conditions, and other issues. The national CDIAC reports to the Board of Governors of the Federal Reserve System.

Forefront: *Technology has certainly transformed the world of banking. What's the next big change, do you expect?*

Steiner: Customers seem to be gravitating toward an "all things digital" expectation. By that, I mean that more and more consumers expect to be able to take care of their financial service needs via digital channels, and increasingly the channel of choice is mobile. From an operations standpoint, banks are reengineering risk management as transactions increasingly move to digital formats. The speed and continuous availability that consumers value provide significant challenges to some of the conventional controls that have long been effective in protecting both the bank and the customer.

I also think you will soon notice more and more community banks using social media to engage with customers. We've learned that from the age of 30 on down, many people in our market don't subscribe to the newspaper, and so running ads may not reach an audience that we need to have in the coming years. Our industry will need to embrace some aspects of social media in order to maintain meaningful interactions with many of our customers.

Forefront: *What story do community banks' present lending volumes tell, and why?*

Steiner: A relatively recent observable dynamic is that loan demand has followed some emerging demographic patterns, specifically migration from suburban and rural areas back into metropolitan areas. Commercial development and housing construction in some cities are significantly outpacing, on a proportional basis, most rural areas in the District. Elsewhere, the shale story in the southeastern portion of the District has generated significant lending in drilling, transportation, field support, machinery and controls, disposal, lodging, and hospitality sectors.

Some borrowers clearly have a diminished appetite for loans because of the recession's impact on their business or financial condition. In localities where the economy is still struggling to regain its footing, some community banks have simply not been able to grow loan balances because of this diminished appetite and are either waiting for increased demand or pursuing loans in new markets or different types of lending.



Holly Wiedemann

Holly Wiedemann is founder and president of AU Associates, Inc., a Lexington, Kentucky-based company focused on adaptive reuse of buildings, including old schools, an old post office—even an old tuberculosis hospital. She has served as a member of the Cleveland Fed's Lexington Business Advisory Council for 3 years. Business advisory councils advise the Cleveland Fed's president and senior officers on current business conditions.

Forefront: *Gentrification within our District has made headlines in recent years. From your vantage point, how do communities best encourage investment, while also ensuring affordable housing and mixed-income neighborhoods?*

Wiedemann: The most important factor is the Low Income Housing Tax Credit, which is the most important tool for the creation of affordable housing. It is *the* tool. The Low Income Housing Tax Credit, along with historic buildings tax credits, is the best way that's really effective to create affordable housing in our region. You can produce affordable housing more easily in other areas because there are much higher rents, but in the Cleveland Fed's footprint, there are not really, really high rents. It costs just as much money to build a market-rate unit as it does an affordable unit, but you can't charge market rents. So the only way to bridge that gap is through the tax credits. It needs to have its 9 percent rate fixed; right now, it has a floating interest rate. That will ensure the production of affordable housing into the future.

Forefront: *What are today's emerging trends in terms of revitalizing existing structures? How are the trends different than 5 or 10 years ago, if at all?*

Wiedemann: The primary focus has been energy efficiency. Our Kentucky Housing Corporation, which is the gateway, the arbiter that awards tax credits, requires you have all Energy Star appliances, new thermal pane windows, Energy Star hot water heaters, specific insulation in your walls and your roofs. It's a good thing.

Another focus is being green in terms of sustainability. That includes recycling rainwater and using pervious paving to reduce additional runoff. We've always been the ultimate green because we are recycling buildings, but the emphasis on Energy Star has definitely increased over the past five years.



Doris Carson Williams

Doris Carson Williams is president and CEO of the African American Chamber of Commerce of Western Pennsylvania, which works to continuously improve business opportunities for African American business owners and professionals throughout the region. It counts more than 500 members, making it the 10th largest chamber in the region (according to the *Pittsburgh Business Times*). She joined the Cleveland Fed's Pittsburgh Branch Board of Directors in January 2014. The board is one of three boards of the Bank. Its members regularly report the business conditions they see.

Forefront: *What's presently on the minds of your chamber members? Is it a new issue, or an existing one?*

Carson Williams: It's an existing one, and it's how to sustain yourself, how to provide business expansion in a cost-effective way and at the same time gain access to new business opportunities. They're always looking for new opportunities. They're always looking for new ways to not only engage major corporations but to engage the whole business community to do business with them. Some members are expanding their businesses and hiring more people.

Forefront: *When it comes to Main Streets across our region and the businesses that populate them, what do you expect in 2015?*

Carson Williams: I expect a continual process on business expansion. Companies are now talking about different activities in which they are about to engage in terms of expanding their footprint in different areas. I have a couple of members who are doing more business overseas. That wasn't the case a year ago. Business expansion for small businesses can have a ripple effect on suburban and rural communities, as they hire not only from the cities, but also from the suburbs. If the front runners (big business) in the business cycle do well, it is appropriate for minority and small business owners to benefit as well.

Next up, Steiner, Wiedmann, and Carson Williams tackle 4 remaining questions we posed to them.

Forefront: *Compared with a year ago, are you more or less optimistic about the state of our region's economy, and why?*



ES: I'm optimistic, although I'll add that banking has a way of teaching one to remain circumspect with such outlooks. It teaches you that recoveries are never consistent across all spectrums. There are clear signs of improvement. I'm seeing a faster decline in the unemployment numbers. In our particular locale, which is 4 counties in northeastern Ohio, the rate of unemployment for the last 6 months has been lower than what it averaged before the crisis. The help-wanted signs are not only in the paper, but literally out in front of businesses, showing they have a pickup in demand for their products and services.



HW: I am slightly more optimistic. I'm delighted to see that it appears as though more manufacturing is returning to the United States, especially in this District. I think everyone is awaiting anxiously what the Fed is going to do with interest rates because I know its target was to raise interest rates toward the third or fourth quarter of this year. As long as the interest rates are lower, as they are now, there will be continued activity in the residential market for construction of rental housing and for homes. It's a great time for people, if they're so inclined, to lock in low interest rates.



DCW: I'm more optimistic about the state of our economy than I was a year ago, and that's due in part to the input I receive from our members. Several members stated they are now planning for a slight business expansion and hiring more people; that is encouraging to me. It's very different from a year ago, when I heard, "We will wait and see." Members then said they were trying to overcome some challenges of the economy—primarily accessing capital. That still remains a challenge, but it is not the challenge that it was. Community banks have been more responsive.

Forefront: *How do you contribute as a member of the Federal Reserve group of which you are part? What's the greatest impact the board/council makes?*

ES: We talk in quite a bit of depth on lending conditions and general economic conditions throughout the Fourth District. We also talk about regulatory issues, new regulations that have been proposed or enacted, and the impacts—intended and unintended. We talk, too, about the future of banking and the many changes that are occurring. The composite and granular perspectives provided at each meeting paint a vivid point-in-time palette of matters pertinent to community banks and communities across the region, thereby helping the Federal Reserve monitor conditions in the region and develop effective responses to emerging concerns.

HW: I think that we are terrific boots on the ground, people who are out in the real world and able to provide our perspectives about what's happening in our particular marketplaces. Lexington is different from the Cleveland area because one of the big contributors to our economy is the equine industry. So, we have different variables that are important economic generators that may not be consistent with what's happening in other parts of the Cleveland Fed's footprint. We bring a unique perspective based upon the differences in our particular regions, and I think that's an important contribution.

DCW: We do our research and gain the input of the business community. We are part of the information flow that goes to Washington. When there is a meeting, and when the Cleveland Fed president [Loretta J. Mester] takes information to Washington, she's representing the whole region. All these opinions from across the country come together, and then the Federal Open Market Committee makes a decision. It is rewarding to say you were part of that process.

Forefront: *What's something you realized about the Federal Reserve that you didn't know before you joined the board/council?*

ES: The Fed's important contributions extend beyond monetary policy actions and its role in bank supervision, payments clearing, and providing credit to financial institutions. For example, the Cleveland Fed's research function is significant and has published vital and at times landmark research.

The Cleveland Fed also provides resources in support of community development through conferences, educational events, and publications. Some of these other functions may be less visible, but they make important contributions to our banking system and society.

HW: The critically important role that it plays in setting the interest rates and determining economic policy. I don't think most people really know what the Federal Reserve does; to be involved and have the opportunity to learn about it and understand what it does has been revelatory. Now, everything I read, I think about the correlation between economic policy and the direction of the country. It's quite dramatic.

DCW: The compliance issues for board members, the fiduciary responsibility, how Reserve Bank board members don't participate in political activities, don't contribute to political candidates, which I think is proper. I had been a banker at one point in my career, so I knew about the Federal Reserve System. It's nice to see it up close. It's one thing when you read about it; it's another when you're a part of it.

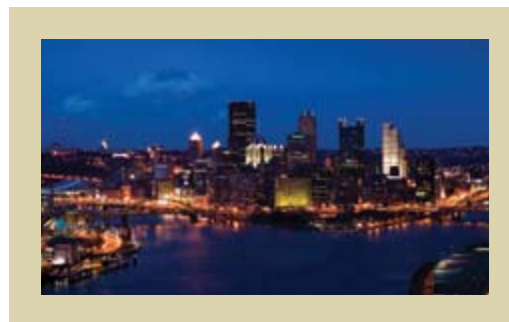
Forefront: *What's a favorite spot of yours in your part of our Fourth Federal Reserve District, and why?*



ES: I live in Holmes County, ranked by National Geographic in 2014 as the third best place in the entire world to see autumn leaves. The rural Amish countryside affords spectacular views, and I particularly enjoy quiet sunrises while pedaling hilly back roads on my bicycle in the spring, summertime, and fall.

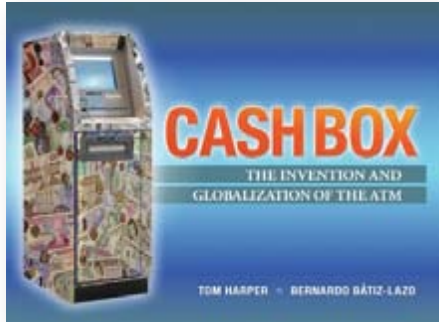


HW: The Kentucky Horse Park. I am what's known as an "eventer," which means I compete in dressage and stadium jumping and cross country. It's really, really fun, really competitive, but also very collegial. There is also an entire Bourbon Trail that winds its way throughout Lexington and Frankfort. There are new distilleries popping up all the time because of the influence (pardon the word) of bourbon. Its resurgence over the past 10 years is unparalleled.



DCW: I enjoy the confluence here, where the 3 rivers (Allegheny, Monongahela, and Ohio) meet. It's just beautiful. It's picturesque. The confluence represents a past period of a robust economy, and signals the transition to a strong, more diverse business climate. ■

Book Review



Cash Box: The Invention and Globalization of the ATM

by Tom R. Harper and Bernardo Batiz-Lazo
Network Media, 2013

Cash Box follows the evolution of the ATM from primitive to sophisticated, and in the process illuminates banking innovation as something that should not be taken for granted.



Reviewed by
Dan Littman
Economist

Many people take the objects that surround them for granted. Everyday objects, whether the toaster on your kitchen counter, the copier in your office, or the light bulb everywhere, are treated as if they sprouted from the earth fully formed. But history—and common sense—reveals that they were not invented in an instant, or even necessarily for their current use. Innovation is a messy process that almost always results from many incremental changes. The incandescent light bulb, that most iconic of inventions, was the result of evolution, not revolution.

The banking and payments industries are rarely the focus of popular or accessible studies of innovation. But these industries have their share of everyday objects that have

come to represent consumers' relationship with the payments system and with their own bank accounts. Take, for instance, banknotes, coins, and checks, all of which emerged centuries ago, as well as credit cards, ATMs, and debit cards (invented in the 1950s, '60s, and '70s, respectively). These objects have innovation histories just as messy, incremental, and surprising as the light bulb.

The *Cash Box: The Invention and Globalization of the ATM* takes banking innovation out of the darkness and gives the ATM the credit it deserves as an everyday object with which consumers across the world interact regularly—and take for granted as part of the modern landscape.

Today's ATM can do many things: dispense cash, take in loose cash and checks, perform check imaging, inform customers of their account balances, and allow for transfers from one account to another. They can also communicate with visually impaired customers and generate messages and receipts in a variety of languages. Currently, ATMs are most often found in free-standing arrangements—in the middle of a shopping mall, in a supermarket, at a gas station, in an airport. They communicate in near-real time with a host computer often hundreds or thousands of miles away. And customers increasingly go to ATMs to do their banking rather than entering a bank branch.

The first device widely acknowledged as the ATM's immediate precursor was installed in a Barclay's branch in suburban London in June 1967. In functionality and operation, it resembled the candy vending machines of my childhood. Such machines performed sophisticated evaluations (for their time) of the inserted coins (size, weight, magnetic properties) and dispensed a uniform, single candy bar to the customer. Vending machines of that day, until fairly recently, did not communicate with a central processor. They could jam or run out of product. They could have a fault that dispensed 10 candy bars instead of just one—all without the owner's knowledge.

Much like a vending machine dispensed candy, early ATMs dispensed cash. Designed by John Sheppard Barron of DeLaRue Systems, reportedly while he was at home in the bathtub, the first cash dispenser did not

Much like a vending machine dispensed candy, early ATMs dispensed cash.

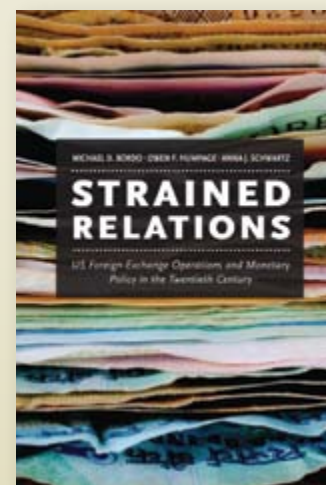
dispense stamps or take deposits, did not contain a personal computer (they had not yet been invented!), was not connected to a bank mainframe computer, and could not tell customers how much money they had in their accounts. That ATM, the very one installed at Barclays in 1967, did not have a cathode ray tube to show messages and did not rely on plastic cards with a magnetic stripe. What it did do was dispense one fixed amount (£20) for each transaction.

A huge amount of incremental innovation was required to move from a cash-dispensing, near-vending-machine approach to the interactive, full-service, branch-replacement machines of today. Reading *Cash Box: The Invention and Globalization of the ATM* is a perfect way to follow the evolution of the ATM from its primitive beginnings in the 1960s to the sophisticated machines of 2015. It is not a scholarly book, a fact which I count as a blessing, but more of what some might call a coffee table book. The authors have included hundreds of photographs, figures, and diagrams to help the reader visualize the evolution of the ATM over the past 50 years. The book also includes helpful chapters on ATM fraud and regulation, the emergence of an ATM trade association, and the possible future of ATMs as consumers shift more of their payment traffic to smartphones and other instruments. ■

Available Now: *Strained Relations*

A new book by Cleveland Fed Economist Owen F. Humpage

The recent financial crisis has piqued interest in foreign-exchange intervention, something the Federal Reserve routinely undertook from 1973 to 1995. A new book, *Strained Relations*, by the Cleveland Fed's Owen F. Humpage and his co-authors Michael D. Bordo and Anna J. Schwartz explains the fundamental conflict that central banks face in simultaneously attempting to stabilize exchange rates, maintain domestic price stability, and achieve full employment. Drawing on a trove of previously unavailable sources, the book traces how the Fed and the US Treasury attempted to deal with this fundamental conflict during the gold standard, the Great Depression, Bretton Woods, and the ongoing system of floating exchange rates. "In 1973, the Fed embraced foreign-exchange intervention as a way to routinely influence exchange rates independent of monetary policy," Humpage says. "By 1995, the Fed came to see intervention as undermining both its independence and its credibility for good monetary policy."



In Case You Missed It

Collaborating for Financial Stability

Participants in the second annual Financial Stability Conference stressed the need for global and interdisciplinary sharing of information and urged continued efforts to improve the quality and availability of data.

Roughly 160 people—among them, economists, banking supervisors, and members of academia from around the world—spent two days in December at the second annual Financial Stability Conference.

The theme of the event was “Measurement Challenges in Macroprudential Policy Implementation: Essential Data Elements for Preserving Financial Stability.” To many, the conference and the discussions it spurred are further evidence that efforts not seen much prior to the financial crisis of 2008 continue to grow in practice and quality.

The industry’s focus on data, for example, is sharpened: There was considerable conversation during the conference, sponsored by the Federal Reserve Bank of Cleveland and the Office of Financial Research, about ways in which the data that are available (and how they are used) can be improved.

And, noticeably different to many attendees is the growing communication between researchers and banking supervisors, who now are sharing information, communication which many expect to produce better policy prescriptions and better banking supervision.

“Today, we do have macro folks talking to supervisors, and you can see it here,” William Hunter, a founding editor of the *Journal of Financial Stability* and past research director for the Chicago Fed, said of the conference in Washington, DC. “It’s been a long time coming. It took a crisis to bring them together.”

The way macroprudential policy, or policy that uses tools to help reduce risks of the financial system as a whole, can either contribute to or detract from financial stability was discussed at length, including during a keynote speech by the Cleveland Fed’s president and CEO Loretta Mester. She noted that policy and regulation can have unintended consequences.

“One of the lessons of the crisis was that incentives matter and regulation itself creates incentives,” Mester said. “Sometimes these incentives work to promote financial stability. But sometimes regulations, no matter how well intentioned, can create counterproductive incentives—so-called unintended consequences.”

The interconnectedness of networks, and the ways in which shocks to one part of the financial sector can cascade, or propagate, to others, was a central topic of the conference.

One panelist, John Bottega, touted the global implementation of LEI, or Legal Entity Identifier, which can be used to uniquely identify entities that engage in financial transactions. (That way, if another large-scale collapse like that of Lehman Brothers were to happen, financial regulators and firms could better understand the true nature and scope of risk exposures across the financial system.)

“As an industry, we’ve been managing the movement of data for years,” Bottega said. “However, we as an industry, where we come up short, has been truly understanding the meaning of our data.”

Overall, while the conference highlighted challenges that remain with regard to data availability, the conference also highlighted progress that has been made in developing various models and approaches to systemic risk identification, despite the data challenges. ■

—Michelle Park Lazette



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