

Michelle W Bowman: My perspective on bank regulation and supervision

Speech (via prerecorded video) by Ms Michelle W Bowman, Member of the Board of Governors of the Federal Reserve System, at the Conference for Community Bankers sponsored by the American Bankers Association, 16 February 2021.

* * *

Good morning. I want to thank the American Bankers Association for inviting me to speak to you today. Two years ago, I gave my first speech as a Federal Reserve governor at this conference in San Diego, and it is always great to be with you—even if remotely from our recording studio at the Board.

It's fair to say that a lot has happened over the past two years. It is an understatement to say that the COVID-19 pandemic has created significant challenges inside and outside the banking sector. Bankers significantly adapted operations to continue serving their communities and customers. You overcame staffing challenges and other hurdles, kept the virtual doors open, worked with your customers, and provided assistance to workers and businesses through the Paycheck Protection Program. Those efforts have made, and continue to make, a huge difference in the lives of many people affected by the pandemic, and I thank you.

Since becoming a member of the Federal Reserve Board, I have made it a priority to enhance the Federal Reserve's dialogue with community bankers. I have embarked on an effort to meet with the leaders of every community bank and regional bank supervised by the Federal Reserve. This valuable interaction helps build an understanding of issues affecting small and regional banks, support supervisory decision-making, and shape some of my perspective. It has also helped the Federal Reserve identify initiatives to support the vital role of community banks in serving the financial needs of communities.

Today, I would like to share my approach to supervision and regulation, which has helped guide the Fed's efforts to improve oversight of community banks over the past few years and shaped our priorities for 2021 and beyond. In most cases, my points about banking regulation also apply to supervision. I will then focus on several Federal Reserve initiatives that are underway to support community banks during the pandemic and into the future.

The first principle is fundamental to regulation but sometimes bears repeating—regulation should always strike the right balance. For banking regulation, that means a balance between actions that promote safety and soundness and actions that promote an acceptable and manageable level of risk-taking. The challenge is doing neither too little to be effective to achieve the public benefit of government oversight, nor too much to prevent the regulated businesses from meeting their customers' needs. Some regulation is appropriate and necessary but striking the right balance means that at some point regulation can go too far and end up reducing the public's welfare. In recent years, the Federal Reserve and other agencies have made oversight more effective by better differentiating prudential regulation and supervision based on the asset size of banks, the complexity of their activities, and the related risks they pose to the financial system. This is especially important for community banks, most of which managed risks well before and during the 2008 financial crisis and have managed their risks well since. Achieving these principles also requires following consumer protection laws and regulations, including fair lending laws, to ensure fairness and broad access to credit and financial services that enable economic opportunity for individuals and communities.

The second principle is that the regulatory framework should be effective, but also efficient, and that means assessing the impact of the requirements. For the Federal Reserve, it means that we consider both a rule's benefit to safety and soundness and any potential negative effect,

including limiting the availability of credit and services to the public, and the implications of compliance costs on banks. The wisdom in this approach is evident when considering the effect of a regulation on community banks and their role in providing financial services to their communities. Community banks have often been one of the few or only sources of credit and financial services to their customers. Their smaller operational scale relies on fewer staff to reach a more dispersed customer base with limited resources for compliance activities. Regulations should consider the potential impact on the availability of services in a community, as well as the costs to the bank of implementing a rule, particularly in more rural locations. It is necessary that a full and careful practical analysis of costs and benefits be a part of every rulemaking.

The third principle is that regulation and supervision should be consistent, transparent, and fair. Regulators are obligated by law to act in this manner, and it also makes good practical sense. These principles enhance safety and soundness and consumer compliance by making sure supervisory expectations are clear and that banks understand and respect the regulatory requirements. Supervisors should not and cannot be everywhere at every moment. But they should be available to provide clarification or answer questions when needed. A clear understanding of the rules and our expectations and a respect for the reasonable application of them is an effective approach to ensure effective compliance. By promoting respect and trust between regulators and the supervised institution, banks are more likely to communicate throughout the examination cycle to inform supervisors of changes they may be considering or challenges they may be facing and how best to resolve or approach them from a regulatory perspective.

A final principle that flows from consistency, transparency, and fairness is that rules and supervisory judgments must have a legitimate prudential purpose, and in the majority of cases must not be solely punitive. The goal should be to encourage sound business practices and activities by supervised institutions. By clearly communicating our objectives, we build respect for the rules and make it more likely that any remedial actions against an institution will not be necessary because we encourage compliance through our supervisory approach. When a supervisory action or formal enforcement action is required to address violations at an institution, those actions should be framed in a way that seeks to promote safe, sound, and fair practices and not simply as punishment.

These principles that guide my approach to regulation and supervision are consistent with many of the major steps that the Federal Reserve has taken to improve community bank oversight since the implementation of the rules following the 2008 financial crisis. Some predate my arrival at the Fed, and some I have played a significant role in achieving. Most of these actions involve tailoring rules that treated community banks in the same way as larger, more complex institutions. For example, the Volcker rule was aimed at curbing proprietary trading by large banks, but it ended up creating significant compliance costs for community banks, which are not involved in this type of trading.

Many of the most important improvements to the Federal Reserve's regulatory framework involve tailoring rules to fit to the size, business model, and risk profiles of community banks. For example, we raised the asset threshold for small banks to qualify for an 18-month exam cycle and similarly raised the threshold for small bank holding companies to be exempted from consolidated risk-based capital rules. The concept of tailoring is also expressed in our community bank supervisory framework, which has been updated to implement the Bank Exams Tailored to Risk (BETR) program. The BETR program allows examiners to identify higher and lower risk activities and, in turn, streamline the examination process for lower risk community banks, thereby reducing burden. In fact, Federal Reserve examiners have tailored examinations by spending approximately 65 percent less time on low/moderate risk state member bank exams than they do on high-risk exams. We also implemented the community bank leverage ratio that allows institutions to opt out of risk-based capital requirements. The Federal Reserve and the

other agencies also raised the threshold for when an appraisal is required for residential real estate loans and tailored safety-and-soundness examinations of community and regional state member banks to reflect the levels of risk present and minimize regulatory burden for banks.

These improvements in regulation and supervision have helped right the balance I spoke of earlier between safety and soundness and consumer protection, on the one hand, and the ability to provide financial services and best meet the needs of their customers. We have also considered the impact of our actions, seeking to revise rules that impose significant costs to community banks but provide limited benefit to safety and soundness, consumer protection, or financial stability.

As a part of this approach, I have also prioritized efforts to improve the consistency, transparency, and reasonableness of regulation and supervision. One of those efforts is promoting greater consistency in supervisory practices across the Federal Reserve System. For example, we are actively working to improve the timeliness of providing banks with consumer compliance exam findings. Further, we are exploring ways to strengthen our ability to understand, monitor, and analyze the risks that are affecting community banks. A key aspect of consistency is ensuring the same supervisory approach and outcomes for similarly situated institutions, with the goal of ensuring, for example, that a “one” composite or component rating in a particular region would be the same for an institution with similar activities and practices in another region. This applies to all areas of our supervisory responsibility, whether safety and soundness, consumer compliance, or analyses of financial stability risk.

I’d like to expand on one important area of focus, which is essential to the future success of the community banking sector: accessible innovation and technology integration. This subject is one that I speak about frequently with stakeholders and our staff at the Board. We are committed to developing a range of tools that will create pathways for banks to develop and pursue potential partnerships with fintech companies. This includes clearer guidance on third-party risk management, a guide on sound due diligence practices, and a paper on fintech-community bank partnerships and related considerations. These tools will serve as a resource for banks looking to innovate through fintech partnerships.

Technological developments and financial market evolution are quickly escalating competition in the banking industry, and our approach to analyzing the competitive effects of mergers and acquisitions needs to keep pace. The Board’s framework for banking antitrust analysis hasn’t changed substantially over the past couple of decades. I believe we should consider revisions to that framework that would better reflect the competition that smaller banks face in an industry quickly being transformed by technology and non-bank financial companies. As part of this effort, we have engaged in conversations and received feedback from community banks about the Board’s competitive analysis framework and its impact on their business strategies and long-term growth plans. We are in the process of reviewing our approach, and we are specifically considering the unique market dynamics faced by small community banks in rural and underserved areas.

Soon after the pandemic began early last year, the Federal Reserve took several actions to support community banks and their ability to help affected customers. We paused examinations and issued supervisory guidance that made it clear that we would not criticize or take public enforcement actions against a bank that was taking prudent steps to help customers and making good faith efforts to comply with regulations. This certainty of regulatory treatment created an environment that built trust between regulators and bankers. It enabled banks to continue to meet the needs of their customers who were struggling with circumstances through no fault of their own.

Let me conclude by again commending the important role that community banks have played in providing financial services during these challenging times. You responded quickly to the needs

of your customers and communities to provide financial services with limited, if any, interruption. You persevered to implement the largest proportion of Paycheck Protection Program funds to small businesses, whether they were your existing customers or new customers. These relationships are the hallmark of community banking, and as we look toward the future, community banks will continue to play an essential role in supporting customers, delivering financial services, and providing resources to their communities and customers.

Let me stop here and thank the organizers for another opportunity to speak to you at this important conference. I look forward to your questions, Rob.