Michelle W Bowman: Independence, predictability, and tailoring in banking regulation and supervision

Remarks by Ms Michelle W Bowman, Member of the Board of Governors of the Federal Reserve System, at the American Bankers Association Community Banking Conference, Orlando, Florida, 13 February 2023.

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I would like to thank the American Bankers Association for the invitation to speak to you today. It is a pleasure to be with you and to have the opportunity to share some of my views on banking regulation and supervision. Of course, as you know, the Federal Open Market Committee (FOMC) recently held its first meeting of the year. So, before getting into the substance of my remarks, I'll provide some brief thoughts on the economic outlook and monetary policy.[1]

Monetary Policy

Let me begin with the FOMC's effort to lower inflation, which continues to be much too high. Stable prices are necessary for a healthy economy and to support a labor market that works for everyone. As a member of the FOMC, I remain focused on bringing inflation down to our 2 percent goal.

Over the past year, the Committee has taken forceful actions to address unacceptably high inflation by significantly raising the federal funds rate and reducing our balance sheet holdings of Treasury and agency mortgage-backed securities. At our most recent meeting, we continued on that path by further increasing the target range for the federal funds rate by 25 basis points to 4-1/2 to 4-3/4 percent. I expect that ongoing increases will be appropriate to bring the federal funds rate to a sufficiently restrictive level and that it will need to remain there for some time to restore price stability.

The economic outlook and the outlook for inflation continue to be highly uncertain. Global and domestic factors are contributing to heightened uncertainty, and I expect that we will continue to be surprised by economic and geopolitical developments and by the incoming data. While we have seen modestly lower inflation readings in recent months, overall inflation remains high. Measures of core services inflation have been persistently elevated, and labor demand exceeds the supply of available workers, which is leading employers to increase wages in an effort to retain and attract workers. The ongoing tightness in the labor market puts upward pressure on inflation, even if some components of inflation moderate due to improvements in supply-side factors. The longer high inflation persists, the more likely it is that households and businesses may come to expect higher inflation in the longer term. Should that be the case, the FOMC's job of lowering inflation would be even more challenging.

Given the highly uncertain environment, my views on the future path of monetary policy will continue to be informed by the incoming data and its implications for the outlook. I will continue to look for consistent evidence that inflation remains on a downward path when considering further rate increases and at what point we will have achieved a sufficiently restrictive stance for the policy rate.

We are still far from achieving price stability, and I expect that it will be necessary to further tighten monetary policy to bring inflation down toward our goal. Doing so will likely lead to subdued growth in economic activity and some softening in labor market conditions. While there are costs and risks to tightening monetary policy to lower inflation, I see the costs and risks of allowing inflation to persist as far greater. Restoring price stability is essential to support a sustainably strong labor market.

Turning to the focus of my remarks today, I would like to share my thoughts on several current aspects of banking supervision and regulation.

What I say next will certainly not surprise you: I expect there will be meaningful changes in regulations, guidance, and supervisory expectations over the coming year. While some of these changes will affect only the largest institutions, many will affect community bankers like you and may impact your work to support your local communities.

To be clear, the issues facing the banking industry continue to evolve over time, and the regulatory response to these changes must adapt as well. But as we continue to review and revisit the regulatory framework, I'd like to share a few thoughts about how the Federal Reserve can best fulfill its missions of furthering the safety and soundness of banks and promoting the stability of the financial system. Specifically, I will discuss three topics that are more interconnected than they may appear: (1) Federal Reserve independence, (2) predictability in applications, and (3) tailoring of regulations and supervision.

Federal Reserve Independence

Most often, the independence of the Federal Reserve is discussed in terms of independence in the setting of monetary policy. While the value of independent decision making in monetary policy is vital, and research shows that it leads to better policy outcomes in the long run, it is also important to emphasize the value of independence in banking supervision and regulation.

You may have seen Chair Powell's recent speech on this topic, in which he noted that independence in our bank regulatory function helps to ensure that our decisions are driven primarily by the goals of promoting a safe and sound financial system and safeguarding the stability of the U.S. financial system stability.[2] In this context, independence also means that we are not influenced by political considerations in making policy decisions. The Federal Reserve's independence in bank regulation also provides stability and consistency to regulated institutions. I am not suggesting that bank regulation remain static in the face of change. To the contrary, the Federal Reserve's regulatory approach must be capable of addressing and adapting to new activities and new risks but also must be constantly directed towards furthering our statutory objectives.

Of course, this independence in bank regulation must be accompanied by accountability, to both Congress and the American public.

Existing law provides a number of mechanisms to ensure this accountability to Congress. First, members of the Board of Governors are appointed by the President, subject to the advice and consent of the Senate. Second, the Board also regularly communicates with Congress, both through in-person testimony to relevant banking and financial services committees and by providing regular reports on key areas within the Federal Reserve's areas of responsibility, including semiannual reports on banking applications activity, supervision and regulation, cybersecurity and financial system resilience, and financial stability. This regular cadence of testimony and public reporting provides visibility into the inner working of the Federal Reserve, not just for Congress, but also for the public.

Beyond these measures though, accountability also means having transparent policies and procedures and conducting supervision in a way that is predictable and fair. Transparency builds legitimacy and helps demonstrate that the Fed is executing its responsibilities in a fair way for all regulated institutions. One area I think we are always looking to improve is the publication of clear, appropriate guidance, especially for community banks. I think there are examples where we have done a pretty good job, for instance providing tools to help community banks estimate their losses under the Current Expected Credit Loss, or CECL, accounting standard. We owe this duty of transparency to all regulated institutions. For example, I expect the Board will soon publish the supervision criteria implemented by the Large Institution Supervision Coordinating Committee-the LISCC manual. Banks should have some assurance that they are being held to the same standards as their peers over time. While publication of the manual may be only a modest improvement in transparency, I think it will be an important step.

Transparency helps us not only with accountability, but also with building legitimacy and public trust. To be clear, I do not consider transparency to mean leniency. We hold banks of all sizes to high standards, commensurate with their size and risk, and being transparent does not dilute the rigor of our regulatory standards. Transparency helps ensure that banks are aware of these standards and expectations so that they can work more effectively and efficiently to meet them.

Perhaps most importantly, though, we must implement the laws that Congress has passed as they are written and not stretch that authority to venture into other areas of policymaking.

For example, consider the distinction between (1) making sure institutions are managing all of their material risks and (2) instructing banks to make certain credit allocation decisions, that is, telling banks to make or not make loans to certain industries. The first objective-making sure financial institutions manage their material risks-is one of the central functions of a bank supervisor, and is fundamental to safety and soundness. But it is equally clear that the second objective-influencing a bank to make certain credit allocation decisions-is not the role of a banking regulator. If you look across the regulated banking sectors, you will find that each bank makes different credit decisions, reacting not only to market demand and economic conditions, but also implementing the bank's strategy. And to be clear, I share the widely held view that the appropriate role of the Federal Reserve is not to make credit allocation decisions for banks.

The Fed's role as a banking supervisor is not to replace a bank's management and board of directors in adopting a banking strategy and risk appetite. Instead, it is to apply appropriate, targeted regulation and supervision, in order to be able to assess that when a bank engages in an activity, it does so in compliance with applicable laws and in a safe and sound manner. This can be a difficult balance to strike but it is something I believe we must always bear in mind whenever the Fed uses or proposes using its regulatory or supervisory tools. Banking regulation and supervision should not be the place to implement new policies that are not mandated by Congress.

In the past, I have shared my views about the Fed's rulemaking agenda, which remain the same today. I continue to support changes based on our experience applying existing rules or prompted by new and emerging issues. However, any incremental changes to regulation should yield significant improvements to safety and soundness at reasonable cost, in consideration of the tradeoffs between cost and safety. And of course, any changes should be to further our regulatory responsibilities as mandated by Congress.

I'll turn now to a few examples of "how" the Federal Reserve should regulate and supervise financial institutions in the context of merger applications and in the tailoring of our regulations and supervision.

Predictability in Reviewing Bank Mergers

Recently, there has been significant attention focused on the role of federal bank regulators in reviewing merger applications, with scrutiny of not only the rigor of the review, but also on how the review process impacts the merger applicants. I certainly welcome this discussion and hearing public feedback, to see if the process can be improved.

Congress established the factors that must be considered when the Federal Reserve and other regulators review bank applications. These include the competitive effects of the proposed merger, financial and managerial resources, future prospects of the merged institutions, convenience and needs of the communities to be served, compliance with money laundering laws, and the effect of the transaction on the stability of the financial system. Although the review framework is the same for all applications, the facts of each case can vary widely, from community bank mergers to mergers of much larger institutions that can affect markets across large regions of the country. While this variability necessitates an in-depth review of each transaction on its own merits, these reviews are most effective when the expectations of the regulators are clear in advance and the parties can reasonably anticipate the application review process.

The agencies are required to review the statutory factors, but it is also important that we understand that timing matters in merger transactions. There are significant consequences to firms when applications are not acted on in a timely manner, including increased operational risk, the additional expense associated with running two institutions in parallel over a longer period of time, employee retention issues, and perceived reputational risk. Congress has also recognized the need for prompt action, imposing a variety of time limits for agency action on bank applications.[3] Recently, we have seen an increase in average processing times in the merger review process.[4] I am concerned about delays in the applications process and am concerned that the increase in average processing times will become the new normal.

I think it's helpful to consider the source of delays in processing applications and consider whether there are opportunities for improvement. This is another area where increased transparency can help. The legal standards we apply have not changed, and yet the review of applications can be affected by incomplete or inaccurate information or information that does not meet the expectations for an approvable transaction. Filling this information gap with clearer guidance, and making sure applicants understand our expectations could meaningfully improve the process. New supervisory information that comes to light during the examination process can also lead to delays, particularly if new supervisory issues need to be remediated before the application can be approved. In these cases, transparency between the regulator and the applicant helps ensure clear expectations about potential delays.

That being said, improved transparency only goes so far. I think it will come as no surprise to the bankers here today that often, the key difference in processing times is whether the application will be acted on by the Reserve Banks on a delegated basis or will require Board action. While an application can come to the Board for many reasons, the most common reason is that the Board has received a protest on the application from a member of the public. I think it is helpful to consider whether this process could be improved, so that bona fide concerns raised by the public are appropriately considered, while still ensuring timely decision-making.

Finally, to reiterate a point I've made in the past, I continue to believe that the application process should not be used as a substitute for rulemaking. If the rules applicable to a firm or group of firms needs to be updated, we should follow the rulemaking process to update those rules.

Tailoring

Finally, I would like to emphasize the role of tailoring in regulation and supervision. Tailoring was a core feature of the response to the 2008 financial crisis and since then has been the subject of a concerted effort to refine and improve the regulatory and supervisory framework based on experience since the framework was implemented.[5] Tailoring has proven to be an effective and efficient way to regulate and supervise banks of all sizes.

Of course, all of you here today are very familiar with risk-based supervision, which is itself a form of tailoring, focusing supervisory attention on areas that pose the greatest risks. But tailoring also helps us adopt meaningful differences in regulatory requirements and supervisory expectations, depending on the size and complexity of the regulated institution, from the largest G-SIBs to the smallest community banks. This tailored approach manifests itself across the spectrum from the stringency of capital requirements, the regulatory reporting obligations, and the frequency of examination, among many others.

Time has demonstrated the virtues of this tailored approach. The U.S. banking system entered the early days of the COVID-19 pandemic with high levels of capital and liquidity, and banks of all sizes supported the economy during the darkest days of the pandemic and have continued to support the economy ever since. This tailored approach should continue to feature prominently in upcoming proposed revisions to the capital framework. While I expect the Board will propose new capital requirements for the largest institutions, including the Basel III "endgame" reforms, I do not expect every tier of firms to be subject to the same changes. And my understanding is that there are no plans to propose changes to the community bank capital framework as part of this capital review.

This tailored approach is sensible not only by matching regulation to risk, but it is embedded in the statutory framework. For example, the bipartisan Economic Growth, Regulatory Relief and Consumer Protection Act included several elements designed to tailor regulatory requirements. For the largest firms, this law instructs the Board to tailor its "enhanced prudential standards" framework-the strictest standards-to firms based on the risks they pose. This statute also reduced the burden on smaller institutions, including through the community bank leverage ratio, the creation of short-form call reports for smaller community banks and a longer examination cycle for small, well-capitalized banks. In my view, the current community bank capital requirements, including the community bank leverage ratio, are functioning well.

In practice, tailoring requires a framework that both distinguishes firms by size, risk, and complexity, and imposes appropriate regulatory requirements in light of these differences. The largest institutions are classified by a number of factors including size, cross-jurisdictional activity, reliance on short-term wholesale funding, off-balance sheet exposures, and nonbank assets. These factors, and the G-SIB scoring methodology more broadly, help contrast the largest firms that pose the greatest risks with the smaller and less systemic firms. This translates into a regulatory regime where the G-SIBs are subject to the most stringent standards, incorporating enhancements like a GSIB-specific risk-based capital surcharge and the enhanced supplementary leverage ratio. Even the smallest banks are subject to size and risk considerations in their supervisory expectations, like a longer examination cycle, and straight forward capital and liquidity requirements and expectations.

This very intentional approach accomplishes utility and efficiency, for both regulators and the regulated institutions, that would be otherwise impossible. Tailoring our regulatory approach enables us to strike an appropriate balance for each relevant bank tier, with requirements that address risks, including financial stability risks, while recognizing the costs of over-regulation.

Closing

We have a dynamic financial system in the United States, a system that has long been supported by having independent and accountable regulators. As the financial system has evolved over time, so has the regulatory and supervisory framework designed to further the goals of safety and soundness, and financial stability. In my view, it is important that we continue to emphasize the value of accountability and transparency, while continuing to improve the fairness and efficiency of this framework.

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[1] These views are my own and do not necessarily reflect those of my colleagues on the Federal Reserve Board or the Federal Open Market Committee.

[2] Chair Jerome Powell, "Panel on Central Bank Independence and the Mandate-Evolving Views" (PDF) (speech at the Symposium on Central Bank Independence, Sveriges Riksbank, Stockholm, Sweden, January 10, 2023).

[3] *See, e.g.,* 12 U.S.C. 1842(b)(1); 4807(a).

[4] *See* Banking Applications Activity Semiannual Report (PDF), January 1-June 30, 2022, Vol. 9, No. 2, Table 1, "Dispositions and processing times of proposals, 2018-2021 and 2021:H1 and 2022:H1" (December 2022).

[5] Economic Growth, Regulatory Relief, and Consumer Protection Act, Pub. L. No. 115-174, 132 Stat. 1296 (2018); Chris Dodd and Barney Frank, interview by David Brancaccio, *Marketplace*, September 12, 2018; Daniel K. Tarullo, "Departing Thoughts" (speech at the Woodrow Wilson School, Princeton, NJ, April 4, 2017); Randal K. Quarles, "Between the Hither and the Farther Shore: Thoughts on Unfinished Business" (speech at the American Enterprise Institute, Washington, DC, December 2, 2021).