For release on delivery
4:15 a.m. EDT (9:15 a.m. local time)
October 11, 2023

Financial Stability in Uncertain Times

Remarks by

Michelle W. Bowman

Member

Board of Governors of the Federal Reserve System

at

The Reinventing Bretton Woods Committee and Policy Center for the New South Marrakech Economic Festival

Marrakech, Morocco

October 11, 2023

It's a pleasure to join you today to discuss the role of central banks and financial regulators in effectively promoting a stable and resilient global financial system.[1] Before I begin my remarks, let me first take a moment to express my deepest sympathies to those who have been impacted by last month's earthquake. I especially wish to recognize the Moroccan authorities for their efforts to host this important gathering under such challenging circumstances. We are grateful for your determination and inspired by your resilience and hospitality.

Today, I will discuss some of the financial system vulnerabilities and risks that I see as most salient. These risks and vulnerabilities are top of my mind but are by no means exhaustive of those monitored by the Federal Reserve.[2] I will then offer some thoughts on how the Federal Reserve, and other financial regulators and central banks, may be able to address and mitigate these financial system vulnerabilities and risks so that monetary policymakers are able to continue to pursue their monetary policy mandates.

The recent macroeconomic experience has presented both monetary policy and financial stability challenges for central banks. In many economies during the pandemic, supply chain disruptions coupled with strong demand as economies emerged from pandemic restrictions acted as catalysts pushing inflation up to very high levels. Aggregate demand was also supported by accommodative monetary and fiscal policies, which served to bolster the balance sheets of households, businesses, and local governments; increased excess savings; and contributed to very tight labor markets.

---

[1] These remarks represent my own views, which do not necessarily represent those of the Federal Reserve Board or the Federal Open Market Committee.

[2] See, for example, Board of Governors of the Federal Reserve System, *Financial Stability Report* (Washington: Board of Governors, May 2023), https://www.federalreserve.gov/publications/2023-may-financial-stability-report-purpose-and-framework.htm.

Many central banks facing these dynamics have tightened monetary policy in an effort to bring demand and supply into better balance and to bring inflation back down to their targets. In the United States, over the past year and a half, the Federal Open Market Committee (FOMC) has increased the federal funds target range by 5¼ percent and has been reducing the Federal Reserve's securities holdings, which had increased substantially during the pandemic period. We have seen some progress on lowering inflation over that time. However, inflation remains well above the FOMC's 2 percent target. Domestic spending has continued at a strong pace, and the labor market remains tight. This suggests that the policy rate may need to rise further and stay restrictive for some time to return inflation to the FOMC's goal.

As they have confronted price stability challenges, central banks have also faced new financial stability risks, with some related to the sizable moves in interest rates in an environment with persistent, elevated inflation. The recent experience has also highlighted how geopolitical tensions can pose financial stability risks, for example, through greater financial market volatility or, more indirectly, through their possible effects on economic activity and inflation.

Financial System Vulnerabilities and Risks

Like many other central banks, the Federal Reserve continually monitors for a wide range of emerging risks and vulnerabilities in the financial system. It is critical to acknowledge that we need to be responsive to changing conditions in our assessment of and response to financial stability risks. As a case in point, in recent years, it seemed that many underappreciated interest rate risk and yet, it was poor management of this risk that created significant disruptions in the financial system this spring. With that in mind, I will discuss in more detail the financial stability risks and vulnerabilities on which I am currently most focused.

Banking sector

Starting with the banking sector, the events of earlier this year have underscored the strength and resilience of the overall U.S. banking system. The vast majority of U.S. banks are adequately managing their interest rate and credit risk and maintaining prudent capital and liquidity positions.

While the banking sector is expected to experience higher funding costs and some deposit outflows as a result of tighter monetary policy and higher interest rates, these outcomes can create vulnerabilities for some banks. Banks relying on more expensive deposits and that also have large holdings of long-term assets like longer-dated loans or securities with low, fixed rates will likely continue to experience a drag on earnings, especially if interest rates stay higher for longer. Should a bank be forced to sell long-term assets, the realized losses can negatively impact regulatory capital. A rising interest rate environment may also erode the credit quality of bank loan portfolios should economic activity and incomes soften, posing an additional source of risk to bank earnings and capital. It is important to monitor these evolving risks, and if necessary, take action to minimize the possible spillover effects on the wider banking and financial system. In the United States, the Federal Reserve's recent stress test of the largest banks' capital positions featured a scenario with extreme declines in asset valuations and a steep rise in unemployment. All banks subject to this test passed.[3]

In March of this year, we saw a run on the deposits of Silicon Valley Bank and other related banking sector stresses which highlighted banking system vulnerability to an erosion of confidence. This erosion of confidence—even when it starts at a single institution with its own unique and isolated issues—can pose risks to a larger set of institutions based on, among other

[3] See Board of Governors of the Federal Reserve System, Dodd-Frank Act Stress Tests 2023, https://www.federalreserve.gov/supervisionreg/dfa-stress-tests-2023.htm.

things, similarities in size, business model, or customer base. As we have seen in the past, an erosion of confidence can lead to sudden large deposit outflows. Today, social media and technology can accelerate the spread of fear among depositors and bank investors, exacerbating contagion risk.

Commercial real estate

Another concern relates to the potential decline in commercial real estate (CRE) property values and a resulting degradation of CRE loan quality in certain markets. Low return-to-office rates and a current trend toward businesses opting to reduce office footprints may lead to higher vacancy rates, which may put downward pressure on property values, especially in certain localities and sectors, including city centers and retail properties. Should the economy slow considerably, CRE loan quality could deteriorate as interest rates stay high or property values soften. Since 2008, underwriting standards and loan-to-value ratios on most U.S. CRE loans have become much more conservative. However, there is still a risk that a decline in property values, reduced rental income cash flows, or other shocks could impair CRE portfolios, especially if those loans mature and are refinanced at higher interest rates.

While many banks are well-positioned to work with their borrowers to restructure loans or to mitigate risks of related losses, some banks with large undiversified and geographically concentrated CRE portfolios may be at greater risk. I am also monitoring the potential financial stability implications of nonperforming CRE loans that are packaged as part of commercial mortgage-backed securities (CMBS). It is much more difficult to restructure a nonperforming loan that is part of a CMBS pool when compared with nonperforming loans held directly by the lender. Pooled CMBS investments are often held in significant volumes or in concentrated shares by institutions that include large insurance companies and pension plans. Were these

institutions to suffer significant losses on their CMBS holdings, there could be broader effects on the securitization pipeline for CMBS and on the CRE market.

Nonbank financial institutions

I am also closely watching other financial stability vulnerabilities posed by large nonbank financial institutions. Hedge fund leverage remains elevated and prime money market funds, insurance companies, and some corporate bond mutual funds remain vulnerable to run risks. In addition to this risk, it is also important to monitor the interest rate and funding vulnerabilities of these entities in the current macroeconomic and interest rate environment. These are not novel vulnerabilities, however, as the nonbank financial institution sector continues to expand, monitoring these risks has become especially important.

U.S. Treasury markets

U.S. Treasury market stress events—including the repo-market stress in September 2019 and the March 2020 dash for cash—have raised concerns about the resiliency of U.S. Treasury markets. Last year's government securities market stress in the United Kingdom also highlighted how disruptions in the functioning of these markets can disrupt central bank plans including the path of balance sheet reduction, even if temporarily. Indicators of U.S. Treasury market liquidity have remained stable, and Treasury markets have continued to function, but risks remain.[4] It will be important to watch for signs of impaired Treasury market functioning, especially as the Federal Reserve continues to reduce its holdings of Treasury securities and Treasury auction volumes expand to meet issuance needs.

---

[4] For example, dealer balance sheet capacity may become strained, especially in times of volatile financial markets, limiting market funding in Treasury markets. See, for example,
Darrell Duffie, Michael J. Fleming, Frank M. Keane, Claire Nelson, Or Shachar, and Peter Van Tassel, "Dealer Capacity and U.S. Treasury Market Functionality," Staff Report 1070 (New York: Federal Reserve Bank of New York, August 2023), https://www.newyorkfed.org/research/staff_reports/sr1070.

Designing and Calibrating Policies to Promote Financial Stability

As a general principle, central banks and other regulatory authorities may choose to proactively use supervisory and regulatory tools to mitigate financial stability risks and vulnerabilities. Should financial stability risks be realized, it may become necessary to implement central bank and other targeted emergency liquidity or lending facilities. A central bank's implementation of monetary policy may influence the financial stability risks that are most salient. In many jurisdictions, including the United States, financial stability tools separate and distinct from monetary policy tools may be most effective to mitigate and address financial stability risks. The separation of these tools can allow monetary policy decisionmaking to remain focused on achieving central bank monetary policy goals.[5]

That said, not all of the financial stability risks and vulnerabilities that I have highlighted require policy changes. In fact, it is possible that an overreaction in adjusting policies in light of recent stresses could worsen conditions rather than ameliorate them.

Balance of bank supervision and regulation

As we learned from the recent U.S. bank failures, responsive, efficient, and effective bank supervision is a strong mitigant for financial system risks and vulnerabilities. The failures revealed that shortcomings in bank supervision can heighten financial stability risks.

The primary focus of supervision should be to address a bank's critical shortcomings in a timely way.[6] To effectively support financial stability, bank supervision cannot simply rely on pinpointing compliance issues, failed processes, or rule violations. It must go further to examine

---

[5] Of course, should a financial stability risk event affect the economy or the economic outlook, for example, through a slowdown in economic activity, monetary policymakers might take this into account when determining appropriate monetary policy.

[6] This timeless principle was recently discussed in the current context by Tobias Adrian, Marina Moretti, Ana Carvalho, Hee Kyong Chon, Katharine Seal, Fabiana Melo, and Jay Surti, "Good Supervision: Lessons from the Field," Working Paper 23/181 (Washington: International Monetary Fund, September 2023), https://www.imf.org/-/media/Files/Publications/WP/2023/English/wpiea2023181-print-pdf.ashx.

a bank's risk exposures while prioritizing core safety and soundness issues in the context of the bank's financial condition. If the supervisory process fails to identify and escalate critical risks, or to hold management accountable for known deficiencies, such as excess interest rate risk-taking, this raises the potential for supervisory shortcomings, including the ability to anticipate how the evolving macro-financial landscape can affect a bank's condition.

As the regulatory framework becomes more complex, we must ensure that supervisors and examiners are adequately equipped to implement and maintain the highest quality of supervision. Even as we focus on improvements to the bank regulatory framework, we should also ensure that supervision includes bank management and their boards of directors. As changes are made to supervisory activities, these changes should be open and transparent, and should be implemented with an appropriate consideration of the tradeoffs and unintended consequences. No regulatory or supervisory framework can be effective without accountability.

Regulatory capital requirements, no matter how conservatively calibrated they may be, are simply no substitute for sound risk management and strong, effective, efficient, and transparent supervision. The vast majority of improvements to supervisory functions could be accomplished without broad changes to the regulatory framework.

While some changes to the regulatory framework may be appropriate to promote financial stability, we should be careful to ensure that changes do not harm the long-term viability of banks, especially midsized and smaller banks. In my view, regulatory reform can pose significant financial stability risks, particularly if those changes to regulation fail to take sufficient account of the incentive effects and potential consequences. Regulatory actions also have the capacity to depress economic activity through the reduced availability of credit or by limiting the availability of financial products or services. These concerns are most acute when

the reforms themselves may be inefficient or poorly targeted. For example, policymakers should carefully consider whether the contemplated significant increases in capital requirements in the United States related to the finalization of Basel III capital standards meet this standard for being efficient and appropriately targeted.

Regulatory approaches in the banking sector must also allow for innovation. Inhibiting innovation in the banking sector could push growth of certain products and services further into the nonbank sector, leading to much less transparency and potentially greater financial stability risk. A comprehensive regulatory approach must include enforcing existing regulation through effective supervision, expanding the regulatory perimeter, and addressing regulatory gaps.

Nonbank financial institution supervision and regulation

A key component of fostering financial stability is to ensure that every institution that engages in similar financial activities with similar risks is treated similarly under supervisory and regulatory authorities. Many nonbank financial institutions and products are subject to differing degrees of regulation, oversight, and monitoring. While it is important that the banking system is well-regulated and supervised, it is equally important that this is the case for other types of financial institutions, products, or services. Developing effective frameworks for regulating and supervising common financial markets and products is important for ensuring the protection of consumers and for the stability of the financial system. The Federal Reserve appreciates the work that the Financial Stability Board (FSB) has undertaken in this area and the strong support my co-panelist Governor Klaas Knot has provided in his role as chair of the FSB.

With respect to Treasury market functioning, it is also important that the U.S. continues to carefully consider proposals that could support Treasury market resilience and reduce the likelihood that the Federal Reserve would need to step in to restore market functioning during

stressed conditions. For example, in the U.S. the largest banks are subject to a leverage ratio and global systemically important bank (G-SIB) surcharge that are set much higher than the international standard. These higher levels need to be reconsidered to ensure that dealers have adequate balance sheet capacity to intermediate Treasury markets in times of stress. Likewise, increasing data transparency on market pricing and flow should also be considered to encourage intermediary entry and competition.[7]

Central bank liquidity provision and lending facilities

Should financial stability risks materialize, central banks must be prepared to provide targeted liquidity to financial institutions during times of stress to restore market functioning and financial stability. The use of these lending programs during the pandemic demonstrated their effectiveness in serving as backstops to support market functioning and the flow of credit in times of stress.[8] When appropriately calibrated, these programs can help promote market functioning but limit the Federal Reserve's overall footprint in financial markets in the longer term. It is also important to clearly distinguish any temporary central bank asset purchase programs to promote core financial market functioning from monetary policy actions.[9]

In the banking system, it is also important that tools to support bank liquidity and payments—including discount window operations and Fedwire® within the Federal Reserve—

[7] See, for example, Inter-Agency Working Group for Treasury Market Surveillance (IAWG), *Enhancing the Resilience of the U.S. Treasury Market: 2022 Staff Progress Report* (Washington: U.S. Department of the Treasury, November 10, 2022), https://home.treasury.gov/system/files/136/2022-IAWG-Treasury-Report.pdf; as well as, Darrell Duffie, "Resilience Redux in the U.S. Treasury Market" (Federal Reserve Bank of Kansas City, Jackson Hole Symposium Paper, August 13, 2023), https://www.kansascityfed.org/Jackson%20Hole/documents/9726/JH_Paper_Duffie.pdf.
[8] For details on these programs, see "Funding, Credit, Liquidity, and Loan Facilities," Board of Governors of the Federal Reserve System, last modified July 7, 2023, https://www.federalreserve.gov/funding-credit-liquidity-and-loan-facilities.htm.
[9] See Michelle W. Bowman, "Panel on 'Design Issues for Central Bank Facilities in the Future'" (speech at the Chicago Booth Initiative on Global Markets Workshop on Market Dysfunction, Chicago, Illinois, March 3, 2023), https://www.federalreserve.gov/newsevents/speech/bowman20230303a.htm.

are available for extended operating hours and are prepared to provide support during times of stress. We should also consider what further steps are needed to ensure that banks have access to liquidity support. In addition, we should encourage, but not mandate, the exercise of contingency funding plans and testing capabilities, requiring bank management to ensure adequate plans are in place.

In the Treasury markets, the Federal Reserve should ensure that tools like the standing repurchase agreement (repo) facility are available to serve as backstops in money markets to support the effective implementation of monetary policy and smooth market functioning. Well-calibrated international swap lines and repo facilities can also be helpful in promoting both Treasury market and dollar market functioning. Of course, all central bank lending tools should serve as temporary backstops. Central banks and other agencies should ensure that regulations and market oversight foster prudent financial institution behavior and resiliency in core financial markets. Doing so can increase the ability of private markets and institutions to function during times of stress and reduce the likelihood of future market interventions by the central bank.

Conclusion

Many central banks are facing challenging and uncertain times as they strive to restore price stability and promote financial stability. A stable and resilient financial system is essential for the effective transmission of monetary policy and for a healthy economy. Healthy economies foster financial stability and financial stability fosters healthy economies. It is essential that central banks facing high inflation bring inflation back to target. A failure to do so would only lead to greater financial stability risks through less certain and unstable economic conditions and through reduced central bank credibility.

It is, therefore, necessary that central banks, in collaboration with other financial regulators as appropriate, develop and use supervisory and prudential regulatory tools to promote financial stability. Effective supervision and regulation, in turn, will support the effective conduct of monetary policy in achieving central banks' macroeconomic objectives. As these issues transcend national borders, central banks and regulatory authorities must also aim to build an international perspective that is complementary to or informed by global collaboration. This perspective has never been more important.