For release on delivery
4:30 p.m. EST
January 8, 2024

New Year’s Resolutions for Bank Regulatory Policymakers

Remarks by

Michelle W. Bowman

Member

Board of Governors of the Federal Reserve System

at

The South Carolina Bankers Association
2024 Community Bankers Conference

Columbia, South Carolina

January 8, 2024

It is a pleasure to join you this afternoon for the South Carolina Community Bankers Conference.[1] I always welcome the opportunity to learn from and share my perspective with bankers on issues affecting the U.S. economy and the financial industry. Today, I will focus my discussion on monetary policy, bank regulatory reforms, the evolving standards in bank supervision, and new developments in the payments system. I look forward to learning from your insights and perspectives on these issues, particularly your views on bank supervision, regulatory reforms, and your thoughts on the direction of the economy. As we kick off the new year, it's also a good time to look back on 2023 and consider a few New Year's resolutions for the coming year.

Before discussing bank regulation and supervision, I'd like to offer my thoughts on the economy and monetary policy.

Our Federal Open Market Committee (FOMC) meeting in December left the target range for the federal funds rate at 5-1/4 to 5-1/2 percent and continued the run-off of the Fed's securities holdings. Inflation data over the past six months indicate that the Committee's past policy actions are having the intended effect of bringing demand and supply into better balance. This continued progress on lowering inflation reflects a restrictive policy stance with the most recent 12-month total and core personal consumption expenditures inflation readings through November at 2.6 and 3.2 percent respectively. Employment data, though often significantly revised, continue to show signs of a tight labor market with reports of healthy job gains. The average pace of job gains has slowed over the past year, which may be a sign that labor market supply and demand are coming into better balance. The economy has remained strong even with

[1] The views expressed here are my own and not necessarily those of my colleagues on the Federal Open Market Committee or the Board of Governors.

the pace of real gross domestic product projected to moderate from the third quarter 2023 strength.

Considering this progress, I voted to maintain the policy rate at its current level while we continue to monitor the incoming data and assess the implications for the inflation and economic outlook. And based on this progress, my view has evolved to consider the possibility that the rate of inflation could decline further with the policy rate held at the current level for some time. Should inflation continue to fall closer to our 2 percent goal over time, it will eventually become appropriate to begin the process of lowering our policy rate to prevent policy from becoming overly restrictive. In my view, we are not yet at that point. And important upside inflation risks remain.

To the extent that both food and energy markets remain exposed to geopolitical influences, they present upside risks to inflation. There is also the risk that the recent easing in financial conditions encourages a reacceleration of growth, stalling the progress in lowering inflation, or even causing inflation to reaccelerate. Finally, there is a risk that continued labor market tightness could lead to persistently high core services inflation. While I do not tend to take too much signal from one report, last Friday's employment report showed continued strength in job gains and wage growth, and the labor force participation rate declined.

Given these risks, and the general uncertainty regarding the economic outlook, I will continue to watch the data closely—including data revisions, which have increased in magnitude and frequency since the pandemic—as I assess the appropriate path of monetary policy. I will remain cautious in my approach to considering future changes in the stance of policy.

It is important to note that monetary policy is not on a preset course. My colleagues and I will make our decisions at each meeting based on the incoming data and the implications for the

outlook. While the current stance of monetary policy appears to be sufficiently restrictive to bring inflation down to 2 percent over time, I remain willing to raise the federal funds rate further at a future meeting should the incoming data indicate that progress on inflation has stalled or reversed. Restoring price stability is essential for achieving maximum employment and stable prices over the longer run.

Twenty-twenty-three was a particularly busy year for banking regulators. Before I dig deeper into bank regulation, I'd like to recap a few of 2023's notable banking industry events. And since we are embarking on a journey into the new year, I will conclude by offering a few ideas for New Year's resolutions for regulators to consider prioritizing for 2024. These resolutions borrow heavily from principles that I have discussed publicly a number of times in the past, but they continue to be critical in guiding my thinking and approach to regulation. And I encourage my colleagues in banking regulation and supervision to consider these ideas as we begin 2024 with a full regulatory agenda.

Key Developments in 2023

Twenty-twenty-three brought many significant developments in bank regulation and supervision, beginning with speculation about the now-issued proposal to finalize the Basel III "endgame" capital rules. The Basel III capital rules were designed to apply only to the largest banks with significant cross-border activities, so much of the speculation early last year focused on *scope*—which banks would be subject to the rules under the new proposal—and *calibration,* how the capital requirements would change—whether they would increase, decrease, or remain the same. On the question of calibration, much of the speculation centered around whether regulators would propose significant increases to aggregate capital requirements or adopt a "capital neutral" approach by refining standards but keeping aggregate capital levels largely the

same. The objective of having a "capital neutral" proposal seemed reasonable to many, based on the understanding that a holistic review of the capital framework was in process at the Federal Reserve Board.

In March, however, priorities and focus changed. The failures of Silicon Valley Bank (SVB) and Signature Bank resulted in the exceedingly rare steps to invoke the systemic risk exception to guarantee all depositors of Silicon Valley Bank and Signature Bank,[2] and to create the Bank Term Funding Program.[3] These were significant emergency actions to support and stabilize the banking system. It is important to note that the Bank Term Funding Program is scheduled to expire in mid-March of this year. Understandably, the bank failures led regulators to take a hard look at what may have been missed in our supervision and what had driven regulatory and supervisory priorities leading up to these bank failures.

Several post-mortem reviews were conducted in the immediate aftermath of the failures to identify and analyze the circumstances and factors that contributed to the bank failures. Many of these reviews suffered from serious shortcomings, including compressed timeframes for completion and the significantly limited matters that were within the scope of review. Nevertheless, these reviews were, and continue to be, singularly relied upon as a basis for resetting regulatory and supervisory priorities. The findings of these limited reviews have also continued to influence proposals that had long been in the pipeline, especially those related to capital reforms.

I view the remainder of last year as something akin to a regulatory tidal wave, in light of the sheer volume of regulatory initiatives considered, published, and finalized. Many were

---

[2] See 12 U.S.C. § 1823(c)(4)(G).

[3] See 12 U.S.C. § 343.

undertaken or expanded with the purported goal to help address root causes of the bank failures and banking system stress. But this also included a rulemaking agenda that at times had little to no nexus with the root causes of the failures. Without a doubt, it was a challenge to support the regulatory agenda this past year.

The published capital rulemaking proposal incorporated an expansive scope, a notable shift in approach, pushing down new Basel capital requirements to all banks with over $100 billion in assets, regardless of their international activities.[4] At the same time, the capital proposal would substantially increase regulatory capital buffer and minimum requirements for the covered firms. In close succession, the agencies proposed new "long-term debt" requirements. This long-term debt proposal would require firms with over $100 billion in assets to issue debt at the top-tier parent level that could better absorb losses during bankruptcy, which only becomes relevant after the bank fails, not in order to prevent a failure. In part, these proposals were characterized as helping to address the root causes of the bank failures. As I've noted in the past, I think there are reasons to question whether these proposed revisions are effective and appropriately targeted and calibrated, particularly when considering that bank management and supervisory shortcomings more directly contributed to the bank failures than regulatory shortcomings. The banking agencies simply cannot regulate better or more effective supervision. We must appropriately manage our supervisory programs and teams to ensure that effective and consistent supervision is implemented within each firm and that it is effective and consistent across our regulated entities.

---

[4] See dissenting statement, "Statement by Governor Michelle W. Bowman" on the proposed rule to implement the Basel III endgame agreement for large banks, news release, July 27, 2023, https://www.federalreserve.gov/newsevents/pressreleases/bowman-statement-20230727.htm.

For community banks, two of the most important developments last year were the finalization of revisions to the Community Reinvestment Act regulations, and the proposal to amend the debit interchange fee cap in the Board's Regulation II. Many in the banking industry have expressed concern with the amendments to the CRA regulations, noting among other things the increased cost and burden associated with a number of the proposed revisions and new data systems required for compliance. In addition, many raised concerns about the potential adverse consequences of the rules, which include the possibility that these rules will reduce the availability of credit in some underserved markets if banks cut back lending activities due to revisions made to assessment areas defined in the new rules.[5] Similarly, the proposed revisions to Regulation II have generated concern from banks directly subject to the rules, but also from exempt banks concerned that the practical effect will be to push lower interchange fees down to all debit card issuers.[6]

Of course, supervision also saw significant changes in 2023, with the publication of new guidance on third-party risk management applicable to all financial institutions, without tailoring or guidance to assist the smallest banks in compliance,[7] and climate guidance that on its face applies only to institutions with more than $100 billion in assets.[8] In 2023, many banks also reported very material shifts in bank examinations, with a renewed focus on interest rate risk,

---

[5] See dissenting statement, "Statement on the Community Reinvestment Act Final Rule by Governor Michelle W. Bowman," news release, October 24, 2023, https://www.federalreserve.gov/newsevents/pressreleases/bowman-statement-20231024.htm.

[6] See dissenting statement, "Statement on Proposed Revisions to Regulation II's Interchange Fee Cap by Governor Michelle W. Bowman," news release, October 25, 2023, https://www.federalreserve.gov/newsevents/pressreleases/bowman-statement-20231025.htm.

[7] See dissenting statement, "Statement on Third-Party Risk Management Guidance by Governor Michelle W. Bowman," news release, June 6, 2023, https://www.federalreserve.gov/newsevents/pressreleases/bowman-statement-20230606.htm.

[8] See dissenting statement "Statement by Governor Bowman on Principles for Climate-Related Financial Risk Management for Large Financial Institutions," news release, December 2, 2022, https://www.federalreserve.gov/newsevents/pressreleases/bowman-statement-20221202.htm.

liquidity risk, and management, and banks continue to see ongoing changes in supervisory expectations. Many of these examination-related shifts have received little public acknowledgement or attention, in large part because the rules designed to protect confidential supervisory information frustrate visibility into structural shifts in the supervisory process. As you all know well, changes in supervisory expectations frequently come without the benefit of guidance, advance notice, or published rulemaking, and in the worst-case scenario these shifts, cloaked by the veil of supervisory opacity, can have significant financial and reputational impacts.

Resolutions for 2024

The new year provides a prime opportunity to reflect on the past 12 months and think about how the Federal Reserve can improve our approach. I'm sure many of us took the opportunity to reflect on recent experiences as we rang in 2024. I see the new year as a perfect time to think about how the banking regulators can implement some recent lessons learned. This very brief snapshot of the past year does not cover all of the important developments in the banking system, and the bank regulatory framework, that occurred in 2023. But it is a helpful starting point for considering the year ahead. So now, I'd like to offer three new year's resolutions for bank regulators.

Prioritize Safety and Soundness

First, safety and soundness should be renewed as the highest priority supervisory concern. This is a regulator's greatest responsibility and ensures the safe and sound continuous operation of the financial system. Last year's stress, precipitated by the spring bank failures, validated the tenet that supervision, when implemented effectively and appropriately, is the single most effective tool to support a safe and sound banking system. In the case of SVB,

supervisors failed to appreciate, appropriately identify, and mitigate the known significant, idiosyncratic risks of a business model that relied on a highly concentrated, uninsured base of depositors, and the buildup of interest rate risk without appropriate risk management.

But as every banker in this room knows, concentration risk and interest rate risk are not novel or unique risks, and these good old-fashioned risks can create vulnerabilities fatal to individual institutions if not appropriately anticipated and managed. Banking regulators and supervisors at all levels of our dual banking system have long focused on these risks. Therefore, I recommend that regulators collectively resolve to renew the focus on these and other longstanding and fundamental risks to banks and the banking system.

So, what should bank regulators do differently to prioritize safety and soundness? In my view, the problems in 2023 resulted from a failure to identify and prioritize the appropriate areas of risk. Instead, the focus was on broader, more qualitative, more process- and policy-oriented areas of risk. This focus resulted in a disproportionate emphasis on issues that distracted from the fundamental risks to the bank's balance sheet.

Regulators often identify evolving conditions and emerging risks before they materialize as pronounced stress in the banking system. But too often, regulators fail to take appropriately decisive measures to address them. Regulators can also fall into the trap of getting distracted from core financial risks, and instead focus on issues that are tangential to statutory mandates and critical areas of responsibility. Focusing on risks that pose fewer safety and soundness concerns increases the risk that regulators miss other, more foundational and pressing areas that require more immediate attention.

In my view, the new climate guidance introduced by the federal banking agencies last year effectively illustrates this lost focus. While perhaps well-intended, this guidance mandates

a diversion of limited supervisory resources away from critical, near-term safety and soundness risks. Setting aside differing views about the appropriateness of the content of the guidance, the fundamental question is whether climate change is a core, present-tense risk to safety and soundness—not whether climate change is an important public policy issue. And here, the evidence suggests that climate change is not currently a prominent financial risk to the banking system.

This lack of attention and focus on the most material safety and soundness risks may result from intentional policy preferences, or simply may be the product of allowing ourselves to be distracted from known, longstanding risks over calm periods of banking conditions. Whatever the cause, it comes at a significant cost, as both banks and regulators shift resources and supervisory attention away from the most pressing risks.

Renewed Commitment to Tailoring

Second, is a renewed commitment to our Congressionally mandated obligation to tailoring. The current bank regulatory framework relies upon a risk-based, tailored approach, which strives to fulfill the congressional mandate to tailor the prudential regulatory framework for institutions with more than $100 billion in assets by aligning regulation with risk.[9] As we engage in ongoing regulatory reform, we must not lose sight of the virtues of this approach, for institutions of all sizes. Tailoring helps regulators prioritize the allocation of supervisory resources to focus on the most important risks and emerging threats to the financial system. Tailoring regulations does not mean that regulators can or should ignore safety and soundness issues at smaller institutions, or that the standards for smaller institutions should not be robust. As this audience knows well, *all* banks are subject to periodic examinations, capital

[9] Economic Growth, Regulatory Relief, and Consumer Protection Act, Pub. L. No. 115-174, 132 Stat. 1296 (2018).

requirements, and regulatory reporting requirements, and have regular engagement with bank examiners at the state and or federal levels. Starting with an approach that acknowledges the importance of tailoring helps us avoid the impulse to simply crank regulatory dials to their highest level for all firms (or "up to 11," like the amplifiers in the classic film, *This Is Spinal Tap*).[10] This type of approach overlooks fundamental differences in business model and asset size, while tailoring ensures that we appropriately calibrate regulations and expectations to the size, complexity, and business model of institutions.

The existing capital framework provides a well-reasoned model for how this tailored approach results in appropriate requirements based on firm characteristics. The largest firms are divided into four categories based on size and complexity, with the largest and most complex firms being subject to the most stringent requirements. Regional banks, with $10 billion to $100 billion in assets, are subject to a somewhat more streamlined capital framework. And finally, the simplest rules are reserved for community banks that rely on a less complex, relationship-based business model.

As this example illustrates, incorporating graduated requirements not only helps to effectively allocate limited supervisory resources, but it also avoids creating regulatory incentives that could unintentionally alter the banking landscape. For example, without tailoring, it is likely that the requirements for the largest and most complex banks would be pushed down to smaller banks that have simple, straightforward business models, either directly through changes to regulation, or indirectly through opaque supervisory expectations. This environment would create overwhelming incentives for industry consolidation, since a bank with a simple business model would be subject to and expected to comply with requirements designed for

[10] *This Is Spinal Tap*, directed by Rob Reiner (1984).

larger and more complex banks, and consolidation creates economies of scale that make it more cost-effective to comply with these requirements.

My concern is that an overbroad application of requirements—requirements that are not tailored—could become a characteristic of future regulatory reforms. The Basel capital proposal highlights this concern. While the comment period is still open until January 16, much of the feedback shared with me so far has focused on two prominent concerns: (1) that the increases to capital requirements would be significantly higher than stakeholders anticipated, and (2) that the proposal would largely "flatten" the regulatory requirements for all banks over $100 billion, creating a severe cliff effect for firms approaching or crossing that threshold. Banks within this asset range are already carefully considering the ongoing viability of remaining at an asset size near that threshold. Firms just above the threshold will face strong pressure to shrink below the threshold or to merge to achieve economies of scale to comply with the breadth and complexity of the new requirements. Firms just below the threshold will need to be very intentional about approaching it and may consider revising business strategies and activities to remain below the threshold.

While the capital proposal does not directly apply to regional and community banks, all banks are affected when policymakers shift away from or deemphasize tailoring. When we fail to recognize fundamental differences among firms, there is a strong temptation to continually push down requirements designed and calibrated for larger and more complex banks, to smaller and less complex banks that cannot reasonably be expected to comply with these standards. As we look to the future and the anticipated regulatory agenda for 2024, the critical role of tailoring must be incorporated as a foundational element of these regulatory reforms.

Increase Transparency

The third and final resolution is increasing transparency in supervisory expectations. While policymakers may have different views on the decisions embedded in the regulatory framework, such as where thresholds should be set, and the calibration of different requirements, one virtue of regulation is that the requirements are spelled out in public, in advance, and in some specificity and granularity. If you are a bank, you know which regulations apply to your business model.

But is this true in practice? As a banker, do you always know the standards to which you will be held prior to the examination? One of the concerning trends in 2023 were reports, including from state banking regulators, that some supervisory actions were excessive in light of the risks posed by some smaller institutions. It seems reasonable that the banking system stress played a role in tightening supervisory expectations. But we must also ensure that supervisory expectations and the resulting actions are appropriately calibrated and based on existing conditions, rather than driven by premature judgments and uncertain or unsupported supervisory predictions or assumptions. Transparency allows bankers to understand supervisory expectations in advance and work to meet those expectations. As you know, bankers have a deep commitment to operate safely and soundly but have no ability to look inside the mind of an examiner to divine that expectations have shifted. Opaque shifts in expectations can create unwelcome surprises in the examination process. These "surprises," in the form of ratings downgrades, can create significant issues for banks: they can disrupt business plans, including bank mergers and acquisitions, and create pressure on a bank to divert resources away from serving customers to addressing non-critical supervisory matters.

The increasing trend of supervisory "surprises" we saw in 2023 suggests to me a shortcoming in supervisory transparency. This by no means suggests that banks should not be held to high standards. To the contrary, it means that we should hold banks to standards that are known and identifiable, and when those standards inevitably evolve over time, we should give advance notice to our regulated institutions so they can manage their businesses accordingly to ensure continued compliance.

Closing Thoughts

I will conclude by expressing my appreciation for the opportunity to speak to you today. We are entering the new year at a time when significant changes to the banking system and bank regulatory framework are actively being considered. Many of these changes will have a lasting impact on banks of all sizes and their current and future customers, how banks run their businesses, and the broader U.S. economy.

My hope is that you, as bankers, and other interested stakeholders play an active role in this process, by sharing your views and concerns broadly, including with regulators directly. This input provides valuable insights into the specific impacts—intended and unintended—of changes to the bank regulatory framework. Voicing your concerns enables us to identify, and where needed, address, the real-world consequences of regulatory and supervisory reforms. I certainly don't need to remind this audience that the stakes are extremely high. My sincere hope for 2024 is that policymakers have the humility to acknowledge the intended and unintended consequences of these and upcoming regulatory reform efforts, and the courage to change course, when necessary, to mitigate and minimize these consequences. The future of the banking system and the ongoing strength of the U.S. economy depend on it.